EUROMONEY SEMINARS

Syndicated & Leveraged Finance Asia-Pacific Conference

Looking to Asia for economic growth: Where we are, and where are we headed?

Stephen Schwartz, Chief Economist for Asia, BBVA

BBVA Research

Outline

1 Asia: Leading the global recovery

- Recent economic developments
- Policy challenges & outlook
- Regional economic outlook

2 Looking for growth: BBVA EAGLEs

Main messages

- **Asia continues to lead the global recovery**, with its economies performing strongly, led by China and India, despite sluggish growth in the industrialized world.
- **We expect growth to stay strong in 2011, albeit at a moderating pace**.
- **Headwinds to growth from higher oil prices and developments in Japan**.
- **Inflation has rapidly become a concern across the region** due to rising food and commodity prices and, increasingly, demand pressures.
- **In China, growth is uncomfortably strong and inflation is rising,** prompting additional tightening measures to restrain credit and cool the property sector.
- **Risks are still tilted toward overheating** from strong domestic demand and **capital inflows** (asset/housing price bubbles).
- **The outlook for the RMB is further gradual appreciation**. Internationalization of the currency—underway with the start of the trade settlement program—could have medium-term implications for the RMB's value.

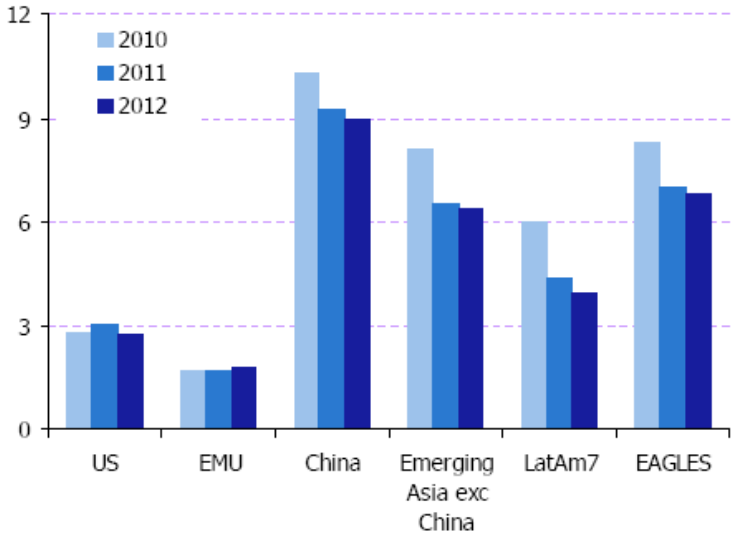
Asia: recent economic developments

An engine for global growth

- Emerging markets are the engine of global growth, and Emerging Asia leads the pack
- The region's larger economies—China, India, and Indonesia—have propelled growth
- Asia's strong fundamentals—solid fiscal positions, high reserves, and sound banking systems

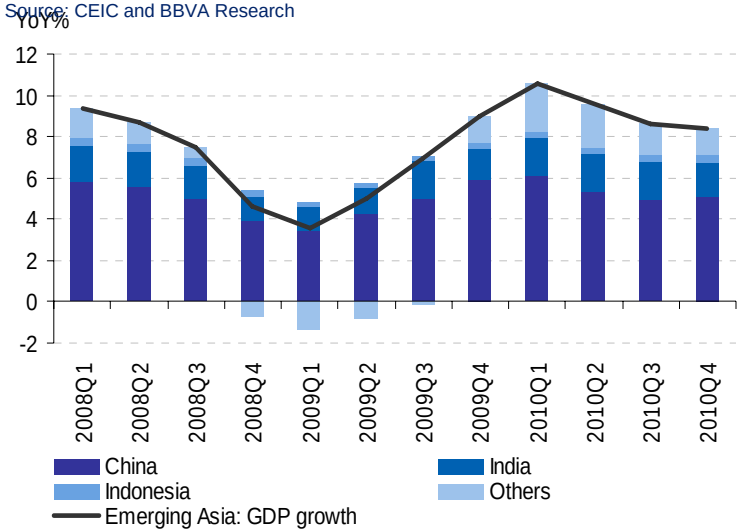
GDP growth forecasts

Source: BBVA Research



Asia's growth is propelled by its larger economies

Source: CEIC and BBVA Research



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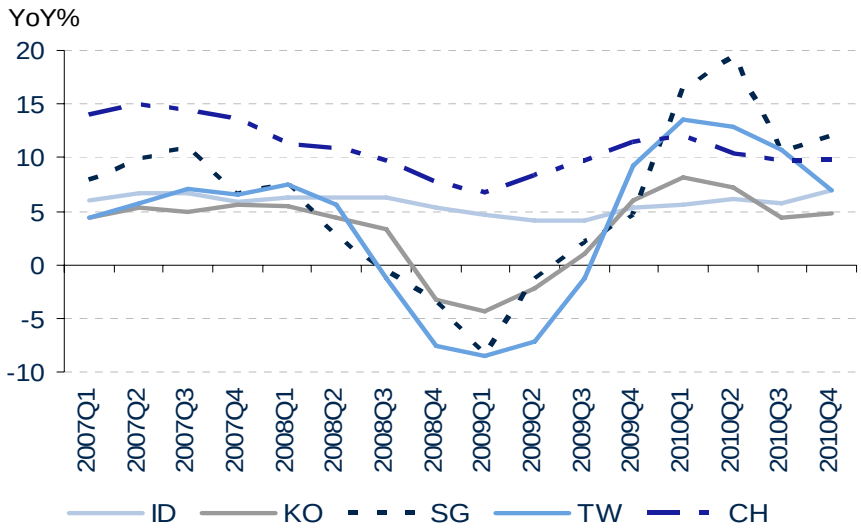
Asia: recent economic developments

Growth is moderating but remains strong

- Momentum gathered pace again in Q4 with upside surprises, and strong indicators in Q1
- Strong demand in the large economies and intraregional trade are sustaining momentum
- Domestic demand is becoming a significant growth engine, especially in Asia's larger economies

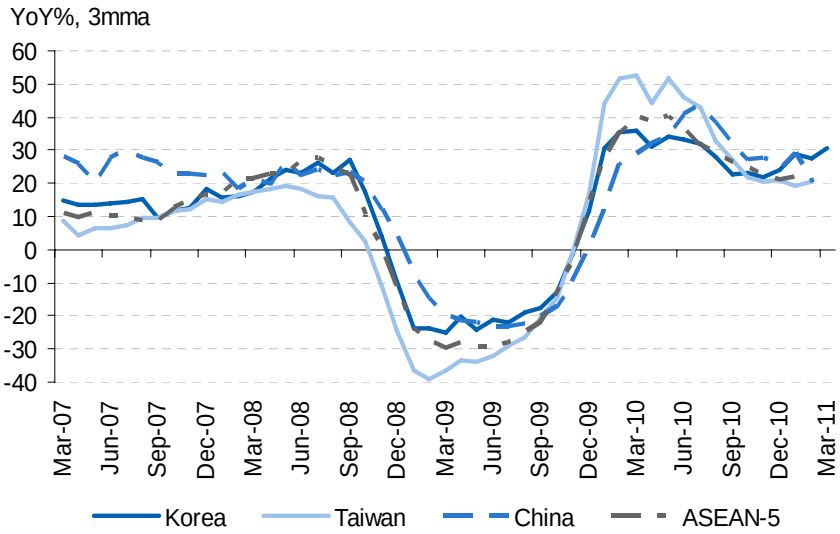
Growth strengthened again in Q4

Source: CEIC and BBVA Research



Export performance remains robust

Source: CEIC and BBVA Research



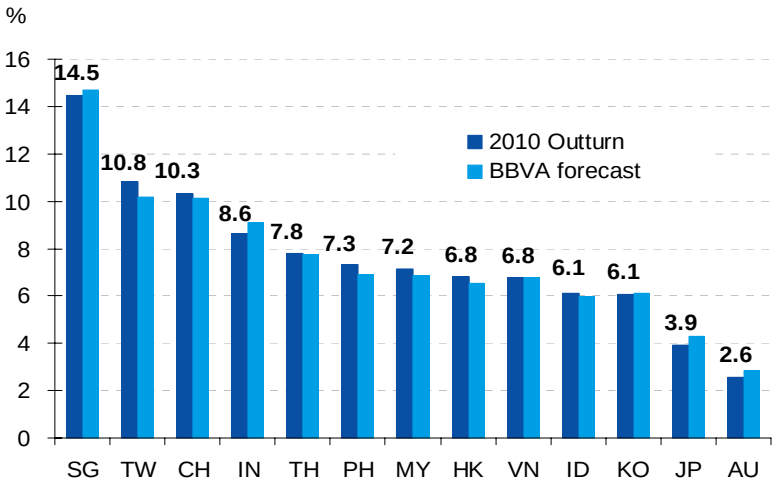
Asia: recent economic developments

Upside surprises to growth and inflation

- GDP outturns in 2010 outpaced forecasts in a number of cases, due to a strong Q4
- Inflation outturns in 2010 were broadly in line with forecasts, and inflation continues to trend higher
- High frequency indicators in Q1 have so far surprised to the upside

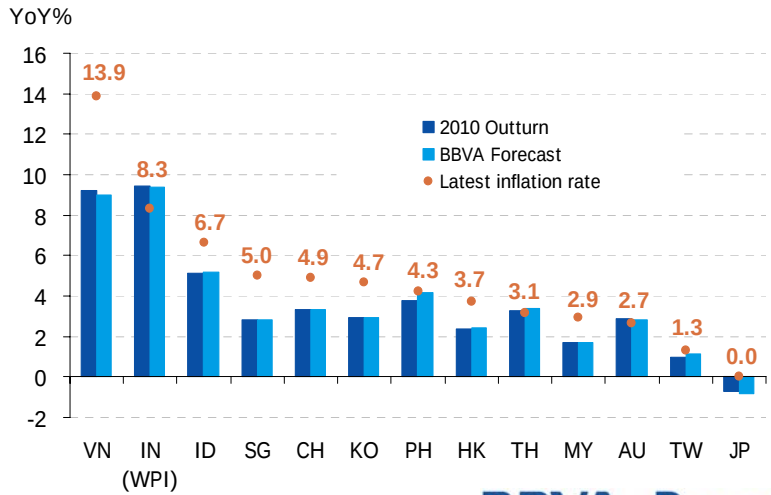
BBVA 2010 GDP growth forecast vs. Outturn

Source: CEIC and BBVA Research



BBVA 2010 CPI growth forecast vs. Outturn

Source: CEIC and BBVA Research



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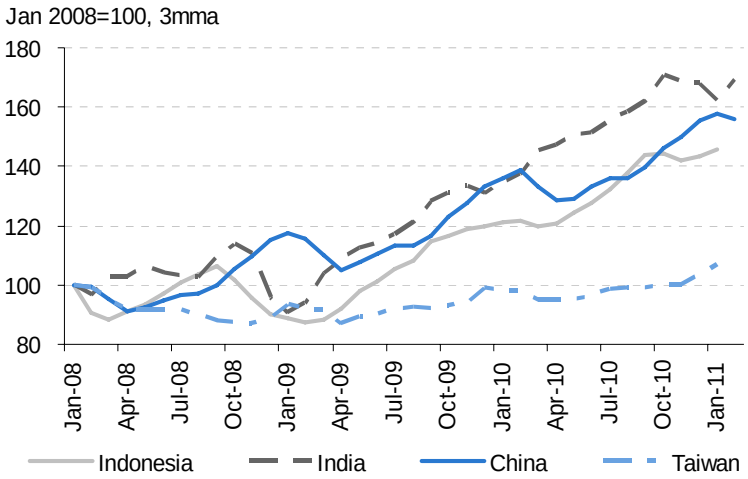
Asia: recent economic developments

Growth has become more self-sustaining

- Private consumption has been picking up
- A revival of credit growth is leading to investment spending and rising production

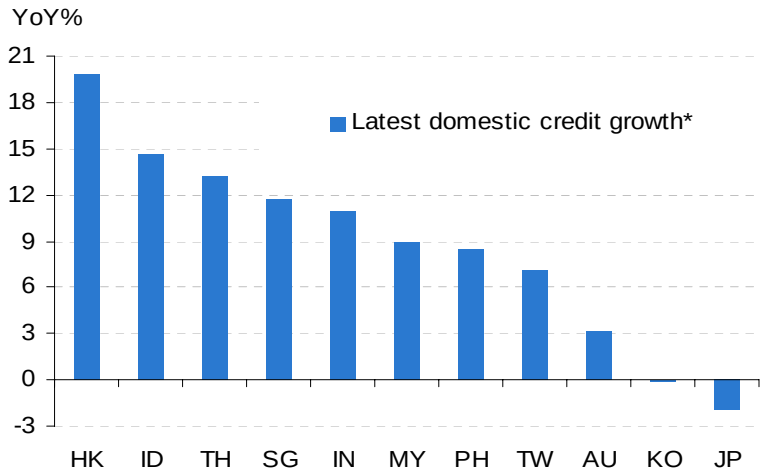
Retail sales have been rising on improved labor markets and consumer confidence

Source: CEIC and BBVA Research



Rapid credit growth is supporting domestic demand

Source: CEIC and BBVA Research



* In real terms. 2011 February data for HK, SG, MY, TW, and JP, 2011 January data for IN, ID, KO, PH, and TH, and 2010 December data for AU.

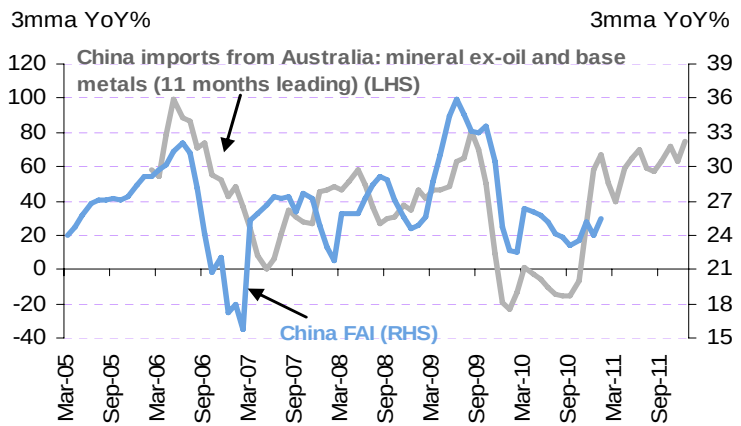
Asia: recent economic developments

Intra-regional trade is propelling regional growth

- China's and India's growth → raw materials demand (benefitting Australia and Indonesia)
- Rising private consumption → demand for final consumer and capital goods (benefitting Korea, the Philippines, and Taiwan)
- As China's import demand increases, its business cycle is more important to the region

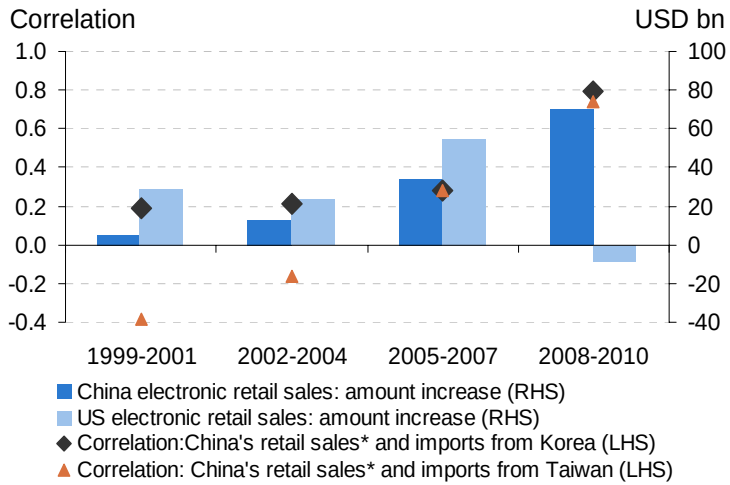
Australia's commodity exports to China are correlated with China's fixed investment

Source: CEIC and BBVA Research



Exports from Korea and Taiwan have become more correlated with China's retail sales

Source: CEIC and BBVA Research



* 3 months lagging the imports

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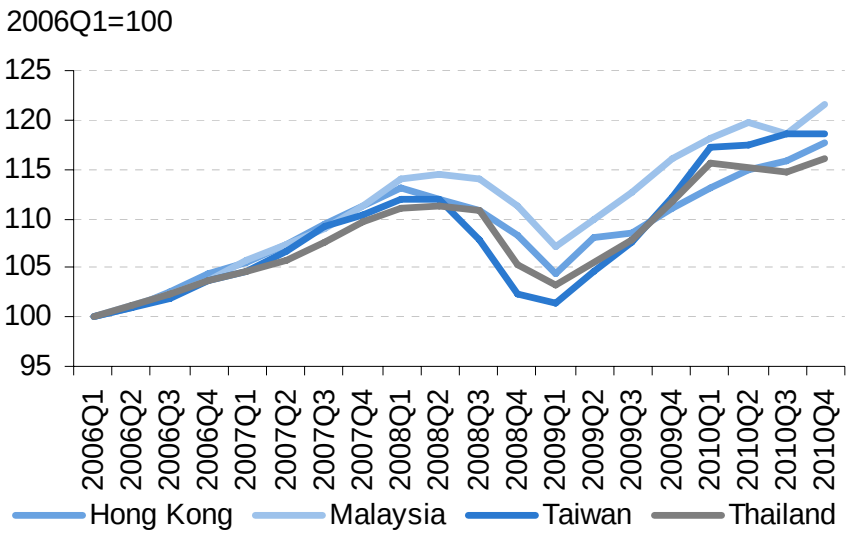
Asia: recent economic developments

Overheating pressures

- GDP levels are well above pre-crisis, and output gaps are closed
- Capacity utilization rates are back to normal

GDP levels* are well above pre-crisis

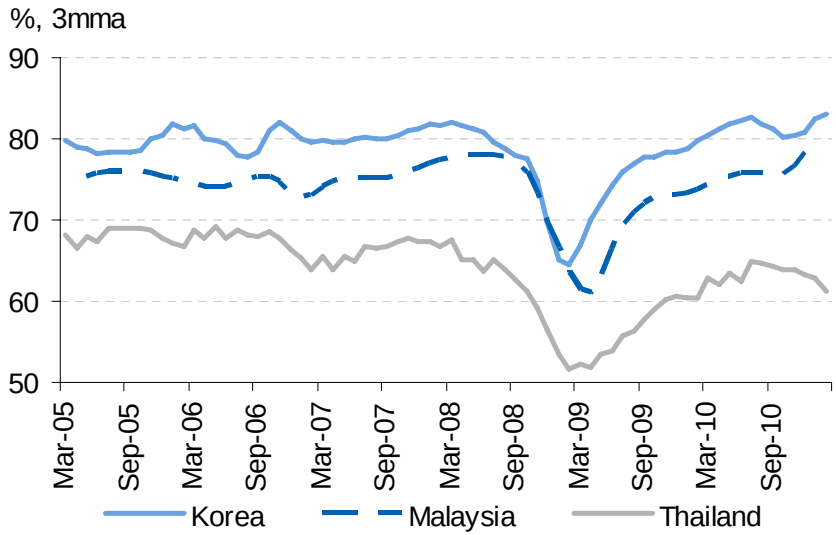
Source: CEIC and BBVA Research



* Real GDP in level terms, seasonally adjusted

Capacity utilization ratios are high

Source: CEIC and BBVA Research



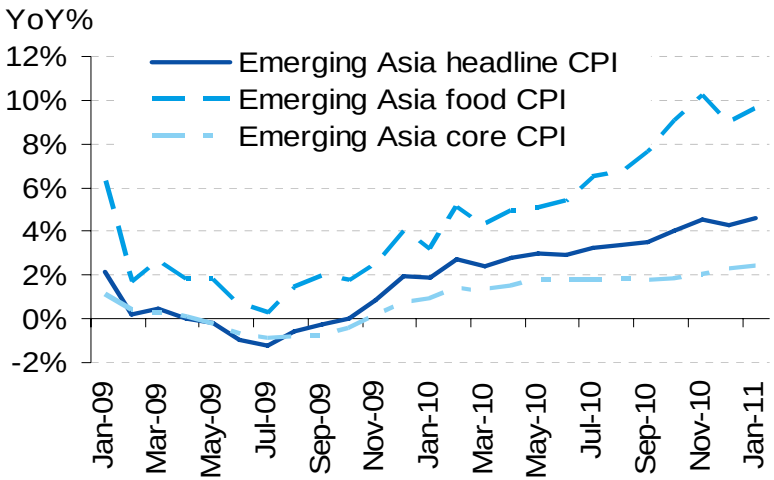
Asia: recent economic developments

Inflation is the main policy concern

- Inflation continues to trend up, driven by food and energy price increases, as well as demand pressures
  - Overheating pressures are particularly severe in Vietnam and India
  - Supply disruptions in Japan may pull the economy out of deflation sooner than previously expected

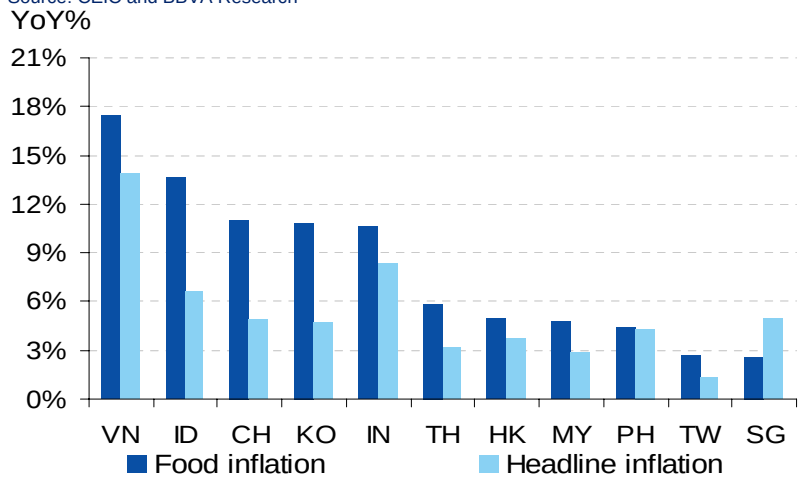
Inflation has been driven by supply-side factors, with spillovers to core

Source: CEIC and BBVA Research



Food price inflation is uneven reflecting country-specific factors

Source: CEIC and BBVA Research



Note: latest monthly inflation available by Apr 6, 2011

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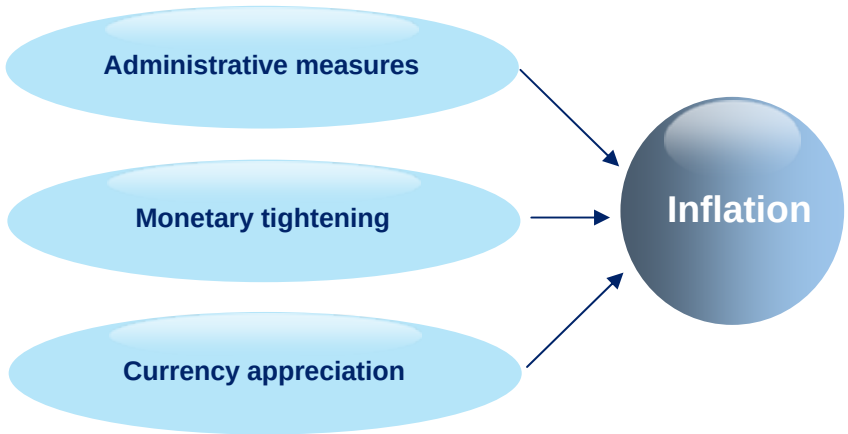
Asia: policy challenges & outlook

Policy focus is shifting from growth to price stability

- A range of administrative measures have been implemented to counter food inflation
- Monetary tightening has continued, through interest rate hikes and quantitative measures
- Currency appreciation is also helping to dampen inflation

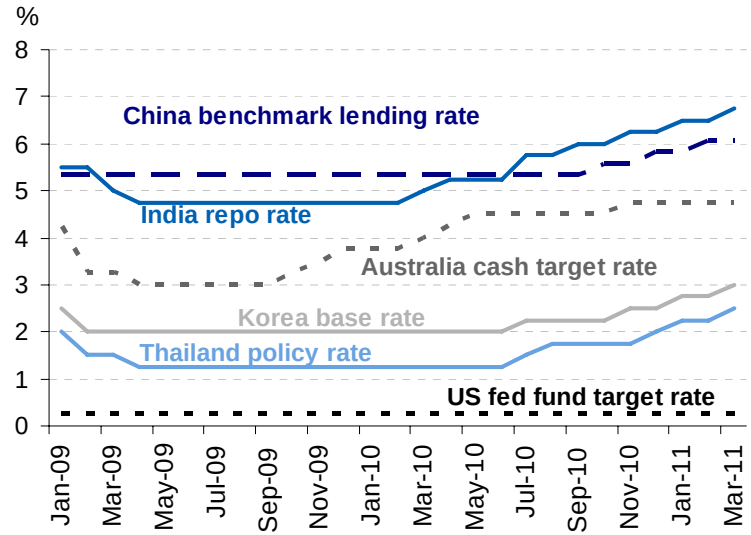
Authorities have steeped up measures to rein in inflation

Source: BBVA Research



Asian central banks are raising interest rates to tame inflationary expectations

Source: CEIC and BBVA Research



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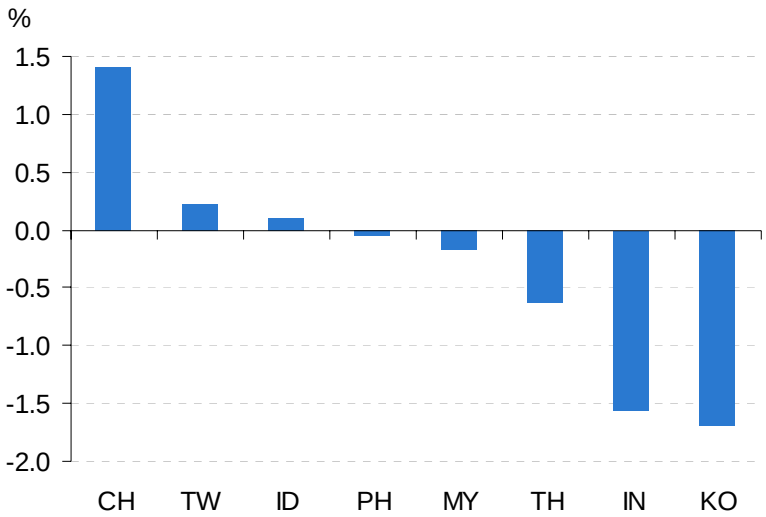
Asia: policy challenges & outlook

Monetary policy is being normalized

- Dilemma of policy tightening and management of capital inflows.
- Front-loaded interest rate hikes in H1, supplemented by quantitative measures.
- Further macro-prudential measures to slow credit growth and capital inflows.

Real policy rates in many Asian countries remain negative

Source: CEIC and BBVA Research



More rate hikes expected

Source: CEIC and BBVA Research

Policy rate forecast by country 2011-15

	CHINA	INDIA	INDONESIA	KOREA	TAIWAN
	Benchmark lending rates	*Repo Rate*	*BI Rate: for 1 Month SBI Auctions*	*BOK base rate*	*Discount rate on 10-day loan*
Current level*	**6.06**	**6.75**	**6.75**	**3.00**	**1.750**
2011F, year end	**6.56**	**7.25**	**7.25**	**4.00**	**2.125**
2012F, year end	**7.06**	**7.50**	**6.50**	**4.50**	**2.625**
2013F, year end	**7.06**	**7.50**	**5.75**	**4.50**	**3.125**
2014F, year end	**7.06**	**7.50**	**5.00**	**4.50**	**3.375**
2015F, year end	**7.06**	**7.50**	**5.00**	**4.50**	**3.625**

* As of April 8, 2011

Asia: policy challenges & outlook

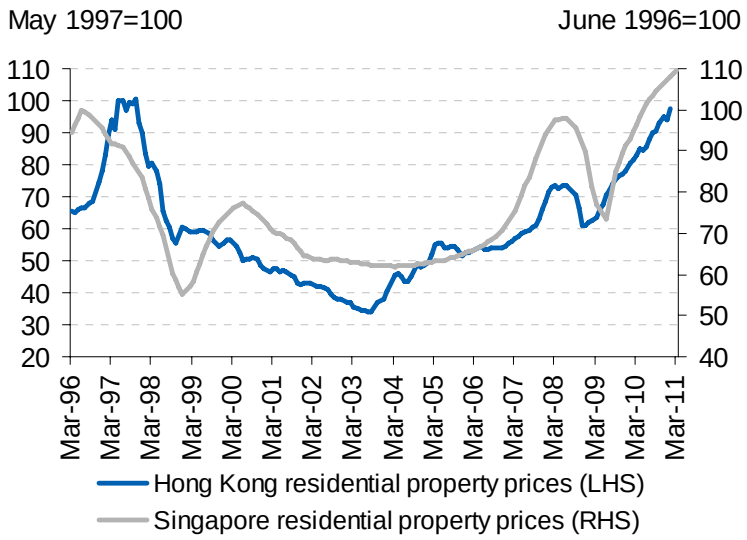
The challenge of managing capital inflows

- **Abundant global liquidity (QE2)**
- **Widening interest rate differentials**
- **Robust Asian growth prospects**

→ **Capital inflows**

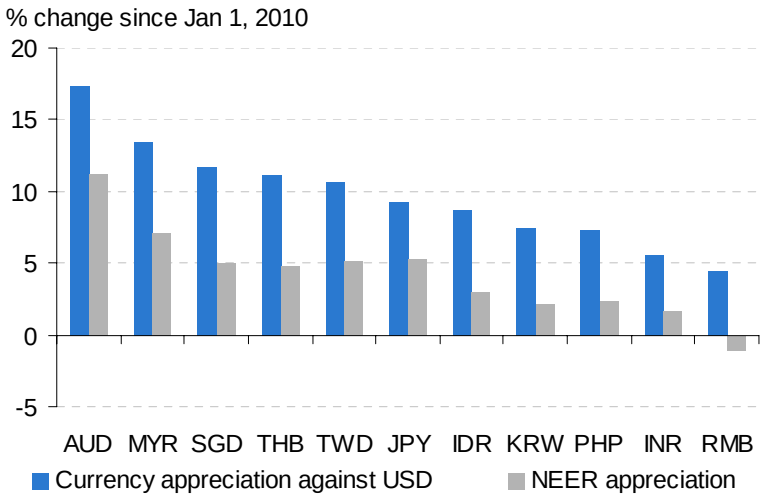
Risks of asset price bubbles, as seen in soaring property prices

Source: CEIC and BBVA Research



Currency appreciation pressures

Source: CEIC and BBVA Research



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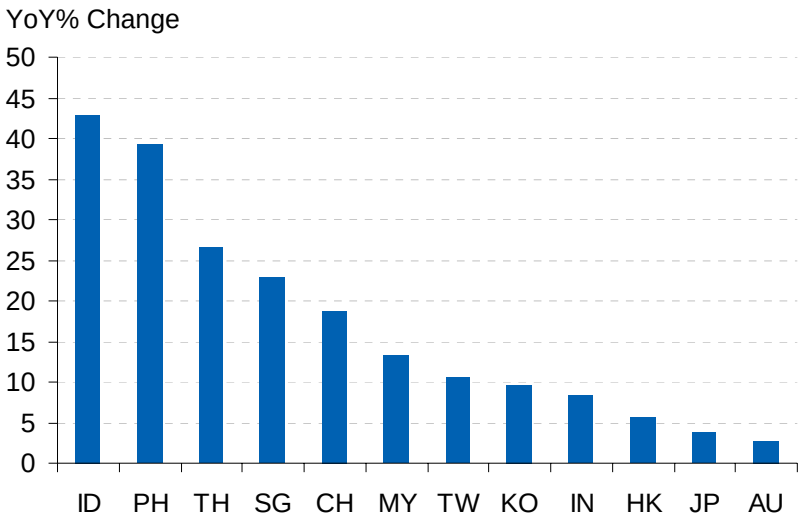
Asia: policy challenges & outlook

Policy responses to capital inflows

- Some degree of currency appreciation has been so far allowed
- Foreign exchange intervention
- Macro-prudential measures

Foreign reserves have increased sharply

Source: CEIC and BBVA Research



Latest data available: March 2011 for Korea and Taiwan, December 2010 for China, and January 2011 for the rest countries

Recent macro-prudential measures across Asia

- **Introducing or restating withholding taxes:** Thailand (Oct 2010) and Korea (Nov 2010)
- **Restricting bank' overseas borrowing:** Korea and Indonesia (Dec 2010)
- **Curbing banks' holdings of fx derivatives:** Korea (Jun 2010) and Taiwan (Dec 2010)
- **Raising reserve requirements on foreign deposits:** Indonesia and Taiwan (Dec 2010)
- **Restricting foreign fund investments in domestic portfolio markets:** Taiwan (Dec 2010)
- **Mitigating capital inflows to domestic housing:** Hong Kong (Oct 2010) and China (Nov 2010)
- **Encouraging capital outflows:** Thailand (Sep 2010) and China (Dec 2010 and Jan 2011)

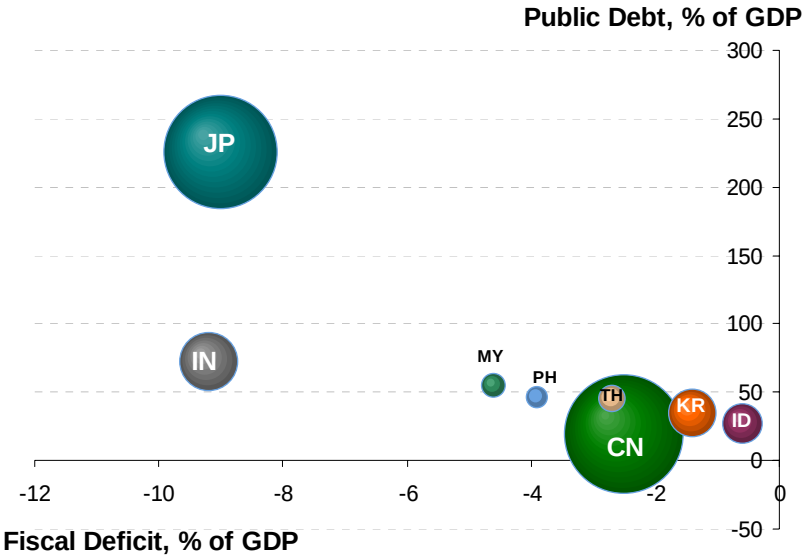
Asia: policy challenges & outlook

Outlook for fiscal policies

- Sound fiscal positions in most Asian economies provide room to slow the pass-through of higher oil prices
- Fiscal room is limited for a few countries (IN, MY and PH)
- Japan's efforts at fiscal consolidation are likely to be undermined by the cost of earthquake reconstruction

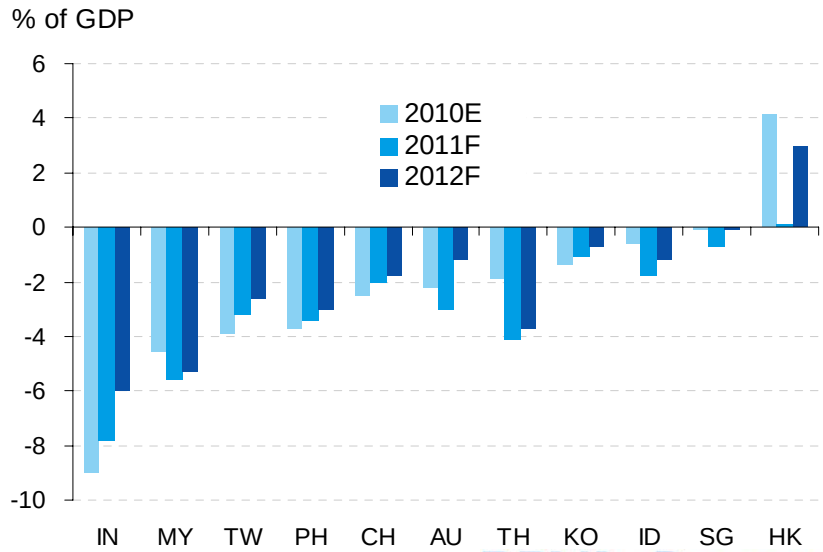
Fiscal position of most Asian countries are favorable

Source: CEIC and BBVA Research



Most countries aim at smaller deficit in the coming years

Source: CEIC and BBVA Research



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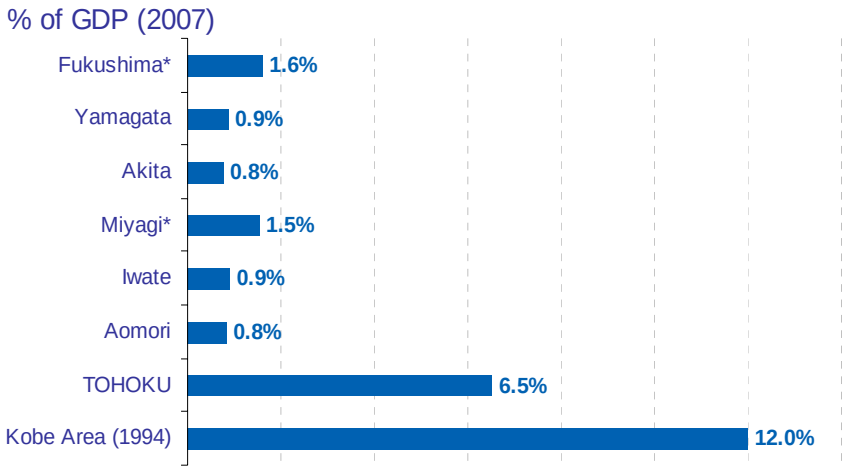
Asia: regional economic outlook

Assessing the impact of Japan's earthquake

- The economic impact is estimated to be temporary and modest—policy responses and rebuilding are usually offsets following natural disasters—although uncertainty is still high.
- We are lowering our 2011 GDP growth projection by 0.5%.

Tohoku area has a smaller economic size relative to Kobe area…

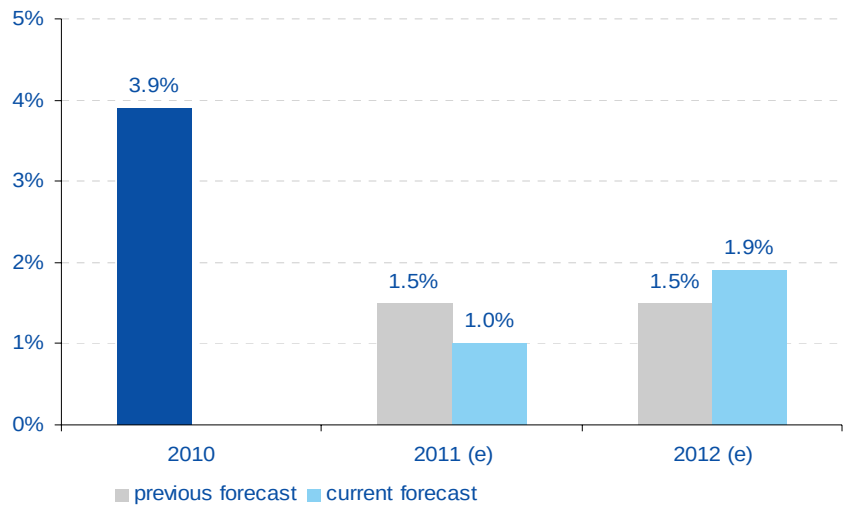
Source: CEIC and BBVA Research



*Areas most affected by the earthquake and the nuclear leak

The quake's impact on Japan is estimated to be temporary and moderate

Source: BBVA Research and IMF



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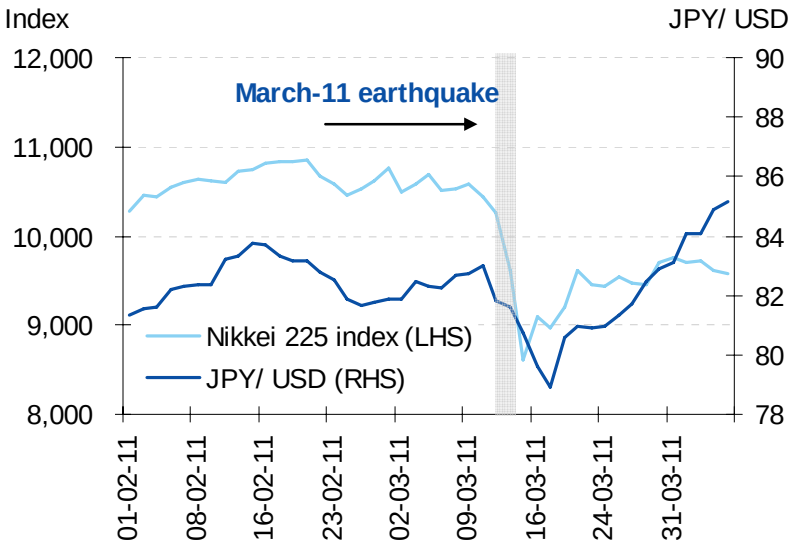
Asia: regional economic outlook

Assessing the impact of Japan's earthquake

- The impact on other Asian economies should be modest, although concern lingers about disruptions to supply chains, especially for Taiwan and Thailand which import heavily from Japan

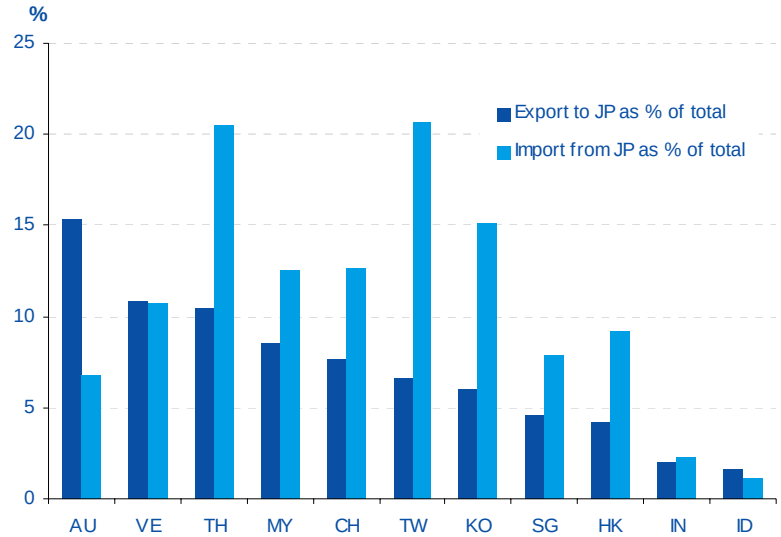
Stock market has rebounded fast, and yen is back to the pre-quake level

Source: CEIC and BBVA Research



Supply chains could be disrupted as Asian economies rely on Japan for components

Source: BBVA Research and IMF



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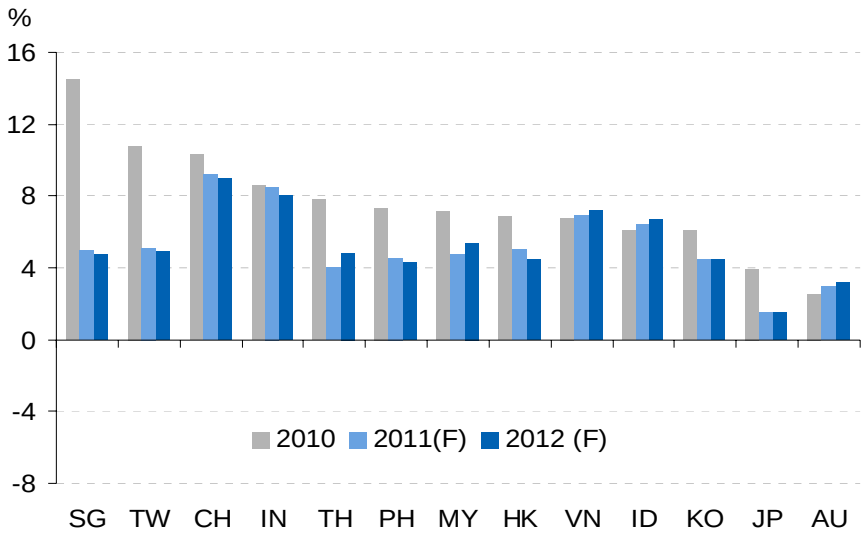
Asia: regional economic outlook

Growth and inflation outlook

- A more sustainable growth path is expected in 2011
- Upside risks to the inflation outlook
- More interest rate hikes

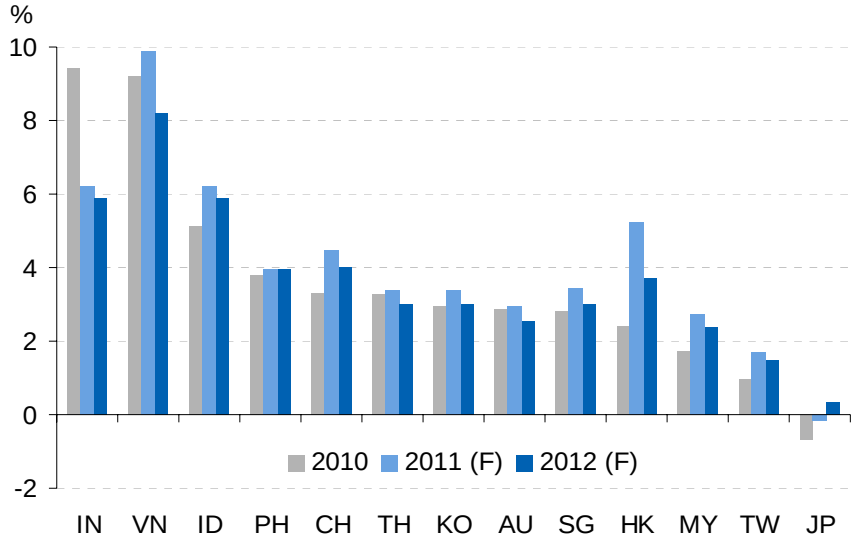
GDP forecasts for Emerging Asia

Source: BBVA Research



CPI forecasts for Emerging Asia

Source: BBVA Research



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China economic outlook

Our baseline scenario incorporates a soft-landing

Macroeconomic Forecast: China Baseline

Source: CEIC and BBVA Research

	2008	2009	2010	2011 (F)	2012 (F)
GDP (%, y/y)	9.6	9.2	10.3	9.2	9.0
Inflation (average, %)	5.9	-0.7	3.3	4.5	4.0
Fiscal bal (% of GDP)	-0.4	-2.8	-2.5	-2.0	-1.8
Current acct (% of GDP)	9.9	6.1	5.2	4.5	4.5
Policy rate* (%)	5.31	5.31	5.81	6.56	7.06
Exch rate* (CNY/USD)	6.83	6.83	6.62	6.30	6.00

* End of period

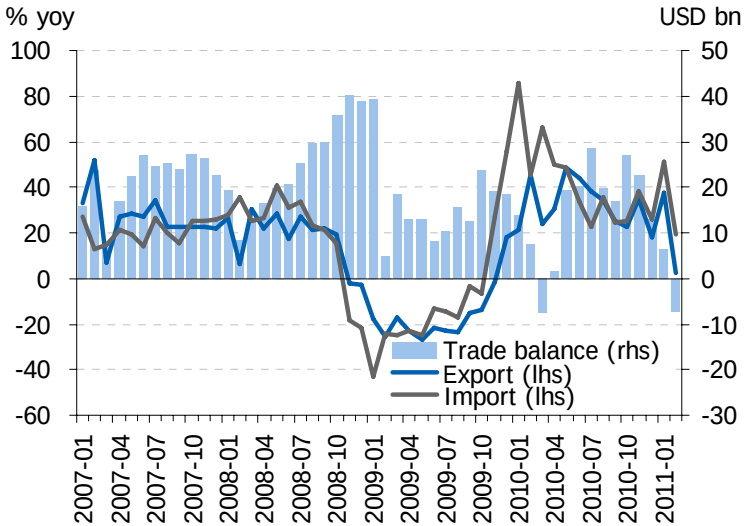
China economic outlook: RMB appreciation

Move to a more flexible exchange rate regime

- The PBoC announced a resumption of a more flexible exchange rate regime in mid-2010.
- The move allows greater two-way flexibility of the exchange rate, although it is widely expected to result in appreciation over time given the strength of China's BOP surplus (we expect 4-5% per year).
- The framework still lacks clarity, leaving the authorities discretion.

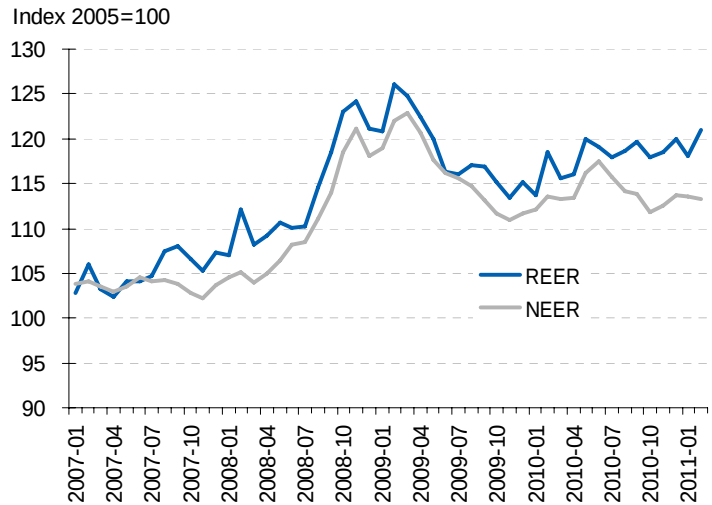
Trade surplus adds to appreciation pressure

Source: CEIC and BBVA Research



Appreciation of the nominal effective exchange rate has been limited so far

Source: CEIC and BBVA Research



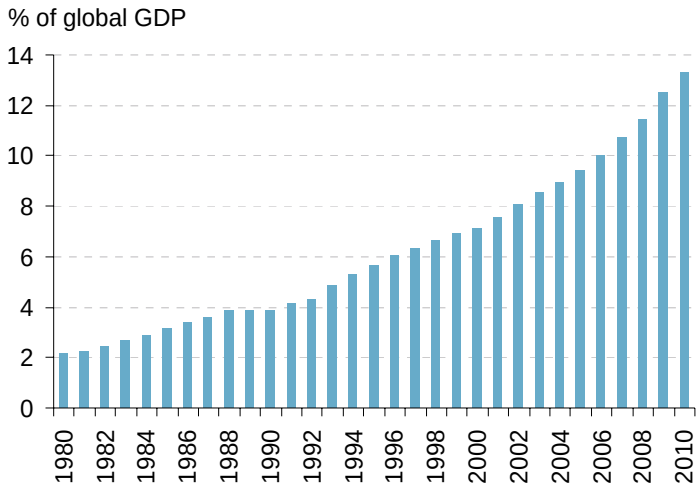
China economic outlook: internationalization of RMB

China's growing economic importance

- China's economic importance (now the world's second largest economy and largest exporter) has naturally increased expectations of internationalization of the RMB.
- The authorities are taking a gradual approach to internationalization of the currency
- No official roadmap, but the process is likely to be step-by-step, beginning with the use of the RMB in trade settlement and investment, eventually followed by a role as an international reserve currency.

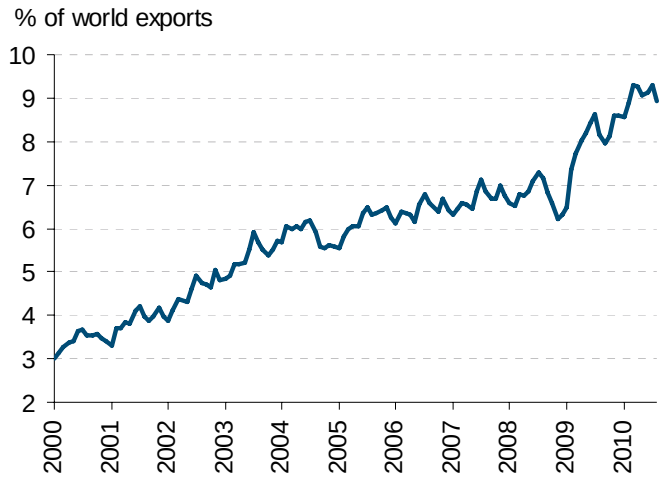
China's share of global GDP (based on GDP PPP)

Source: CEIC and BBVA Research



China's Share of World Exports

Source: CEIC and BBVA Research



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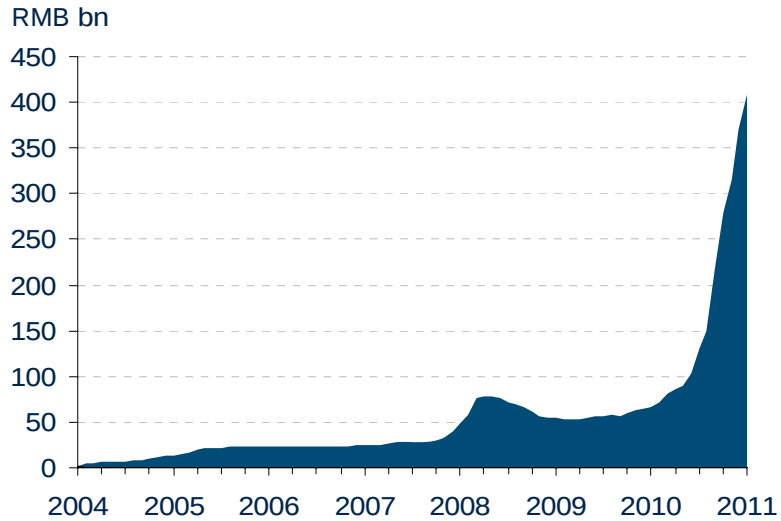
China economic outlook: internationalization of RMB

Hong Kong's emergence as an offshore RMB center

- As the main offshore RMB center, Hong Kong has seen a sharp increase in RMB deposits.
- Hong Kong is endeavoring to develop an offshore RMB bond market
- The pilot program of cross-broader trade settlement is an important step toward internationalization of the RMB (launched in 2009 and expanded in 2010).

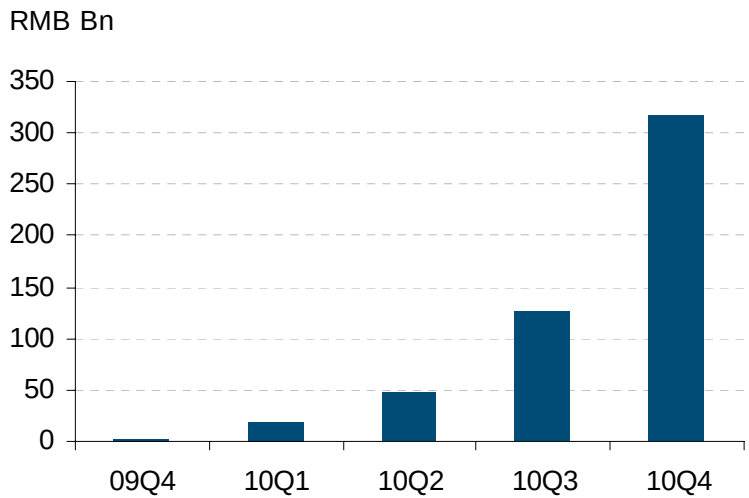
RMB Deposits in Hong Kong are rising

Source: HKMA and BBVA Research



The use of RMB trade settlement is increasing

Source: HKMA and BBVA Research



Outline

1 Asia: Leading the global recovery

- Recent economic developments
- Policy challenges & outlook
- Regional economic outlook

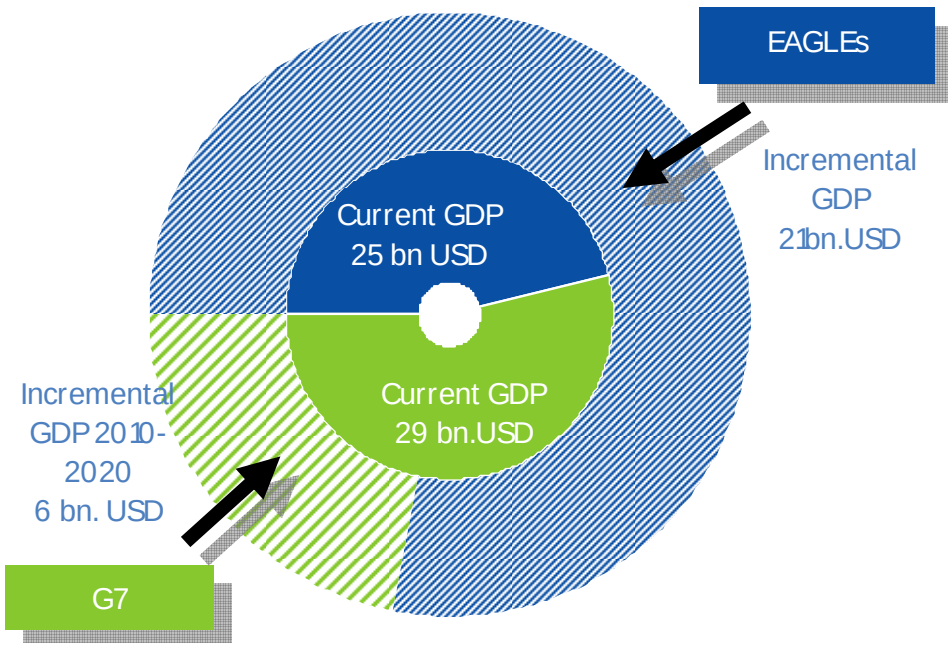
2 Looking for growth: BBVA EAGLEs

EAGLEs: Emerging and Growth-Leading Economies

- Economies which will add more to global growth than average of the "G6" developed economies (G7 ex-US)
- More relevant to new business than size
- Not too long horizon for projections (10 years); relevant for business
- Dynamic and flexible: revised yearly and not linked to a given set of countries

EAGLES vs G7: current GDP vs. "new business"

Source: BBVA Research

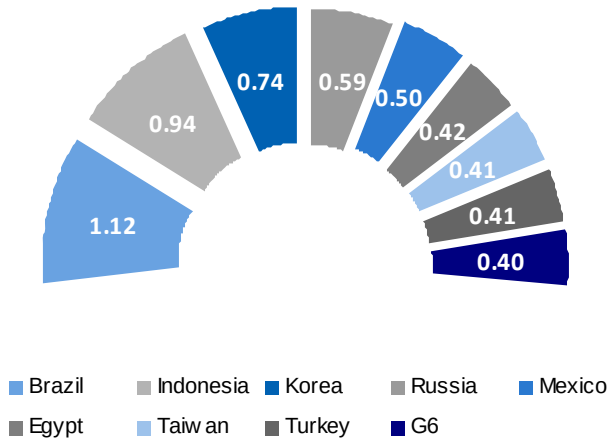


BBVA Research

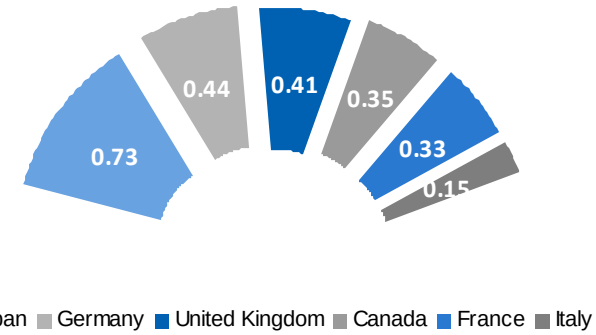
Who are the other EAGLEs? 5 of 10 are in Asia!

- Brazil, Indonesia and Korean incremental GDP will exceed that of Japan
- Russia and Mexico will exceed German's contribution
- Egypt, Turkey and Taiwan will play a more important role than UK, Canada, France and Italy!

GDP adjusted by PPP: change in 2010-2020 (trillions)
Source: BBVA Research and IMF

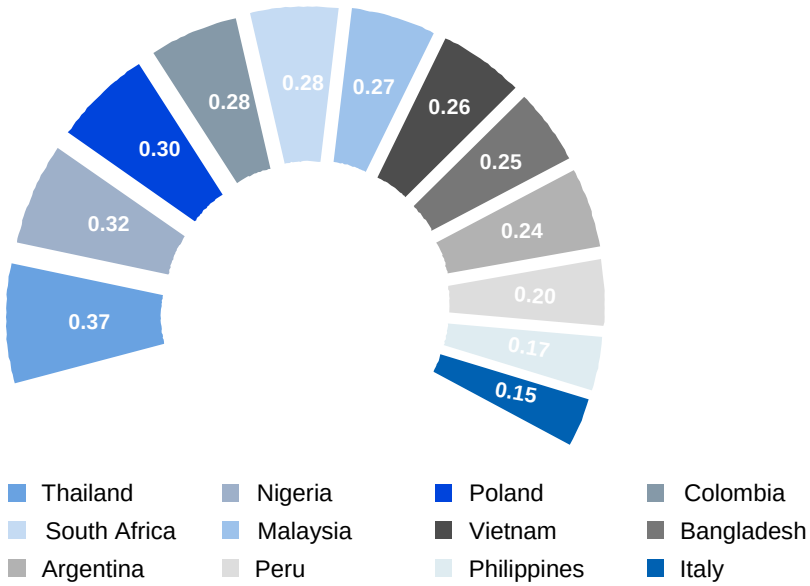


GDP adjusted by PPP: change in 2010-2020 (trillions)
Source: BBVA Research and IMF



G6 Average: Canada, Germany, France, Italy, Japan and UK

The EAGLE's Nest: Who might be next?

- Additionally, 11 economies are expected to add to global growth more than Italy, the smallest contributor within the G6

GDP adjusted by PPP: change in 2010-2020 (trillions)
Source: BBVA Research and IMF