Rabobank

Outlook 2013: Emerging Asia

Regional outlook

Assumptions

In 2013, global economic growth is expected to be 3¾%, with growth estimated to remain subdued in the US (1¾%), the eurozone (½%) and Japan (1%)[2]. China's economy is expected to grow by between 7½% and 8½%[3].

Figure 1: Economic growth (Real GDP change, year-on-year)

Regions[1]	2011	2012	2013
East Asia	8.2	6.8	7.4
South Asia	6.9	5.0	6.0
ASEAN	4.6	5.1	5.5
Emerging Asia	7.4	6.1	6.8

Data: 2011 actual data, 2012 and 2013 latest projections.
Source: IMF World Economic Outlook, October 2012

Introduction

Economic growth in Emerging Asia[4] slowed over 2012, largely as subdued growth in Europe and the US and a soft landing in China resulted in weaker export demand. In India, domestic factors played a key role in the slowdown of growth. In 2013, despite continued lackluster demand for Asian export products, overall economic growth in Emerging Asia is expected to pick up slightly compared to 2012. The private domestic market and government spending are expected to compensate for weak external demand. Moreover, there is some room for monetary loosening next year if growth disappoints, as interest rates are still relatively high. However, higher inflation expectations will stimulate the current wait-and-see policy. With the fiscal debt ceiling in the US and many eurozone issues unresolved, the downside risks to these growth expectations are still very much present. If necessary, fiscal and monetary stimuli are an option in most countries. India is the notable exception, as the country already struggles with a deteriorating fiscal situation and high inflation.

Export weakness will affect growth

Malaysia, Vietnam, Thailand, Taiwan and South Korea are all very export oriented. The total export value of goods and services for these countries ranges from 60% of GDP (South Korea) to more than 90% of GDP (Malaysia) (figure 2). China, Japan, the US and Singapore are the main export destinations of their products, although part of the end demand for the products lies in Europe. Thailand, for example, is a major supplier in the region for components for cars, electronics and machinery. A substantial part of the final products are ultimately sold in the US, Europe and, increasingly, in China.

[1] East Asia: China, Hong Kong, South Korea, Taiwan. South Asia: Bangladesh, India, Sri Lanka. ASEAN: Brunei, Cambodia, Indonesia, Lao P.D.R., Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam. Emerging Asia: East Asia, India, Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam.
[2] See for more information *Outlook 2013: Lower growth is the new reality*
[3] *China Outlook 2013*, Rabobank Special 12/18, November 2012.
[4] The focus of this report is on Emerging Asia other than China. For China, please see *China Outlook 2013,* Rabobank Special 12/18, November 2012.

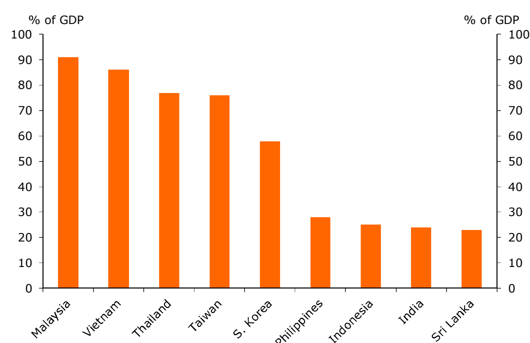
While it is fair to say that lackluster demand from the US, Europe and China will negatively affect economic growth in the export-oriented countries, the actual impact will also strongly depend on the type of products exported (figure 3). South Korea, Taiwan and the Philippines focus on high-end, sophisticated products, like semiconductors, IT products and electronics. When consumers in Europe need to tighten their belt again in 2013, the demand for these products is likely to suffer more than demand for basic goods. On the other end of the spectrum, Vietnam, Bangladesh, Sri Lanka and Cambodia have specialized in cheaper products, mostly textiles and footwear. These products are generally less sensitive to economic fluctuations in the West. However, the textiles sector is notoriously footloose. Rising labor costs in China have lured producers to Vietnam, but Bangladesh and Cambodia have even lower wages. Moreover, the recent developments in Myanmar could make it a serious competitor in the coming years. Its infrastructure is still severely underdevelopment, but already foreign investors have expressed interest in Myanmar.

Next to exporting actual goods, 'exporting' people abroad is an important foreign currency earner for countries like Philippines and India. Filipinos crew ships around the world and clean houses in the Middle East, while India staffs Silicon Valley. During the global financial crisis it was feared that rising unemployment in Europe and the US would hit expatriates. However, so far this has not materialized on a large scale and remittances inflows have remained more or less steady so far. For 2013, this pattern is unlikely to change, thereby bringing some stability.

Capital flows create sensitivity

Next to strong trade ties, Asia is also strongly linked with the developed world through foreign direct investment, portfolio inflows and the banking sector. The withdrawal of bank funding by European banks is also happening in Asia, but not to the extent seen in, for example, Central Europe. Moreover, domestic banks

Figure 2: Export value of goods and services (% of GDP)



Source: EIU

Figure 3: Main export products

Country	Export products
South Korea	ICT products; semiconductors; chemicals
Taiwan	Electronic products; base metals; ICT products
Philippines	Electronic products
Malaysia	Machinery and transport equipment; mineral fuels
Thailand	Machinery; food; manufactured goods; chemicals
Vietnam	Textiles & garments; footwear; crude oil
Sri Lanka	Textiles; tea
Indonesia	Oil and minerals; edible oils; machinery and transport equipment
India	Engineering goods; refined petroleum products; textiles; jewelry

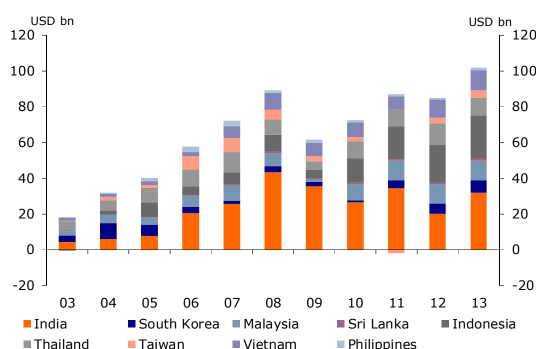
Source: EIU

and other non-European banks seem able to fill the gap. With relatively low debt levels and adequate capital ratios, most Asian banking sectors are in good shape.

As a result of the turmoil on financial markets worldwide, foreign direct investment (FDI) to Asian countries decreased substantially between 2008 and 2009 (figure 4). While FDI flows have since been recovering, they are still below their 2008 peak. However, this development does not hold for all countries equally. Indonesia has performed much better than average, as strong economic growth above 6% in the past years made the country very attractive to investors. Sri Lanka has been benefitting from a post-war bonus, after the civil war ended in 2009. On the other hand, investors lost confidence in India, due to a lack of reforms and ambiguous policy measures. The 2013 outlook for FDI will therefore be a combination of ability on the side of investors – a prolonged economic slowdown at home will eat into their investment capacity – and local developments in Asian countries.

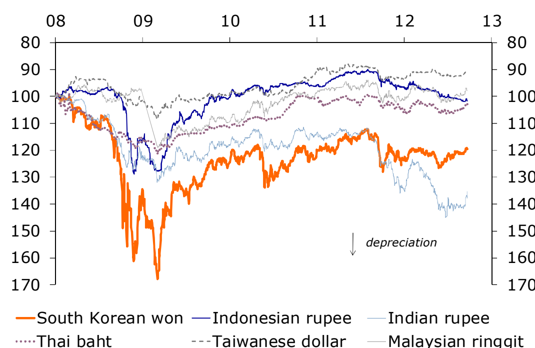
Portfolio inflows show a similar pattern, but with more volatility. Foreign investors have been attracted by the high returns on government bonds, low public debt level and open capital account of, for example, Indonesia. Also, Malaysia and Taiwan are expected to receive a fair amount of portfolio inflows next year. Again, India has made itself quite unpopular. However, investors are also strongly influenced by the developments at home. When taking currency movements as a proxy for investor interest, you see a depreciating trend in the fall of 2011, when tensions in the eurozone increased (figure 5). Early 2012, at the time of LTRO and other measures, investor confidence in Emerging Markets and thus also Emerging Asian markets returned, leading to currency appreciation. As portfolio inflows are dependent on so many factors, they are very difficult to predict for 2013. With the risk of an escalation of the eurozone problems or the US' fiscal cliff in mind, it is worth noting the risk of reversing capital flows. Being major recipients of foreign capital, Indonesia, Taiwan, South Korea and Malaysia

Figure 4: Inward foreign direct investment flow



Source: EIU

Figure 5: Asian currencies



Source: Reuters EcoWin. Data: 1-1-2008=100

are especially at risk. However, in general, the fundamentals and buffers of Emerging Asian countries have improved substantially since the Asian crisis in late 1990s, thereby reducing the vulnerability to reversal of capital flows.

Not only investor sentiment, but also the recently announced QE3, the latest program of quantitative easing in the US, is expected to affect the Asian currencies. As part of QE3, the Federal Reserve has said it will buy mortgage-backed securities worth USD 40bn per month, until the labor market has recovered. This could last until well after 2013. The extra liquidity is expected to put downward pressure on the US dollar. Meanwhile, the bank of Japan is aiming for a weaker yen too. An appreciation of Asian currencies vis-à-vis the dollar and the yen will hurt their competitive position and thus the export sector. With several Asian countries depending heavily on the export sector, this could have a negative effect on economic growth – or a positive effect on rebalancing on a global scale as some economists claim more optimistically.

Export weakness domestically compensated
In the second and probably also the third quarter of 2012, weakening export was a drag on economic growth, but the domestic situation compensated for weak external demand in many countries. This pattern is expected to continue in 2013. Therefore, we now turn towards the individual countries.

Both India and Indonesia have a large domestic market and are less reliant on the external sector. However, the comparison ends there. India is struggling to get economic growth back on track with economic growth in the first half of 2012 below 6% and monthly indicators suggest only a moderate improvement. In September, the government announced a series of unpopular reforms, which should help to boost investor confidence and limit the fiscal deficit. Lack of confidence in India combined with a weak external environment and tight monetary policy to curb the high inflation are often mentioned as the reasons for the economic slowdown. In 2013, these factors are expected to continue to hamper economic growth, although a recovery from this year is expected. Economic growth is therefore expected to be 5-6% in fiscal year 2012/13 (until March 2013) and around 6% in 2013/14.

Indonesia is also expected to grow around 6% this year and next year. However, for Indonesia this is considered booming. India’s GDP per capita is lower than in Indonesia, which implies a higher growth rate to catch up, and India also needs a higher growth rate to keep up with the population growth. In Indonesia, the main drivers of growth will continue to be strong private consumption and fixed investment growth, while external demand is expected to remain subdued on the back of sluggish global growth and lower commodity prices. An accommodative monetary policy and increasing wages are likely to support consumption and investment. The latter also benefits from the strong

foreign investment flows into Indonesia. While this is also an area of concern, as discussed above, foreign direct investment is very welcome to lift the under-developed economy to a higher level. In this regard, the recent changes in laws governing mining and agricultural exports could deter investors in the medium term, as they include export bans and restrictions on investment. Even though the changes fit within the long-term development plan to move Indonesia up the value chain, they were poorly communicated.

South Korea's economy is slowing, but less than one would expect given the country's strong dependence on exports. Private consumption growth has remained relatively robust, although a mild slowdown has been recorded, which is preventing a sharper overall economic slowdown. In 2012, real GDP growth is estimated to slow to 2.6%, down from 3.6% in 2011. Monetary policies are loose and have been eased only slightly, as authorities remain concerned about inflation picking up again. Inflation, however, is estimated to average only 2.3% in 2012 and 2.9% in 2013, just below the center of the central bank's target (3%). Although some further monetary easing is anticipated, no major steps are expected. Next year's economic performance will depend largely on the strength of external demand. In addition, social spending will likely increase after the presidential elections, as all major presidential candidates have expressed their support for such policies. If needed, the government will be able to roll out an economic stimulus program, as the government is financially healthy. In all, we expect economic growth in South Korea to accelerate next year, with real GDP estimated to expand by 3.7%.

In Thailand, post-flood recovery spending by households and companies provided a major boost to growth in 2012. Also, public investment in water management and government support for rice farmers held up economic growth. However, such recovery-driven growth may look good on the surface, but is far from desirable, as the development level of Thailand does not benefit from this type of growth. Depending on this year's rain season, new flood recovery efforts might be needed - so far rain is strong, but the physical damage is expected to be more limited than in 2011. It is therefore expected that the recovery 'bonus' is unlikely to last long in 2013. Populist fiscal stimulus measures and loose monetary policy, on the other hand, are expected to continue next year. Economic growth around 4% is expected, which is lower than the 6% estimated this year.

This year, Malaysia's economy is benefitting from a pre-election spending spree by the government, several fiscal stimulus measures taken in light of weaker external demand and accommodative monetary policy. This has pushed the fiscal deficit deeper into the red this year (to around 4.5% of GDP), which suggests that fiscal austerity measures are needed. However, as the 2013 budget will be approved this year and elections will be held in the first half of

2013, real fiscal consolidation is not expected until 2014. Economic growth is therefore expected to slow slightly to around 4.5%, down from an estimated 4.9% this year.

The economic performance in the Philippines has been better than expected in 2012, with real GDP growth estimated at 5.4%, on the back of increased public spending, investment growth and robust private consumption. Private consumption, which amounts to 70% of GDP, has in turn been supported by strong remittances inflows. In spite of weakening external demand, exports have remained relatively strong. Although the export of electronic products has contracted, the better performance of other types of exports offset this decline. Inflation, meanwhile, eased this year to 3.4%, down from 4.7% in 2011, which gave the central bank room to ease monetary policies. Domestic demand will remain relatively strong next year, although it will slow compared to 2012 as public spending will slow while remittances inflows will decrease slightly as well. Nonetheless, on the back of a somewhat improved global economy and continued strong investment growth, real GDP growth is estimated to remain relatively strong at around 6% in 2013. Inflation will increase as well, to an estimated 3.9% next year. In case external demand would disappoint, room for further fiscal policy support is available.

Taiwan's export-driven economy is adversely affected by the slowdown of global demand. Exports of goods and services will therefore contract by about 1% this year and, moreover, investment growth will be negative in 2012, particularly due to the uncertain outlook with regard to demand for IT products. Domestic consumption growth also weakened in 2012. Inflation is expected to increase to 2.3% in 2012, which is still relatively low, largely as a result of increased petrol prices. Next year, inflation is expected to ease slightly to 2%, as Taiwan is increasingly liberalizing the economy, thereby increasing competition. Taiwan has some fiscal room to stimulate the economy if needed, as public debt stands around 40% of GDP. However, we do not expect strong fiscal support next year. Nonetheless, real GDP growth is expected to accelerate to 2.5% in 2013 on the back of increased external demand, which will have a positive impact on export growth and investment.

In 2011, the government of Vietnam took measures to stabilize the economy. The measures were successful, as they have lowered inflation back into single-digit territory (averaging 9.2%) in 2012 and have alleviated the most pressing balance of payments pressures. However, real GDP growth has slowed to an estimated 5.3%, on the back tighter credit supply and weaker domestic demand in 2012. Authorities have been seeking the fine balance between supporting growth while not exerting too much upward inflationary pressures with regard to monetary policy. This is of great importance, as economic instability could return quickly in case inadequate policies are implemented. However, the Vietnamese

authorities will also be careful not to let growth slow too much, as this could have serious adverse consequences for the weak banking sector. Therefore, some further fiscal support of the economy in 2013 is not unlikely. In addition, the export sector's outlook should improve on the back of a somewhat improved external environment. In all, we expect Vietnam's growth rate to increase to around 6% in 2013. Downside risks are present, though. In addition to weaker than expected external demand, risks are present with regard to Vietnam's banking sector that is in weak shape, while public confidence in the banking sector and the overall economy is weak. Any problems in the banking sector could quickly lead to a bank run and capital flight. In turn, this would signify-cantly hurt GDP growth as well as strongly increase pressure on the still weak balance of payments.

Less fiscal and monetary room

In the previous section, we discussed the baseline scenarios for Emerging Asia. The downside risks to these scenarios are larger than the upside risks at this point in time. If the current eurozone issues are not resolved, a crisis over the public debt ceiling or fiscal cliff hits the US or a hard landing materializes in China, it will spill over into Emerging Asia. Simulations in a recent IMF report[5] show that neighboring countries are generally most sensitive to events, i.e. Central and Eastern Europe in case of a eurozone crisis and Mexico and Canada when the US fiscal cliff becomes reality. However, Asia is certainly not shielded from problems in the West. When necessary, fiscal and monetary stimulus measures are an option for most Asian countries, although in general there is less fiscal and monetary room than during the 2008/09 financial crisis (figure 6).

At the eve of the previous crisis (end-2007), the unweighted average of the fiscal balances of the nine countries in figure 6 was -1.5% of GDP, while in 2012, this figure is expected to be -3.3% of GDP. Moreover, the available room is not evenly divided. The fiscal stimulus route is nearly closed for some countries, most notably Sri Lanka and India. Being in the post-war recovery phase, the government of Sri Lanka is spending a lot on infrastructure and other rebuilding efforts. This leaves little room for extra stimulus measures. In India, fiscal consolidation is much needed to reduce crowding out of the private sector and prevent a downgrade by the major rating agencies. However, given coalition politics and lavish subsidy schemes, this is difficult to achieve. The fiscal consoledation plan, which is hoped for in the near term, and the 2013/14 budget, which is expected in February 2013, will be closely watched by the market. If fiscal stimulus is extended, it could undermine investor confidence in the Indian government further. Malaysia also saw a deterioration of the fiscal situation, with strong pre-election spending and investment plans putting pressure on the budget. The room for extra measures has thereby decreased

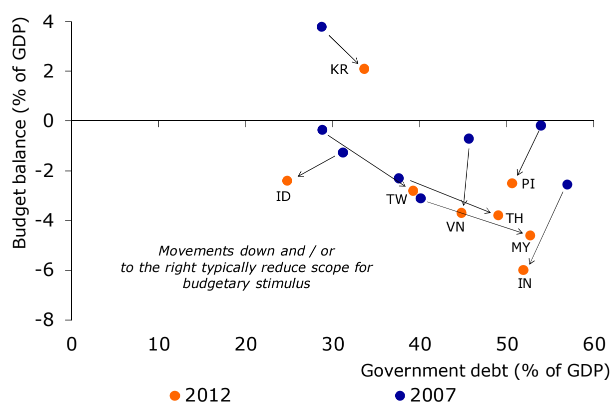
[5] IMF, *2012 Spillover Report*, July 2012.

substantially. For Vietnam, Taiwan, the Philippines, Indonesia and Thailand, the situation looks better. While these countries, except Thailand, have seen an increase of their fiscal deficits, the current level of around 3-4% of GDP leaves some room in case of emergency. South Korea looks best situated with a surplus on the fiscal balance and a public debt level of around 33% of GDP. The low level of public debt in Indonesia, around 25% of GDP by end-2012, also gives that country some extra leeway.

The other obvious option to stimulate economic growth is through monetary loosening. Even though the transmission mechanisms are far from perfect in most Asian countries, their central banks are likely to use a rate cut if they want to give the economy a push. As a lower interest rate will also make the country less attractive for investors, a rate cut is expected to create a depreciating pressure on the local currency and thereby aid the export competitiveness. Therefore, monetary loosening seems to kill two birds with one stone; boost the economy and support the export sector. This is especially interesting for export-dependent countries, which are faced with a depreciating dollar if the QE3 works as planned. However, central banks will encounter two major 'buts' when considering rate cuts, i.e. the current policy rate and inflation. Moreover, if more countries will aim for a depreciation of their currency, the net effect on export competitiveness will decrease.

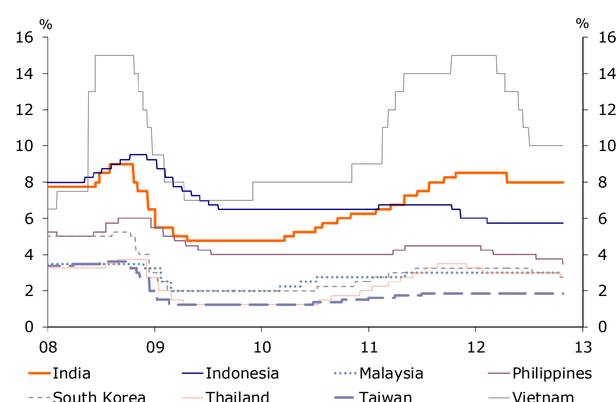
In the wake of the global financial crisis in 2008/09, most central banks in Asia rapidly cut their policy rates to stimulate growth (figure 7). Over the course of 2010 and 2011, the policy interest rates were hiked again to stem inflation. Especially India and Thailand had a rather aggressive monetary policy. Starting early 2012, most central banks switched to a wait-and-see stance, although Thailand and South Korea recently cut their policy rates by 25bps. Still, there is some room to cut rates further, if economic growth weakens too much to the liking of policy makers. However, similar to the fiscal situation, the available room is now smaller than at the start of the 08/09 crisis.

Figure 6: Fiscal room in 2007 and 2012



Source: EIU
Abbreviations: India (IN), Malaysia (MY), Vietnam (VN), Taiwan (TW), Philippines (PI), Indonesia (ID), Thailand (TH), South Korea (KR).

Figure 7: Central bank policy rates



Source: Reuters EcoWin

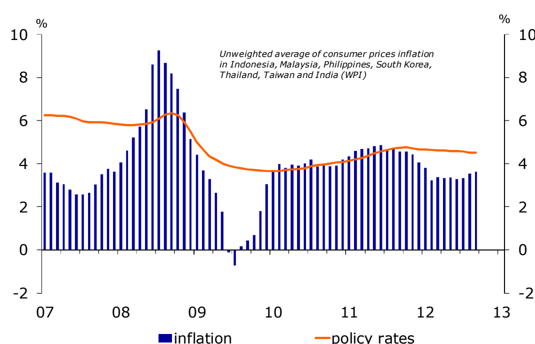
The current wait-and-see policy of central banks is driven by the uncertain global economic outlook, while also seeing an increase in inflationary pressure (figure 8). India and Vietnam saw inflation increase in the past months while South Korea and Thailand experienced an uptick in inflation in September. Higher food and fuel prices are an important factor in this increase – also because Asian consumers spend a relatively large part of their income on food and fuel.

Globally, food prices had risen on the back of droughts in the US, South America and Russia, but have recently decreased again. Even if food prices continue to rise, it is not expected that this will lead to the same peak in inflation and associated social unrest seen in 2008. In 2008, the price of wheat, rice and other staple foods rose rapidly, due to poor harvests and rice export bans in countries like India and Vietnam. At this moment, the commodities used in animal feed, such as soybeans and corn, are most affected, which will push up the price of meat. Unlike in 2008, consumers now have the option to switch from meat to rice. Despite the recent decline in food and fuel prices, in most Asian countries, consumer prices are expected to increase from 2012 to 2013 (figure 9). Even though food price inflation is hardly curbed by higher interest rates, central banks will be more hesitant to turn on the monetary tap. In India, Sri Lanka and Vietnam, inflation is expected to decrease next year. However, the inflation levels in these countries do not warrant a loose monetary policy. In fact, curbing inflation further is essential for medium-term macroeconomic stability in those countries.

Conclusion

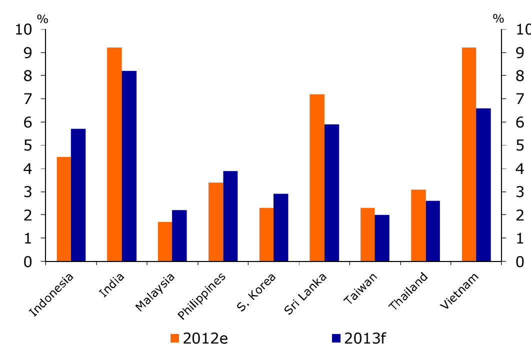
The global outlook for 2013 is probably best described as a muddle-through scenario. However, with the fiscal debt ceiling in the US and many eurozone issues unresolved, the downside risks to these growth expectations are still very present. Against this background, how will Emerging Asia fare in 2013? Overall, economic growth in Asian countries is expected to be slightly higher in 2013

Figure 8: Consumer price inflation



Source: Reuters EcoWin

Figure 9: Inflation expectation



Source: EIU

than this year, but markedly weaker than the recovery years 2010-11, let alone the pre-crisis years. The private domestic market and government spending are expected to compensate for the lackluster external demand. However, central banks are likely to only hesitantly loosen monetary policy, as they struggle to balance weak external demand and slowly rising inflation. If some of the above mentioned downside risks become reality, a dip in foreign investment and reversal of portfolio flows are likely, but the region is far less sensitive to a sudden reversal of capital flows than it was during the Asian crisis in the late 1990s. When economic growth is affected, fiscal and monetary stimuli are an option available in most countries when need be, except for India, which struggles with a high fiscal deficit and elevated inflation.

Sources:
IMF, *2012 Spillover Report*, July 2012.
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http://overons.rabobank.com/publicationservice/download/South%20Korea-201209.pdf
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Data tables

Economic growth (Real GDP % change pa)							
	2007	2008	2009	2010	2011	2012e	2013f
India	9.8	3.9	8.2	9.6	6.9	5.8	6.5
Indonesia	6.3	6.0	4.6	6.2	6.5	6.0	6.3
Philippines	6.6	4.2	1.1	7.6	3.9	5.4	6.0
Malaysia	6.3	4.8	-1.5	7.2	5.1	4.9	4.5
Sri Lanka	6.8	6.0	3.5	8.0	8.3	6.7	6.8
South Korea	5.1	2.3	0.3	6.3	3.6	2.6	3.7
Thailand	5.0	2.5	-2.3	7.8	0.1	6.0	4.2
Taiwan	6.0	0.7	-1.8	10.7	4.0	1.3	2.5
Vietnam	8.5	6.3	5.3	6.8	5.9	5.3	5.9

Source: EIU

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Budget balance (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
India	-2.5	-6.0	-6.4	-4.8	-5.8	-6.0	-5.4
Indonesia	-1.3	-0.1	-1.6	-0.7	-1.1	-2.4	-1.7
Philippines	-0.2	-0.9	-3.7	-3.5	-2.0	-2.5	-2.4
Malaysia	-3.1	-4.6	-6.7	-5.4	-4.8	-4.6	-4.2
Sri Lanka	-6.9	-7.0	-9.9	-8.0	-6.8	-7.0	-6.8
South Korea	3.8	1.5	-1.7	1.4	1.5	2.1	2.6
Thailand	-2.3	-2.9	-2.3	-2.2	-1.6	-3.8	-3.6
Taiwan	-0.4	-0.9	-4.5	-3.3	-2.2	-2.8	-2.8
Vietnam	-0.7	-0.5	-7.2	-5.2	-2.6	-3.7	-4.0

Source: EIU

Public debt (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
India	56.9	56.1	54.7	51.3	50.5	51.9	50.9
Indonesia	31.2	29.5	26.4	25.7	24.1	24.8	24.0
Philippines	53.9	54.7	54.8	52.4	50.9	50.6	49.8
Malaysia	40.1	39.8	50.8	51.2	51.8	52.7	53.2
Sri Lanka	85.0	81.4	86.1	81.9	78.1	77.4	77.5
South Korea	28.7	30.4	33.5	34.6	34.7	33.6	31.2
Thailand	37.6	38.0	44.9	43.1	44.6	49.0	50.4
Taiwan	28.8	29.9	33.1	33.3	34.7	39.2	42.9
Vietnam	45.6	42.9	51.2	54.2	48.8	44.8	44.0

Source: EIU

Consumer prices (% change pa, average)							
	2007	2008	2009	2010	2011	2012e	2013f
India	6.4	8.3	10.8	12.0	8.9	9.2	8.2
Indonesia	6.3	9.9	4.8	5.1	5.4	4.5	5.7
Philippines	2.8	9.3	3.2	4.1	4.7	3.4	3.9
Malaysia	2.0	5.4	0.6	1.7	3.2	1.7	2.2
Sri Lanka	15.8	22.6	3.4	5.9	7.0	7.2	5.9
South Korea	2.5	4.7	2.8	2.9	4.0	2.3	2.9
Thailand	2.2	5.4	-0.9	3.3	3.8	3.1	2.6
Taiwan	1.8	3.5	-0.9	1.0	1.4	2.3	2.0
Vietnam	8.3	23.2	6.9	10.0	18.7	9.2	6.6

Source: EIU

Current account balance (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
India	-0.6	-2.5	-2.0	-3.1	-3.2	-4.0	-3.2
Indonesia	2.4	0.0	2.0	0.7	0.2	-2.4	-2.2
Philippines	4.8	2.1	5.6	4.5	3.1	4.9	4.6
Malaysia	15.4	16.8	15.7	11.1	11.1	6.7	6.0
Sri Lanka	-4.6	-9.8	-0.7	-3.0	-7.9	-8.0	-7.1
South Korea	2.1	0.3	3.9	2.9	2.4	2.1	2.2
Thailand	6.3	0.8	8.3	4.1	3.4	-0.7	1.5
Taiwan	8.9	6.9	11.4	9.3	8.9	8.6	8.4
Vietnam	-9.8	-12.0	-7.1	-4.1	0.2	-0.2	-2.5

Source: EIU