

China

- Chinese leadership signals further structural reforms and economic liberalization in the near term.
- Economic prospects are underpinned by services sector momentum and the Chinese consumer as credit-fuelled investment slows down; the US–China trade dispute poses a downside risk to growth.
- Prudent and neutral monetary policy remains the foundation for stable financial conditions.

POLICY OUTLOOK

The Chinese society and the economy will evolve according to President Xi Jinping's vision for years to come. The National People's Congress, China's annual parliament held in March, removed the two-term limit for the country's president and vice president, allowing President Xi Jinping to stay in power indefinitely. Meanwhile, the parliament named the former leader of China's rigorous anti-corruption campaign, Wang Qishan, as Vice President. While we assess that President Xi's structural reform agenda and his achievements so far are encouraging and point to further modernization and opening up of the economy, we cautiously note that generally speaking authoritarianism rarely leads to higher-quality policymaking over the longer term.

We expect broad policy continuity over the coming months and years, with the Chinese leadership's agenda centered on structural reforms, preserving the socialist thought, and strengthening China's global role. The March appointment of President Xi's top economic adviser Liu He as one of the four Vice Premiers to Premier Li Keqiang implies a strong near-term focus on the first objective. Mr. Liu—who is responsible for overseeing the economy and the financial sector—has implied that significant market liberalization measures will be implemented in the near term. We believe that Mr. Liu will prioritize financial sector reforms to reduce systemic risks given that a solid banking system is a prerequisite for further successful economic liberalization. In addition, he will likely pay particular attention to reforming inefficient state-owned enterprises (SOEs) as well as to advancing China's industrial policies with further reductions in overcapacity. Beyond these domestic responsibilities, Mr. Liu will also look after China's relations with the US, a key task that will have significant implications worldwide, both in the very near term due to ongoing trade tensions and for years to come as China's economic might continues to approach that of the US (chart 1).

ECONOMIC GROWTH OUTLOOK

China's economic outlook is rather favourable. While growth will decelerate gradually in 2018–19, we expect to see higher-quality and more sustainable rates of expansion. The 2018 real GDP growth target was unveiled during the National People's Congress in March; China will aim for 6.5% expansion this year. While the goal remained unchanged from last year, this time around the government's intention to exceed the target if possible was removed. We maintain our forecast that China's real GDP gains will meet the official target this year, with growth decelerating further to 6.2% next year. Last year, output increased by 6.9%.

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China	2017	2018f	2019f
Real GDP (annual % change)	6.9	6.5	6.2
CPI (y/y %, eop)	1.8	2.3	2.5
Central bank policy rate (% , eop)	4.35	4.35	4.85
Chinese yuan (USDCNY, eop)	6.51	6.30	6.10

Source: Scotiabank Economics.

Chart 1

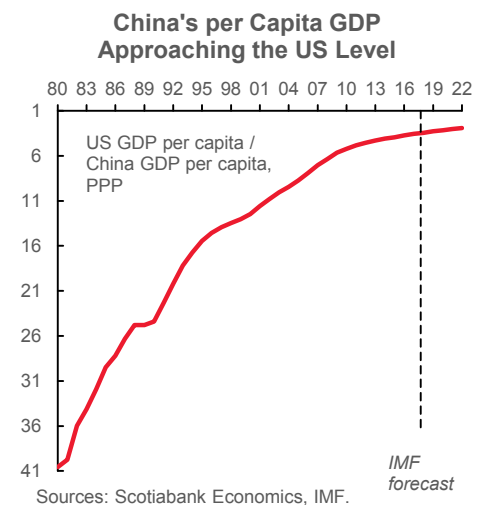
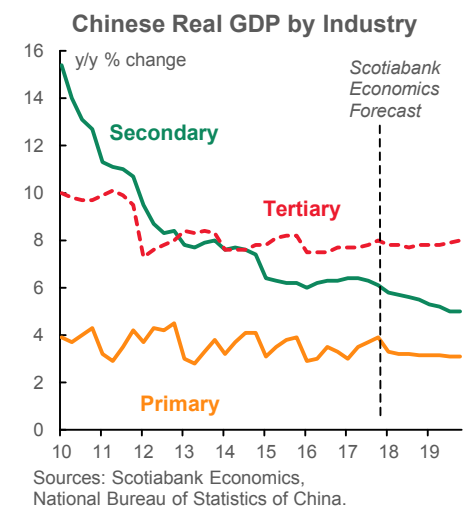


Chart 2



Meanwhile, the Chinese economy's structural transition continues, with the services sector becoming an increasingly important source of growth (chart 2). Indeed in 2017, services accounted for 52% of the economy while the industrial sector's share declined to 40%. On the back of continued economic development, we expect the former to maintain close to 8% y/y expansion over the next two years while the latter's annual output gains are set to decelerate toward 5% by the end of 2019.

The key forces behind China's economic growth deceleration are less fiscal stimulus and weaker credit-fueled investment momentum. In March, the country's legislature announced a reduction in China's 2018 fiscal deficit target to 2.6% of GDP from 3.0% last year, implying that public spending will not contribute to growth as much as before. Meanwhile, Chinese policymakers will continue to focus on gradually deleveraging the domestic economy, which has led to slower growth in fixed capital investment (chart 3). Indeed, the country's credit impulse—the change in new credit issued as % of GDP—has been negative in recent months, which will translate to smaller real GDP gains in the near term. Despite the aforementioned brakes in China's economic momentum, household spending growth will remain robust on the back of rising incomes and an expanding middle class. Indeed, the economy is shifting away from the investment-driven growth model to one powered by the consumer.

Solid global demand is supporting Chinese exporters and the overall growth outlook. Favourable external sector performance is providing Chinese policymakers with elbow room to focus on addressing domestic imbalances—such as excess credit growth—without real GDP growth slowing dramatically. However, we acknowledge the downside risk to economic growth stemming from ongoing trade tensions between the US and China. Following the implementation of tariffs on imported steel and aluminum—and the Chinese retaliation—the US administration has indicated that it is considering adding 25% duties on up to USD150 bn worth of imports from China. Should such tariffs be truly applied, they would affect a third of all Chinese shipments to the US (and 6.2% of China's global exports). Nevertheless, the relative impact on the US would be more significant if China retaliated in kind: an implementation of additional levies on USD150 bn worth of US exports to China would virtually cover all US merchandise sales to China—which totalled USD155 bn in 2017—and 10% of the US's global exports. With its centrally-planned economy, China could retaliate in other ways as well, including via foreign exchange intervention, SOE guidelines for doing business with US companies, or additional direct regulations for American firms operating in China. Given that there are no winners in a trade war, we assess that policymakers on both sides will have a strong incentive for solving the trade dispute through dialogue over the coming months.

INFLATION AND MONETARY POLICY OUTLOOK

The People's Bank of China (PBoC) has a new leader; former Vice Governor Yi Gang replaced retiring Governor Zhou Xiaochuan in March. Governor Yi is known as a proponent of the PBoC's efforts to reduce financial risks; accordingly, monetary policy continuity and sustained deleveraging efforts can be expected. Since taking office, Governor Yi has re-emphasized that the central bank's monetary policy stance will remain "prudent and neutral". The PBoC will avoid any sudden changes in monetary conditions, intending to maintain a favourable and stable financial environment that will allow Chinese authorities to push ahead with structural reforms. Indeed, Governor Yi has promised a further opening of the financial sector.

China's consumer price inflation jumped in early 2018 (chart 4) reflecting the changing timing of the Chinese New Year, but has since eased to slightly above 2% y/y. We expect inflation to close the year at 2½% y/y. The PBoC is expected to leave the official benchmark one-year loan and deposit rates unchanged in 2018 (at 4.35% and 1.50%, respectively), though the central bank will likely continue to raise the 7-day reverse repo rate—the PBoC's de-facto policy rate—cautiously over the coming months. The most recent hike of 5 basis points to 2.55% took place in March following the US Federal Reserve's policy rate increase. Despite gradual tightening, China's monetary conditions are set to remain relatively loose and growth-supportive overall through 2018.

Chart 3

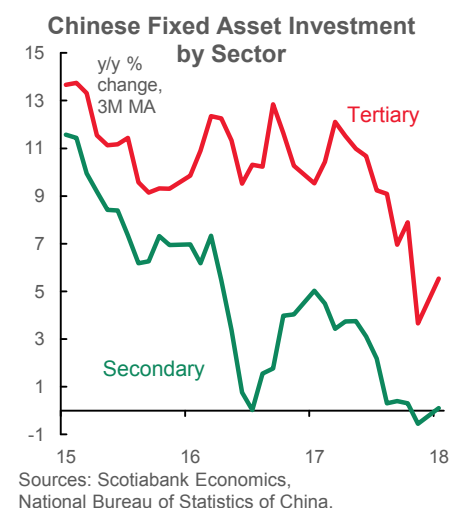
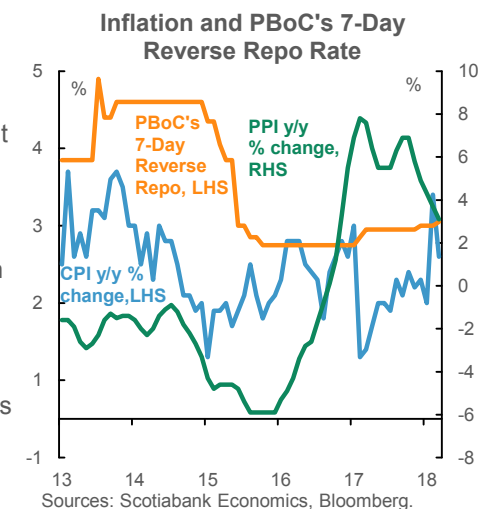


Chart 4



Japan

- Japan is enjoying broad-based economic growth momentum.
- Absent wage gains will keep inflation low and monetary policy loose.

ECONOMIC GROWTH OUTLOOK

The Japanese economy is performing strongly by historical standards. Real GDP grew by 1.7% in 2017, buttressed by both domestic and external demand. In 2018–19, further labour market tightness (chart 1) will support consumer spending even though real wages have failed to nudge higher (chart 2). Meanwhile, output will be bolstered by growth-oriented fiscal policies and companies' healthy balance sheets that lift business investment prospects. The main downside risk to Japan's outlook is a further escalation of US-initiated trade tensions. Japan is the US's ally, yet it is not exempt from the US import tariffs on steel and aluminum. Moreover, Japan is deeply integrated into Asian supply chains—more than half of its exports consist of intermediates—hence it is also indirectly exposed to the US–China tensions. China and the US are Japan's most important export markets, together purchasing around 40% of the nation's shipments abroad, equivalent to almost 6% of Japanese GDP. While we continue to monitor the trade-related risks, we expect the country's real GDP to expand by 1.3% in 2018, faster than its potential. In 2019, growth will decelerate to a more sustainable level of 0.9% y/y reflecting cyclical factors and the scheduled consumption tax rate increase in October 2019.

INFLATION AND MONETARY POLICY OUTLOOK

Japanese headline inflation has been on the rise in recent months, reaching 1.5% y/y in February. The pickup has been driven by higher food and fuel prices. The CPI excluding fresh food—the Bank of Japan's (BoJ) preferred measure—is currently at 1.0% y/y (chart 2) while the measure that leaves out both food and fuel remains low at 0.5% y/y, highlighting the absence of demand-driven inflation. We estimate that headline inflation will peak near the current level, before base effects will bring the rate lower in the second half of 2018. The recent strength of the Japanese yen is creating further headwinds for the inflation outlook. Hence, the BoJ's goal of reaching 2% y/y inflation in a sustainable manner is not expected to be met in 2018 unless wage gains—or global energy prices—pick up in a more notable fashion. We forecast the headline rate to close 2018 at 1.1% y/y. The hike in the consumption tax rate will temporarily take inflation above 2% in late 2019.

The BoJ will likely continue its “Quantitative and Qualitative Monetary Easing with Yield Curve Control” through 2019. Governor Kuroda had stated that the BoJ will start talking about policy exit in FY2019 (April 2019–March 2020), given that it forecasts inflation to reach the 2% target during that fiscal year. However, we note that a discussion regarding an exit may not result in actual policy tightening. Two factors underpin our view: 1) the consumption tax rate hike (from 8% to 10%) is planned for late-2019 and it will be the key reason for inflation reaching the 2% target—instead of stronger demand-driven price pressures; and 2) consumption will likely be severely hit by the rate hike, in line with developments in 2014 when the tax rate was raised from 5% to 8% and the economy dipped into a brief recession. Recessionary conditions do not form an environment where the BoJ would be tightening monetary policy.

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Japan	2017	2018f	2019f
Real GDP (annual % change)	1.7	1.3	0.9
CPI (y/y %, eop)	1.0	1.1	2.3
Central bank policy rate (% eop)	-0.10	-0.10	-0.10
Japanese yen (USDJPY, eop)	113	110	105

Source: Scotiabank Economics.

Chart 1

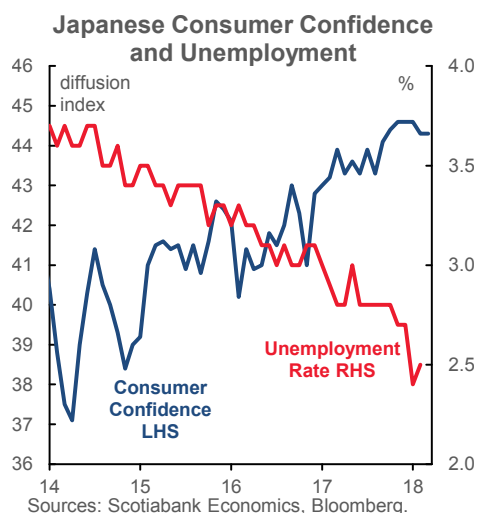
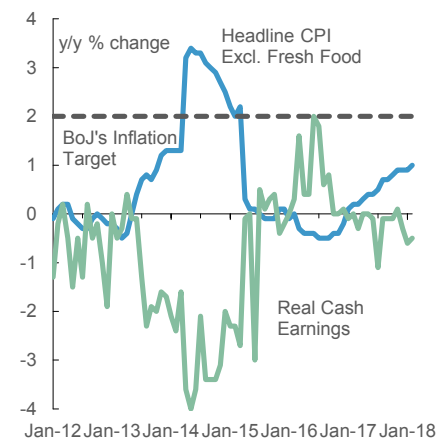


Chart 2

Japan's Inflation and Wage Dynamics



India

- Economic momentum driven by strengthening domestic demand.
- Monetary policy to stay unchanged in 2018 with inflation within target.

ECONOMIC GROWTH OUTLOOK

The Indian economy is on the mend and it has emerged as the regional growth outperformer. Output grew by 7.2% y/y in the fourth quarter of 2017 following an average gain of 6.1% y/y in the first three quarters of the year (chart 1). Domestic demand is—and will continue to be—the key driver of activity. Meanwhile, the fact that the Indian economy is less export-oriented than its regional peers is sheltering it from rising US protectionism. We forecast India's real GDP to grow by 7½% y/y over the next two years following a 6.4% advance in 2017.

We assess that strengthening business conditions in India will support better income and employment prospects, underpinning household sentiment and spending over the coming quarters. Meanwhile, the country's fiscal policy stance remains growth-supportive with a focus on the rural economy and infrastructure. Indeed, some fiscal slippage is evident in the Union Budget for FY2018–19 (April–March), ahead of Indian general elections in 2019.

The Indian economy is well-positioned to benefit from the medium- to longer-term impacts of recently implemented reforms after the short-term adverse effects dissipate further. A tax reform, a new bankruptcy code, bank recapitalization, and efforts to formalize the economy are examples of the government's drive to improve the country's business environment. We assess that such efforts will translate to a sustained pick-up in fixed investment, improving the country's GDP growth prospects. Nevertheless, downside risks to the economy's outlook also lie within the realm of investment; the confidence shock stemming from recently discovered fraudulence in the public sector banking system may result in weaker credit growth, potentially constraining fixed capital formation.

INFLATION AND MONETARY POLICY OUTLOOK

The Reserve Bank of India's (RBI) monetary policy stance will remain growth-supportive over the coming quarters; we expect the benchmark repurchase rate to be left unchanged at 6.0% through 2018 with a cautious tightening cycle likely to begin in the first quarter of 2019 (chart 2). India's headline inflation is currently hovering near 4½% y/y, while core inflation is stronger at slightly above 5% y/y; increasing housing costs are the key driver of core inflation, reflecting the impact of higher housing rent allowances given to government employees. We estimate that headline inflation will pick up slightly over the coming months—peaking at 5.8% in June 2018—before easing to 4.6% y/y by year-end. The RBI's Monetary Policy Committee has recently turned slightly more hawkish, highlighting various upside risks to inflation. While we acknowledge such risks—e.g. price pressures resulting from fiscal slippage or potentially higher food costs should rainfall during the approaching southwest monsoon (June–September) be below normal—we forecast India's headline inflation to remain within the RBI's medium-term target of 4% ±2% y/y through our forecast horizon.

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India	2017	2018f	2019f
Real GDP (annual % change)	6.4	7.4	7.5
CPI (y/y %, eop)	5.2	4.6	5.7
Central bank policy rate (% , eop)	6.00	6.00	6.50
Indian rupee (USDINR, eop)	63.9	64.0	63.0

Source: Scotiabank Economics.

Chart 1

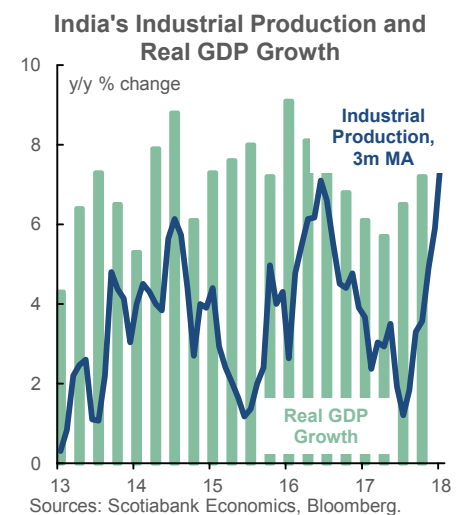
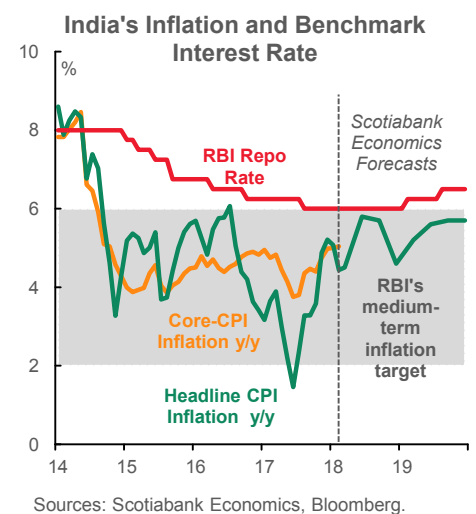


Chart 2



South Korea

- **Global trade tensions cloud the South Korean outlook, yet domestic demand remains solid.**
- **Further cautious monetary tightening in sight on the back of gradually accelerating inflation.**

ECONOMIC GROWTH OUTLOOK

Rising trade protectionism globally represents the main downside risk for the export-oriented South Korean economy, which is benefiting from robust global demand, particularly for semiconductors. The nation's exports were up by more than 14% y/y (in USD terms) over the past 12 months. Encouragingly, near-term uncertainties have eased somewhat as trade negotiators from the US and South Korea have agreed on the latter nation's exemption from US steel import tariffs as well as on an amendment of the KORUS FTA, the bilateral free trade agreement between the two countries. Over 13% of South Korea's goods exports are shipped to the US, equivalent to more than 5% of the country's GDP. In addition to the direct exposure to US demand, South Korean exports are tightly integrated into the global supply chains—including those with China and NAFTA—and they would be adversely affected should global trade tensions spread or intensify.

South Korean business confidence indicators remain robust, at least for the time being, despite elevated trade-related risks. Indeed, the economy is performing well with activity driven by domestic demand—consumer spending, fixed investment, and public spending. Rising incomes and sound consumer confidence point to maintained household spending growth over the coming quarters. Meanwhile, accommodative monetary conditions—despite gradual normalization—will underpin investment, which has been robust especially in the IT sector. Additionally, the government's 2018 budget maintains a supportive fiscal policy stance. We expect the nation's output to rise by around 2.8% y/y in 2018–19 following a 3.1% expansion in 2017 (chart 1).

INFLATION AND MONETARY POLICY OUTLOOK

The Bank of Korea (BoK) will take a cautious approach to monetary tightening over the coming quarters as external risks—related to trade protectionism, geopolitics, and monetary policy changes in major economies—persist. The 7-Day Repo Rate was raised by 25 basis points (bps) to 1.50% in November 2017, marking the BoK's first rate hike in over six years. However, with domestic demand showing signs of strength, the economy's output gap having turned positive and inflationary pressures building, further gradual monetary tightening is in store.

South Korea's headline inflation is expected to climb gradually from the current level of 1½ y/y (chart 2) on the back of strong domestic demand. We expect it to reach the BoK's 2% inflation target in the second half of 2018. The rising inflation trajectory combined with the fact that BoK Governor Lee has been reappointed for a second term—which implies continuity of a cautious policy tightening bias—will likely prompt the BoK to raise the benchmark rate by 25 bps to 1.75% relatively soon, most likely in the third quarter of 2018.

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South Korea	2017	2018f	2019f
Real GDP (annual % change)	3.1	2.8	2.8
CPI (y/y %, eop)	1.5	2.1	2.5
Central bank policy rate (% , eop)	1.50	2.00	2.25
South Korean won (USDKRW, eop)	1,067	1,040	1,020

Source: Scotiabank Economics.

Chart 1

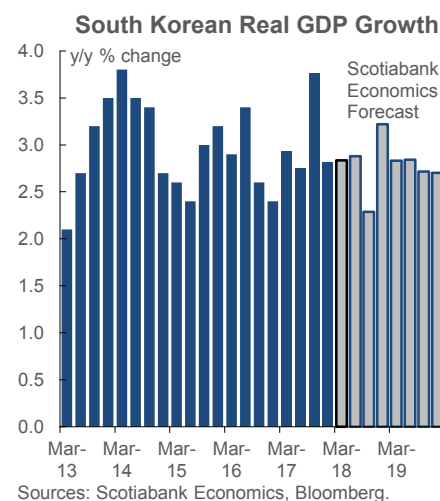
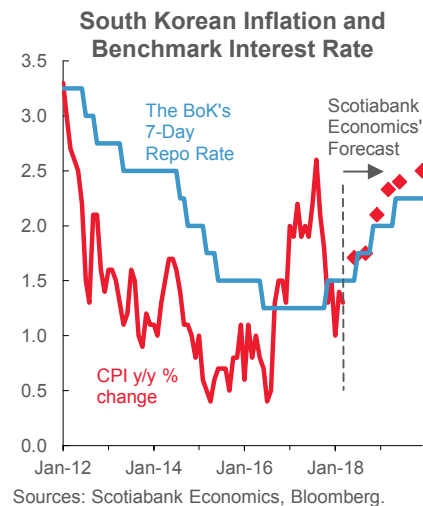


Chart 2



Australia

- **Australia's domestic demand will be supported by rising non-mining investment, particularly infrastructure.**
- **The divergent trends of rising protectionism in the US and deeper regional integration will shape Australia's external sector outlook.**
- **Solid employment gains will eventually translate to higher wages and modest inflationary pressures, prompting the RBA to start tightening monetary policy towards the end of the year.**

ECONOMIC GROWTH OUTLOOK

The Australian economy's prospects are sound for 2018–19. We expect the country's real GDP growth to average 2.6% y/y over the next two years, roughly in line with the nation's potential (chart 1). In 2017 as a whole, the economy expanded by 2.3%. On the domestic side of the economy, business activity and consumer confidence indicators are solid (chart 2), pointing to continued employment gains, business investment, and consumer spending. Public infrastructure investment projects will provide support to growth momentum while they further improve the economy's productivity and longer-term outlook.

The outlook for the external side of the Australian economy will be impacted by two prevalent trends in world trade: 1) rising protectionism in the US and 2) further integration efforts in the rest of the world. As for the former, Australia is not a major exporter of steel into the US yet it is currently exempt from the US steel import tariffs imposed on March 23. Nevertheless, Australia is an important exporter of iron ore—a key steel-making ingredient—to China, whose export products will be facing higher US duties. Nevertheless, given that around 85% of China's steel production is consumed domestically, e.g. in real estate and infrastructure, the secondary impact on Australia stemming from the US tariffs will likely be relatively small. The main impact on the Australian economy from an escalation in global trade frictions will likely come through financial markets and Australia's terms of trade as commodity prices and the Australian dollar react to protectionist policies. While we expect the prices of iron ore and coal to decline over our forecast horizon, higher resource export volumes will provide the economy some counterbalance.

As for the second trend in world trade—deeper integration—Australia will feel the impact of shifting global economic power from West to East as the US turns inwards and Asia-Pacific continues to promote freer international trade. Australia is part of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which was signed by the 11 participating countries in early March and is awaiting ratification by its members. Following the US withdrawal from the original pact, Australia was a strong supporter of reviving the agreement. Additionally, the country is part of the Regional Comprehensive Economic Partnership (RCEP), which includes ten Southeast Asian nations (that are part of the ASEAN), as well as China, Japan, India, South Korea, and New Zealand. The RCEP has yet to be signed. Given that Asia will continue to be the global

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Australia	2017	2018f	2019f
Real GDP (annual % change)	2.3	2.6	2.5
CPI (y/y % eop)	1.9	2.2	2.6
Central bank policy rate (% eop)	1.50	1.75	2.25
Australian dollar (AUDUSD, eop)	0.78	0.80	0.82

Source: Scotiabank Economics.

Chart 1

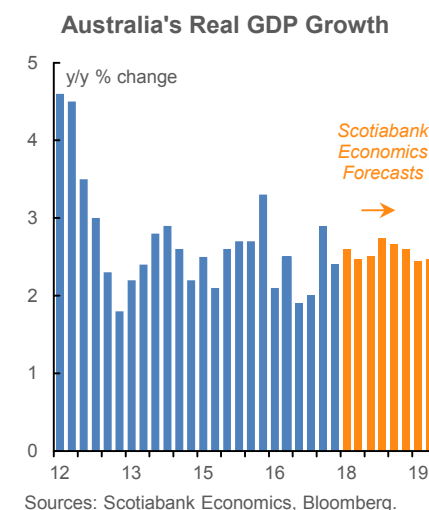
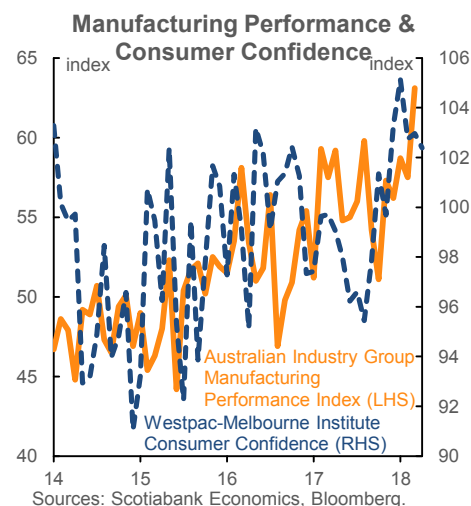


Chart 2



economic growth outperformer for years to come, we believe that deeper Asian integration will benefit the Australian economy over the coming years.

INFLATION AND MONETARY POLICY OUTLOOK

Australian monetary conditions are expected to remain growth-supportive over the coming quarters. Following the Reserve Bank of Australia's (RBA) April 3 monetary policy meeting, the Cash Rate Target was left at 1.50%. The RBA's policymakers expect that headline inflation will accelerate gradually over the course of 2018 to slightly above 2% y/y; inflation picked up a notch to 1.9% y/y in the fourth quarter of 2017 from 1.8% in the third quarter. The RBA's authorities also assess that tighter credit conditions and recently implemented supervisory measures have eased the build-up of risks related to the housing market and households' financial vulnerabilities.

We maintain our forecast that the RBA will likely begin a cautious monetary normalization phase in the final quarter of 2018 on the back of expected gradual strengthening in wage pressures that will feed demand-driven inflation. Moreover, movements in commodity prices—particularly that of iron ore following the US steel tariff announcement—and their impact on the Australian dollar will influence Australia's inflationary developments over the coming quarters. While we estimate that price pressures will intensify somewhat, the inflation rate will likely hover below the mid-point of the RBA's 2–3% target range through 2018. Price gains will likely strengthen in 2019, reaching 2½% y/y by the end of the year (chart 3).

Australian wage inflation remains subdued; wages rose by 2.1% y/y in nominal terms in the fourth quarter of 2017, barely exceeding the nation's inflation rate. While we continue to monitor employment developments closely—and their impact on wages—over the coming months, we assess the Australian labour market is showing notable signs of strength. Full-time job gains over the preceding 12-month period exceeded 25,000 each month between September 2017 and February 2018 (chart 4), an advance that Australia has not witnessed since the beginning of the data series in 1978. Surveys on companies' hiring intentions and job advertisements point to further solid employment gains over the coming months, which should feed modest wage pressures in the economy.

Chart 3

Australia's Headline Inflation, Wage Inflation & Policy Interest Rate

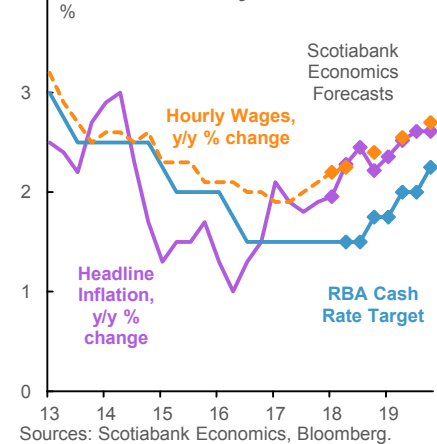


Chart 4

Full-Time Employment Change in Australia



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