China

- **The US-China trade conflict clouds the economic outlook, but we are not yet marking down our growth forecasts.**
- **Monetary authorities try to find a balance between deleveraging and growth-supportive policies.**
- **Significant structural changes are advancing, driven by government-orchestrated policies.**

ECONOMIC GROWTH OUTLOOK

China's economic outlook continues to be reasonably encouraging; while the country's real GDP growth will likely decelerate to more sustainable levels, it will remain solid by emerging market standards. Simultaneously, the economy's structural transition will proceed from investment- and industrial-sector-focused activity to being driven by the consumer and the services sector. Accordingly, growth in fixed asset investment continues to slow (chart 1), maintaining the trend of recent years. Meanwhile, an expanding middle class and rising incomes—Chinese nationwide nominal wages rose by 9.0% y/y in the first quarter of 2018 (chart 2)—will underpin household spending growth. Furthermore, sound labour market conditions—the unemployment rate is currently at 3.86% (chart 2)—and contained inflation are underpinning disposable incomes. We expect Chinese output to grow by 6.6% y/y this year, followed by a 6.3% gain in 2019 (chart 3).

A further escalation of the trade dispute between the US and China is one of the key downside risks to China's economic growth outlook. Indeed, the US is China's main export destination, purchasing 21% of Chinese goods shipments abroad. Trade will remain a key contributor to growth given that the country's exports of goods and services are equivalent to 20% of GDP. Nevertheless, the external sector's importance to the economy has diminished markedly in recent years; in 2006 exports amounted to almost 40% of GDP. Trade tensions between the US and China have intensified once again following the US administration's announcement that it will move ahead with imposing tariffs on roughly US$250 billion worth of imports from China. If implemented, these tariffs will likely lead to retaliation by China followed by another response from the US. While tariffs on imports and exports will harm the Chinese economy, the country's policymakers likely have more ability to manage the economic impacts of these tariffs than do US policymakers. We will update our forecasts for China as the dimensions of the trade tensions become more clear.

INFLATION AND MONETARY POLICY OUTLOOK

China's inflation outlook continues to be manageable. Consumer prices are currently rising by 1.8% y/y (chart 4). We expect inflation to accelerate slightly in the second half of 2018—driven by higher transport prices—and close the year at 2.1% y/y. Somewhat stronger price gains are expected to materialize over the course of 2019, taking the headline inflation rate to 2½% y/y.

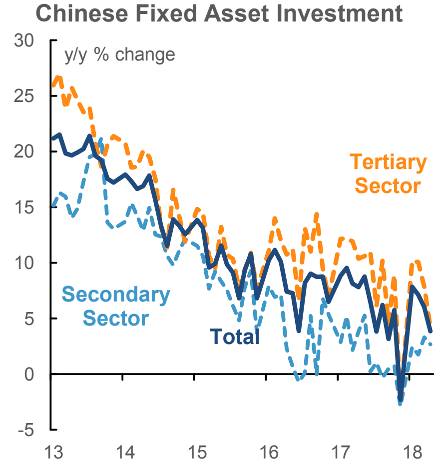
CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

China	2017	2018f	2019f
Real GDP (annual % change)	6.9	6.6	6.3
CPI (y/y %, eop)	1.8	2.1	2.5
Central bank policy rate (%, eop)	4.35	4.35	4.85
Chinese yuan (USDCNY, eop)	6.51	6.45	6.30

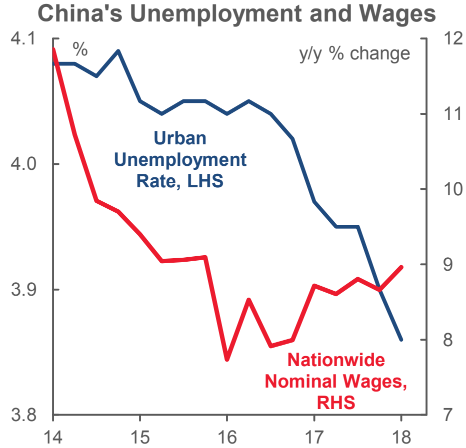
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, National Bureau of Statistics of China.

Chart 2



Sources: Scotiabank Economics, National Bureau of Statistics of China, Bloomberg.

Monetary conditions will remain accommodative in China over the coming quarters in order to support output growth while the country's authorities continue to focus on deleveraging and containing financial risks in the economy. Balancing these objectives will drive monetary policy actions by the People's Bank of China (PBoC). The central bank will likely continue to raise interest rates on its open market operations; the 7-day reverse repo rate (the PBoC's de-facto policy rate) has been raised several times since early 2017 (chart 4) with the most recent hike in March 2018. Simultaneously, the PBoC will continue to provide the financial system with ample liquidity; we expect further reductions in the reserve requirement ratios over the coming quarters following the most recent cut announced at the end of June.

The Chinese administration continues to address systemic risks stemming from the rapid increase in corporate debt over recent years. Accordingly, credit growth has recently decelerated toward more sustainable levels (chart 5). Particular efforts have been directed to curbing shadow banking activity while ensuring that sectors with favourable growth prospects will continue to have access to funding. Aggregate financing—which includes the less-transparent credit products—has declined by 15% y/y over the past six months. However, the deleveraging process has not been without its challenges: following a series of corporate defaults, the PBoC extended the implementation period for tighter rules on asset management business until end-2020 (from mid-2019) in order to better manage the potentially tumultuous transition. We assess that repricing of risk will continue in China in the foreseeable future as implicit guarantees are gradually eliminated and the financial system adopts an appropriate risk management framework. Bouts of volatility during this process can be expected.

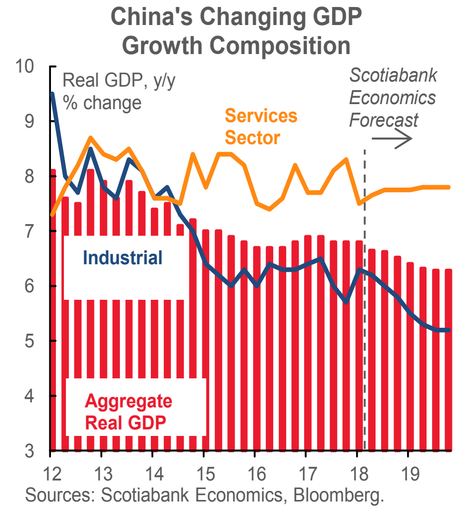
POLICY OUTLOOK

The Chinese economy is in the midst of massive structural changes, which are orchestrated by synchronized government policies. The "Made in China 2025" industrial strategy has recently drawn attention in the US given the plan's aim to form China into a high-technology powerhouse like Germany, the US, and Japan. While being contentious in the US, the plan is sensible from China's economic development point of view; reflecting the fact that Chinese wages have been rising fast in recent years and manufacturers of low-value-added goods are finding it harder to compete globally, the "Made in China 2025" strategy aims to move the economy up in the manufacturing value chain, thereby helping China escape the middle-income trap.

Another policy priority for the Chinese government is the Belt and Road Initiative, a massive infrastructure development plan that will connect Eurasian countries by land and sea. The initiative will help China to address its domestic industrial overcapacity through capacity cooperation with central Asian countries, thereby underpinning the "Made in China 2025" strategy's value-chain climb. At the same time, the Belt and Road plan will increase China's economic, financial, and political power within the region as well as globally.

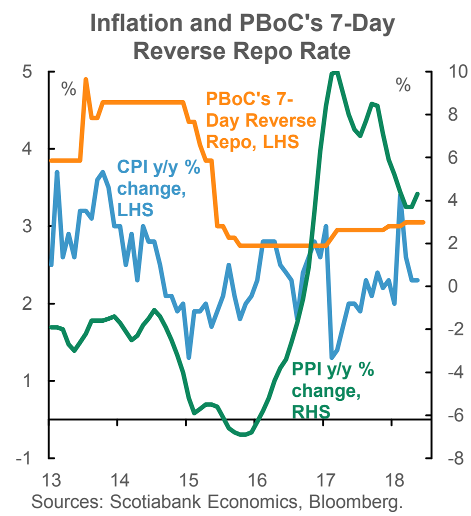
Financial liberalization represents another key policy focus area and is closely connected to the two other strategies. For instance, a gradual opening of China's capital account will promote investment flows that can transfer technology and know-how to support the "Made in China 2025" strategy, while the Belt and Road Initiative will advance the internalization of the renminbi. We expect further reform steps regarding capital account liberalization to be unveiled in the near future, integrating China more deeply into the global economy and capital markets.

Chart 3



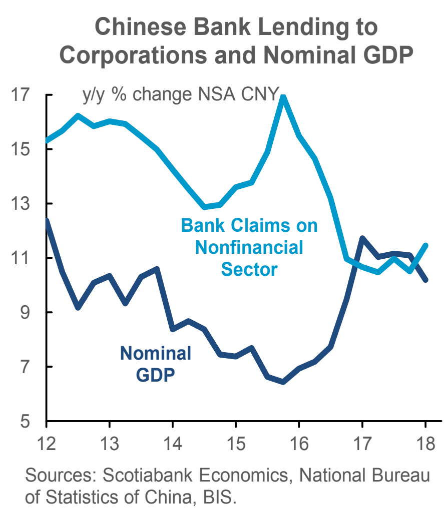
Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, National Bureau of Statistics of China, BIS.

Japan

- **The Japanese economy is approaching sustainable levels of expansion, with real GDP growth near potential through 2019.**
- **Persistently muted inflationary pressures will keep accommodative monetary policies in place in the foreseeable future.**

ECONOMIC GROWTH OUTLOOK

Japan's economic growth momentum is showing signs of softening after a period of rapid (by Japanese standards) gains (chart 1). Real GDP contracted by 0.2% q/q in the January–March period, marking the first quarterly decline since the final quarter of 2015. In year-over-year terms, output increased by 1.1% following an average gain of 1.7% y/y in 2017. While we do not expect the economy to dip into recession—i.e. to record a second consecutive quarterly contraction in output—the pace will likely continue to converge toward more sustainable rates. The Bank of Japan (BoJ) estimates that the economy's current potential growth rate is 0.9% y/y and that its output gap has been positive since the end of 2016.

We believe that robust global activity will support the export-oriented Japanese economy over the coming quarters despite persistent trade-related uncertainties that warrant close monitoring. Japan's stronger employment conditions are expected to underpin household spending prospects, though the tighter labour market has yet to push wages higher in a notable fashion. Fixed investment growth should find support from corporations' healthy balance sheets and growth-oriented fiscal and monetary policies. We expect Japanese real GDP growth to average 1.0% y/y in 2018–2019, virtually in line with the economy's potential.

INFLATION AND MONETARY POLICY OUTLOOK

Japan continues to struggle with meeting the BoJ's inflation target of 2% y/y. Headline inflation rate has dropped back to 0.7% y/y from the recent peak of 1.5% y/y recorded in February. The CPI excluding fresh food—the BoJ's preferred measure—is currently at 0.7% y/y (chart 2) while the measure that leaves out both food and fuel remains low at 0.3% y/y, highlighting the absence of demand-driven inflation. We estimate that headline inflation will barely reach 1% y/y by the end of this year. The planned hike in the consumption tax rate from 8% to 10% in October 2019 will take inflation above the 2% mark in late 2019, yet the uptick will be temporary, similar to the development in 2014 when the tax rate was raised from 5% to 8%. The key factor impacting future demand-driven price pressures is wage inflation; nevertheless, with real wages remaining stagnant, the likelihood of inflation reaching the target in a sustainable fashion is rather small.

Recent soft GDP and inflation data suggest that the BoJ will not be normalizing monetary policy any time soon. With Haruhiko Kuroda continuing as the BoJ's Governor for the next five years, we expect the central bank to maintain the current policy stance of "Quantitative and Qualitative Monetary Easing with Yield Curve Control" through 2019. The BoJ's monetary authorities recognize that "there is still a long way to go" before inflation will reach the target, making it appropriate to "pursue powerful monetary easing with persistence".

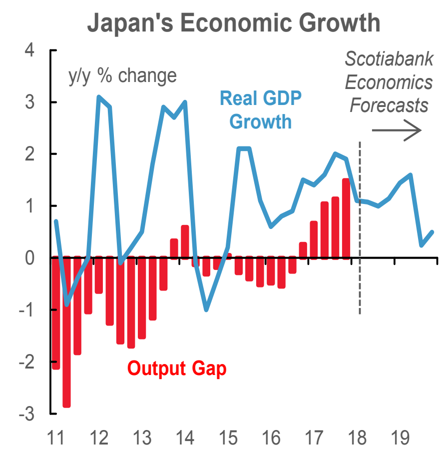
CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

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

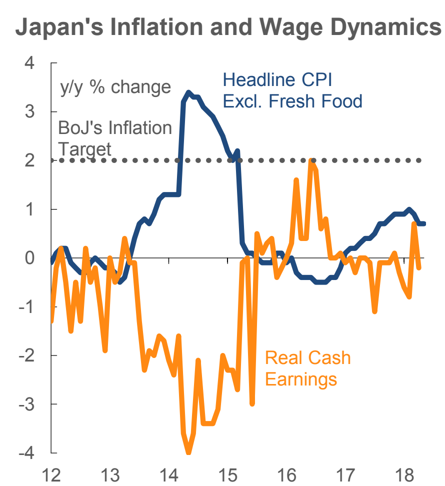
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bank of Japan, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **Favourable growth traction in India, reflecting solid domestic demand.**
- **Monetary tightening under way due to intensifying inflation.**

ECONOMIC GROWTH OUTLOOK

The Indian economy's growth signals are robust after a period of subdued performance in recent quarters. First quarter real GDP growth was solid at 7.7% y/y following a 7.0% gain in the final three months of 2017 (chart1). A pick-up in credit expansion is mirrored in reviving investment activity. Consumer spending prospects should get support from the expected normal rainfall during the southwest monsoon that will boost the large agricultural sector's output and rural incomes as well as from employment gains that reflect solid business conditions and industrial sector momentum. In addition, the nation's fiscal policy stance remains growth-supportive with a focus on the rural economy and infrastructure. Given favourable growth traction, Indian monetary authorities estimate that the country's output gap has nearly closed. In our view, the economy's growth outlook is rather encouraging on the back of improved fundamentals, implemented reforms, and favourable demographics. We forecast that the nation's real GDP will grow by 7½% y/y over the next two years following a 6.3% advance in 2017.

INFLATION AND MONETARY POLICY OUTLOOK

A monetary tightening phase has commenced in India following the Reserve Bank of India's (RBI) bi-monthly policy meeting on June 4–6. The benchmark repo and reverse repo rates were raised by 25 basis points to 6.25% and 6.00%, marking the first hike since January 2014. Given that the Indian economy is at the early stages of recovery following disruptive reform implementations over the past year and a half, the RBI will likely tighten monetary policy cautiously. We expect the next interest rate hike to take place in the fourth quarter of 2018 (chart 2).

The key reason behind the RBI's rate hike decision was India's worsening inflation outlook. Headline inflation picked up to 4.9% y/y in May from 4.6% a month earlier, continuing to hover above the midpoint of the central bank's medium-term target of 4% ±2% y/y. We estimate that headline inflation will pick up further in the near term before easing to 4⅔% by year-end. In recent months, monetary authorities have shown particular concern about the upward trajectory of core inflation. Following the June monetary policy meeting, they pointed out that core inflation has seen "an abrupt acceleration", which suggests "a hardening of underlying inflationary pressures". Indeed, annual core inflation has accelerated more notably than the headline print, reaching the 6% mark in May. Increasing housing rental prices, which reflect the impact of higher housing rent allowances given to government employees, and miscellaneous costs (such as household goods, health, transport, education, and personal care) are the key drivers of core inflation. We assess that the RBI's gradual monetary tightening will help limit future demand-driven price pressures, keeping inflation within the RBI's target through 2019. Moreover, we believe that the decisive action will strengthen the RBI's policy credibility regarding its inflation-targeting monetary policy framework, thereby strengthening investor sentiment toward Indian assets.

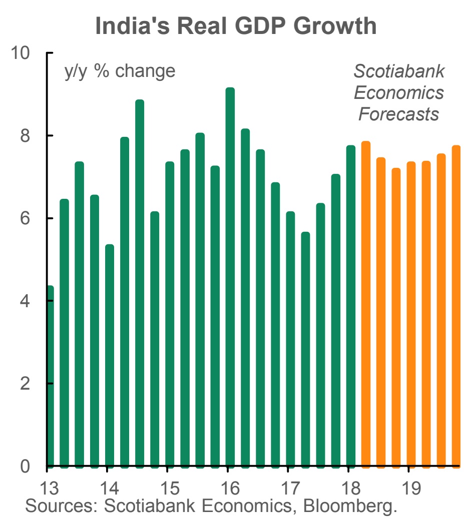
CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

India	2017	2018f	2019f
Real GDP (annual % change)	6.3	7.5	7.5
CPI (y/y %, eop)	5.2	4.6	5.6
Central bank policy rate (%, eop)	6.00	6.50	6.50
Indian rupee (USDINR, eop)	63.9	67.0	65.0

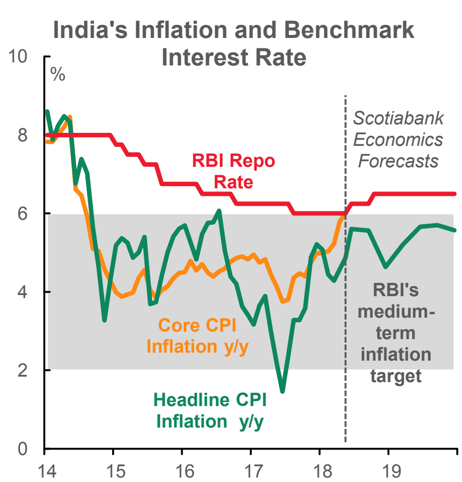
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

South Korea

- **Solid domestic demand continues to propel the economy.**
- **Cautious monetary normalization will continue as inflation picks up.**

ECONOMIC GROWTH OUTLOOK

The South Korean economy continues to perform well on the back of solid domestic demand—consumer spending, fixed investment, and public spending. While consumer sentiment remains reasonably sound, recent business confidence indicators are showing some signs of softness on the back of ongoing global trade tensions; the purchasing managers' index for the manufacturing sector has been in contractionary territory (below 50) in recent months (chart 1). Given the external sector's importance to the economy, we will carefully monitor global trade developments over the coming months and adjust our forecasts accordingly. The nation's real GDP grew by 2.8% y/y in the first quarter of 2018, in line with the pace recorded in the final quarter of last year. We expect South Korea's output to rise by 2¾% y/y in 2018–19 following a 3.1% expansion in 2017.

South Korea's fiscal policy stance continues to be growth-supportive. Indeed, the parliament passed a US$3.5bn supplementary budget on May 21. President Moon Jae-in's government will direct the additional spending on measures that will reduce youth unemployment; joblessness among young South Koreans remains elevated at around 10%. Despite such accommodative policies, South Korea's government finances are robust, providing the administration room to maneuver should global trade tensions escalate and adversely impact the economy's growth prospects. According to the International Monetary Fund, South Korea's fiscal surplus—general government net lending—will average 2% of GDP in 2018–19. Meanwhile, gross public debt is expected to hover at a relatively low level of 38% of GDP over the next two years.

INFLATION AND MONETARY POLICY OUTLOOK

South Korea's headline inflation is expected to accelerate gradually from the current level of 1½% y/y. We expect the inflation rate to reach the Bank of Korea's (BoK) 2% inflation target in the second half of 2018 (chart 2). Taking a cautious approach to monetary normalization, the BoK has opted to leave the benchmark interest rate unchanged at 1.50% since the most recent hike in November 2017. Reflecting our inflation forecast and the fact that South Korea's output gap has turned positive, we assess that the economy is ready for further cautious monetary tightening by the BoK in the third quarter of the year. Nevertheless, our view is based on the assumption that global trade tensions do not escalate further in the very near term and that the geopolitical situation on the Korean Peninsula continues to stabilize. Indeed, the BoK has stated that it will pay close attention to geopolitical and trade developments when conducting monetary policy. Following the historic summit between the US President Donald Trump and Supreme Leader of North Korea Kim Jong-un—which was held on June 12 in Singapore—we are cautiously optimistic about an improving geopolitical climate as the meeting outcome suggests that eventual denuclearization of the Korean Peninsula is a possibility.

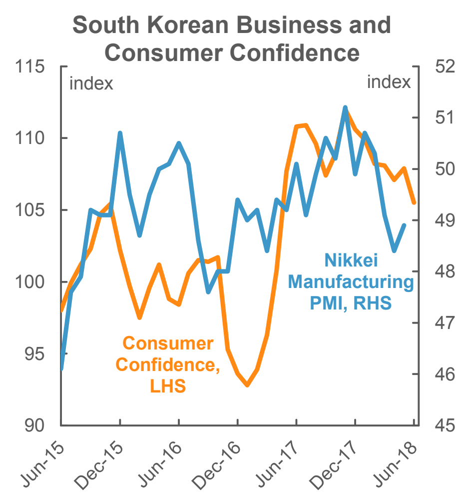
CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

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	1,080	1,060

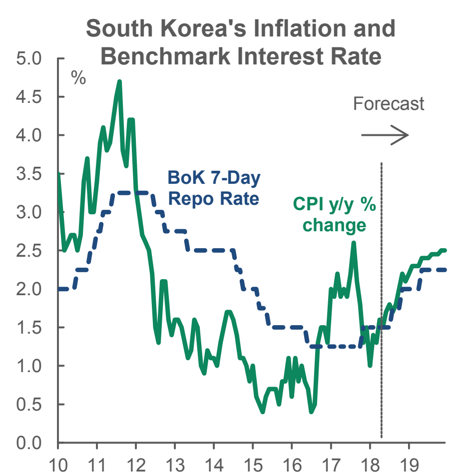
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **Solid domestic demand maintains real GDP growth at potential amid a weaker price outlook for Australia's key commodities.**
- **Fiscal outlook is improving on the back of higher revenues.**
- **Monetary conditions will remain growth-supportive despite gradual tightening.**

ECONOMIC GROWTH OUTLOOK

The Australian economy is performing reasonably well, driven by domestic demand. The country's fixed investment gains are boosted by public infrastructure projects while business confidence remains sound, leading to solid gains in non-mining business investment. Such strong momentum will offset the impact from softer residential investment growth that reflects the ongoing cooling in the housing market (chart 1). The outlook for the Australian consumer is two-fold: strong recent employment gains are supporting confidence yet still-weak wage gains and high household debt levels will limit spending growth. Conditions in the Australian labour market continue to tighten gradually. Following very strong employment gains in 2017, this year started on a somewhat softer note. Regardless, full-time job gains over the June 2017–May 2018 period have averaged 15,000 jobs per month (chart 2). Job advertisements and surveys on companies' hiring intentions point to further above-average employment gains over the coming months, which should feed modest wage pressures in the economy.

The outlook for the external side of the economy is shaped by developments in China and in commodity markets. Despite higher export volumes, net exports will likely not provide a notable contribution to Australia's real GDP growth over the coming quarters. This reflects our expectation for lower prices of iron ore and coal together with slower growth in commodities demand in China. Iron ore and coal make up a third of Australia's total exports; meanwhile, China purchases a third of Australia's total exports and over half of its combined shipments of the two key commodities.

The Australian economy started 2018 with strong momentum. Real GDP grew by 3.1% y/y in the first quarter of 2018 following a 2.4% advance in the final three months of 2017 (chart 3). We estimate that the economy will expand by 2⅔% y/y in 2018–19, virtually in line with the country's potential growth.

FISCAL OUTLOOK

Australia's Treasurer Scott Morrison delivered the Federal Budget for fiscal year 2018–19 (July–June) on May 8, 2018. The country's budget deficit (i.e. the underlying cash balance) is expected to narrow from an estimated AUD18.2bn (1.0% of GDP) in FY2017–18 to AUD14.5bn (0.8% of GDP) in FY2018–19. The government remains committed to returning public finances to a balanced position in FY2019–20 (with the underlying cash balance at +0.1% of GDP) and to a surplus position by FY2020–21 (of 0.5% of GDP). A key measure in the Budget is a seven-

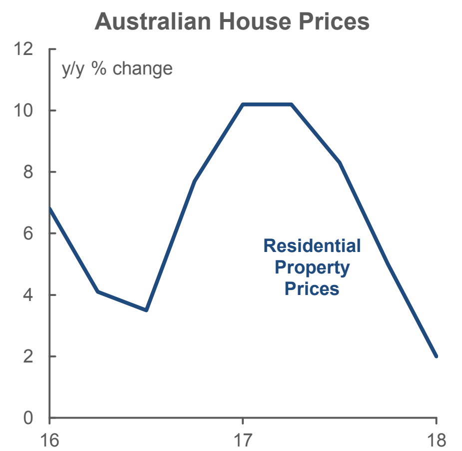
CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Australia	2017	2018f	2019f
Real GDP (annual % change)	2.2	2.8	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	0.73	0.77

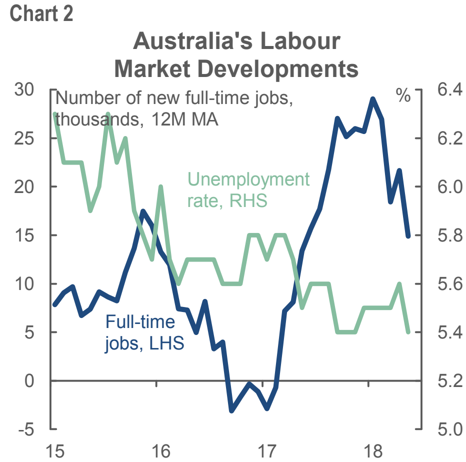
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

year scheme to lower personal income taxes for low- and middle-income earners. Tax cuts are possible partially because of higher income tax collection that reflects rapid employment gains and improved corporate performance. While we assess that Australia's planned fiscal path is favourable, we note that the government's underlying economic forecasts may turn out to be overly optimistic. The budget expects real GDP to grow by 3% y/y through FY2021–22. Moreover, the Treasury expects wage growth to pick up significantly, reaching 3¾% y/y by FY2019–20.

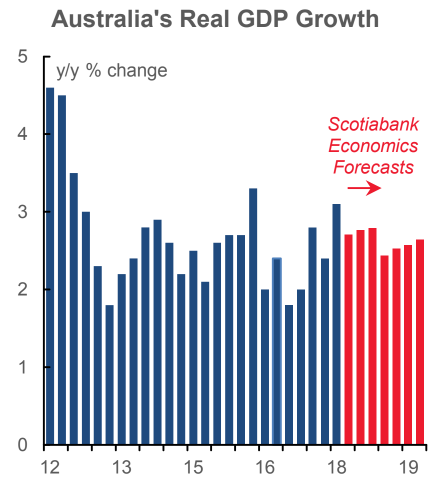
Australia's improved budgetary outlook was welcomed by international credit rating agencies Standard & Poor's and Moody's. The former pointed out that there is now less pressure on Australia's "AAA" sovereign credit rating, yet it maintained a "negative" outlook on the rating due to uncertainties related to global trade tensions and emerging market vulnerabilities. Moody's maintains Australia's triple-A rating with a "stable" outlook.

INFLATION AND MONETARY POLICY OUTLOOK

The Reserve Bank of Australia's (RBA) monetary policy stance will remain accommodative over the coming quarters. The benchmark Cash Rate Target has remained at 1.50% since August 2016. The RBA's policymakers expect that both headline and underlying inflation will accelerate gradually over the course of 2018 to slightly above 2% y/y; the headline inflation measure remained unchanged at 1.9% y/y in the first quarter of 2018 (chart 4). We expect headline inflation to hover below the mid-point of the RBA's 2–3% target range through 2018. Price gains will likely strengthen in 2019, reaching 2⅔% y/y by the end of the year. Wage inflation, at 2.1% y/y in the first quarter, will likely accelerate gradually over the coming quarters. According to the RBA, Australian businesses have reported that labour shortages are limiting output, yet such capacity constraints have yet to filter through to higher wage gains.

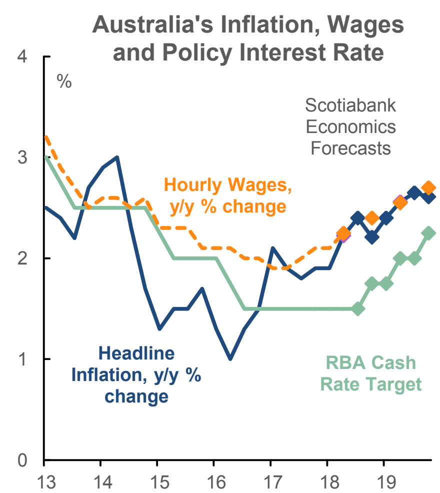
We maintain our forecast that the RBA will join global central banks and begin a cautious monetary normalization phase in the final quarter of 2018 on the back of expected gradual strengthening in wage pressures that will feed demand-driven inflation. Indeed, the RBA's policymakers have recently indicated that it is "more likely that the next move in the cash rate would be up, rather than down". Regardless of modest tightening through 2019, monetary conditions will remain growth-supportive in Australia.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.