Asia Pacific Macro
Are We Rebalancing Yet?

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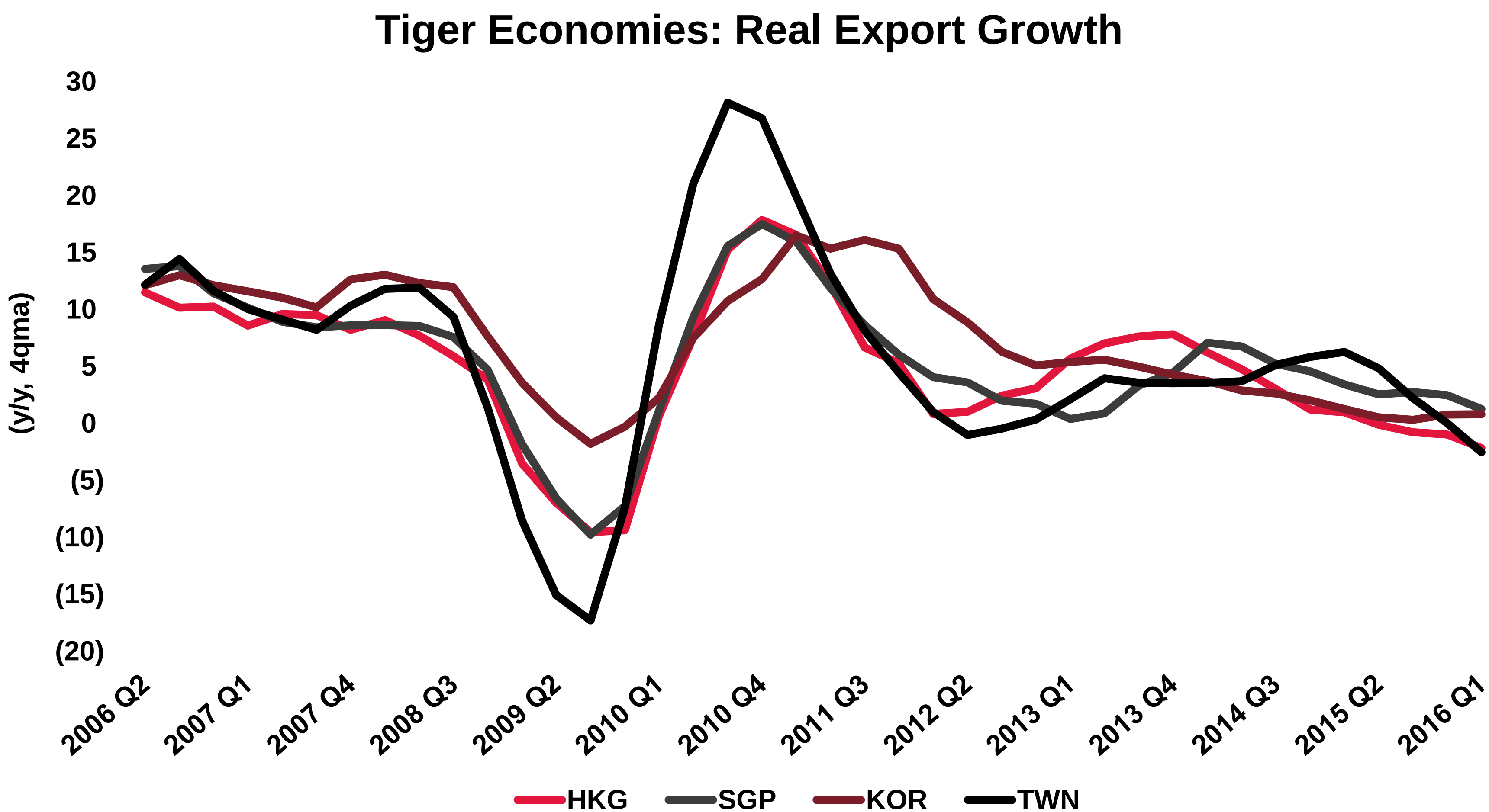
S&P Global

Asia Pacific Macro Narrative
Is Domestic, Credit-Led Growth The Best Path?

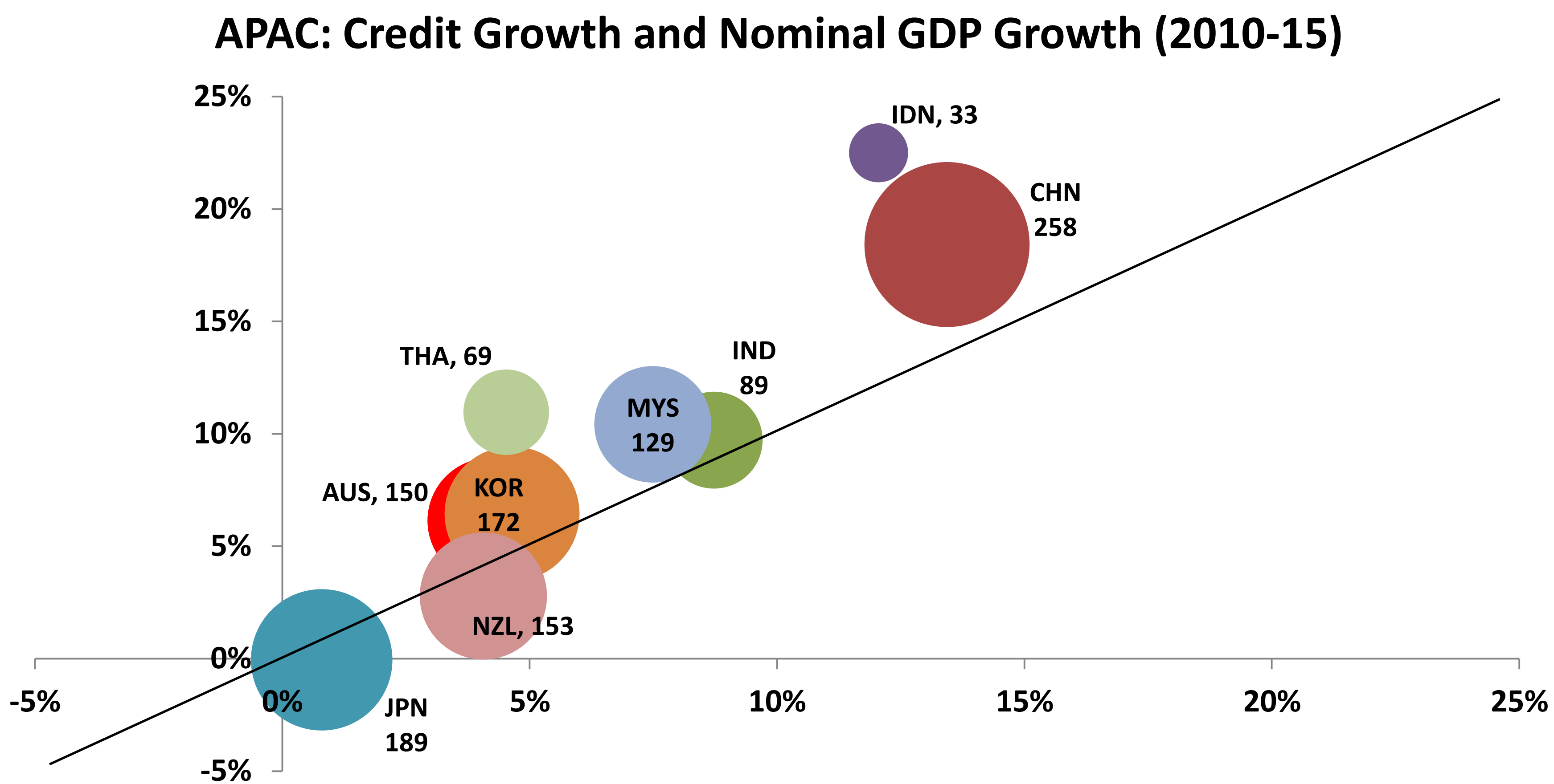
1. **G2 Outlook Remains Sub-Par**
    - US struggles to reach 2% growth, Fed path not clear
    - EU has identity problems, uneven recovery, QE mode
2. **World Trade Remains Weak**
    - Partly due to weak global recovery (cyclical)
    - Partly due to on-shoring by China and the US (structural)
3. **Productivity Growth Remains Weak (less well understood)**
    - Reform efforts have flagged
    - Measurement is tricky
4. **China Is Wobbling**
    - No crisis yet, but we are not comfortable with the macro trajectory
    - Rebalancing is happening and has implications beyond China

Export Growth Remains Sluggish Even In The Dynamic Tiger Economies



Source: Oxford Economics

Credit Growth Has Outpaced Nominal GDP Growth In The Post-Crisis Period



Sources: S&P Global, Bank of International Settlements.

Our Latest GDP Growth Forecasts
India Has Bumped China To Head The Pack

Asia-Pacific Summary Baseline GDP Growth Forecasts

(Annual growth rates in percent)

	2015	2016f	2017f	2018f
Asia Pacific	5.4	5.3	5.3	5.2
Japan	0.6	0.7	0.9	0.5
Emerging Asia	6.2	6.0	5.9	6.0
China	6.9	6.3	6.1	6.0
India	7.6	7.9	8.0	8.1
Tiger Economies	1.9	2.2	2.5	2.8
ASEAN	4.6	4.8	4.9	5.2

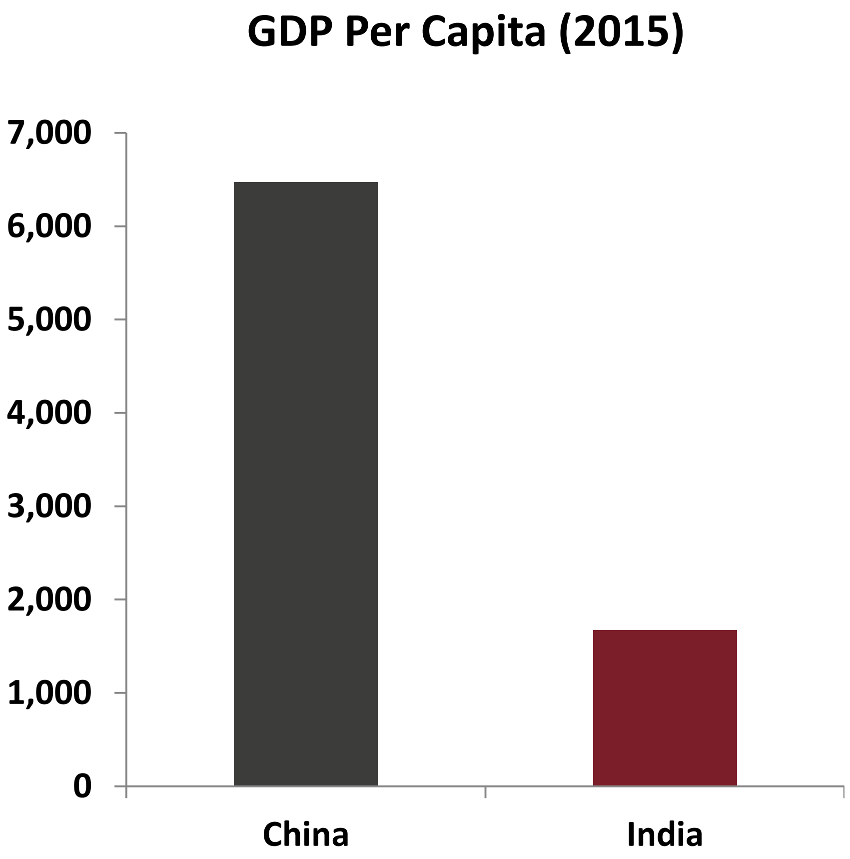
Source: S&P Economics,.

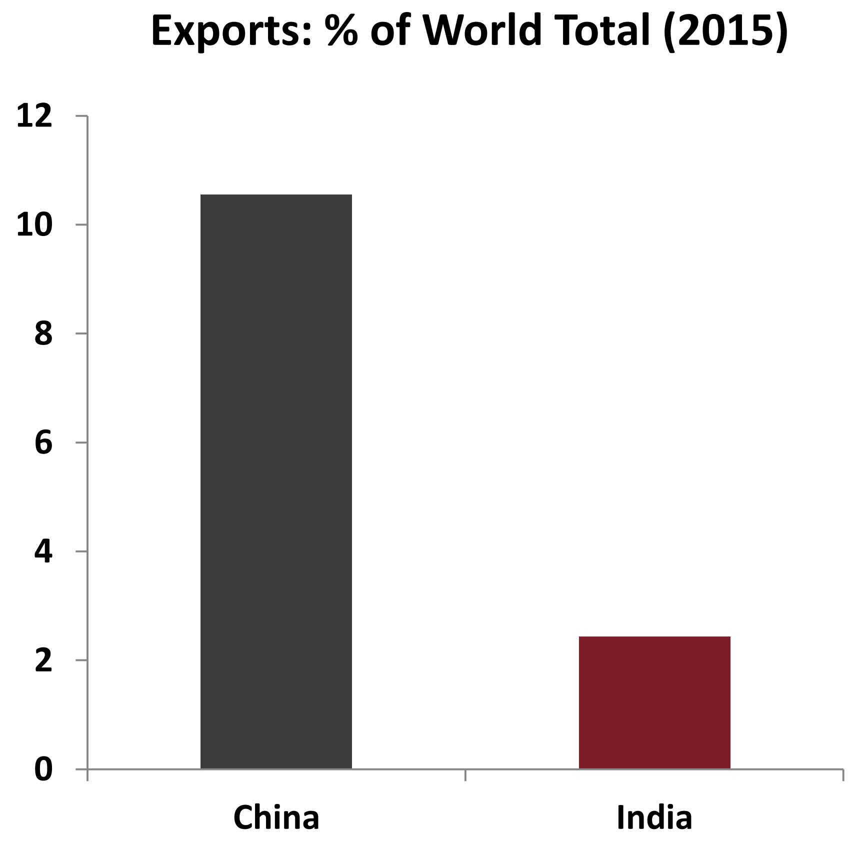
China vs. India: Different Directions?

- GDP growth trending lower
- Structural reform sluggish
- Banks hiding NPLs
- Confidence shaky
- Capital flowing out
- …

- GDP growth trending higher
- Structural reform picking up
- Banks reporting NPLs
- Confidence rising
- Capital flowing in
- …

But Let's Not Get Carried Away …
India's Economy Is A Fraction Of China's





Sources: S&P Global, Oxford Economics.

China Macro View: What Is The Correct Narrative?

What Is The China Narrative?
Pick Your Poison

1. **Hard Landing**
   - The “true” growth rate (based on Li Keqiang index) is 2% to 3%-ish.
   - Official numbers can’t be trusted/are highly suspect.

2. **Things Are Still Largely Under Control**
   - There may be problems, but the authorities have a great track record.
   - Intensity inversely correlated with distance from the Mainland.

3. **Manufacturing Growth: Extend And Pretend**
   - Growth is probably close to the official number, but being propped up.
   - No big short-term macro risks, but the trajectory is unsustainable.

Our View: Extend And Pretend
Balance Sheets Being Sacrificed For Growth

- Outlook: GDP growth is 6-ish%, but will be low quality!
- Hard landing fears overdone (for now) as they ignore two key points:
  - Consumption is holding up well and HH balance sheets strong.
  - Reaction Function: Authorities have lots of tools and are using them!: fiscal spending, policy bank lending, propping up SOEs, local gov't debt relief.

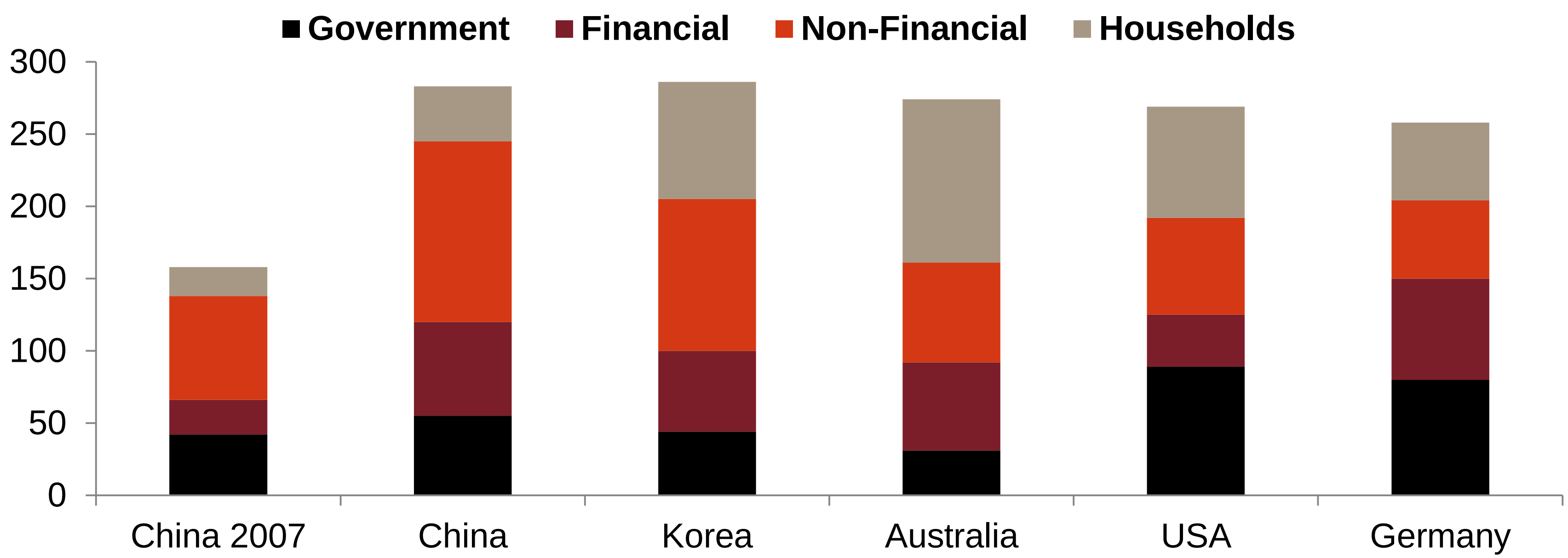
- **The main macro risk is not a hard landing, but a period of propped up GDP growth leading to more imbalances, requiring more adjustment and lower GDP growth later.**

- Solution: (i) lower, more sustainable growth; (ii) move to a range (maybe 5½% to 6½% over medium-term); and (iii) dethrone the growth rate.

China's Debt/GDP Has Reached "First World" Levels: Room For Manoeuvre Not Unlimited

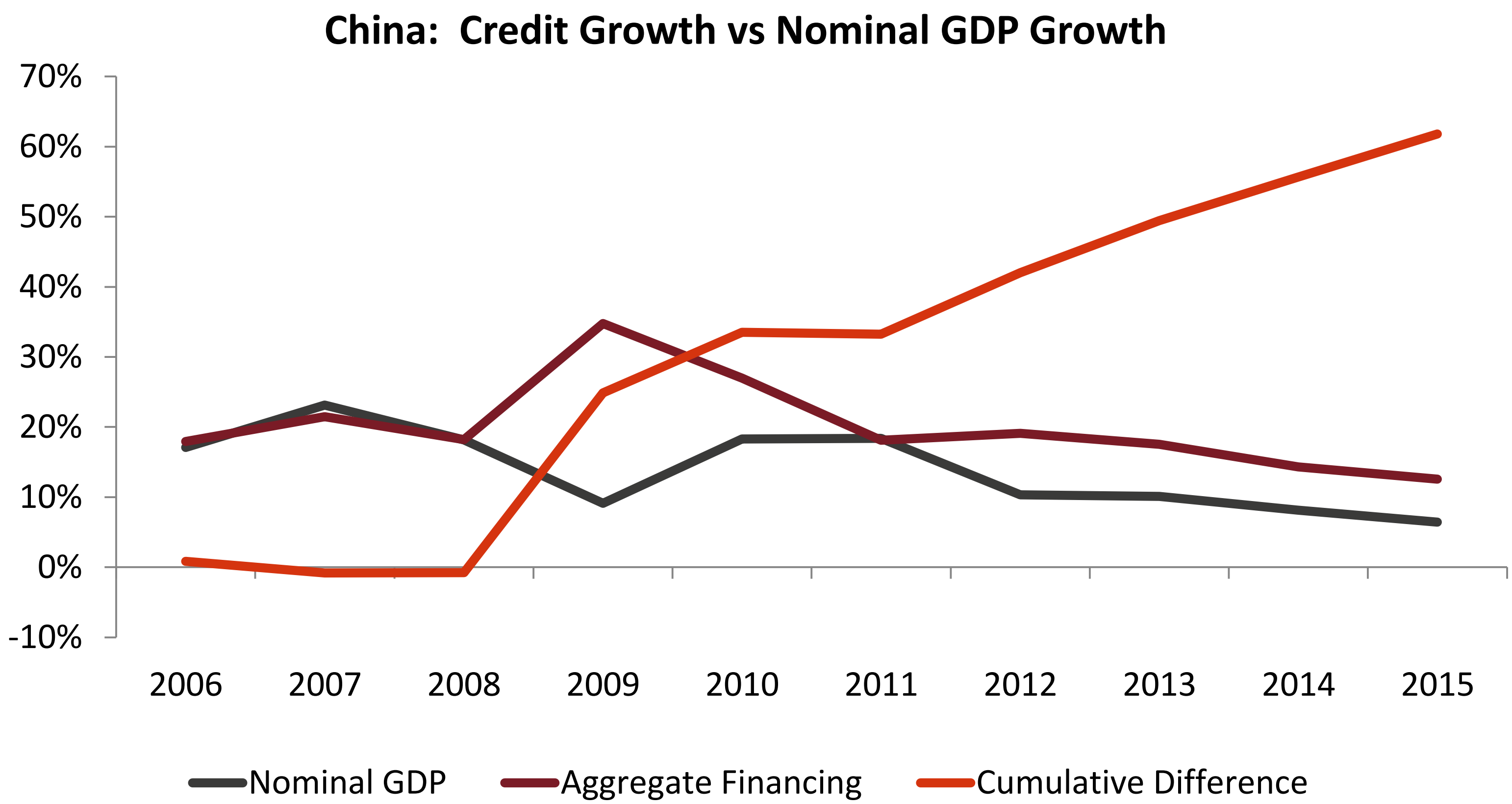
- **"Wiggle room" (fiscal space) for debt-fuelled growth has clearly shrunk.**
- **Household balance sheets relatively strong.**
- **So is easing fiscal/monetary stance to achieve 6½%-7% GDP growth wise?**

Debt/GDP Ratios By Sector (Q2 2014)



Source: McKinsey Global Institute, S&P Economics.

China's "Credit Overhang" Continues to Grow As Credit Growth Runs Ahead of Nominal GDP



Source: S&P Economics, CEIC.

Chinese Authorities' "To Do" List
Short Version

1. **Lower GDP and Credit Growth /Increase Credit Discipline**
   - Credit Growth Is Still Running 2X Nominal GDP
   - Allow more defaults? Develop "default transition matrices"
2. **Reform SOEs**
   - Yes, employment in this sector helps social stability …
   - But the sector is low valued added, sucking up resources
3. **(Continue to) Reform the Financial Sector**
   - Are non-performing loans correctly reported?
   - Credit needs to find new growth drivers (consumption, services)
4. **Internationalize The Yuan**
   - Be as clear as possible with the markets, allow some volatility
   - Earn the trust of the markets: increase "voluntary" demand for CNY

China’s Macro/Growth Challenge
Political Promises vs Economic Reality

1. The 6½% to 7% GDP growth target derives from the “China Dream”, which includes doubling per capital GDP between 2010 and 2010, but the world has changed since then:
   - World trade has slowed and now has zero contribution to growth (not unique to China and largely beyond its control).
   - Productivity growth has slowed (also a worldwide phenomenon, but there clearly is a link to slow structural reform).
2. As a result, the growth target should arguably be lowered, but this would entail a political climb down:
   - The alternative is “extend and pretend”, with lower credit quality.
   - Perhaps a change can be made at the 2017 Party Congress.

How Does China's Rebalancing Affect The Rest Of Asia?

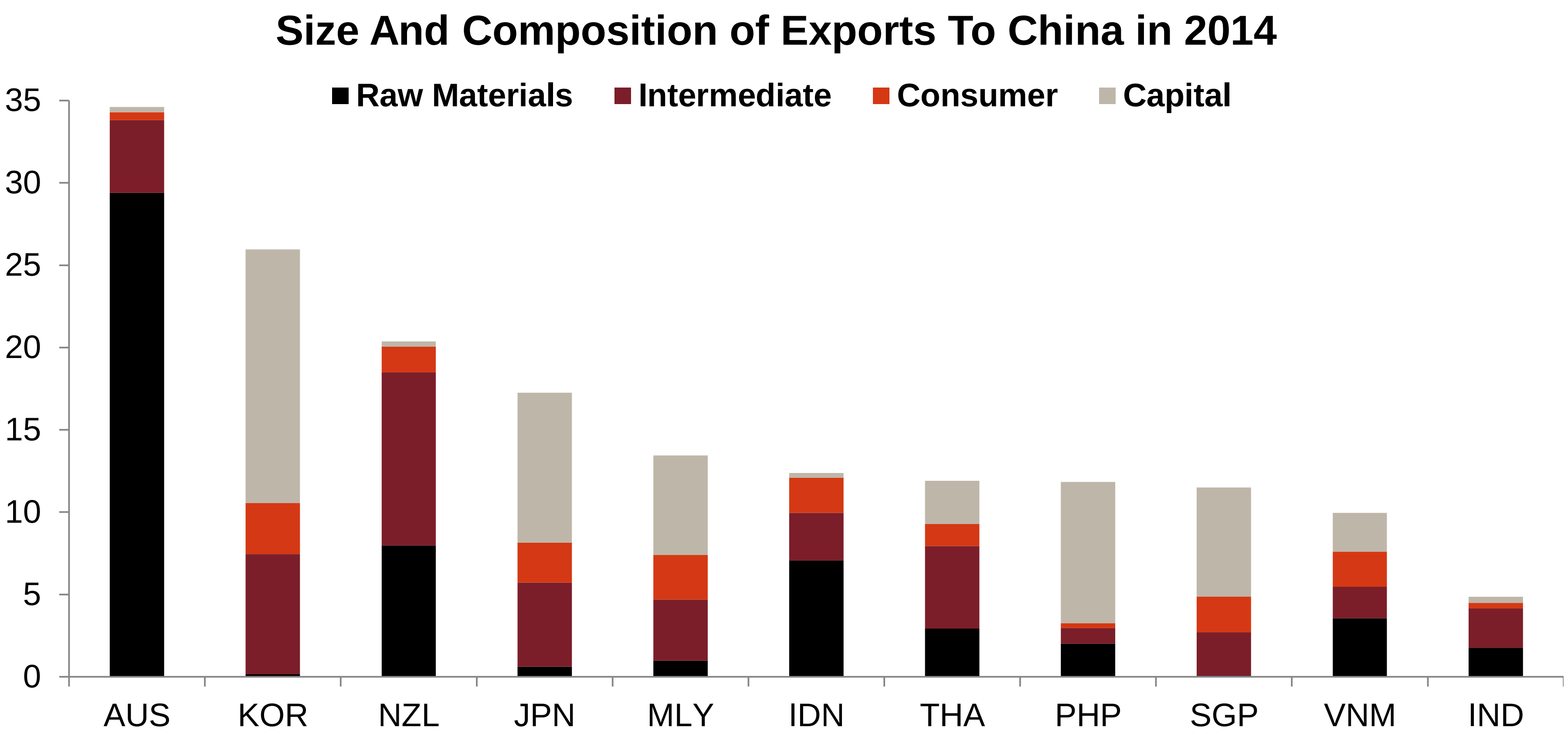
China Cannot Unilaterally Rebalance

Consider the following:

1. Rebalancing requires a change in the mixture of consumption and investment.
2. Any change in spending patterns will have an external dimension unless it is exactly matched by changes in domestic production. (Need not be symmetric across C and I.)
3. China is not a textbook small open economy or price taker. It moves (global) markets!
4. Global trade must balance.

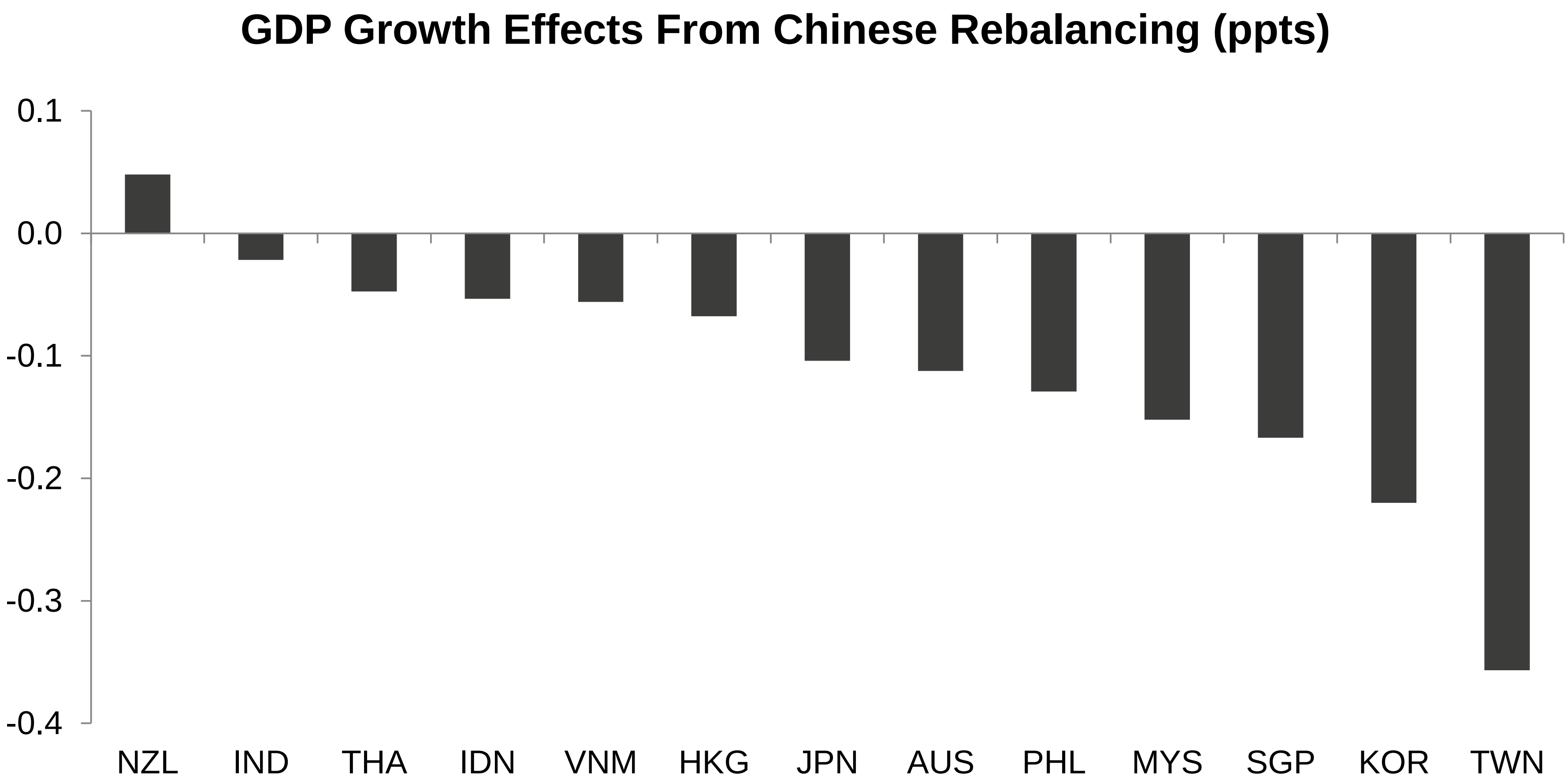
Therefore, changes in Chinese imports and exports as it rebalances must be exactly offset by exports and imports of its trading partners.

China Is A Major Trading Partner Of Many APAC Economies, But Details Differ: India Is Last!



Source: S&P Economics, UN COMTRADE.

(On Impact) GDP Growth Effects From Chinese Rebalancing Reflect Trade Composition



Source: IMF.

The Dynamics Of Rebalancing Around China What Matters?

1. **Exchange Rate Depreciation (Dutch Disease in reverse)**
   - Lower Chinese demand leads to a terms of trade shock and a weaker currency, bringing potentially new export sectors into play
2. **Government Policy, Fiscal Space**
   - If fiscal space and policy effectiveness allow, governments can help cushion the effects of the foreign demand shock, re-orientate markets
3. **Flexible Factor Markets**
   - Labor and capital need to be able to respond to price signals and policy initiatives (previous point) in order to migrate to new export sectors
4. **Financial Market Nimbleness**
   - New growth sectors will need access to credit, so the financial sector needs to have the nimbleness to respond

Services Trade In Asia Some Preliminary Results

Why Is It Important to Follow Services Trade Developments In Asia Pacific?

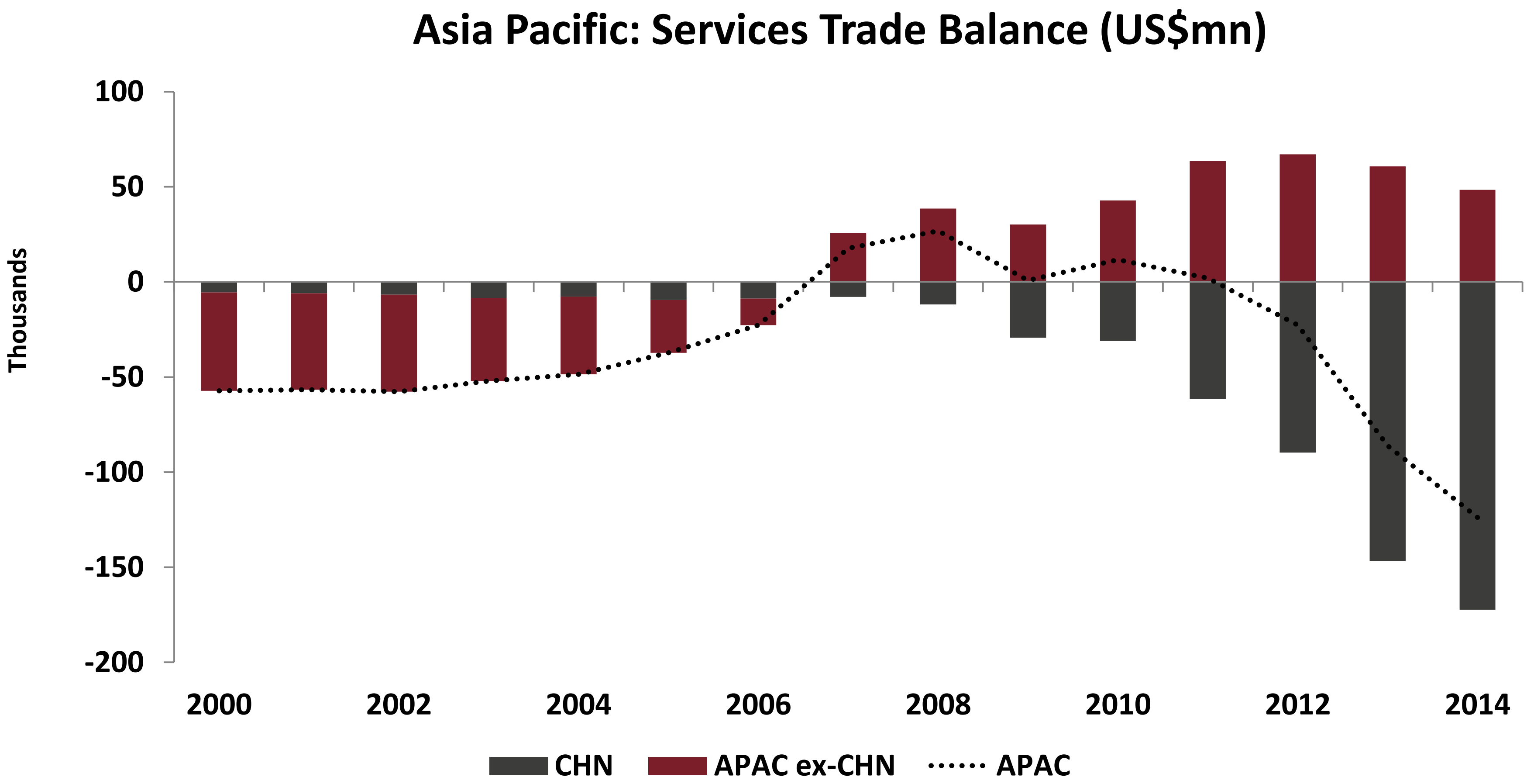
1. **Rising Middle Class Story**. As incomes rise, spending by the middle class on services (as opposed to basic goods) should rise as well.

2. **Chinese Rebalancing Story**. China's rebalancing means a shift away from expenditure on manufacturing towards consumption and services.

3. **Flying Geese Story Revisited**. Just as we saw in manufacturing, will countries follow Japan on services side and move up the value chain?

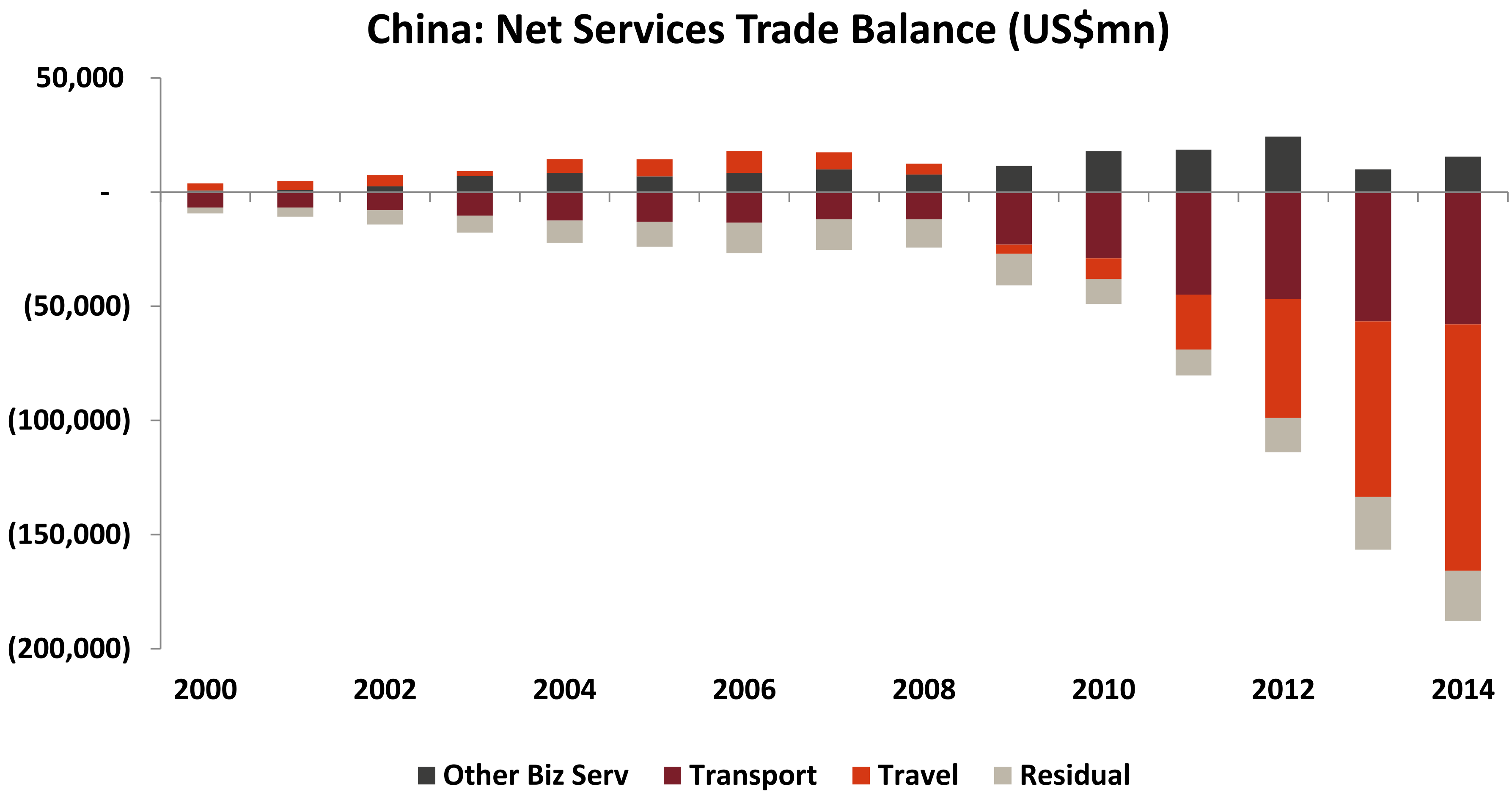
4. **Global Trade Story**. Can faster growth in services trade reflecting the points above give a fill-up to sluggish global trade growth?

Is China's Rebalancing Driving An Asia Pacific Service Trade Revolution?

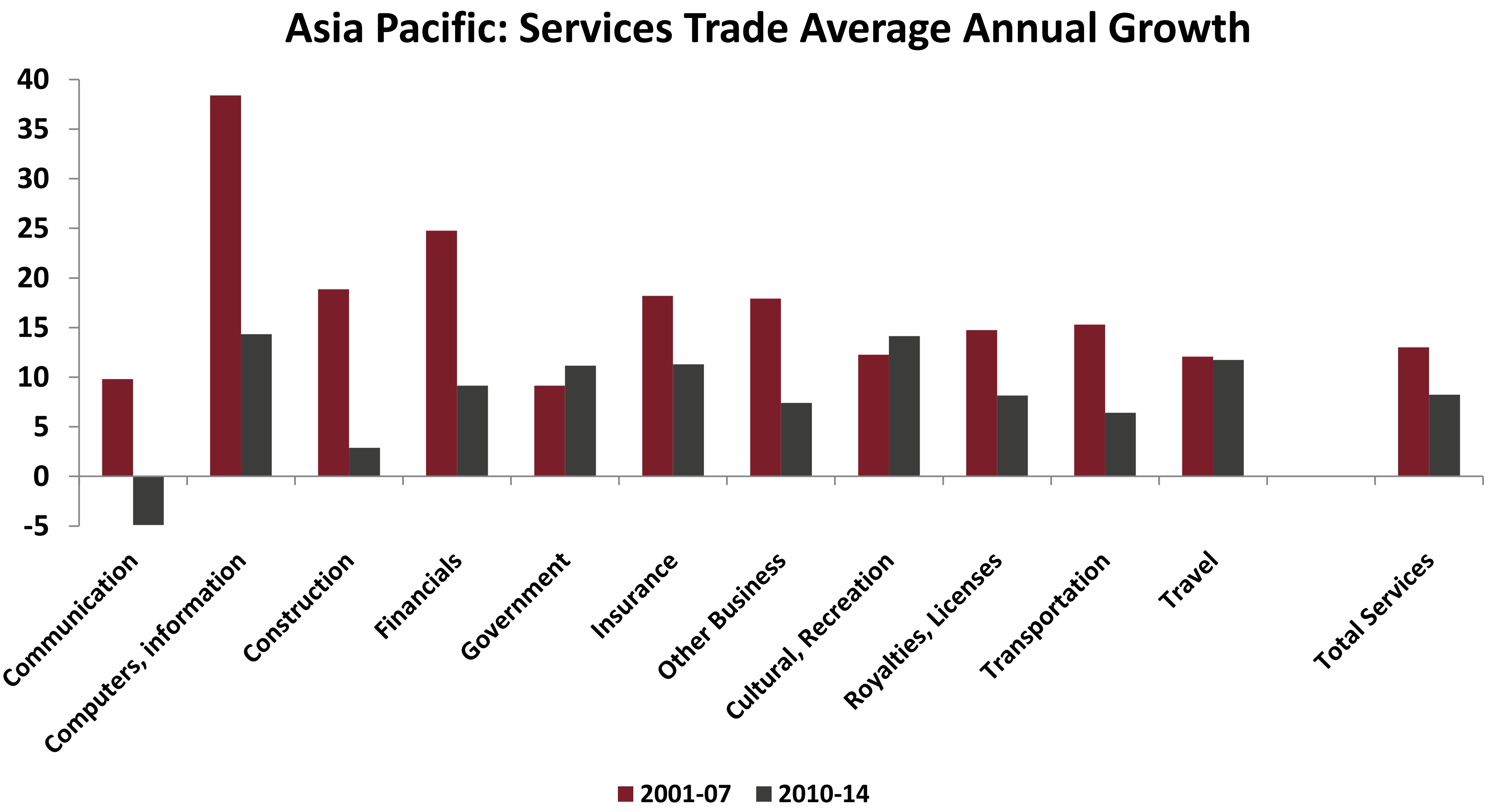


Source: S&P Economics., COMTRADE

Decomposing China's Services Trade Deficit
Travel (Tourism, Education) Is The Main Driver

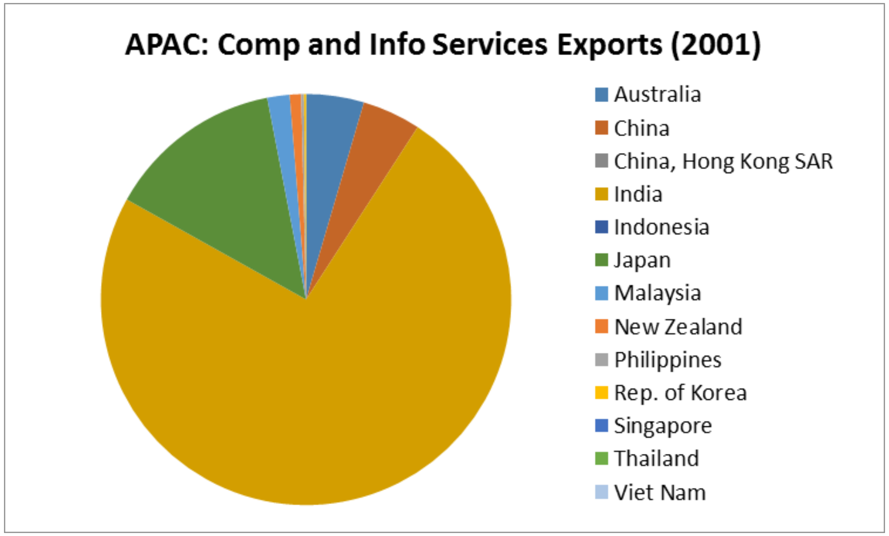


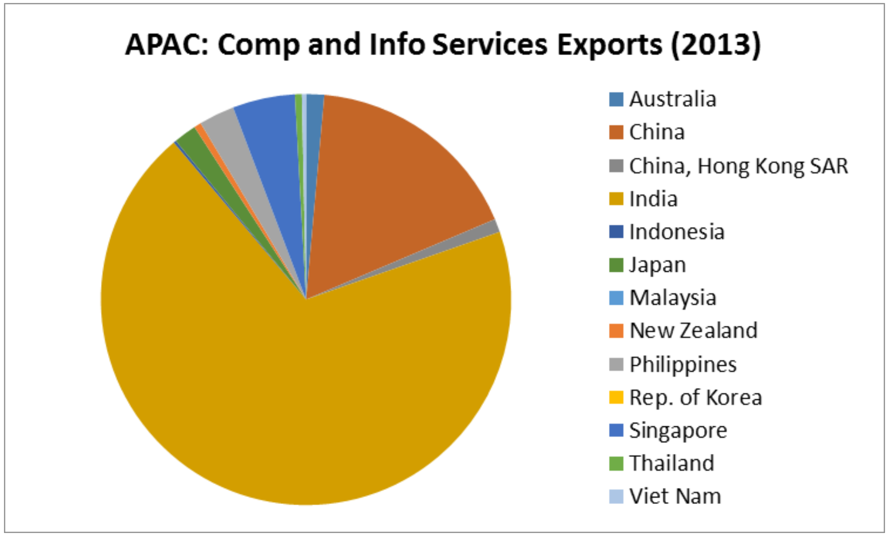
Services Trade Growth Has Been Very Uneven Like Most Pan-Asian Stories!



India Remains The Leader In Computer And Information Services, China Gaining Ground

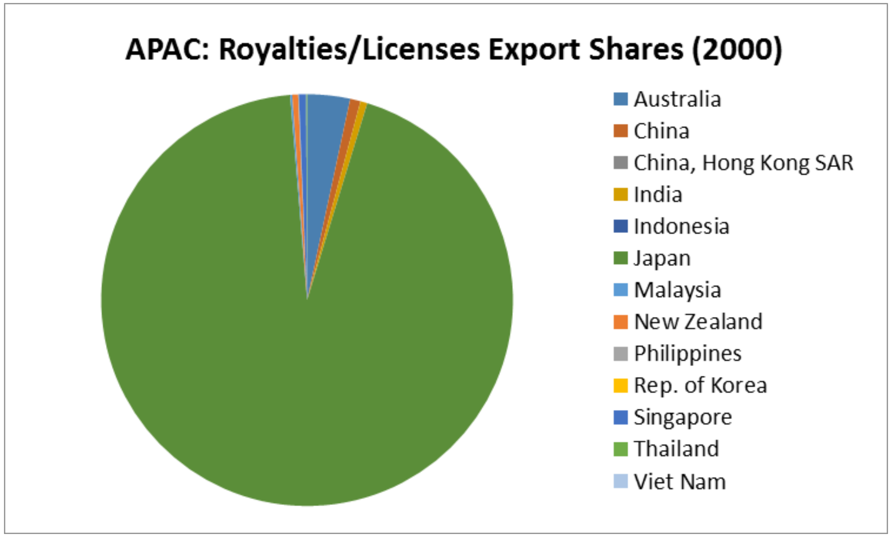
- Computer and information services account for 7% of Asia Pacific services exports and was the fastest growth component over 2010-14.
- India dominates this space (and also runs a large overall services surplus).
- China has made some inroads of late and now has a 10% share. Singapore has gained a bit as well.
- These both came mainly at the expense of Japan.

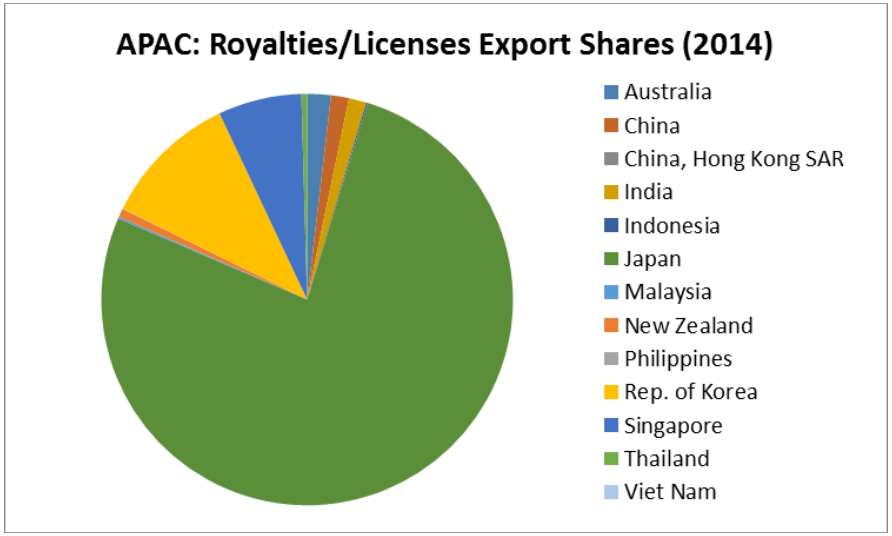




At The High End (Royalties, Licenses), Japan Is Still The Top Dog, With Korea Gaining Ground

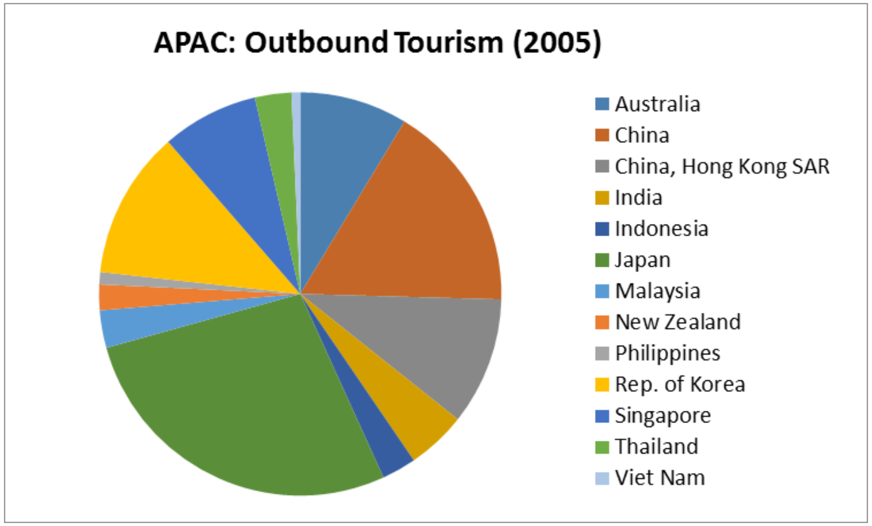
- Royalties and licenses are about X% of Asia Pacific services trade.
- Exporting these services is a high value added space since others are paying for your brand and “IP”.
- Japan, not surprisingly has been the “Top Dog” in the region.
- More recent, Korea and Singapore have begun to make inroads

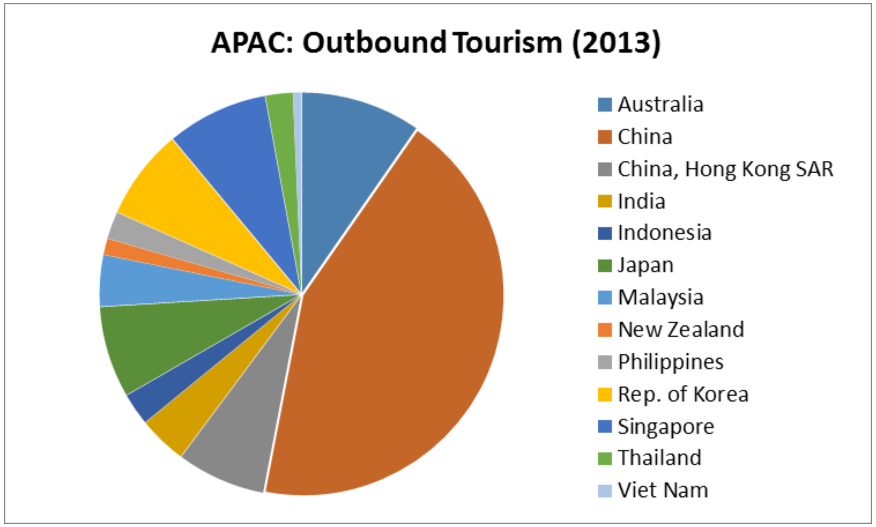




Guess Who Is Coming To Dinner? China's Outbound Tourism Is Surging

- Chinese outbound tourism has exploded, growing by 30% over 2010-14 (inbound grew 7½%).
- As a result, China's share of the region's tourism imports has tripled since 2005, pushing toward 50%.
- Japan, which accounted for about one-third of these flows early last decade, is not in single digits.
- Inbound tourism shares are more stable (combining China and HK) with Thailand the big winner, rising from 8% to 15% over 2005-13.





Questions And Answers