China

- **Gradual real GDP growth deceleration will continue while stimulative fiscal and monetary policies are set to provide some counterbalance.**
- **The Chinese government remains committed to economic liberalization amidst ongoing trade negotiations with the US.**
- **China and the US are expected to reach a reasonably satisfactory agreement within the next couple of months, helping alleviate global growth concerns.**

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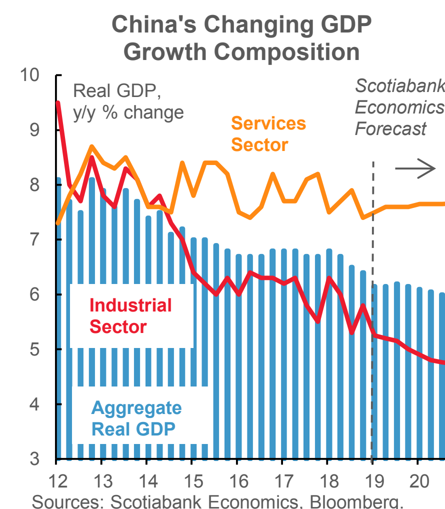
China	2017	2018	2019f	2020f
Real GDP (annual % change)	6.8	6.6	6.2	6.0
CPI (y/y %, eop)	1.8	1.8	2.2	2.3
Central bank policy rate (%, eop)	4.35	4.35	4.35	4.35
Chinese yuan (USDCNY, eop)	6.51	6.88	6.70	6.50

Source: Scotiabank Economics.

ECONOMIC GROWTH OUTLOOK

The Chinese economy's long-term structural evolution toward a lower growth trajectory continues as activity becomes increasingly driven by the consumer and the services sector instead of fixed investment and the industrial sector (chart 1). Simultaneously, we identify two medium-term dynamics that are amplifying the economy's long-term trend. First, the government's deleveraging drive—a dominant policy priority in 2018—reduced access to credit as policymakers attempted to deflate the economy's financial imbalances stemming from the fast buildup of debt since the global financial crisis. We assess that the curtailing of funding over the course of last year is a key factor behind the current softer real GDP growth momentum. Nevertheless, policymakers' focus on deleveraging seems to be easing, which should help limit the downward pressure on the economy over the coming quarters. Second, the ongoing US-China trade dispute is reflected in external sector activity and China's export-oriented industries, with shipments to the US contracting from year-ago levels (chart 2). The dispute has triggered a weakening in sentiment, particularly in the manufacturing sector, yet early signs are emerging that business confidence is stabilizing on the back of recent progress in the trade talks.

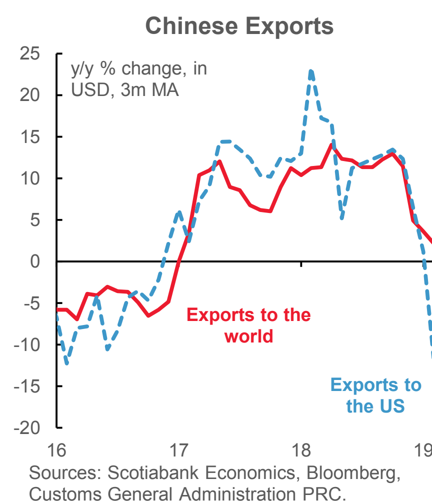
Chart 1



Sources: Scotiabank Economics, Bloomberg.

High-frequency indicators reveal the economy's decelerating momentum. Activity in the industrial sector is weakening and its enterprises' profits are declining (chart 3). Softer retail sales and contracting auto sales demonstrate that households are less willing to spend in the current environment of elevated uncertainties and rising unemployment. Now, Chinese policymakers are taking decisive steps to counterbalance the downward pressure on the economy. The People's Bank of China (PBoC) has unveiled monetary stimulus measures while the government has adopted a more accommodative fiscal policy stance (see commentary below). We anticipate further policy support in the near future. While we recognize the fact that the Chinese administration has less policy space left to boost the economy compared with the post-2008 stimulus, we assess that the toolkit is big enough to help stabilize the Chinese economy within the next few quarters. We expect China's real GDP growth to average 6.2% y/y in 2019 following a 6.6% advance in 2018. In 2020, the economy will likely expand by 6.0% y/y.

Chart 2



Sources: Scotiabank Economics, Bloomberg, Customs General Administration PRC.

POLICY OUTLOOK

China's 13th National People's Congress wrapped up its annual parliamentary session in mid-March and identified key macroeconomic goals for 2019 and

required policies to meet such targets. Recognizing elevated uncertainties surrounding the economic outlook and the downward pressure on the economy, the government lowered the real GDP growth target to 6.0–6.5% for this year from "around 6.5%" in 2018 (table 1). In March, the administration announced large-scale tax cuts and various fee reductions, amounting to almost CNY 2 trillion (equivalent to 2% of GDP). Further CNY 300 billion worth of support measures were unveiled in early April. For example, the value-added tax rate for manufacturers has been cut notably (effective on April 1), from 16% to 13%, while the tax rate for construction and transportation sectors was lowered from 10% to 9%. Spending by both corporations and consumers will be further supported by lower social security contributions, reduced electricity and internet costs and smaller fees associated with government-run licensing processes, such as real estate registration and passport issuance. In addition, a nearly 60% y/y increase (to CNY2.15 trillion) in the issuance of special-purpose local government bonds—which are not included in government debt figures— has been announced, with such outlays aimed at rural development, infrastructure, programmes to boost high-quality manufacturing, and fighting pollution. Indeed, the nascent pickup in infrastructure investment seen at the end of 2018 (chart 4) will likely gain momentum over the coming months.

In terms of economic reforms, Chinese policymakers have indicated that the economy will be liberalized further over the course of 2019. One of the cornerstones of China's recent reform drive is the newly-passed foreign investment law that will address market access issues, protect intellectual property rights, forbid forced technology transfers, and ensure equal treatment for foreign and domestic firms. The law— which will come into force on January 1, 2020—addresses several of the US administration's complaints, yet further amendments are still required to reduce its ambiguity. Another vital aspect in the Chinese economy's opening-up relates to financial sector reforms. China is planning to allow foreign financial firms to have a larger presence in China; greater openness would likely bring notable benefits to the economy, including improved risk management, transparency, competitiveness, and more effective allocation of capital. Indeed, we note that the strengthening of the financial system is a prerequisite for further economic and capital account liberalization.

Trade discussions between the US and China continue. According to both parties, the negotiations have been progressing well and have reached final stages that focus on more practical issues, such as implementation and enforcement. The talks over the past 4½ months have covered issues beyond trade, such as intellectual property protection, technology and cyber security, market access, and exchange rate management. We assess that both countries have strong economic incentives to reach an agreement soon; accordingly, we believe that an accord that satisfies both parties will likely be reached within the next two months. While this would be a welcome development for the global economy, we highlight that concrete actions need to be taken before the real economy would benefit from the easing of the trade conflict.

Regardless of any trade agreement between the US and China, the countries' differing fundamental views regarding the economy and the society at large will remain in place for years to come. Technological rivalry, in particular, will likely continue to create tensions between the two countries. From economic development point of view, it is important for China to transform itself toward an economy that is driven by productivity and technological advances in order to escape the middle-

Chart 3

Sources: Scotiabank Economics, Bloomberg.

Chart 4

Sources: Scotiabank Economics, Bloomberg.

Table 1

China's Key Economic Targets	2019 Target	2018 Actual	2018 Target
Real GDP Growth, y/y % change	6.0-6.5%	6.6%	~6.5%
CPI Inflation, y/y % change	~3%	2.1%	~3%
Fiscal Deficit, % of GDP	2.8%	2.6%	2.6%
Urban Jobless Rate	~4.5%	3.8%	<4.5%

Sources: Scotiabank Economics, Bloomberg, CPC.

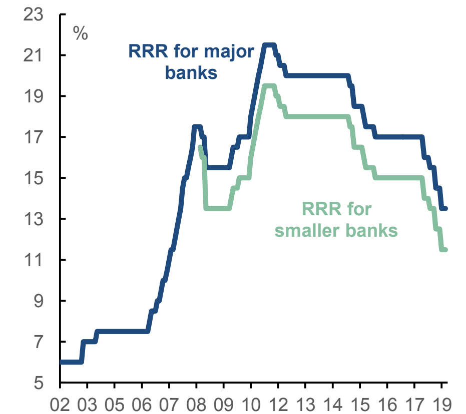
income trap. Therefore, China will likely maintain its focus on its current industrial strategy that aims to make the country a global technological powerhouse, though it will likely do so with less fanfare.

INFLATION AND MONETARY POLICY OUTLOOK

Chinese inflationary pressures will remain contained in the foreseeable future. Headline inflation will likely hover around 2% over the coming quarters, below the government's target of around 3% y/y. Price pressures further up the distribution chain are even lower with annual producer price gains near deflationary territory. Muted inflation allows monetary policy to become more accommodative. Indeed, Chinese monetary authorities have responded swiftly to the downward pressure on the economy. The PBoC will continue to provide the financial system with needed liquidity through open market operations, reserve requirements, and standing and medium-term lending facilities. The central bank will likely lower banks' reserve requirement ratios (RRR) further over the course of 2019, with the next reduction likely to take place in the current quarter. The most recent cut of 100 basis points was implemented in January, taking the ratio to 13.5% for major banks and 11.5% for smaller banks (chart 5). Meanwhile, we do not expect the PBoC to lower the 7-day reverse repo rate—which has stayed at 2.55% since March 2018—or the benchmark one-year deposit and lending rates—unchanged at 1.50% and 4.35%, respectively, since October 2015—over the coming quarters, as lower rates could add to financial instability risks.

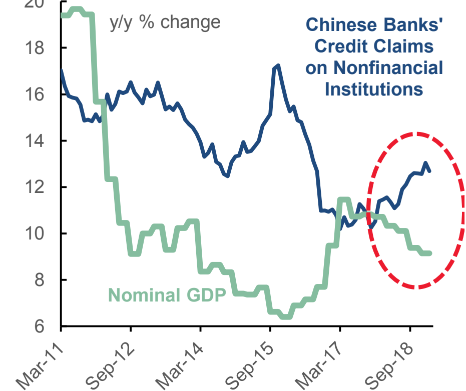
The government's deleveraging efforts have diminished somewhat, triggering a pickup in credit growth (chart 6). Nevertheless, the shadow banking sector will not play a key role in the current stimulus drive; instead, traditional bank lending will dominate. In March, the Chinese administration announced that its 2019 growth target for total social financing—which also captures shadow banking activity—is in line with China's nominal GDP growth. Hence, our estimates point to aggregate financing expanding by around 8½% y/y this year, which is notably slower than the average growth of 13¼% y/y over the past three years. Meanwhile, small/micro and private companies are set to benefit from improved access to funding following the government's another announcement that state-owned banks would increase lending to such entities by 30%. In the past, small firms have faced difficulties in obtaining credit as banks have prioritized other state-owned entities in credit allocation. Overall, we assess that monetary conditions in China will stay growth-supportive in the foreseeable future, yet the country's monetary authorities are more aware of the risks related to flooding the financial system with excessive liquidity, as was the case after the global financial crisis.

Chart 5



Sources: Scotiabank Economics, the People's Bank of China, Bloomberg.

Chart 6



Sources: Scotiabank Economics, National Bureau of Statistics of China, The People's Bank of China.

Japan

- **Global growth uncertainties pose challenges for policymakers in Japan.**

ECONOMIC GROWTH OUTLOOK

Japan's near-term economic growth prospects are reasonably firm as consumers and businesses will likely bring forward their spending in anticipation of the consumption tax rate increase from 8% to 10%, which is scheduled for October 2019. The implementation of the higher tax is expected to cause a temporary dip in output (in q/q terms) in the fourth quarter of 2019; nevertheless, the adverse impact is set to be smaller than in 2014—when the tax rate was raised from 5% to 8%—due to planned offsetting measures, such as rebates and support for low-income households. Japan's 2019–20 real GDP gains are expected be in line with the country's potential growth of ¾% y/y, equal to the advance in 2018.

The Japanese economy grew by 0.5% q/q (non-annualized) in the final quarter of 2018 following a 0.6% q/q contraction in the third quarter (which reflected natural disasters). Net exports have recently been a drag on growth as shipments are adversely impacted by weaker global and Chinese demand. Softer export sector activity will continue to be reflected in weaker industrial production and manufacturing sector sentiment (chart 1). Consumer and public spending as well as investment have recently recorded decent growth, a trend that should continue over the medium term on the back of expansionary fiscal and monetary policies, sound corporate balance sheets, and tight labour market conditions.

INFLATION AND MONETARY POLICY OUTLOOK

The Bank of Japan (BoJ) will likely maintain its ultra-accommodative monetary policy stance through 2020, under the framework of "Quantitative and Qualitative Monetary Easing with Yield Curve Control". We expect the BoJ to keep the short-term policy rate and the 10-year bond yield target unchanged at -0.1% and around 0%, respectively, over the coming quarters. Against the background of rising global uncertainties and late-cycle dynamics, we note that the BoJ's monetary policy room is fairly limited. Should the economy need further stimulus in the foreseeable future, the main responsibility may fall onto fiscal policy—despite already weak government finances.

Inflation remains low and the BoJ's 2% annual inflation target seems unattainable: following years of deflation, Japan's cumulative inflation over the past two decades is only 2% (chart 2). In addition to domestic reasons, such as lackluster wage growth, reaching the inflation target can potentially be further challenged by weaker global growth prospects that might trigger a more pronounced domestic slowdown and renewed deflation, as well as by elevated global uncertainties that might translate to safe-haven flows and appreciation of the Japanese yen. Prices at the headline level are currently rising by only 0.2% annually while the CPI excl. fresh food—the BoJ's preferred inflation measure—also remains soft at 0.7% y/y. We estimate that in the near-term, headline inflation will stay below 1% y/y until the consumption tax rate hike will prompt a temporary pickup in the final months of 2019. After the tax hike impact wanes in late-2020, inflation is set to return below the 1% mark.

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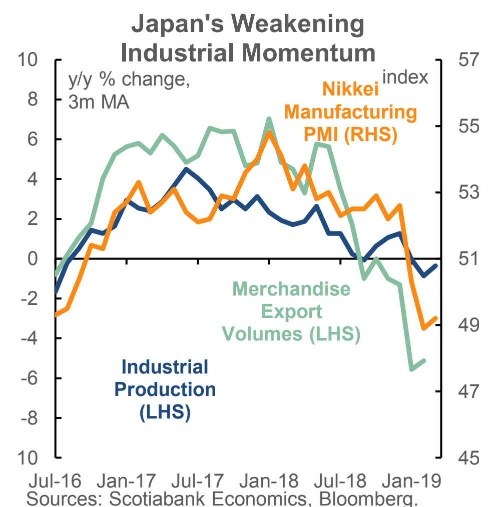
Japan	2017	2018	2019f	2020f
Real GDP (annual % change)	1.9	0.8	0.8	0.7
CPI (y/y %, eop)	1.0	0.3	2.3	1.0
Central bank policy rate (%, eop)	-0.10	-0.10	-0.10	-0.10
Japanese yen (USDJPY, eop)	113	110	108	105

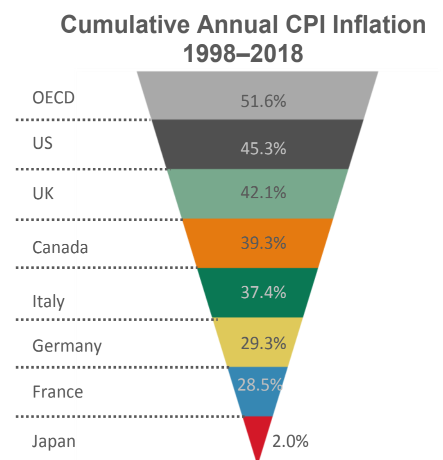
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, OECD.

India

- **India continues to be a growth outperformer among major economies globally through 2020, fuelled by sound domestic demand.**
- **Fiscal and monetary policies underpin the economy's momentum.**
- **Rising inflation limits the central bank's ability to loosen monetary policy aggressively.**
- **Political uncertainty remains elevated ahead of the general elections in April and May.**

ECONOMIC GROWTH OUTLOOK

India's economic growth will likely average 7.1% y/y over the next two years (chart 1). We have downgraded the forecast slightly (from the prior figure of 7.4% y/y in 2019–20), reflecting weaker sentiment and softer demand conditions globally. With real GDP gains in line with the country's estimated 7–7½% potential growth rate, India will continue to be the growth leader among major economies globally. We assess that India could reach even higher potential growth over the coming years on the back of the country's favourable demographics and continued streamlining of the Goods and Services Tax structure. Implementation of labour and land reforms would bolster India's longer-term growth outlook further.

Domestic demand will be the key driver of the Indian economy in the foreseeable future. The country is less export-oriented than its regional peers, which provides the economy with some protection against global headwinds. Fixed capital investment continued to outperform the economy's growth rate of 7.3% y/y in 2018, expanding by 11.1% y/y. Ongoing public infrastructure outlays as well as robust business confidence and bank credit growth (charts 2 and 3) point to continuing activity; the Reserve Bank of India's (RBI) looser monetary policy should further underpin business investment prospects. Nevertheless, momentum in eight core industries—electricity, steel, refinery products, crude oil, coal, cement, natural gas and fertilizers—has slowed in recent months (chart 3), which warrants close monitoring as weaker industrial activity and higher spare capacity could have an adverse impact on investment. Consumer spending will continue to be supported by rising incomes and the government's fiscal measures, such as tax rebates and support to small-scale farmers. Indeed, India's February 1st Interim Union Budget for fiscal year 2019–20 (April–March) is expansionary, arguably reflecting the imminent general election. The government expects the fiscal deficit in the FY2019–20 to be 3.4% of GDP, vis-à-vis the original target of 3.1% of GDP. We assess that the shortfall will likely turn out to be higher.

INFLATION AND MONETARY POLICY OUTLOOK

The RBI is taking steps to stimulate the economy. Following the Monetary Policy Committee's (MPC) bimonthly meeting on April 2–4, the benchmark repo rate was cut by 25 basis points to 6.0%, marking a second consecutive interest rate reduction. We believe that the MPC's sense of urgency to cut rates reflects its expectation of gradually rising inflation and the general election. Communications

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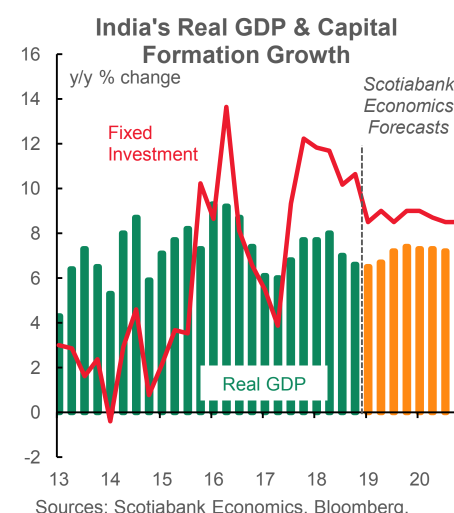
India	2017	2018	2019f	2020f
Real GDP (annual % change)	6.7	7.3	7.0	7.3
CPI (y/y %, eop)	5.2	2.1	5.1	5.0
Central bank policy rate (%, eop)	6.00	6.50	6.00	6.00
Indian rupee (USDINR, eop)	63.9	69.8	68.0	66.0

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

Sources: Scotiabank Economics, Bloomberg.

from the RBI reveal divisions within the six-member MPC regarding India's inflation outlook and risks. Accordingly, we do not foresee further interest rate cuts over the coming quarters, unless inflation significantly surprises on the downside.

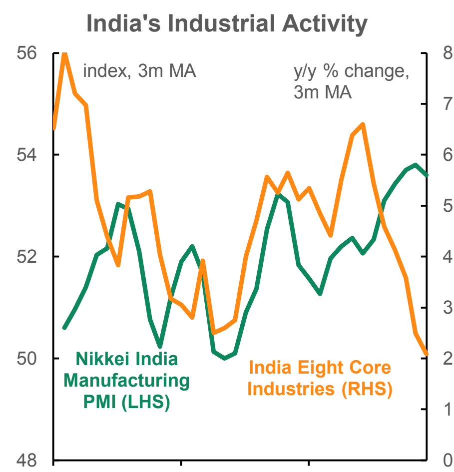
India's inflation signals are mixed. Core inflation has been decelerating gradually in recent months but remains elevated at 5⅓% y/y, vis-a-vis slightly over 6% in October (chart 4). Nevertheless, we note that the recent disinflation has not been broad-based across all index components. Meanwhile, headline inflation has been soft in recent months on the back of lower food and energy prices, yet the trend is now reversing. After reaching the low point of 2% y/y in January, inflation has rebounded to the current level of 2⅔%. The year-ago base effect will likely continue to inch the headline inflation rate higher over the coming months. We expect price gains to reach 5% y/y by the end of 2019; nevertheless, headline inflation is estimated to remain within the RBI's 4% ±2% target through 2020. We continue to observe carefully the development of the following risks to inflation: 1) financial market volatility and potential depreciation pressure on the Indian rupee; 2) volatile food prices; 3) international crude oil price developments; 4) ongoing global trade tensions that may cause a growth slowdown and softer commodity prices; 5) the approaching southwest monsoon (June–September) that will have an impact on food prices and rural incomes; and 6) fiscal measures announced in the Interim Union Budget that may trigger inflationary implications.

POLITICAL OUTLOOK

Political uncertainty will remain elevated in the near term. Elections for the Lok Sabha—the lower house of Parliament—are scheduled to take place in seven stages between April 11 and May 19. With India's 900 million eligible voters, the ballot is the largest in the world. Votes will be counted on May 23. An election outcome leading to a political standstill would have a significant adverse impact on India's structural reform prospects and long-term growth potential.

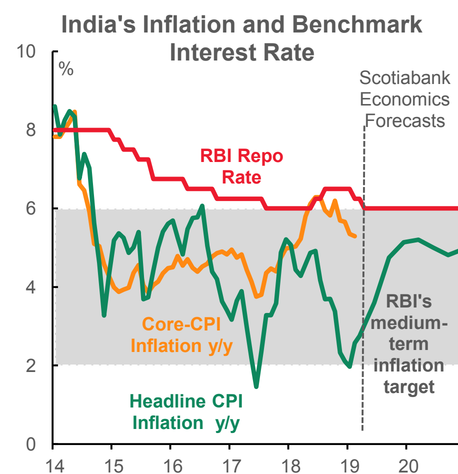
The ruling National Democratic Alliance—led by Prime Minister Modi's Bharatiya Janata Party (BJP)—would need a minimum of 272 of the 543 elected seats to be able to form a government; it currently holds 341 seats. We assess that the coalition has reasonably good chances of remaining in power despite the fact that the BJP has lost popularity recently while the approval ratings of the main opposition party, the Indian National Congress, have recuperated. Indeed, the BJP may not be able to replicate the 2014 election success when it secured a single-party majority. Nevertheless, populist fiscal measures announced in the Interim Union Budget on February 1 and looser monetary policy—which followed the appointment of pro-Modi RBI Governor Shaktikanta Das at the end of 2018—will likely help with the BJP's election ambitions.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

South Korea

- **Global trade-related uncertainties cloud South Korea's economic growth prospects.**
- **Fiscal and monetary policies are set to remain growth-supportive.**

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South Korea	2017	2018	2019f	2020f
Real GDP (annual % change)	3.1	2.7	2.5	2.5
CPI (y/y %, eop)	1.4	1.3	1.3	1.6
Central bank policy rate (%, eop)	1.50	1.75	1.75	1.75
South Korean won (USDKRW, eop)	1,067	1,116	1,120	1,080

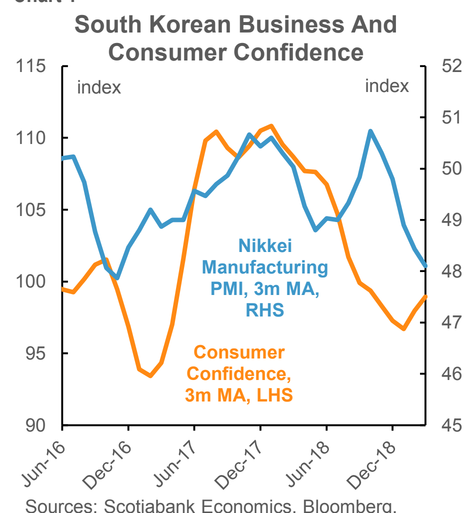
Source: Scotiabank Economics.

ECONOMIC GROWTH OUTLOOK

South Korea's economic performance is expected to stay virtually in line with the country's potential growth through 2020, with real GDP expanding by 2½% y/y. The external sector will remain an important growth driver over the coming years, yet the outlook is shadowed by trade-related global uncertainties. A slowdown in Chinese demand is causing South Korean exports to China—the nation's largest export market—to decline. While shipments to the US—the second largest export destination—have been growing at a double-digit annual pace in recent months, the pending decision by the US on whether to impose tariffs on automobile imports poses a notable downside risk to South Korea's outlook, particularly as 30% of the nation's exports to the US consist of vehicles and their parts.

The domestic side of the economy will be supported by consumer and public spending. The government's stimulative fiscal policies—the already-expansionary budget for 2019 will likely be followed by a supplementary spending package—focus on "income-driven" growth. Indeed, job creation measures, higher minimum wages, and outlays related to the social safety net will support the consumer. We assess that active fiscal policy will play a key role in keeping the economy on a decent growth track in 2019–20 as global headwinds impact the externally-oriented economy. While the outlook for fixed investment remains uncertain on the back of softening global growth momentum and the associated dip in confidence (chart 1), the Bank of Korea's (BoK) ongoing accommodative monetary policy stance will provide needed support for private sector investment.

Chart 1



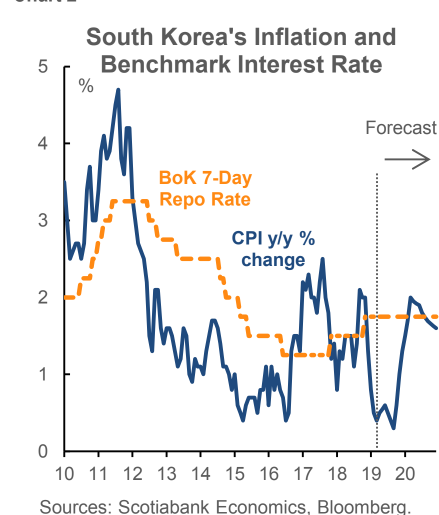
Sources: Scotiabank Economics, Bloomberg.

INFLATION AND MONETARY POLICY OUTLOOK

South Korea's inflation is expected to remain contained in the foreseeable future. Price pressures at the headline level have surprised on the downside; inflation is currently hovering below ½% y/y after being in line with the BoK's 2% inflation target as recently as in November (chart 2). Weaker price pressures reflect lower energy costs and stagnant government-administered prices (related to public transportation and communications, for instance). We expect headline inflation to rebound somewhat in the second half of 2019, closing the year at a still-low level of 1.3% y/y.

With demand-driven inflationary pressures likely to remain largely absent over the next two years, the BoK will be able to maintain an accommodative monetary policy stance through 2020. The central bank raised the benchmark interest rate by 25 basis points to 1.75% in November 2018; we do not expect any changes to the policy rate in the foreseeable future. The BoK will continue to monitor any risks related to financial stability and imbalances stemming from persistently rising household debt, while remaining vigilant regarding the elevated downside risks to the economy.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **The Australian economy continues to extend its non-recession record with at-potential output growth.**
- **A cooling residential real estate market and strong labour market send conflicting signals regarding consumer spending prospects.**
- **Monetary policy to remain accommodative on the back of contained inflation and elevated global growth uncertainties.**

ECONOMIC GROWTH OUTLOOK

Australia's economic growth is showing signs of moderation. Real GDP expanded by 2.3% y/y in the final quarter of 2018 following an average gain of 3.0% y/y in the first nine months of the year. We expect the nation's output growth to average 2½% y/y in 2019–20, roughly in line with the economy's potential. Accordingly, the Australian economy is expected to prolong its already respectable track record of having gone 27 years without a recession.

Australia's economic activity will continue to be driven by consumer spending, yet high household debt and cooling in the residential real estate market will weigh on the consumer. Nevertheless, a robust labour market and gradually rising wages should provide reasonable counterbalance. An easing in global uncertainties would be constructive for Australia's investment outlook, while solid government finances will allow for continued public spending in infrastructure.

The external sector will continue to feel the impact of slowing demand in China, which is Australia's main export destination. In the near term, however, Australian commodity exporters will benefit from two developments: 1) the Chinese government is in the process of rolling out fiscal stimulus, including higher infrastructure spending, and 2) iron ore prices have picked up following the dam disaster in Brazil; iron ore accounts for a fifth of Australia's total global exports and almost half of its exports to China (chart 1). We expect Australia's external sector to provide a moderate positive contribution to real GDP growth over the coming quarters, supported by improved terms of trade (chart 2) and higher resource export volumes.

HOUSING AND LABOUR MARKET DEVELOPMENTS

Australia's residential property market continues to cool. According to the Australian Bureau of Statistics, after rising by over 50% between early 2012 and end-2017, prices at the national level have dropped by 5.1% by the end of 2018 (chart 3). Private sector estimates point to continued price declines in the first quarter of 2019. Developments vary across the country, with Sydney and Melbourne leading the declines; housing prices have fallen in the two cities by 9.1% and 6.4% respectively, from their 2017 peaks. Meanwhile, in some other parts of the country, such as in Adelaide, house prices have been more stable. In our assessment, the correction is largely a result of tighter regulatory lending standards and increased housing supply, which is a delayed response to the prior price boom. Given Australia's low interest rates, a strong labour market, robust

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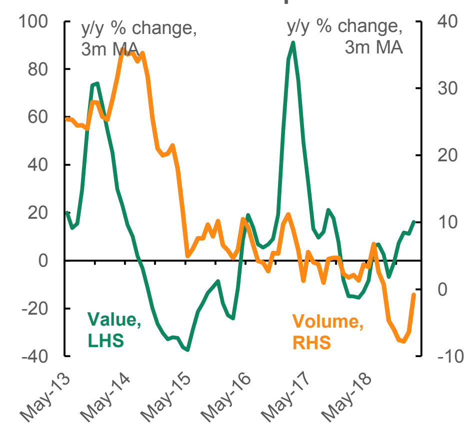
Australia	2017	2018	2019f	2020f
Real GDP (annual % change)	2.4	2.8	2.5	2.5
CPI (y/y %, eop)	1.9	1.8	2.0	2.2
Central bank policy rate (%, eop)	1.50	1.50	1.50	1.50
Australian dollar (AUDUSD, eop)	0.78	0.70	0.75	0.78

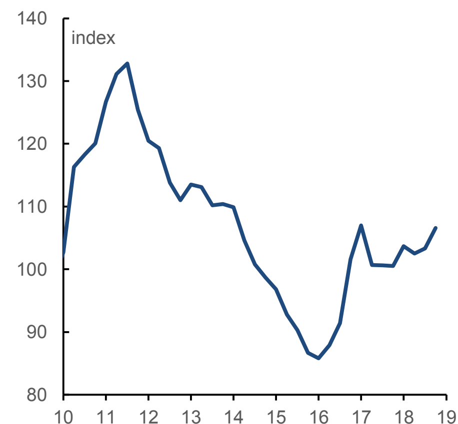
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

loan quality, and continued strong net immigration, we assess that the housing market developments are not a cause for major concern at this point. While we expect the market to stabilize over the course of 2019, we continue to monitor the situation closely, particularly the price adjustment's impact on consumer confidence and any potential adverse developments in the labour market that could impact households' debt-servicing abilities.

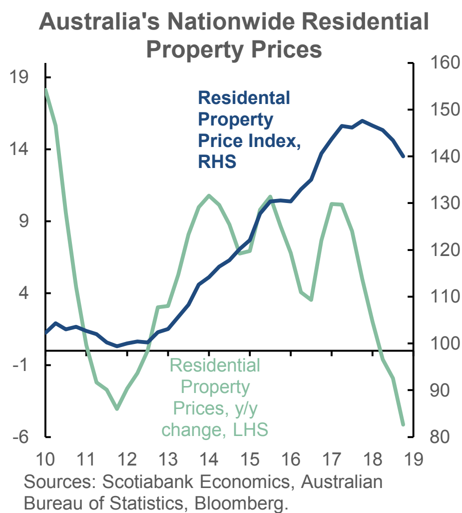
Australia's labour market conditions remain sound (chart 4); in the past 12 months to February, monthly job creation has averaged 24,000 positions, a high number by historical standards. More importantly, three-quarters of them have been in the full-time category. Surveys of hiring intentions indicate further employment gains. At 4.9% in February, unemployment is in line with the Reserve Bank of Australia's (RBA) "around 5%" estimate for the economy's NAIRU (non-accelerating inflation rate of unemployment), suggesting that labour market slack has virtually disappeared. This should boost incomes over the coming quarters.

INFLATION AND MONETARY POLICY OUTLOOK

Inflationary pressures will likely remain contained in the foreseeable future. At the headline level, prices rose by 1.8% y/y at the end of 2018. Meanwhile, consumers' inflation expectations are elevated at over 4% y/y, exceeding the RBA's 2–3% inflation target. Nevertheless, we assess that somewhat softer household spending prospects will likely keep demand-driven inflation in check. While we forecast a slight pickup in wage and price gains (chart 5), headline inflation is expected to remain in the RBA's target range through 2020.

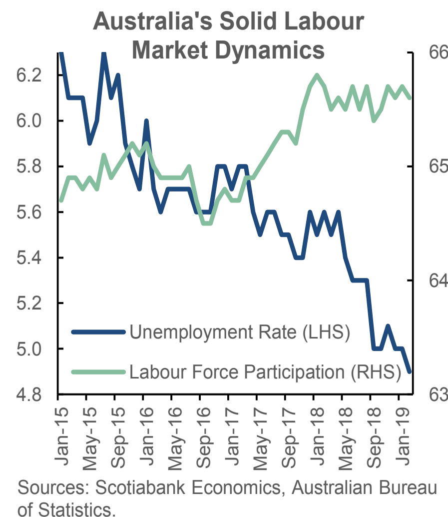
On the back of contained inflation and a challenging global growth outlook, the RBA will likely keep monetary policy on hold over the coming quarters. The central bank now assesses that the scenario in which it would need to ease monetary policy is equally likely as a scenario where policy would need to be tightened. Earlier, the RBA had assessed that an interest rate hike was the most likely next policy action. Given the RBA's changing tone, a challenging global growth outlook, and contained inflation domestically, we now anticipate the central bank to keep the benchmark interest rate on hold through 2020.

Chart 3



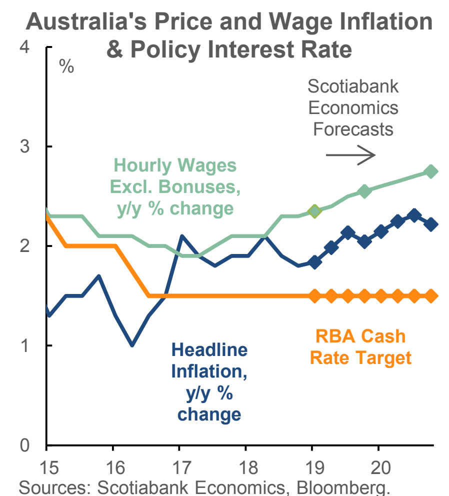
Sources: Scotiabank Economics, Australian Bureau of Statistics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

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