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Regional Outlook

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Executive Summary

Tuuli McCully 1.416.863.2859
tuuli.mccully@scotiabank.com

China Will Be The World's Economic Growth Locomotive | Regional Performance Remains Stable

The massive Chinese economy remains the engine of global activity. Nevertheless, the ongoing rebalancing will naturally lead to slower, yet higher-quality growth, with China's real GDP expected to advance by 6.4% this year and 6.2% in 2017, down from 6.9% in 2015. Meanwhile, India should continue to outperform, recording average output gains of 7½% y/y over the next couple of years. At this pace, however, India is still operating below potential given challenges faced by policymakers in reaching an agreement regarding necessary structural adjustments. Japan's outlook remains muted due to weak economic fundamentals and bleak demographics. Economic growth in South Korea, Australia and Hong Kong will continue to be driven by domestic demand given that the countries' export sectors are adversely affected by weaker Chinese demand. On a regional weighted average basis, we expect real GDP to grow by 4.9% y/y in 2016-17, recording only a mild deceleration from the 5.0% gain in 2015.

Loose Monetary Policies Support Activity | Stronger Japanese Yen Adds To Policy Complexities

Most central banks, except for Hong Kong, in Asia-Pacific will maintain a monetary policy easing bias for the foreseeable future in order to support economic growth. The Bank of Japan has added a negative benchmark interest rate to its super-accommodative monetary policy stance and will likely take the rate further into negative territory over the course of the year in order to revive growth and end deflation. Regardless, the Japanese yen has appreciated substantially against the US dollar — up by over 11% year-to-date — adding to Japan's policy challenges. This has prompted Japanese authorities to intervene verbally, describing the currency strength as "undesirable" and pointing to a willingness to "act appropriately". Hong Kong's monetary policy follows developments in the US very closely due to the fixed exchange rate. Nevertheless, monetary tightening dynamics in the territory will be cautious in order to properly manage the risk of a disorderly property market correction.

Capital Flows Remain Subject To Sharp Reversals | Fundamentals Determine Risk Differentials

Changing expectations regarding the US Federal Reserve's (Fed) monetary policy actions continue to be the primary driver of capital flows in Asia-Pacific. This year commenced with elevated financial market volatility and strong capital outflows from emerging market economies. China's foreign exchange reserves have declined by US$780 billion since June 2014. Nevertheless, increased confidence in the stability of the Chinese renminbi and accommodative central banks in major advanced economies have eased market participants' concerns over waning global economic momentum and resulted in an improvement in risk appetite. As the US Fed is expected to resume its gradual monetary policy normalization later in the year, capital outflows from emerging markets will likely intensify once again. Individual country fundamentals — such as government finances, external balances, and the health of domestic household and corporate balance sheets — will determine the degree of forthcoming adjustments in Asia-Pacific currencies and capital markets.

Sovereign Rating Ratings Diverge | Geopolitical Risks And Elections Add To Uncertainty

China's perceived sovereign creditworthiness is weakening on the back of a "negative" outlook revision to its credit ratings by Standard & Poor's and Moody's in March. Given substantial economic and financial linkages between mainland China and Hong Kong, China's adjustment resulted in a similar action on Hong Kong. While sovereign credit ratings of Australia, Japan and South Korea are set to remain unchanged over the coming quarters, India may be subject to an upgrade revision. The potential for further intensification of geopolitical risks in the Middle East and select regional disputes add to economic uncertainty in Asia-Pacific over the course of 2016. Two events shaping regional prospects are the G7 Summit in Japan in May and the G20 Summit in China in September. In addition, the electoral cycle in Asia-Pacific may cause periods of investor risk aversion: India will hold various state elections this year, South Korea's parliamentary elections will take place in mid-April, Hong Kong's election for the Legislative Council will take place in September, and Australia's next federal election is expected in late 2016.

China's Economic Reform Efforts Shape Regional Outlook | Risks And Opportunities Emerge

Chinese policymakers' ability to support the country's ongoing structural transformation away from industrial and investment dependent growth toward a more market and consumer driven economy will drastically shape Asia-Pacific's regional outlook. The 13th Five-Year Plan for 2016-2020, approved by the National People's Congress in mid-March, confirmed the Chinese government's commitment to implementing further reforms in order to create a "moderately prosperous society". Reform priorities are centered on supporting innovative economic development to enhance the nation's productivity and promote sustainable output growth as well as on increased openness to integrate China more deeply into global markets. Given that reforms of this scale and complexity are unprecedented, substantial implementation risks exist. Indeed, with global investor sentiment being closely linked to developments in China, bouts of financial market volatility triggered by Chinese policymakers' actions are likely to occur over the coming quarters. However, the emergence of new industries and competences in China will provide vast business opportunities globally over the coming years.

CHINA

Tuuli McCully 1.416.863.2859
tuuli.mccully@scotiabank.com

Capital Market Dynamics

Foreign Exchange ► The renminbi (CNY) will likely remain under moderate depreciating pressure vs. the US dollar (USD) through 2016 given capital flows out of China and the fact that market forces are playing a more significant role in determining the currency's value. Nevertheless, the People's Bank of China (PBoC) continues to emphasize that maintaining currency stability is its key objective. In August 2015, the central bank took another step toward renminbi internationalization by reforming the exchange rate fixing mechanism; the daily USDCNY central parity (with a ±2% daily trading band) is now determined using the previous day's closing value, which allows for the currency's value to better reflect market demand and supply. The CNY has depreciated by around 4% vs. the USD after the adjustment; the PBoC has intervened to support the currency, which contributed to the US$449 billion reduction in foreign reserves in July 2015-February 2016. In November 2015, the International Monetary Fund (IMF) announced that the CNY will be included in its Special Drawing Rights basket on October 1st, 2016, with a weight of 10.9%, making the CNY a recognized international reserve currency. We expect USDCNY to close 2016 at 6.70.

Sovereign Debt & Credit Ratings ► Perception of Chinese sovereign credit worthiness is weakening. In March 2016, Standard and Poor's (S&P) and Moody's gave China's credit ratings — "AA-" and "Aa3", respectively — a "negative" outlook on the back of rather slow progress on the nation's economic rebalancing. Fitch rates China in the "A+" category with a "stable" outlook. Investor sentiment toward China is impacted by corporate debt overhang, house price developments, industrial-overcapacity, slower economic growth, structural reform progress, and policymaker intervention. The 5-year credit default swap is currently trading at 125 basis points (bps), slightly above the six month average of 118 bps. Despite recent declines, China's foreign reserves (US$3.2 trillion) remain sizable.

Economic Outlook

Growth ► Chinese real GDP growth is set to moderate due to the economy's reliance on industry that is suffering from excess capacity. A transition toward a more consumer and services-oriented economy is becoming increasingly evident; the services sector accounts for around half of the economy and its growth rate exceeds that of the industrial sector by a wide margin. Due to these rebalancing dynamics, we expect Chinese output expansion to slow to 6.4% this year and 6.2% in 2017 from 6.9% last year. The government will aim to maintain a relatively stable economic environment to mitigate the risk of disruptive market volatility amid the implementation of its ambitious structural reform agenda. Accordingly, we anticipate further fiscal intervention to be unveiled in the near term in order to counteract the strong decelerating forces the economy is facing.

Inflation & Monetary Context ► Monetary stimulus will continue to support the economy in 2016. On March 1st , the PBoC eased monetary policy by reducing the banks' reserve requirement ratio by 50 bps to 17% of deposits — the fifth cut since February 2015 — in order to maintain liquidity in the banking system and support money supply and credit growth. We expect further monetary accommodation to be implemented in the near term, particularly in the form of targeted policy measures, such as open market operations. The most recent benchmark interest rate cut took place in October 2015, when the PBoC lowered the one-year loan and deposit interest rates by 25 bps to 4.35% and 1.5%, respectively. Consumer prices rose by 2.3% y/y in March. We expect inflationary pressures to remain manageable through 2017 as industrial overcapacity has resulted in persistent producer price deflation. The headline inflation will likely close the year around 2¼% y/y.

Fiscal & Current Account Balance ► Additional fiscal stimulus are expected to be unveiled over the course of 2016 to support the economy. The budgetary deficit will likely hover slightly above 3% of GDP this year. China's gross public debt ratio will average around 47% of GDP in 2016-17, according to the IMF. We estimate that China's current account will maintain a surplus of 2½% of GDP in 2016-17, yet it has narrowed substantially over the past decade.

Institutional Framework & Political Environment

Governance ► The 13th Five-Year Plan, approved by the National People's Congress in mid-March, confirmed the Chinese government's commitment to implementing further reforms in order to create a "moderately prosperous society". The administration aims for a more globally integrated and market-driven economy. Interest and exchange rate liberalization has progressed, which will allow for the government to focus on issues related to capital flow management and liberalization. Other key adjustments address inefficiencies in the management of local government finances and state-owned enterprises.

Financial Sector ► The financial system is moving toward a market-oriented framework. The liberalization of interest rates is virtually complete; in October 2015, policymakers removed the deposit rate floating ceiling, allowing banks to set their rates freely according to market dynamics. Interest rate liberalization will foster competition among financial institutions and promote adequate risk management techniques. Uncertainty regarding the banking sector's asset quality persists given the rapid credit growth in recent years. Authorities continue to curb shadow banking activities to limit the build-up of systemic risk.

JAPAN

Tuuli McCully 1.416.863.2859
tuuli.mccully@scotiabank.com

Capital Market Dynamics

Foreign Exchange ► The Japanese yen (JPY) began 2016 with a strengthening trend against the US dollar (USD) despite domestic monetary easing bias; the JPY has appreciated by 11% year-to-date against the greenback. Regardless, the JPY will likely resume its prior depreciating path given Japan's fundamental economic weakness — inadequate structural reform, massive public sector indebtedness, monetary easing, and unattractive interest rate differentials relative to other economies. However, occasional bouts of investor risk aversion may temporarily support the JPY over the course of 2016. We expect USDJPY to close the year at 118, 1.9% stronger since the end of 2015.

Sovereign Debt & Credit Ratings ► Japan's sovereign debt profile is weak, with gross public debt estimated at 248% of GDP in 2016-17. In September 2015, Standard & Poor's downgraded Japan's sovereign credit rating by one notch to "A+", assessing that the government's strategy to revive economic growth and end deflation has not been successful enough to support the prior rating. Moody's rates Japan in the corresponding "A1" category, and Fitch one notch lower at "A". Japan's public indebtedness is counterbalanced by high private sector wealth, large institutional savings, strong external position, and stable financial system.

Economic Outlook

Growth ► Japan's economic outlook remains muted. Real GDP growth returned to negative territory in the final quarter of 2015, as output declined by 0.3% q/q (+0.8% y/y) following a 0.3% (1.7% y/y) expansion in the prior three month period. A struggling consumer was the primary driver behind this weakness. In 2015 as a whole, the economy grew by 0.5%. We expect only a modest improvement this year with output expansion reaching 0.7% as subdued wage growth will discourage spending by Japanese households. However, higher corporate profits should underpin private sector investment. Economic activity, particularly in terms of household spending, will likely experience a marked pick-up at the end of this year and in early 2017 before the April 2017 increase in the consumption tax rate (from 8% to 10%). We expect Japan's real GDP growth to average 0.6% in 2017.

Inflation & Monetary Context ► The Bank of Japan (BoJ) will keep monetary policy accommodative for the foreseeable future as it implements its policy of "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate", introduced in January 2016. In addition to increasing the monetary base by ¥80 trillion annually through large-scale asset purchases, the central bank applied an interest rate of -0.1% to financial institutions' new excess deposits at the central bank. BoJ Governor Haruhiko Kuroda has stressed policymakers' preparedness for additional easing if the price stability target of 2% y/y for core inflation (excluding food) is at risk. Given that Governor Kuroda has stated that altering the Japanese deflationary mindset may be subject to a delay, we consider the aforementioned risk to have materialized and expect further monetary stimulus over the coming quarters, which would take the policy rate deeper into negative territory. The BoJ estimates that the inflation target will be achieved in between April and September 2017. In February, headline inflation accelerated to 0.3% y/y from zero the month before, while core inflation remained at 0.0% y/y. When energy costs are also stripped out of the measure, prices rose by 0.8% y/y. Inflation is set to remain muted until April 2017 when the hike in the consumption tax rate will temporarily lift price gains; we expect the headline rate to close next year at 1½% y/y.

Fiscal & Current Account Balance ► Japan's fiscal profile remains structurally weak. Regardless, in January a ¥3.5 trillion supplementary budget was approved by parliament; spending measures are focused on welfare services. New debt will not be issued for financing the additional spending as it will be funded by tax revenues. The fiscal deficit will likely average 4½% of GDP in 2016-17. Despite bloated public finances, the government has no difficulty refinancing its debt obligations. The trade deficit has narrowed substantially as low oil prices have reduced the import bill and the weak yen has supported exports. A strong primary income account balance will maintain the current account surplus at around 3½% of GDP in 2016-17.

Institutional Framework & Political Environment

Governance ► The Liberal Democratic Party, led by Prime Minister Shinzo Abe, and its junior partner, the Komeito party, maintain a majority in the lower house. An election for half of the seats in the upper house will take place in July 2016 and the government aims to achieve a two-thirds majority, which would allow for easy constitutional amendments. The next lower house election is due by 2018, yet Prime Minister Abe may opt to call it early.

Financial Sector ► Japan's financial sector has a large exposure to government debt securities; 52% of government bonds are held by domestic banks and insurance companies. Outstanding bank lending was up by 2.2% y/y in February, marking a slight deceleration from the average gain of 2.6% in 2015. The BoJ's stress testing exercises indicate that the country's financial system has strong resilience to potential adverse economic shocks.

INDIA

Tuuli McCully 1.416.863.2859
tuuli.mccully@scotiabank.com

Capital Market Dynamics

Foreign Exchange ► Rapid shifts in risk aversion as well as global investors' portfolio rebalancing will continue to impact the value of the Indian rupee (INR) given relatively large foreign holdings of Indian equities. Moreover, a domestic monetary easing bias amid gradual policy tightening in the US puts the INR on the defensive. We expect USDINR to close 2016 at 69.5, implying a 4.8% depreciation over the course of the year.

Sovereign Debt & Credit Ratings ► India's sovereign credit rating profile points to a potential upgrade, subject to ongoing improvement in government finances; Moody's holds a "positive" outlook on India's "Baa3" rating. Fitch and Standard & Poor's rate India in the equivalent "BBB-" category, with a "stable" outlook. According to Fitch, the country's creditworthiness is bolstered by improvements in policymaking that have raised economic and fiscal prospects, though India's low per capita income and weak public finances remain its key vulnerabilities. India's gross public debt will likely average 63% of GDP in 2016-17, according to the International Monetary Fund (IMF).

Economic Outlook

Growth ► India's economic expansion will remain below the country's estimated growth potential of 8-10% y/y in the foreseeable future; we expect real GDP to advance by 7.5% y/y in 2016-17 following a 7.3% gain last year. Private investment remains relatively sluggish due to the country's rather slow progress on reforms and improving the ease of doing business; nevertheless, business sentiment is showing signs of revival. Consumer spending growth is expected to accelerate, supported by low oil prices, rising wages, and accommodative monetary policy. India is relatively insulated from concerns regarding China's economic growth deceleration as less than 5% of its exports are shipped to China; India's top two export destinations are the US and the euro area, which purchase a quarter of India's shipments abroad.

Inflation & Monetary Context ► Monetary conditions continue to ease in India. In April, the Reserve Bank of India (RBI) reduced the policy repo rate by 25 basis points (bps) to 6.50% — adding to the executed interest rates cuts totaling 125 bps in 2015 — and implemented various liquidity measures to make monetary policy transmission more effective. The decision to provide additional monetary stimulus was justified by India's relatively favourable inflation outlook and muted economic growth. Indeed, consumer prices rose by 5.2% y/y in February, in line with the long-term consumer price inflation target of 4% ±2 percentage points. The RBI has set the next milestone for the inflation rate to be 5% y/y in March 2017. Moreover, the Union Budget for fiscal year 2016/17 was relatively cautious; monetary policy will carry larger responsibility for stimulating economic activity now that government spending will remain relatively restrained. In addition, the prudent fiscal policy stance will not pose a threat to the country's inflation outlook.

Fiscal & Current Account Balance ► India's Union Budget for fiscal year 2016/17, presented at the end of February, maintained the government's prior promise for further consolidation. The administration kept its previous fiscal targets in place and aims to narrow the central government deficit to 3.5% of GDP in FY2016/17 from 3.9% in 2015/16. Nevertheless, the shortfall remains larger at the general government level, averaging 6¾% of GDP through 2017, according to the IMF. The budget focuses on rural development and infrastructure. India benefits from low oil prices as it is a large net energy importer and meets around three quarters of its petroleum needs through imports. India's current account deficit will likely continue to hover slightly above 1% of GDP in 2016-17.

Institutional Framework & Political Environment

Governance ► Prime Minister Narendra Modi of the Bharatiya Janata Party (BJP) has been in power since the general election in May 2014. The BJP holds a majority in the lower house; however, its minority position in the upper house slows policy execution and reform implementation. Improvement of the ease of doing business is one of the government's main policy priorities; the administration aims to enact some key legislation, such as the proposed bankruptcy law and the goods and services tax bill, during the second half of the budget session of parliament, which will commence at the end of April. The government's attention to the national reform agenda may be swayed away by several important state elections, such as West Bengal, Kerala, Assam and Tamil Nadu, that will be held in 2016.

Financial Sector ► The latest RBI's Financial Stability Report (December 2015) points out that the Indian financial system is sound, yet risks to the sector have risen recently reflecting increased stressed assets, lower banking sector soundness and sluggish profitability. According to the IMF, the non-performing loans ratio has steadily risen in recent quarters and reached 5.9% in December 2015, up from 4.4% at the end of 2014; meanwhile, the banking sector's Tier 1 Capital ratio was 10.1% in the fourth quarter, up from 9.6% a year before.

SOUTH KOREA

Tuuli McCully 1.416.863.2859
tuuli.mccully@scotiabank.com

Capital Market Dynamics

Foreign Exchange ► The South Korean won (KRW) has strengthened against the US dollar (USD) over the past month and recovered some of its recent losses thanks to ongoing portfolio inflows. Nevertheless, we expect this trend to reverse over the coming months as the KRW remains vulnerable to monetary tightening in the US amid a domestic easing bias. USDKRW will likely close 2016 at 1250, implying a 6% depreciation over the course of the year.

Sovereign Debt & Credit Ratings ► South Korea's sovereign credit rating outlook is stable following notable improvement in perceived creditworthiness in 2015. In September, Standard & Poor's upgraded the country's credit rating by one notch to "AA-" on the back of a sound economic growth outlook as well as a decline in the banking sector's external debt and a lower share of short-term borrowing. This move was followed by a rating upgrade to "Aa2" by Moody's in December 2015. Fitch currently rates the country in the "AA-" category. General government gross debt will average 40% of GDP through 2017, according to the International Monetary Fund (IMF), comparing favourably with an advanced economy average of around 105%. Market metrics point to an improvement in the global market perception of South Korean creditworthiness; the 5-year credit default swap is trading at 66 basis points (bps) — roughly in line with the 6-month average — after peaking at 81 bps in February.

Economic Outlook

Growth ► South Korea's economic outlook will improve gradually over the coming quarters, yet the export-oriented economy will feel the adverse impact of muted world trade. We expect that the nation's real GDP growth will average 2.9% y/y over the next two years, following a 2.6% gain in 2015. Output expanded by 0.7% q/q (3.1% y/y) in the final quarter of 2015. Domestic demand remains solid while net exports continue to be a drag on growth. Weaker demand from China — a destination for a quarter of South Korea's shipments abroad — as well as increased competition from Chinese manufacturers will create challenges for South Korean exporters. Consumer spending is supported by authorities' fiscal and monetary stimulus measures, though a high household debt burden will restrain private consumption growth somewhat. Meanwhile, government spending will provide vital support to economic activity.

Inflation & Monetary Context ► Monetary conditions will remain conducive to economic activity in South Korea; we think that further cautious monetary stimulus may be implemented in the second quarter of 2016, taking the Bank of Korea's (BoK) benchmark interest rate 25 bps lower to 1.25%. The policy rate has been kept at 1.50% since June 2015. The BoK will pay close attention to the following developments when setting its policy stance: 1) major countries' monetary policy direction, 2) financial and economic conditions in China, 3) international capital flow dynamics, 4) geopolitical risks, and 5) increasing household debt burden in South Korea. The central bank will likely maintain monetary conditions accommodative for an extended period of time, followed by a gradual normalization in the second half of 2017 as inflationary pressures intensify gradually. The inflation outlook remains manageable, with the headline inflation rate at 1.0% y/y in March. We expect to see a modest pick-up in price pressures over the coming months and the annual inflation rate will likely reach around 1⅔% by the end of the year, remaining below the BoK's 2% inflation target for 2016-18.

Fiscal & Current Account Balance ► Public sector finances remain healthy with a virtually balanced budget — based on the IMF's definition of a general government net lending ratio — likely to be recorded through 2017. The government maintains an expansionary fiscal policy stance in order to support economic growth; new stimulus measures were unveiled in February 2016, which frontload budgetary spending planned for this year. A smaller oil import bill has boosted South Korea's external accounts, offsetting the struggling export sector performance; the nation's current account surplus will remain sizable, averaging close to 7½% of GDP in 2016-17.

Institutional Framework & Political Environment

Governance ► The next presidential election will be held in December 2017; President Park Geun-hye from the Saenuri Party will not be able to run for the presidency again due to a single five-year term limit. Parliamentary elections will take place on April 13th, 2016. We assess that given a divided opposition, the Saenuri Party will likely win another majority. The party's election platform is centered on finalizing labour market reforms, reducing income inequality, boosting job creation and youth employment, and raising birth rates by subsidizing child care costs.

Financial Sector ► The IMF assesses that the South Korean financial sector's near-term vulnerabilities are limited and banks' funding and liquidity conditions are stable. The country' banking system is well-capitalized; the Tier 1 Capital ratio was 11.4% in December 2015, according to the Financial Supervisory Service. Household credit growth remains elevated, accelerating to 11.2% y/y at end-2015 from 10.4% in the third quarter, according to the BoK.

AUSTRALIA

Tuuli McCully 1.416.863.2859
tuuli.mccully@scotiabank.com

Capital Market Dynamics

Foreign Exchange ► The Australian dollar (AUD) has reversed some of its losses recently; it has appreciated by over 10% against the US dollar since bottoming in mid-January. Nevertheless, a protracted slump in Australia's key export commodity prices and investor concerns regarding slowing economic growth in China (Australia's largest trading partner) will keep the Australian dollar (AUD) on the defensive against the US dollar (USD). Moreover, an accommodative domestic monetary policy stance at a time of a gradual policy tightening bias in the US will continue to impact the AUD. We expect the AUDUSD rate to close 2016 at 0.70, implying a near-4% depreciation over the course of the year.

Sovereign Debt & Credit Ratings ► Australia continues to enjoy a top sovereign credit status by all major credit rating agencies. This reflects the country's high degree of fiscal and monetary flexibility, a track record of sound macroeconomic management, and economic resilience. The highest yielding AAA-debt has attracted substantial foreign holdings; as of December 2015, 64% of Australian government securities were held by non-residents. The yield on the 10-year government bond currently hovers at 2.4%.

Economic Outlook

Growth ► Australia's economic performance will continue to be adversely impacted by low commodity prices and weaker Chinese demand, yet the domestic side of the economy will remain solid. The country's real GDP grew by 0.6% q/q (3.0% y/y) in the final quarter of 2015, taking output gains to 2.5% for the year as a whole. Consumer spending will be supported by loose monetary policy, the wealth effect of high house prices, gradually improving labour market conditions, and low fuel prices. Private investment growth will remain negative now that the mining sector investment boom has ended. Public infrastructure outlays will provide modest support to the economy. External sector challenges are partially offset by higher export volumes that are a result of increased mining capacity following investment project completions. Australia's annual real GDP growth will likely average 2.7% in 2016-17.

Inflation & Monetary Context ► Monetary conditions will remain accommodative over the coming quarters with the benchmark interest rate currently set at the record low level of 2.0%. The Reserve Bank of Australia (RBA) lowered the policy rate by 25 basis points (bps) in May 2015 and has held it steady following subsequent monetary policy meetings, most recently on April 5th. Monetary authorities have indicated that the outlook for inflation provides room for further easing of policy should the economy need additional support. Consumer price inflation in Australia rose slightly to 1.7% y/y in the fourth quarter of 2015 but remained below the RBA's 2-3% target. We estimate that headline inflation will likely accelerate slightly over the coming quarters — closing the year at 2.4% y/y — and will remain comfortably within the RBA's target in 2017.

Fiscal & Current Account Balance ► Australia's government finances remain relatively healthy; the gross government debt ratio will likely average 37% of GDP in 2016-17, according to the International Monetary Fund (IMF). The fiscal year 2016/17 (July-June) budget will be delivered in May. Policymakers have eased their stance toward fiscal consolidation and now aim to achieve a budget surplus by FY2020/21. The general government deficit will likely average close to 1½% of GDP in 2016-17, according to IMF estimates. Low commodity prices are reflected in Australia's external balance. We forecast that that the current account deficit will hover around 4⅓% of GDP in 2016 (compared with a 3% shortfall in 2014) before narrowing slightly to 4% in 2017.

Institutional Framework & Political Environment

Governance ► In September 2015, the Liberal Party elected Malcolm Turnbull as Prime Minister replacing Tony Abbott. The Liberal-National coalition currently holds a comfortable majority in the lower house of parliament, but not in the upper house. The next federal election is expected in late 2016; all seats in the lower house and 40 out of 76 seats in the upper house will be subject to re-election.

Financial Sector ► Australia's financial system is sound, resilient, and profitable. Standard & Poor's assesses that the country has one of the lowest-risk banking systems globally. China accounts for 5% of Australian banks' total international exposure. The banking sector enjoys sufficient capital adequacy; the Tier 1 Capital ratio rose to 12% in the fourth quarter of 2015 from 10.8% a year earlier, according to the IMF. The non-performing loans ratio of 1.0% in Q4 remains low by international standards. Australian authorities continue to monitor the level of household debt, which has increased steadily to over 100% of GDP. Private sector credit growth was 6.6% y/y in February — twice as fast as the recent low in mid-2013; housing credit expansion, at 7.3% y/y in February, has started to show early signs of stabilization as investor lending growth has decelerated due to the RBA's supervisory measures to cool the housing market.

HONG KONG

Tuuli McCully 1.416.863.2859
tuuli.mccully@scotiabank.com

Capital Market Dynamics

Foreign Exchange ► The Hong Kong dollar's (HKD) managed exchange rate is set to remain at 7.75-7.78 vis-à-vis the US dollar (USD), supported by the territory's large foreign reserves of US$362 billion (equivalent to around 110% of GDP) and healthy current account and fiscal surpluses. We do not expect any changes to the fixed exchange rate in the near term given its vital role in supporting financial and economic stability.

Sovereign Debt & Credit Ratings ► Hong Kong's perceived creditworthiness is weakening; in March 2016, Standard and Poor's (S&P) and Moody's gave the territory's credit ratings — "AAA" and "Aa1", respectively — a "negative" outlook. According to S&P, the outlook revision reflects the combination of a similar action on mainland China and strong financial and economic linkages between the two economies. Fitch rates Hong Kong in the "AA+" category with a "stable" outlook. Hong Kong's ratings remain two to three notches higher than that of the mainland, supported by a solid external position, large fiscal reserves, and healthy fiscal performance.

Economic Outlook

Growth ► Hong Kong's economic outlook will continue to be adversely affected by weaker global and Chinese demand; more than half of Hong Kong's exports are shipped to mainland China. However, services exports to the mainland are set to remain solid. Private consumption will remain the main pillar of Hong Kong's economy as a tight labour market continues to support household income gains. However, consumer spending growth will be impacted by the negative wealth effect arising from an ongoing property price correction. Public sector outlays, particularly large-scale infrastructure projects, will provide further support to economic momentum. Hong Kong's real GDP grew by 2.0% y/y in the fourth quarter of 2015, taking last year's average output growth to 2.4%. We expect the territory's economic expansion to decelerate slightly over the coming quarters, averaging close to 2% y/y in 2016-17.

Inflation & Monetary Context ► US monetary policy is a major determinant of local interest rates due to the fixed exchange rate. The Hong Kong Monetary Authority raised the base rate by 25 basis points (bps) to 0.75% the day after the first interest rate hike by the US Federal Reserve in December 2015. We expect Hong Kong's benchmark rate to be raised by 50 bps this year in line with developments in the US. Meanwhile, policymakers in Hong Kong will continue to focus on managing the risks of potential capital outflows and a disorderly property market correction. Headline inflation has accelerated recently— consumer prices rose by 3.1% y/y in February on the back of higher food prices — but we expect the pick-up to be temporary. Given a stable USDHKD exchange rate and persistently low oil prices, we expect inflation to moderate over the coming months and close the year at around 2.3% y/y.

Fiscal & Current Account Balance ► Hong Kong's budgetary surpluses since 2004 have allowed the territory to accumulate sizable fiscal reserves. Despite solid government finances, a property market downturn will limit the administration's revenues in the foreseeable future; this combined with increased public outlays to support the economy will result in smaller fiscal surpluses, averaging roughly 1% of GDP in 2016-17 — down from around 3¾% over the past two years. In the absence of independent monetary policy, fiscal policy is the primary tool for dealing with any external shocks. A low oil import bill has more than offset the impact of Hong Kong's weak export performance, resulting in a narrower trade deficit. Services provision to mainland China will keep the services balance in a substantial surplus. The current account surplus will likely average 3% of GDP in 2016-17.

Institutional Framework & Political Environment

Governance ► Debates regarding democracy and electoral reform, as well as anti-mainland sentiment will remain sources of tension, yet the status quo will likely be maintained until after the next Chief Executive vote in 2017. We expect current Chief Executive Leung Chun-ying to remain in office until the end of his term but he is unlikely to stand for re-election given his unpopularity. Election for the Legislative Council will take place in September 2016.

Financial Sector ► The property market remains the main downside risk for Hong Kong's economic outlook; elevated real estate prices are a result of near-zero real interest rates and solid demand from mainland China. Now, price correction pressures are rising along with higher domestic interest rates. In February, territory-wide private property prices recorded the fifth consecutive monthly decline (averaging -2.3% m/m); in year-over-year terms, prices were 6.4% lower. Hong Kong's banking system is well-capitalized and asset quality remains high: in the fourth quarter, the Tier 1 Capital ratio rose to 15.3% (from 13.9% a year earlier). The non-performing loans ratio remains very low, yet it increased slightly in the fourth quarter to 0.7%, according to the International Monetary Fund. As mainland China's capital flows are gradually liberalized, its financial integration with Hong Kong will continue to deepen. Despite Shanghai's emergence as a major financial center, Hong Kong is set to maintain its attractiveness given the internationally recognized ease of doing business in the territory.

Key Economic Indicators

China

Key Economic Indicators	2013	2014	2015	Forecast 2016	Forecast 2017
Real GDP (% change)	7.7	7.3	6.9	6.4	6.2
Current Account Balance (% of GDP)	1.5	2.7	3.1	2.7	2.4
Foreign Reserves (months of imports)	23.5	23.5	23.8	24.0	22.2
Exchange Rate USDCNY (% change)	2.9	-2.4	-4.4	-3.1	0.8
CPI (eop, % change)	2.5	1.5	1.6	2.2	2.3
Government Fiscal Balance (% of GDP)	-1.1	-1.2	-1.9	-3.2	-3.0
Government Debt (% of GDP)	39	41	43	46	48
Population (million people)	1361	1368	1375	1382	1389
Nominal GDP (USD bn)	9591	10271	10720	11078	11925
Exchange Rate USDCNY (eop)	6.05	6.21	6.49	6.70	6.65
Central Bank Interest Rate (eop)	6.00	5.60	4.35	4.10	4.35
Exports (USD bn)	2210	2343	2285	2307	2400
Imports (USD bn)	1950	1960	1681	1698	1783
Trade Balance (USD bn)	259	382	603	609	617
Current Account Balance (USD bn)	148	277	331	300	285
Foreign Reserves (USD bn)	3821	3843	3330	3400	3300

Japan

Key Economic Indicators	2013	2014	2015	Forecast 2016	Forecast 2017
Real GDP (% change)	1.4	-0.1	0.5	0.7	0.6
Current Account (% of GDP)	0.9	0.8	3.3	3.9	3.7
Foreign Reserves (months of imports)	17.6	18.2	21.8	21.1	21.4
Exchange Rate USDJPY (% change)	-17.6	-12.1	-0.4	1.9	-5.6
CPI (eop, % change)	1.6	2.4	0.2	1.0	1.5
Government Fiscal Balance (% of GDP)	-8.5	-7.3	-5.9	-4.6	-4.1
Gross Government Debt (% of GDP)	243	246	246	248	249
Population (million people)	127	127	127	126	126
Nominal GDP (USD bn)	4828	4488	4136	4387	4211
Exchange Rate USDJPY (eop)	105.3	119.8	120.2	118.0	125.0
Exports (USD bn)	703	674	627	684	668
Imports (USD bn)	819	792	650	695	685
Trade Balance (USD bn)	-116	-118	-23	-12	-18
Current Account Balance (USD bn)	45	37	135	170	155
Foreign Reserves (USD bn)	1202	1200	1179	1220	1220

India

Key Economic Indicators	2012	2013	2014	2015	Forecast 2016	Forecast 2017
Real GDP (% change)	5.1	6.4	7.1	7.3	7.4	7.5
Current Account Balance (% of GDP)	-5.1	-2.7	-1.4	-1.1	-1.1	-1.1
Foreign Reserves (months of imports)	7.3	7.6	8.3	10.8	10.3	10.2
Exchange Rate USDINR (% change)	-3.5	-11.0	-2.0	-4.7	-4.8	2.2
CPI (eop, % change)	10.6	9.9	9.5	5.6	5.5	5.8
Government Fiscal Balance (% of GDP)	-7.4	-7.6	-7.0	-7.2	-7.0	-6.7
Government Debt (% of GDP)	67	66	66	65	64	63
Population (million people)	1243	1259	1276	1293	1310	1327
Nominal GDP (USD bn)	1801	1837	1994	2125	2268	2546
Exchange Rate USDINR (eop)	55.0	61.8	63.0	66.2	69.5	68.0
Central Bank Interest Rate (eop)	8.00	7.75	8.00	6.75	6.25	6.50
Exports (USD bn)	297	315	323	267	278	294
Imports (USD bn)	489	466	463	393	408	431
Trade Balance (USD bn)	-192	-151	-140	-126	-131	-136
Current Account Balance (USD bn)	-92	-49	-27	-23	-26	-28
Foreign Reserves (USD bn)	297	296	320	352	350	365

South Korea

Key Economic Indicators	2013	2014	2015	Forecast 2016	Forecast 2017
Real GDP (% change)	2.9	3.3	2.6	2.9	2.9
Current Account Balance (% of GDP)	6.2	6.0	7.8	7.6	7.2
Foreign Reserves (months of imports)	8.1	8.3	10.1	10.4	9.8
Exchange Rate USDKRW (% change)	1.4	-3.8	-7.2	-6.0	2.5
CPI (eop, % change)	1.1	0.8	1.3	1.7	2.4
Government Fiscal Balance (% of GDP)	0.7	0.8	-0.5	0.4	0.6
Government Debt (% of GDP)	35	36	38	39	40
Population (million people)	50.2	50.4	50.6	50.8	51.0
Nominal GDP (USD bn)	1306	1408	1360	1336	1390
Exchange Rate USDKRW (eop)	1050	1091	1175	1250	1220
Central Bank Interest Rate (eop)	2.50	2.00	1.50	1.25	2.00
Exports (USD bn)	560	573	527	511	534
Imports (USD bn)	516	526	436	427	457
Trade Balance (USD bn)	44	47	90	84	77
Current Account Balance (USD bn)	81	84	106	102	100
Foreign Reserves (USD bn)	346	364	368	370	375

Australia

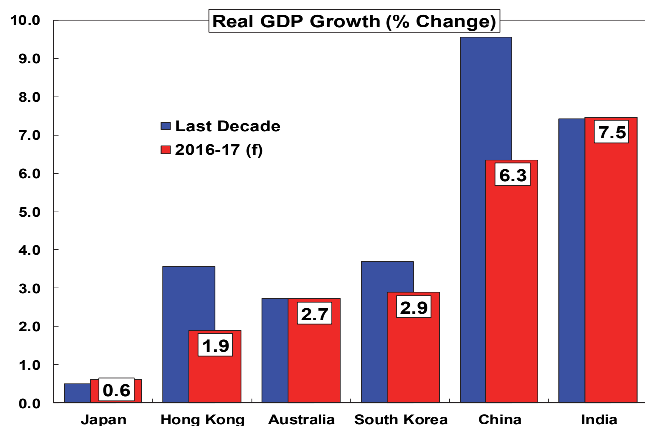
Key Economic Indicators	2013	2014	2015	Forecast 2016	Forecast 2017
Real GDP (% change)	2.0	2.6	2.5	2.7	2.8
Current Account Balance (% of GDP)	-3.4	-3.0	-4.6	-4.3	-4.1
Foreign Reserves (months of imports)	2.0	2.2	2.3	2.5	2.4
Exchange Rate AUDUSD (% change)	-14.2	-8.3	-10.9	-3.9	7.1
CPI (eop, % change)	2.7	1.7	1.7	2.4	2.3
Government Fiscal Balance (% of GDP)	-2.8	-2.8	-2.4	-1.8	-0.9
Government Debt (% of GDP)	31	34	36	37	38
Population (million people)	23.3	23.6	24.0	24.4	24.9
Nominal GDP (USD bn)	1469	1424	1206	1225	1319
Exchange Rate AUDUSD (eop)	0.89	0.82	0.73	0.70	0.75
Central Bank Interest Rate (eop)	2.50	2.50	2.00	1.75	1.75
Exports (USD bn)	301	292	235	231	249
Imports (USD bn)	311	300	261	255	269
Trade Balance (USD bn)	-10	-8	-26	-24	-21
Current Account Balance (USD bn)	-50	-43	-55	-52	-54
Foreign Reserves (USD bn)	53	54	49	53	54

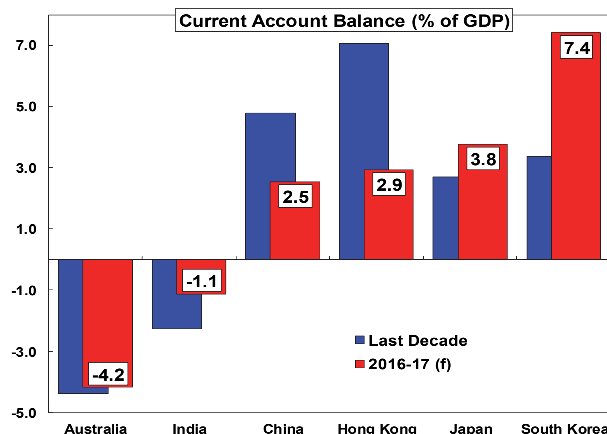
Hong Kong

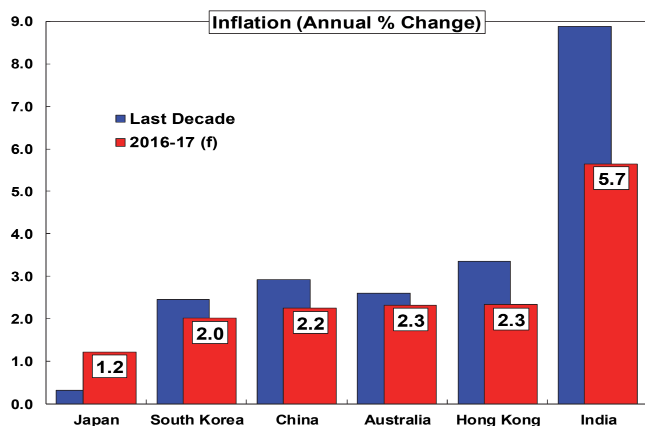
Key Economic Indicators	2013	2014	2015	Forecast 2016	Forecast 2017
Real GDP (% change)	3.1	2.5	2.4	1.8	2.0
Current Account Balance (% of GDP)	1.5	1.3	3.1	3.1	2.8
Foreign Reserves (months of imports)	7.1	7.2	8.2	8.2	7.7
Exchange Rate USDHKD (% change)	0.0	0.0	0.1	-0.4	0.1
CPI (eop, % change)	4.3	4.8	2.4	2.3	2.4
Government Fiscal Balance (% of GDP)	1.1	3.8	3.5	0.7	1.0
Government Debt (% of GDP)	0.6	0.1	0.1	0.1	0.1
Population (million people)	7.2	7.3	7.3	7.4	7.4
Nominal GDP (USD bn)	276	291	310	325	336
Exchange Rate USDHKD (eop)	7.75	7.76	7.75	7.78	7.77
Central Bank Interest Rate (eop)	0.50	0.50	0.75	1.25	1.75
Exports (USD bn)	459	474	466	469	480
Imports (USD bn)	524	545	523	529	542
Trade Balance (USD bn)	-65	-71	-57	-60	-62
Current Account Balance (USD bn)	4	4	10	10	9
Foreign Reserves (USD bn)	311	329	359	360	350

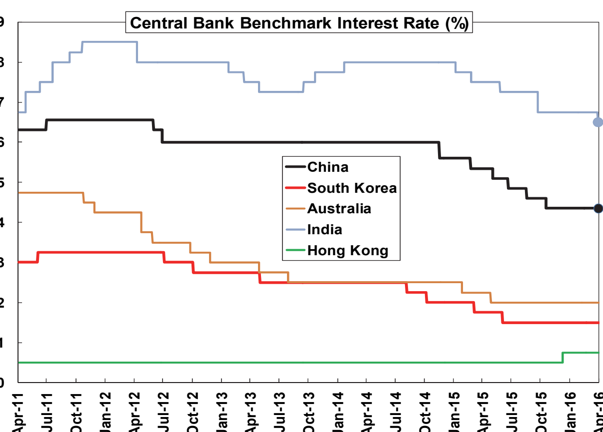
Source: National authorities, IMF, OECD, Bloomberg and Scotiabank Economics. Data as of April 11, 2016.

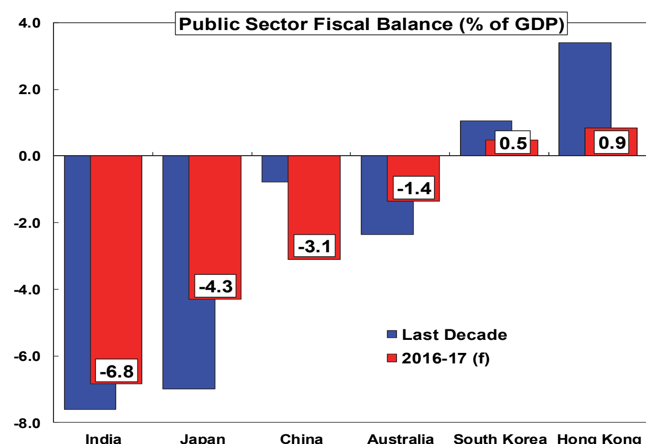
Macroeconomic Metrics

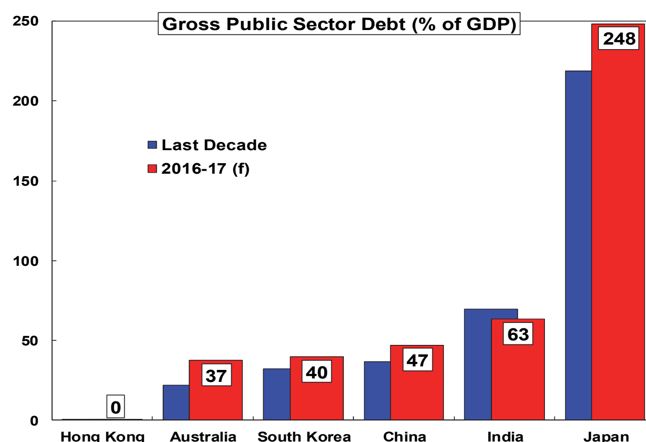






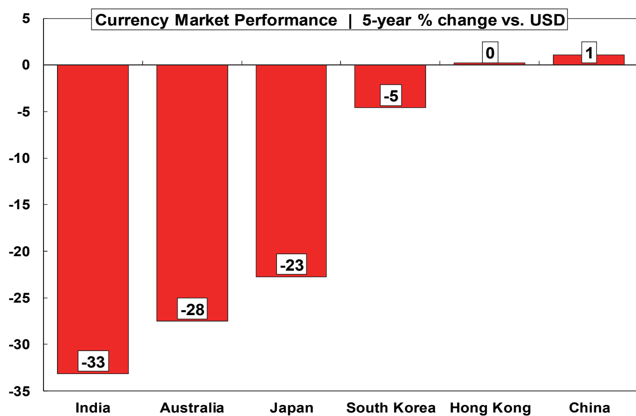


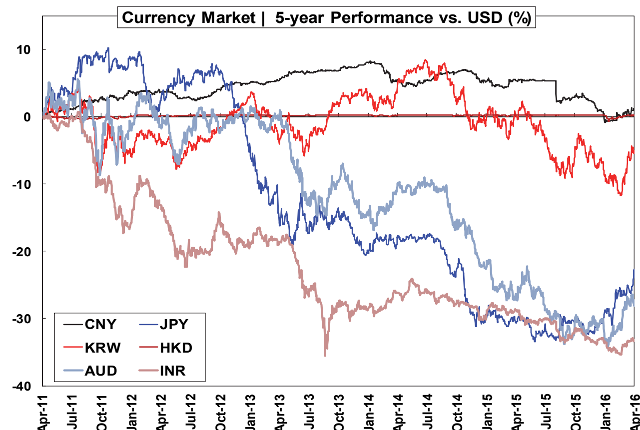


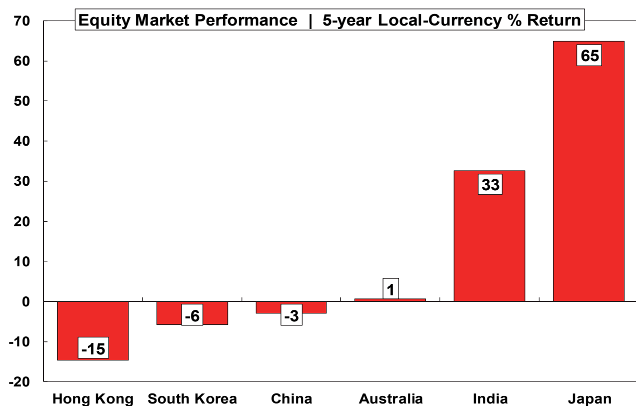


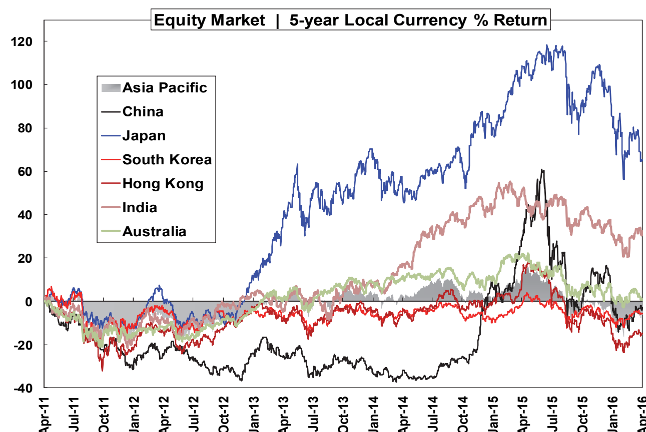
Source: National authorities, IMF, OECD, Bloomberg and Scotiabank Economics. Data as of April 11, 2016.

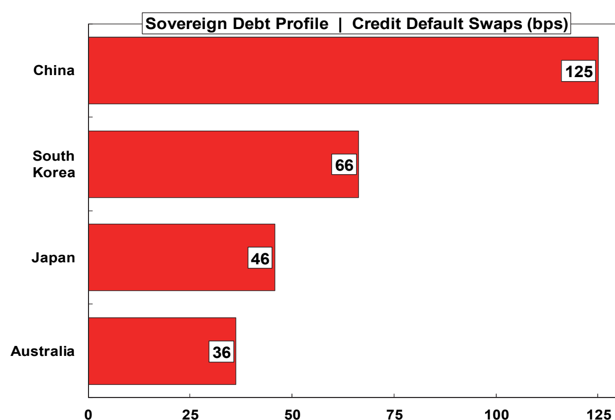
Financial Market Metrics

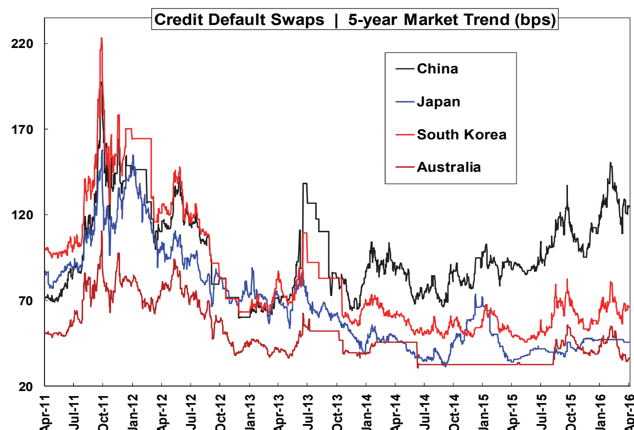












Source: Bloomberg. Data as of April 11, 2016.

Foreign Currency Long Term Sovereign Credit Ratings

INVESTMENT GRADE														
Moody's					Standard & Poor's					Fitch				
RATING	AMERICAS	EUROPE	ASIA & OCEANIA	MIDDLE EAST & AFRICA	RATING	AMERICAS	EUROPE	ASIA & OCEANIA	MIDDLE EAST & AFRICA	RATING	AMERICAS	EUROPE	ASIA & OCEANIA	MIDDLE EAST & AFRICA
Aaa	Canada United States	Austria (-) Denmark Finland (-) Germany Luxembourg Netherlands Norway Sweden Switzerland	Australia New Zealand Singapore		AAA	Canada	Denmark Germany Luxembourg Netherlands Norway Sweden Switzerland United Kingdom (-)	Australia Hong Kong (-) Singapore		AAA	Canada United States	Denmark Germany Luxembourg Netherlands Norway Sweden Switzerland	Australia Singapore	
Aa1		United Kingdom	Hong Kong (-)		AA+	United States	Austria Finland (-)			AA+		Austria Finland United Kingdom	Hong Kong	
Aa2		France	Macau *- South Korea	Kuwait *- Qatar *- United Arab Emirates *-	AA		Belgium France (-)	New Zealand	Kuwait Qatar	AA		Belgium (-) France	New Zealand	Kuwait Saudi Arabia (-)
Aa3	Cayman Islands Chile	Belgium	China (-) Taiwan	Saudi Arabia *-	AA-	Chile	Czech Republic	China (-) South Korea Taiwan		AA-			South Korea	
A1	Bermuda	Czech Republic	Japan	Israel	A+	Bermuda	Ireland Slovakia	Japan	Israel	A+	Chile	Czech Republic Slovakia	China Taiwan (+)	
A2		Poland Slovakia			A	Trinidad and Tobago (-)				A		Ireland Malta	Japan	Israel
A3	Mexico (-) Peru	Malta	Malaysia	Oman *-	A-		Slovenia (+)	Malaysia	Saudi Arabia	A-		Poland	Malaysia	
Baa1		Ireland (+)	Thailand		BBB+	Aruba Mexico Peru Turks and Caicos	Iceland Malta (+) Poland (-) Spain	Thailand		BBB+	Mexico Peru	Iceland Italy Slovenia (+) Spain	Kazakhstan Thailand	
Baa2	Bahamas Colombia Panama Trinidad and Tobago *- Uruguay	Iceland Italy Spain	Kazakhstan *- Philippines	South Africa *-	BBB	Colombia (-) Panama Uruguay		Philippines		BBB	Colombia Panama			
Baa3		Romania (+) Slovenia Turkey (-)	India (+) Indonesia		BBB-	Bahamas (-)	Italy Romania	India Kazakhstan (-)	Morocco Oman South Africa (-)	BBB-	Aruba Uruguay	Romania Russia (-) Turkey	India Indonesia Philippines (+)	Bahrain (-) Morocco South Africa

SPECULATIVE GRADE														
Moody's					Standard & Poor's					Fitch				
RATING	AMERICAS	EUROPE	ASIA & OCEANIA	MIDDLE EAST & AFRICA	RATING	AMERICAS	EUROPE	ASIA & OCEANIA	MIDDLE EAST & AFRICA	RATING	AMERICAS	EUROPE	ASIA & OCEANIA	MIDDLE EAST & AFRICA
Ba1	Costa Rica (-) Guatemala (-)	Hungary (+) Portugal Russia *-		Bahrain *- Morocco	BB+		Hungary Portugal Russia (-) Turkey (-)	Indonesia (+)		BB+	Brazil (-) Costa Rica (-)	Hungary (+) Portugal		
Ba2	Brazil (-)	Croatia (-)			BB	Brazil (-) Guatemala	Croatia (-)		Bahrain	BB	Guatemala	Croatia (-)		
Ba3	El Salvador (-)		Bangladesh	Tunisia	BB-	Costa Rica (-) Dominican Republic	Cyprus (+)	Bangladesh Vietnam	Jordan	BB-			Vietnam	Tunisia (-)
B1	Dominican Republic	Cyprus	Papua New Guinea *- Sri Lanka Vietnam	Jordan	B+	El Salvador Nicaragua		Papua New Guinea (-) Sri Lanka (-)		B+	Dominican Republic (+) El Salvador	Cyprus (+)	Sri Lanka (-)	
B2	Nicaragua		Cambodia	Lebanon (-)	B	Barbados (-) Ecuador Jamaica				B	Ecuador Jamaica		Pakistan	Egypt Lebanon (-)
B3	Ecuador St. Vincent and the Grenadines (-)		Pakistan	Egypt	B-	Belize	Greece	Pakistan (+)	Egypt Lebanon (-)	B-				
Caa1	Barbados				CCC+					CCC+				
Caa2	Belize Cuba (+) Jamaica (+)				CCC	Venezuela (-)				CCC	Venezuela	Greece		
Caa3	Venezuela (-)	Greece			CCC-					CCC-				
-					CC					CC				
-					C					C				
Ca	Argentina (+)				SD	Argentina				RD				

Note : (+) positive outlook (-) negative outlook N.R. - Not Rated.
When Moody's places a rating on watch in the short-term *+ denotes possible upgrade, *- denotes possible downgrade & * denotes developing. A credit is removed from the Watchlist when the rating is upgraded, downgraded or confirmed.

Ratings as at April 2016

CONTRIBUTORS

Pablo F.G. Bréard, Head
1.416.862.3876
pablo.breard@scotiabank.com

Tuuli McCully
1.416.863.2859
tuuli.mccully@scotiabank.co

Erika Cain
1.416.866.4205
erika.cain@scotiabank.com

Juan Manuel Herrera
1.416.862.3174
juanmanuel.herrera@scotiabank

Rory Johnston
1.416.862.3908
rory.johnston@scotiabank.com

Estela Molina
1.416.862.3199
estela.molina@scotiabank.com

Scotiabank Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: 416.866.6253 Fax: 416.866.2829
Email: scotia.economics@scotiabank.com

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