



Asia Focus

*Asia's 4-D Challenge:
Debt, Demand, Deflation &
Depreciation*

*India:
Back at the Crossroads*

Business Climate Outlook 2016
Lanka Business Online

Key Themes

Demand Remains Subdued, Private Capex the Weakest Link

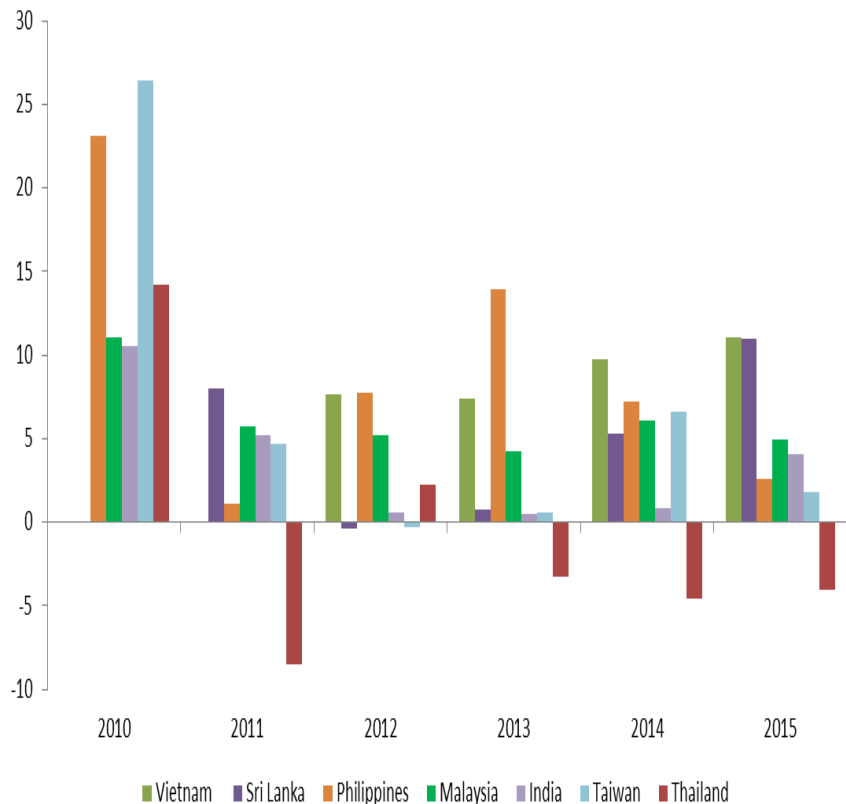
- **Aggregate Demand remains weak**, region remains in the adjustment phase
- **Exports contraction led by commodity price slowdown** negatively impacting growth. Some exports to DM cushioning the impact of intra-regional trade weakness
- **Indebtedness rises, led by domestic private sector debt**
- Falling commodity prices, resulting in **producer price deflation. Consumer prices still remain positive**; unlikely to cause the deflationary spiral
- **New investment, especially led by private sector, remains weak** on low capacity utilization levels and weak demand
- **Policymakers stepping up by modest monetary and fiscal easing due to macro constraints**

Weak Domestic Demand Despite Favorable Input Prices

Demand Subdued as Region Suffers from Lower Growth & Reduced ToT

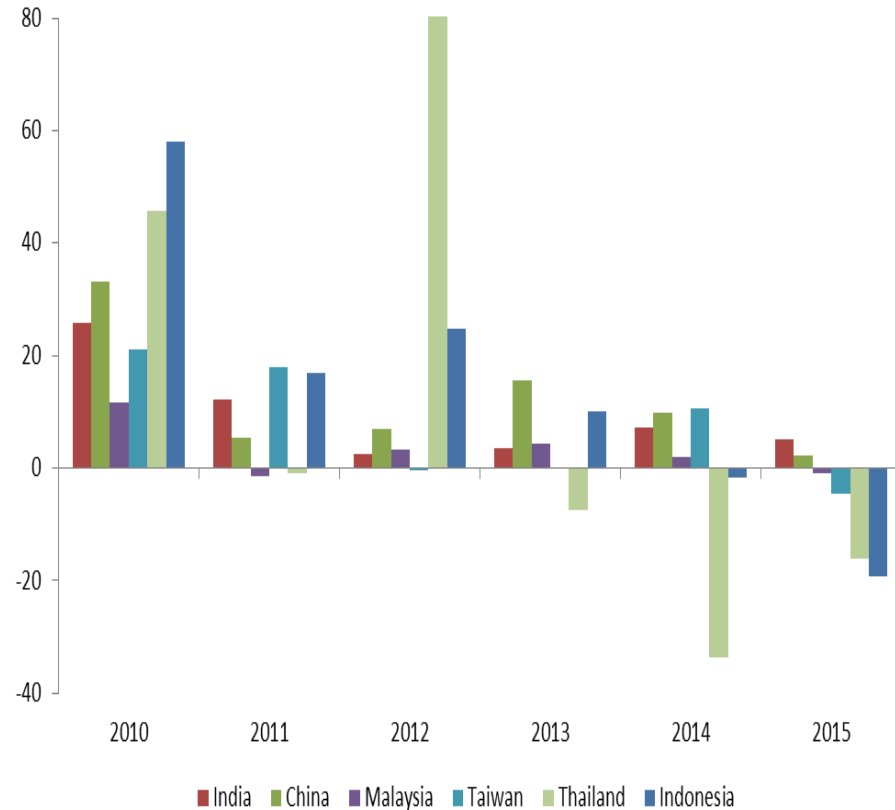
Production: IP Manufacturing

(Percent, year-on-year)



Consumption: Car Sales

(Percent, year-on-year)



- **Weaker domestic demand**, despite oil price windfall and higher real incomes.
- Some economies showing **signs of stabilization**, led by monetary easing, fiscal expansion and tax incentives

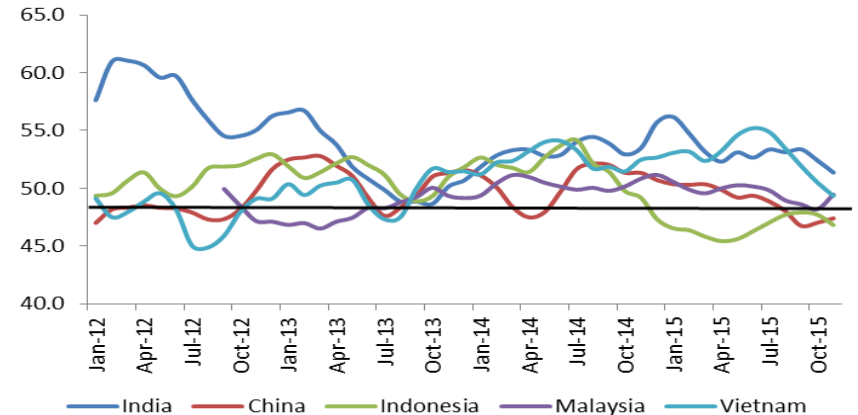
Investment Remains the Weak Link

Tighter Monetary Conditions Limiting Private Investment, Policymakers Await Fed Decision

- Indicators of capex activity, continue to weaken
- Private capex continues to suffer headwinds from high real interest rates, excess capacity, high corporate debt and weak growth hurting corporate profitability, limiting material increase in investment
- Fiscal support in some economies, but private investment remains weak

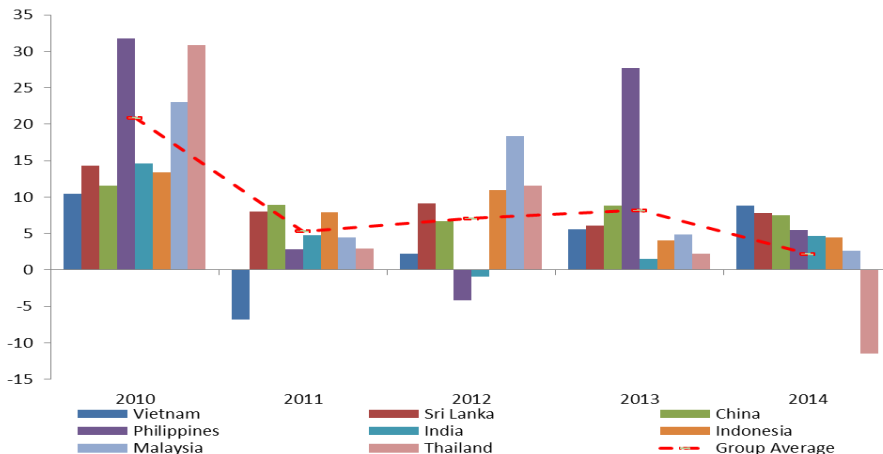
PMI Manufacturing New Orders

(3mma, 50+= Expansion)



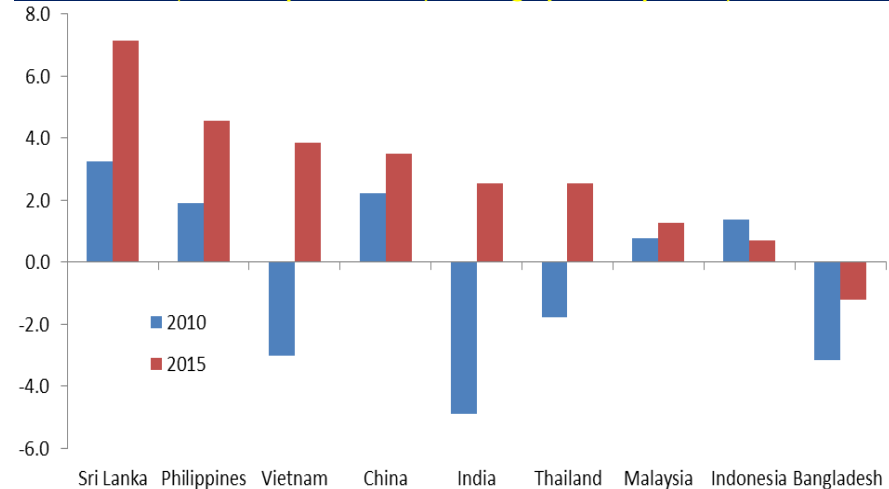
Fixed Capital Formation

(Percent, year-on-year)



Real Interest Rates

(Percent per annum, average for the period)

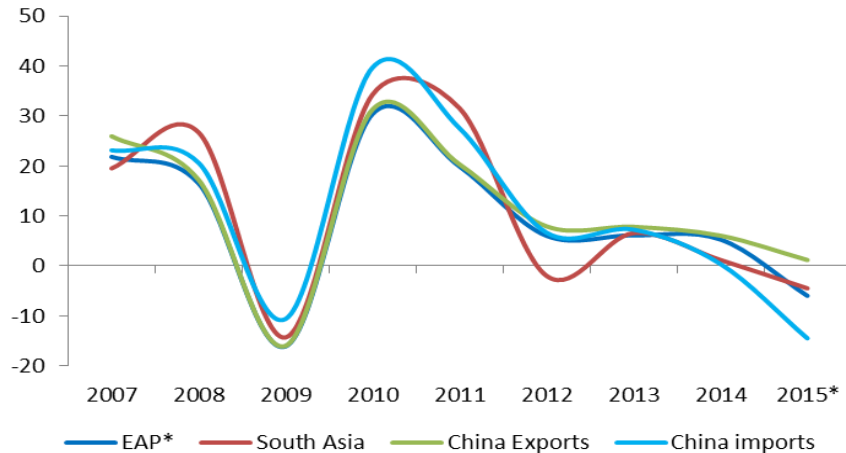


Demand for Asian Exports Continues to Suffer

Change in Export Linkages Appears Structural

Merchandise Exports

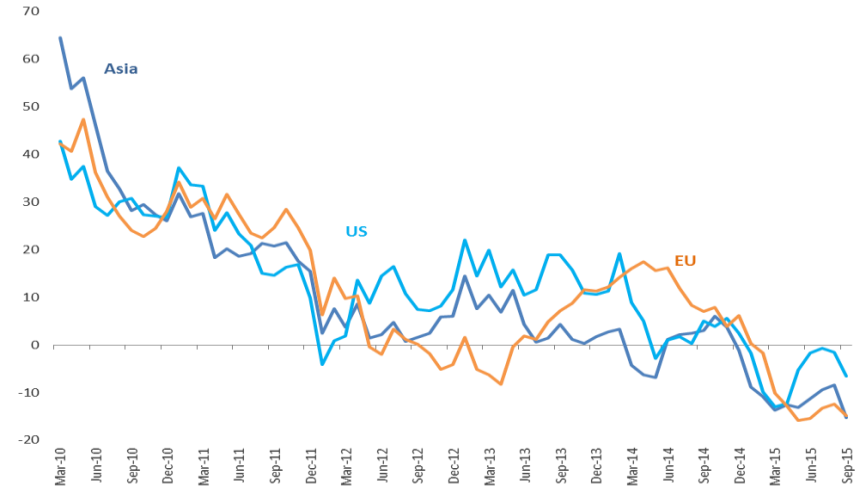
(US\$, Percent year-on-year)



* Developing East Asia Pacific countries, Data till August 2015

Origin of Chinese Imports

(Percent year-on-year)



Source of Export Demand, 2014

(Percent of GDP)

% of GDP	Total		Euro Area			Asia ex Japan ex China
	Exports	Area	China	US	Japan	
Malaysia	52.3	3.7	8.1	6.1	5.9	11.7
Thailand	41	3.2	4.8	4.7	4.2	8
Hong Kong	40.2	3.3	10.8	6.1	2.4	6.9
Taiwan	38.5	2.9	9.3	7.1	3.3	5.6
Korea	29.8	2.5	5.4	4.9	2.4	3.4
Philippines	24.4	2.2	3.6	4.1	2.9	5.0
Indonesia	21.6	1.9	2.8	2.5	3.3	4.9
India	18.8	3.2	1.3	3.3	0.6	1.9
China	17.2	2.3	0	3.7	1.7	2.6

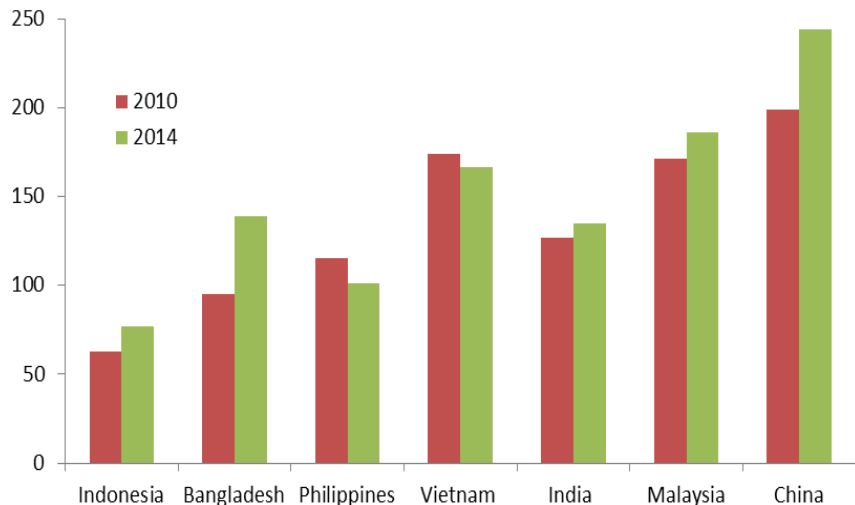
- **Sharp contraction in exports**
- **Intra-Asia trade has strengthened** to nearly 38% of EM Asia's exports; causing spill-over effects on region's demand for exports
- **Recovery in exports to DM providing support to some pockets.** DM account for an average 40% of exports, but US growth increasingly less import heavy

Debt Leverage Limiting New Investment

Private Debt Significant in a Few Countries

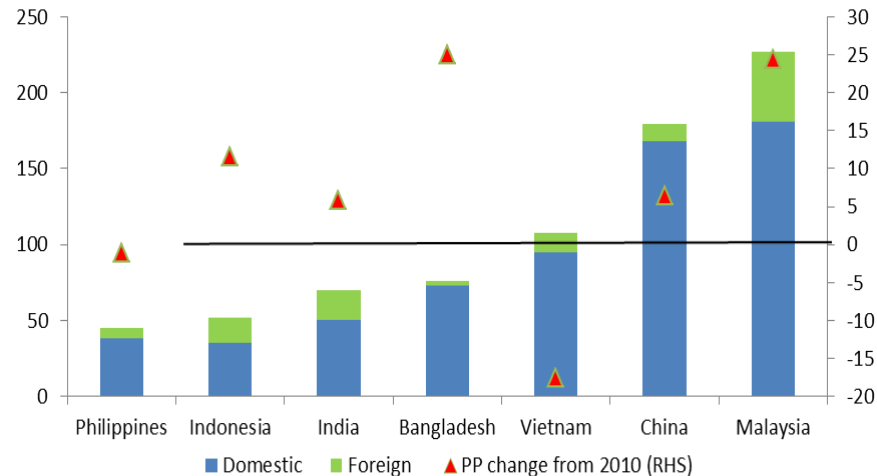
Total Debt to GDP

(Percent of GDP)



Private Sector Debt

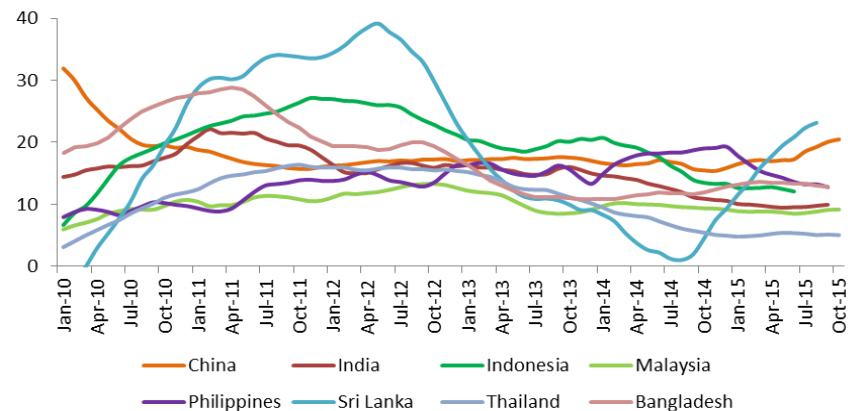
(2014, Percent of GDP)



- **Asian indebtedness risen rapidly since 2008**
- **China played a significant role**, with total debt-to-GDP nearly doubling from 126% in 2000 to 244% in 2014
- **Asian borrowing dominated by corporates bank lending.** Slow growth & high interest rates have increased NPLs, especially in China, India, Indonesia
- **Credit demand weakening** on asset quality concerns, weak demand and conservative monetary easing

Private Credit

(3mma, Percent year-on-year)

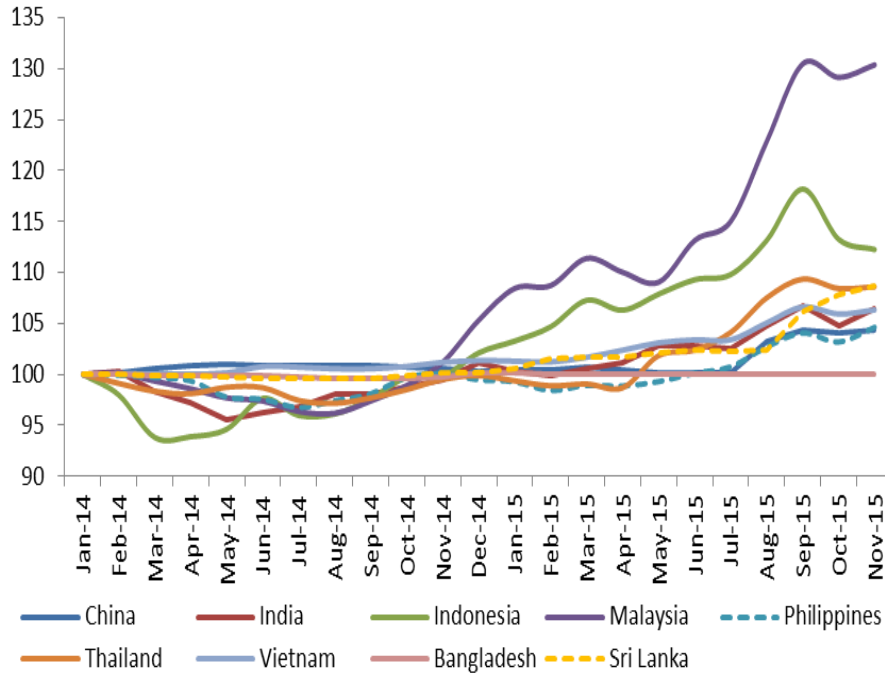


Depreciation Concerns Amidst Fed Lift-Off & Local Slowdown

Central Bank Intervention Limiting Volatility

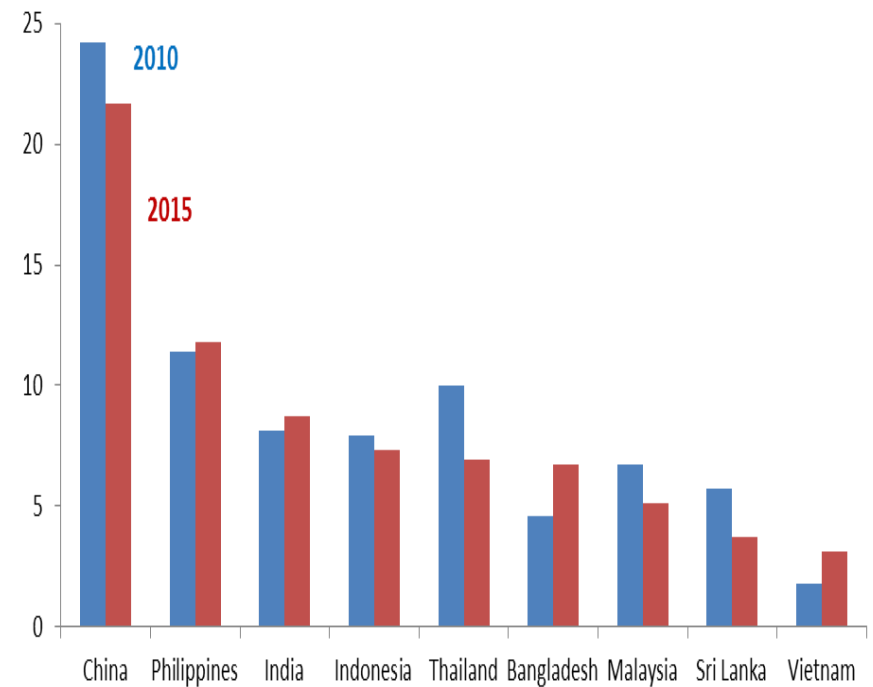
Nominal Exchange Rate

(Per US\$, 2010=100)



Forex Reserves

(months of imports)



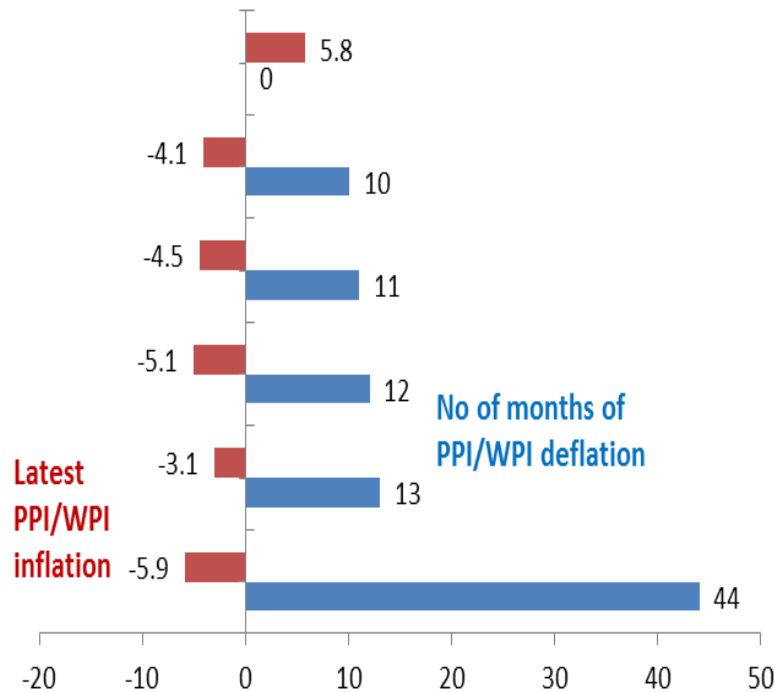
- Accelerated currency depreciation in 2015, led by the Fed liftoff expectations
- Central banks intervening to manage volatility
- China, India, have healthy reserves to allow for central bank intervention
- However, most Asian countries' currencies have appreciated on a real basis, increasing the likelihood of a sharp adjustment

Deflation in Producer Prices, Core Prices Remain Positive

Risk of Deflationary Spiral Unlikely

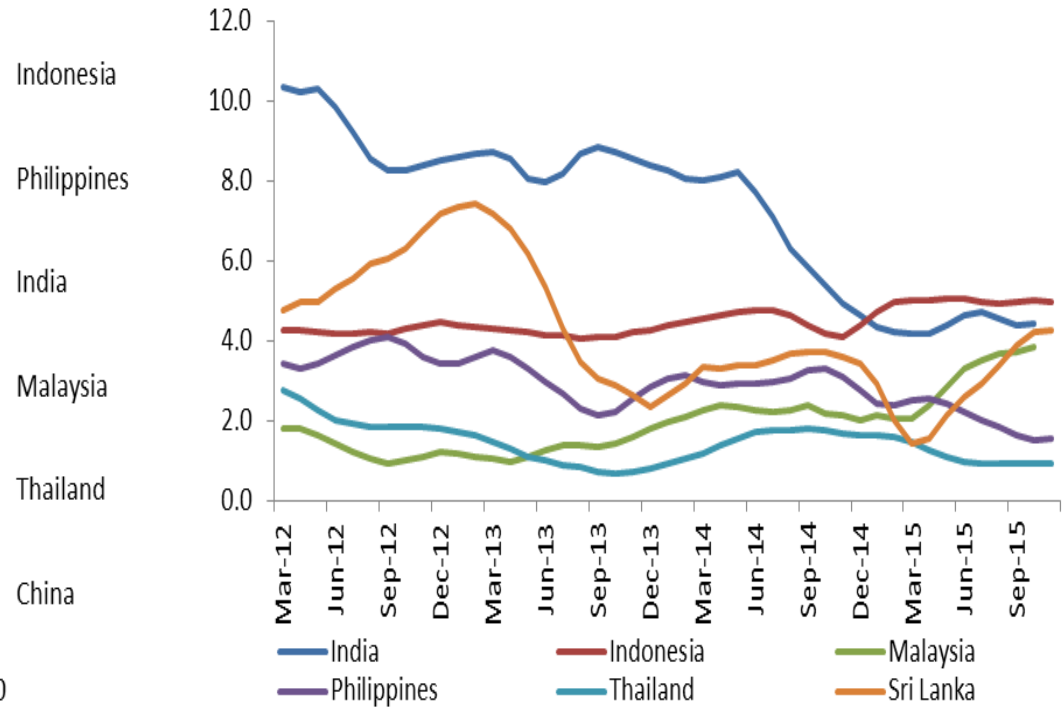
Producer Price Deflation

(Percent, year-on-year)



CPI Core Inflation

(3mma, Percent year-on-year)



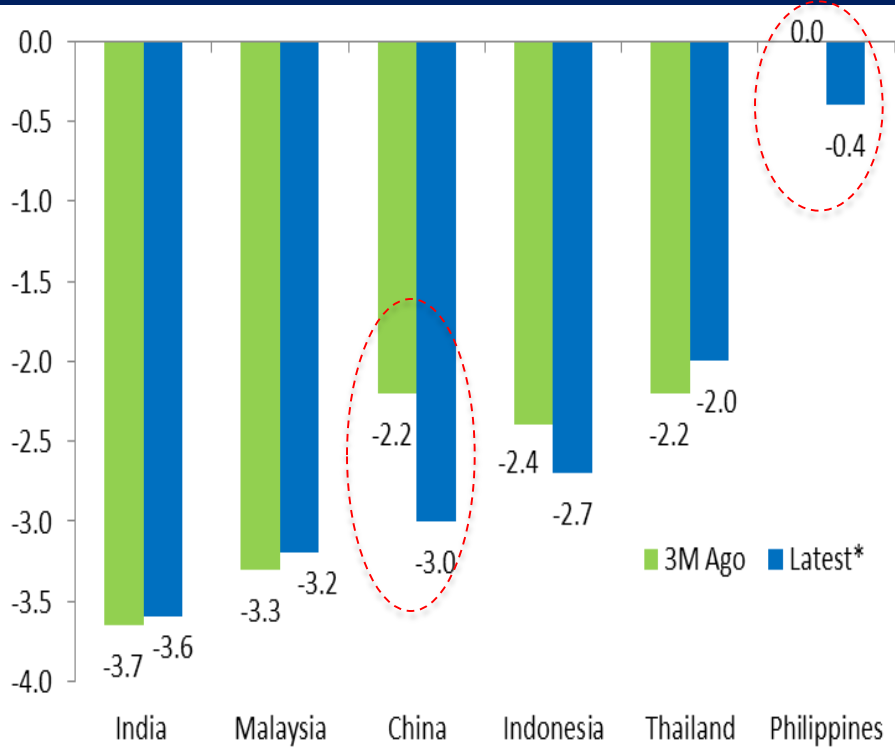
- **Excess capacity and deflation in producer prices** led by commodity price slowdown and reduced consumer appetite
- **Lower pricing power & high leverage could risk debt servicing capacity of corporates**

Policymakers Stepping Up to Limit Weak Demand

But Response Muted Led by Financial Stability Concerns

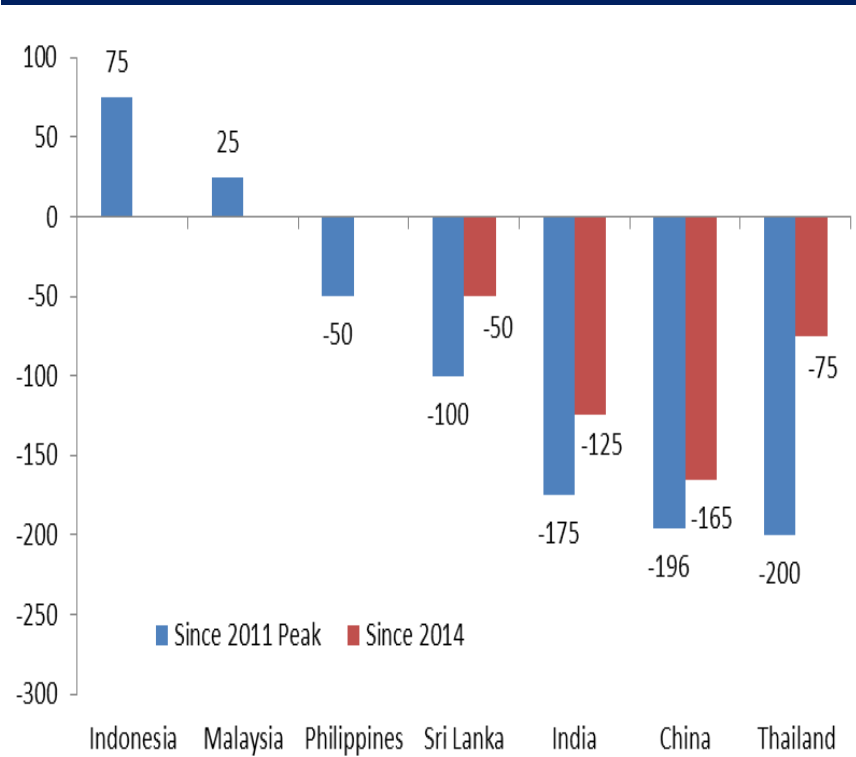
Fiscal Balance

(Percent of GDP, 12M trailing sum)



Monetary Easing

(Reduction in policy rates, in basis points)

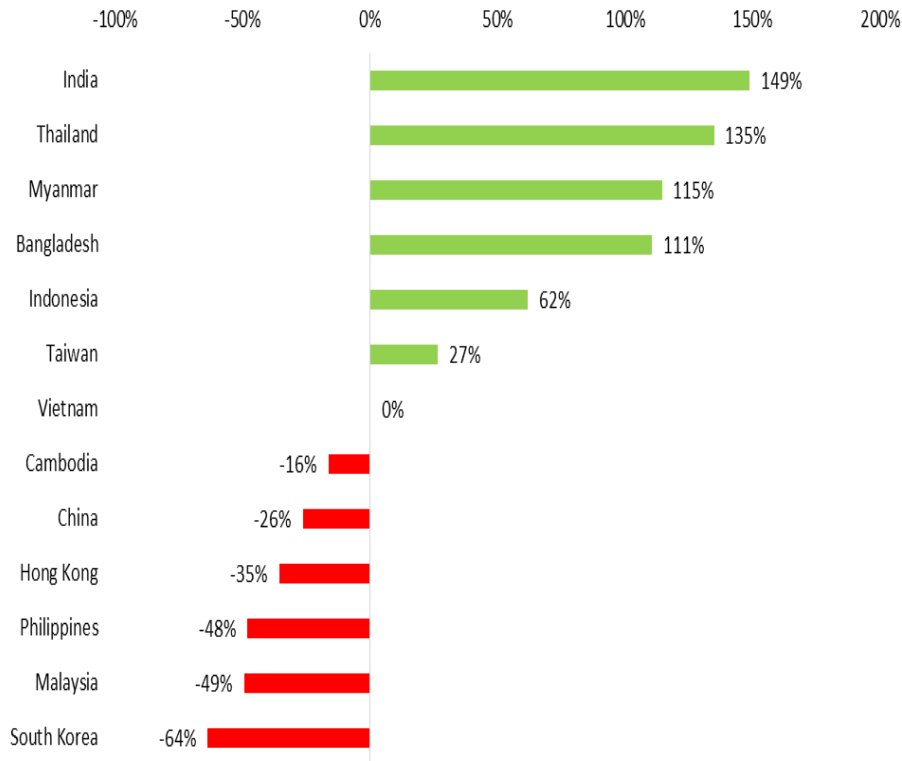


- **Policymakers responding by way of gradual monetary/fiscal easing**, balancing the risks from impending Fed tightening and corresponding weak aggregate demand that could increase deflationary pressures
- **Rising concerns about financial stability**, worsening domestic credit quality, rising FX liabilities – a key concern

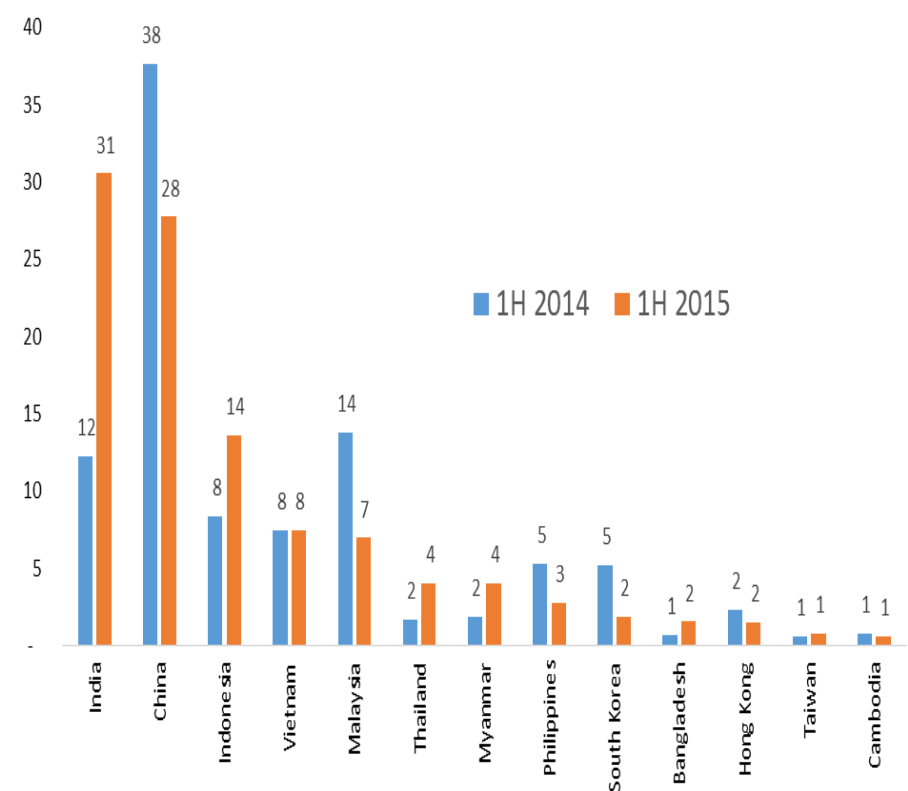
Mixed FDI Flows to EM Asia in H1 2015

Increases in India, Thailand, Indonesia; But Declines in China, Korea, Philippines

Change in FDI - H1 2015 vs. H1 2014
(% change)



Foreign Direct Investment
(\$ billions)

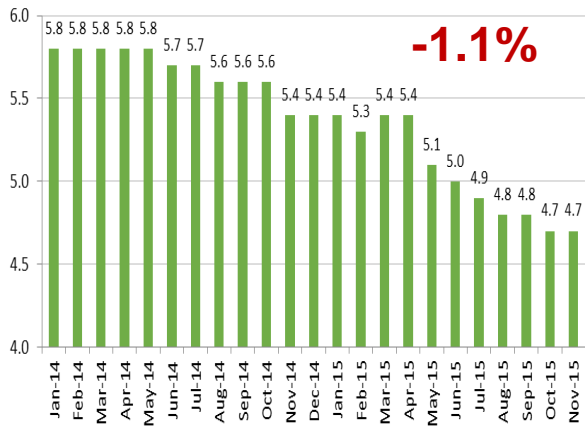


- Greenfield investments (FDI) have declined in the first half of 2015 relative to the same period of 2014 in a large number of emerging markets
- On a relative basis, EM Asia's FDI drop in FDI is less severe

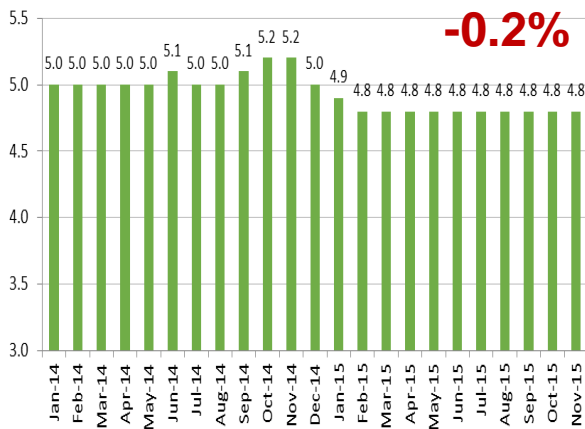
Moderating Expectations Across East Asia

Philippines Expected to Register Steady Growth, Indonesia May Draw Support from Reforms

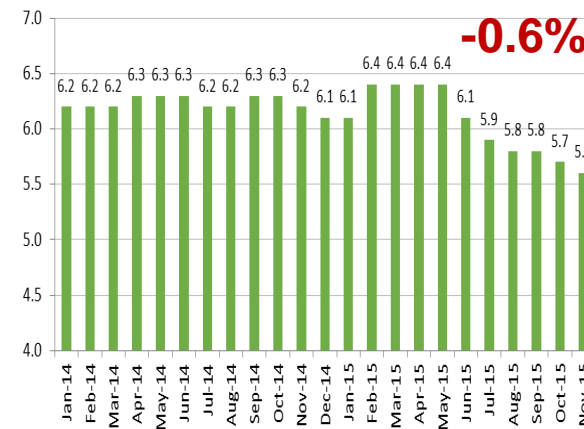
2015 GDP Growth - Indonesia
(% - evolution of Consensus Forecasts)



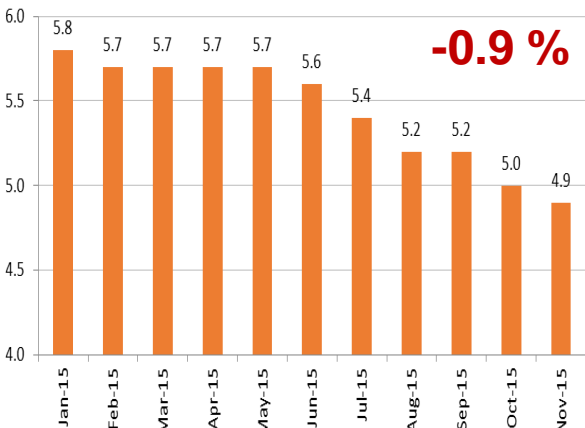
2015 GDP Growth - Malaysia
(% - evolution of Consensus Forecasts)



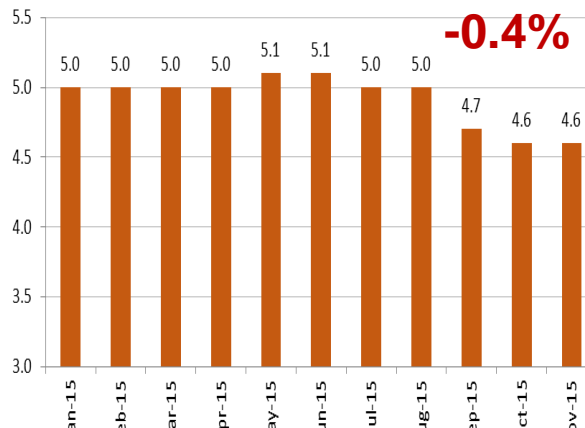
2015 GDP Growth - Philippines
(% - evolution of Consensus Forecasts)



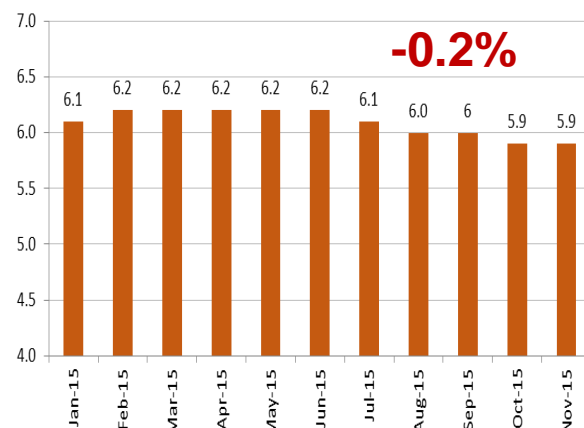
2016 GDP Growth - Indonesia
(% - evolution of Consensus Forecasts)



2016 GDP Growth - Malaysia
(% - evolution of Consensus Forecasts)



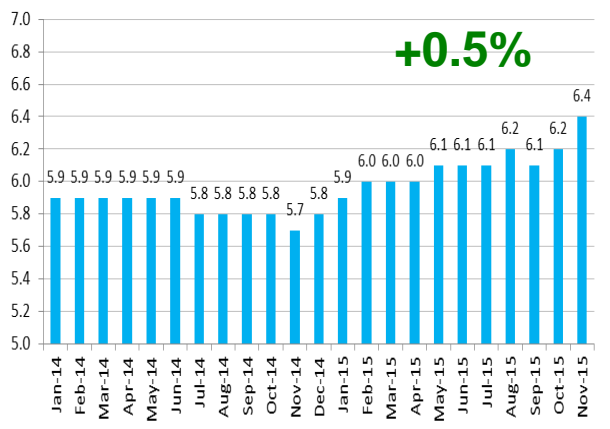
2016 GDP Growth - Philippines
(% - evolution of Consensus Forecasts)



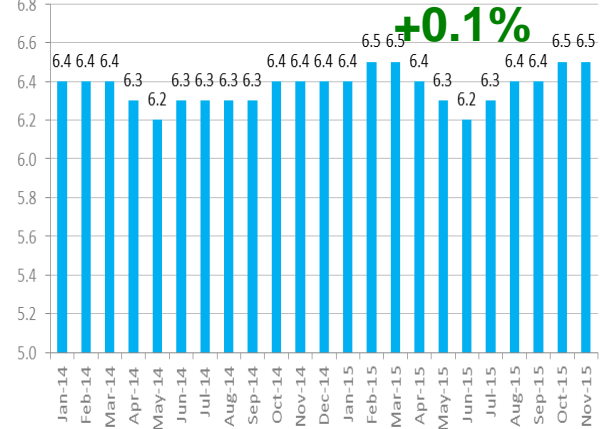
Pockets of Growth Still Available

Vietnam, Bangladesh Expected to Maintain Steady Growth, Sri Lankan Expectation Moderating Sharply

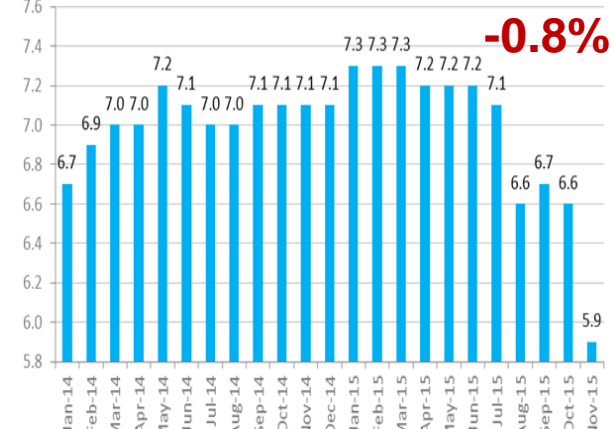
2015 GDP Growth - Vietnam
(% - evolution of Consensus Forecasts)



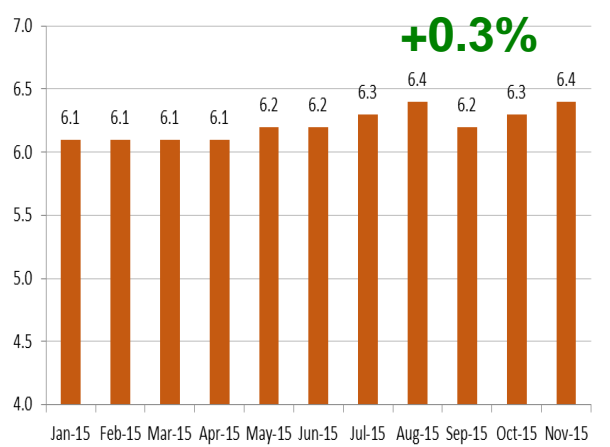
2015 GDP Growth - Bangladesh
(% - evolution of Consensus Forecasts)



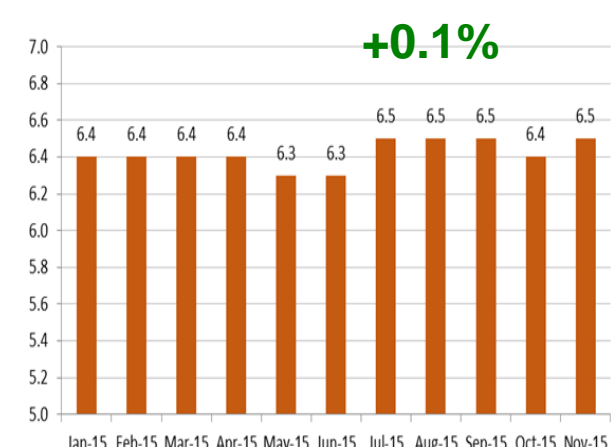
2015 GDP Growth - Sri Lanka
(% - evolution of Consensus Forecasts)



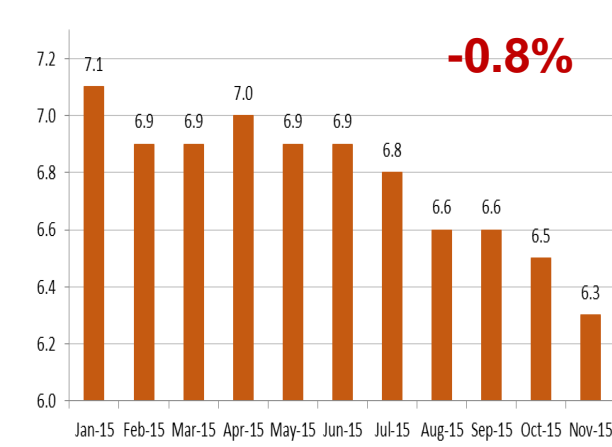
2016 GDP Growth - Vietnam
(% - evolution of Consensus Forecasts)



2016 GDP Growth - Bangladesh
(% - evolution of Consensus Forecasts)



2016 GDP Growth - Sri Lanka
(% - evolution of Consensus Forecasts)



Outlook

Dependent on US, China Shocks; MT Growth Dependent on Identifying New Growth Drivers

- **Asia continues to deliver the highest growth rates in EM**, though intra-regional growth dynamics differ
- **Amidst China's growth transformation and slowing momentum, India is emerging as the investor's favorite large cap Asian country**
- **A continued strong US Dollar and monetary policy normalization in the US** will directly affect Asia-Pacific economies
- **Challenging global conditions may prompt governments to undertake long-term structural reforms.** Political constraints may delay their implementation
- **India's** outlook dependent on pace of economic reforms and the strength of external demand recovery impacting the capital inflows and currency dynamics
- **Indonesia's** growth affected by weakness in commodity exports and slower than expected reforms; public investment reviving but from low base
- **Thailand's** implementation of investment projects should partially offset subdued export performance and weak private consumption
- **Philippines** - dependent on steady inflow of remittances and services sector growth; investment & export face challenges
- **Bangladesh-** stable political situation since early 2015; higher public wages/arrears to support growth



India *At the Crossroads*

Macro Highlights

Improving Macroeconomic Dynamics

- **Faster growth** – one of the few large emerging markets with favorable growth inflation mix
- **Moderating inflation** – driven by lower oil prices, lower food inflation and sluggish wages
- **Fiscal position is gradually improving**, but limited fiscal space. Deficit consolidation risks from lower growth realization, disinvestment targets
- **C/A deficit smaller** due to import controls and lower oil prices
- **More stable currency** due to intervention by the Central bank and relatively better macro

Delayed Reform Delivery & Political Headwinds May Lead to Macro Disappointments

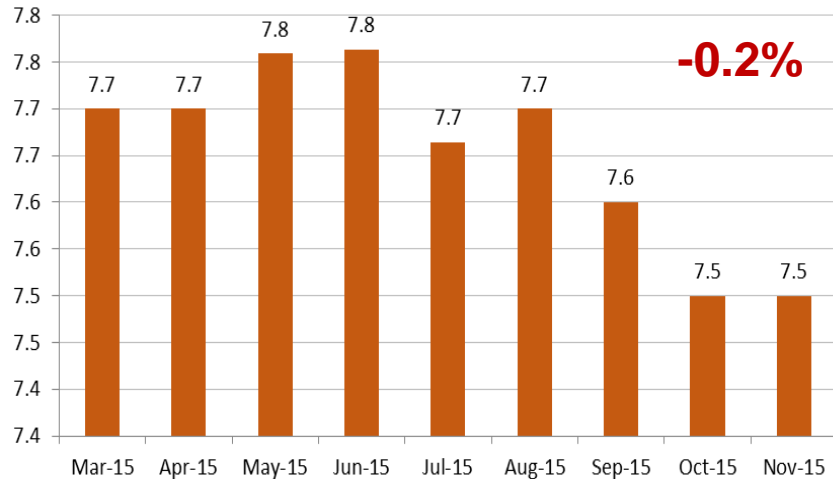
- **Moody's changed the outlook from "stable" to "positive"** based on reforms and an improvement in the macroeconomic outlook
- **Reform and anti-corruption focus set the stage for more durable growth...**
- **But, disenchantment grows on slower than expected pace of reform delivery**
- **Potential risks on ongoing macro adjustment, if Modi loses key upcoming federal elections**

India – Lower Growth Expectations

Expectations Hinge on Reform Delivery and Revival of Investments

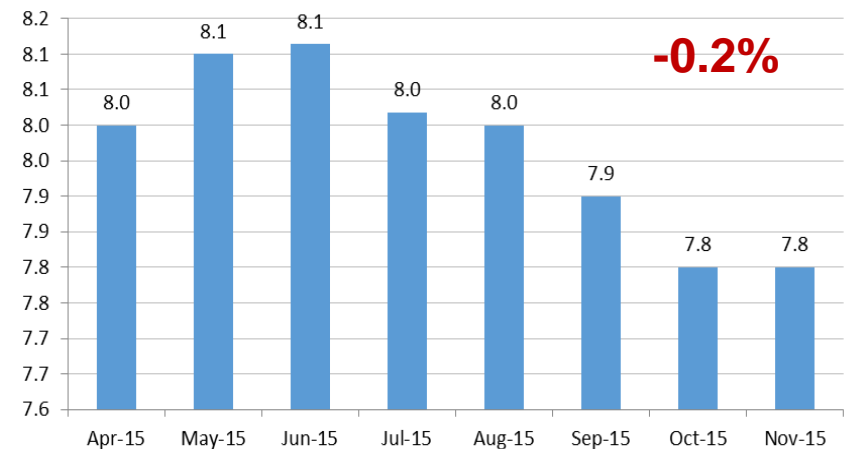
FY2015-16 GDP Growth

(Evolution of Consensus Forecasts; GDP at fc)



FY2016-17 GDP Growth

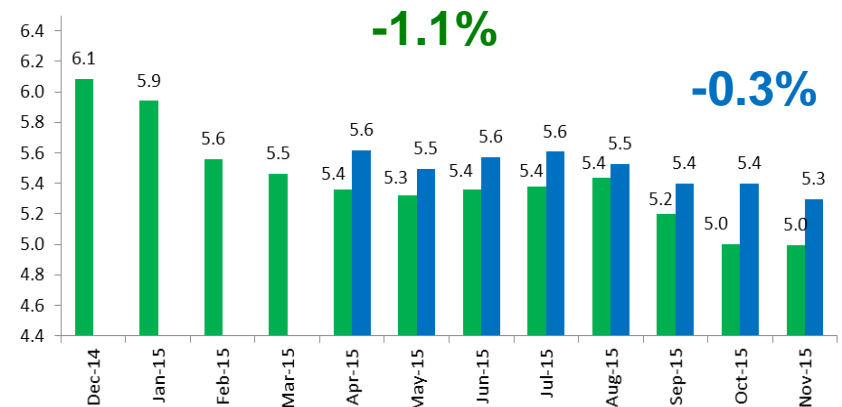
(Evolution of Consensus Forecasts; GDP at mp)



- Real GDP growth surprises positively in FY15; but downward revisions to growth expectations for FY16 & FY17
- Moody's revised India's outlook to "Positive" from "Stable" in April 2015 citing that actions by policy makers will enhance India's economic strength
- Adoption of inflation targeting & lower global commodity prices has helped in anchoring inflation expectations

FY16 & FY17 Inflation Expectations

(Evolution of Consensus Forecasts, % y-o-y change)

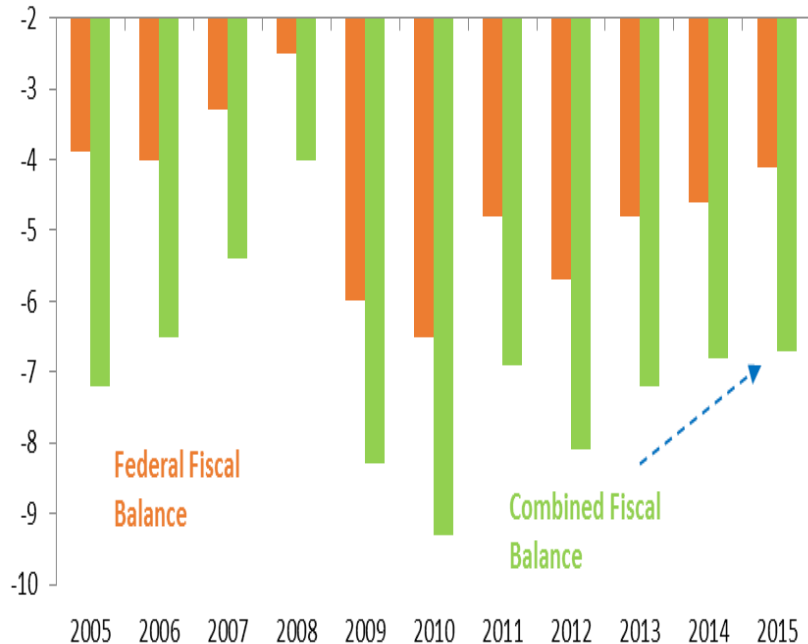


India's Macro Adjustment is Happening

Twin Deficits Consolidating, But Challenges Remain

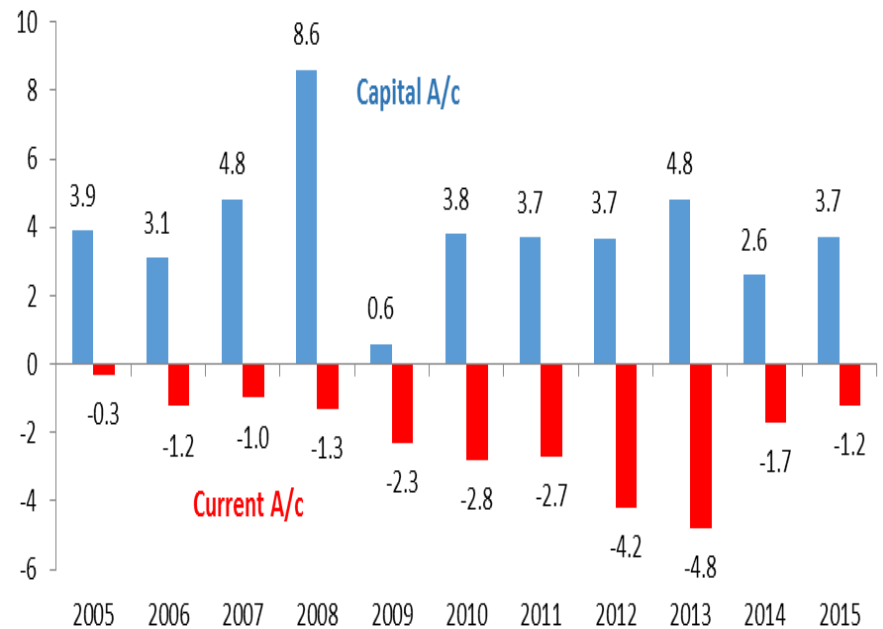
Fiscal Balance

(Percent of GDP)



External Balance

(Percent of GDP)



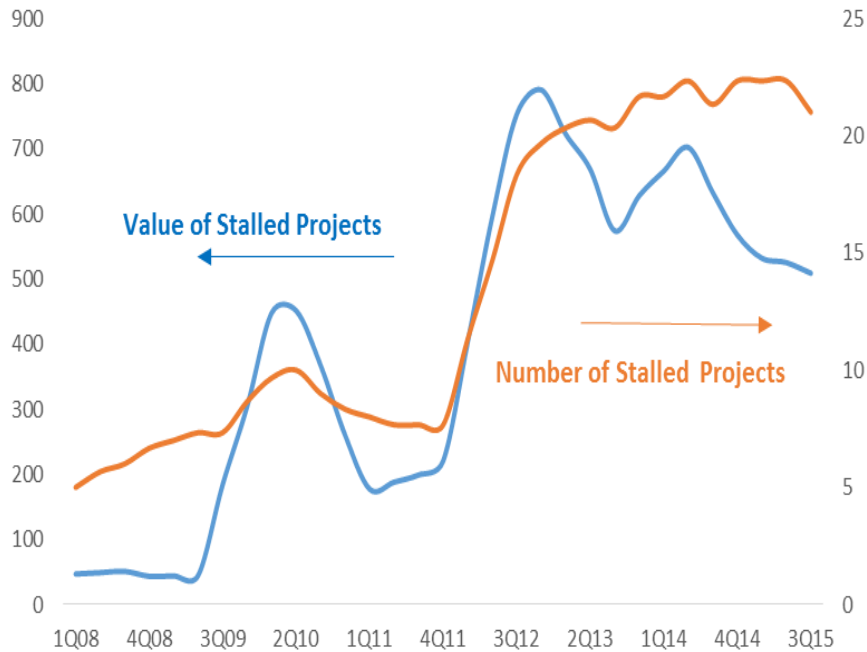
- Policymakers committed to medium term fiscal consolidation, the government reduced the federal fiscal deficit target to 3.9% of GDP for FY16 from 4.1% in FY15
- External sector consolidation most stark; CAD narrows down from 4.8% of GDP in FY13 to 1.2% in FY15, aided by fall in global oil prices and moderation in aggregate demand.
- Capital flows to remain healthy; but risks can't be understated in light of Fed normalization. But, **India is better prepared this time by way of higher forex reserves, healthy external account**

Pace of Recovery Remains Slow

Investment Revival Signs Not Sustaining

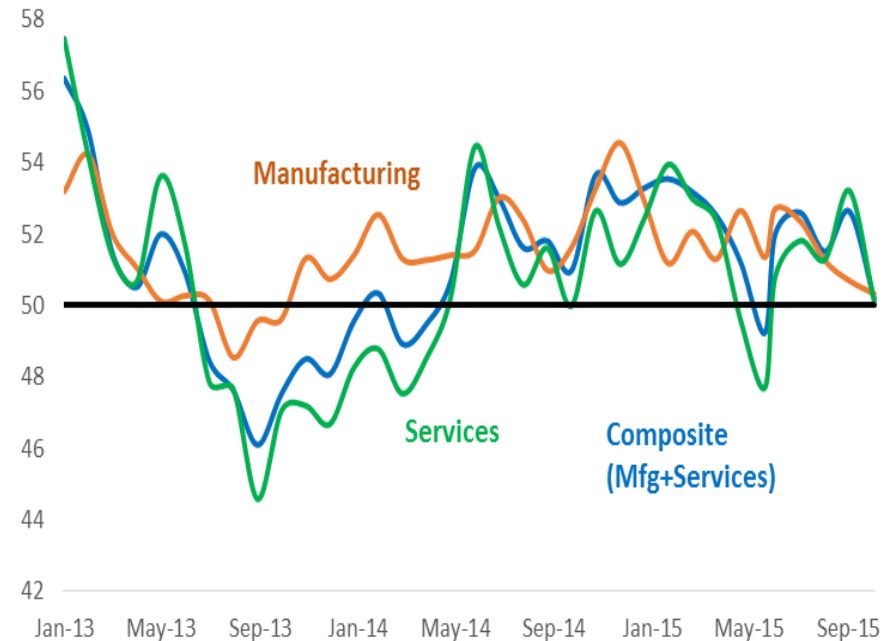
Stalled Projects

(value in INR bn)



PMI

(SA, 50+= Expansion)



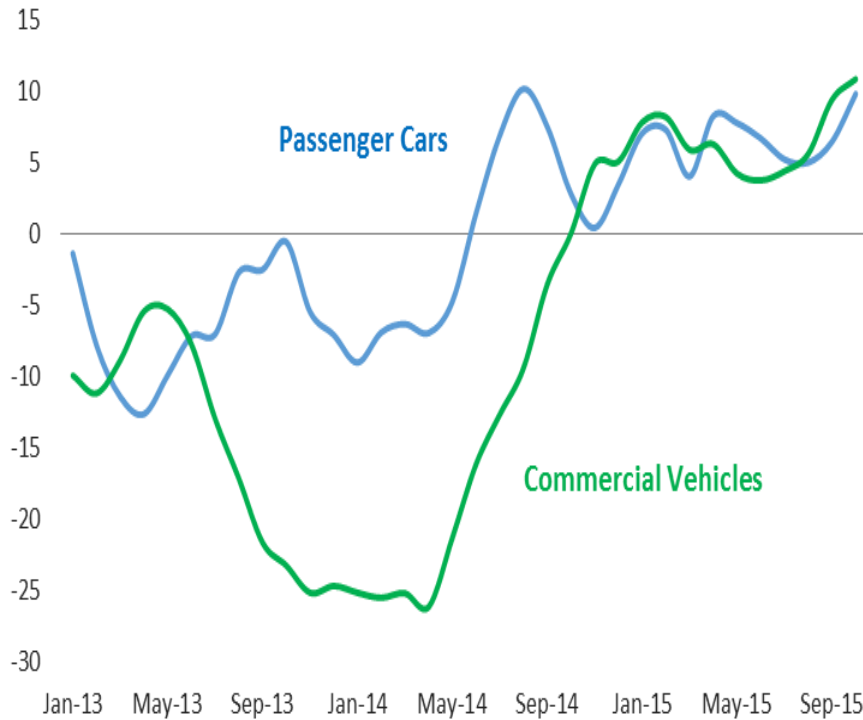
- **Government's policy efforts to improve business climate reflecting in improvement in stalled projects, but not much traction on new projects**
- PMI for both sectors displaying volatility
- **Pick up in capex, to be led by public spending.** Private investment limited by concerns of asset quality, high corporate leverage, weak demand

But Pace of Recovery Remains Slow (2)

Urban Consumption Looking Up, Rural Demand Muted

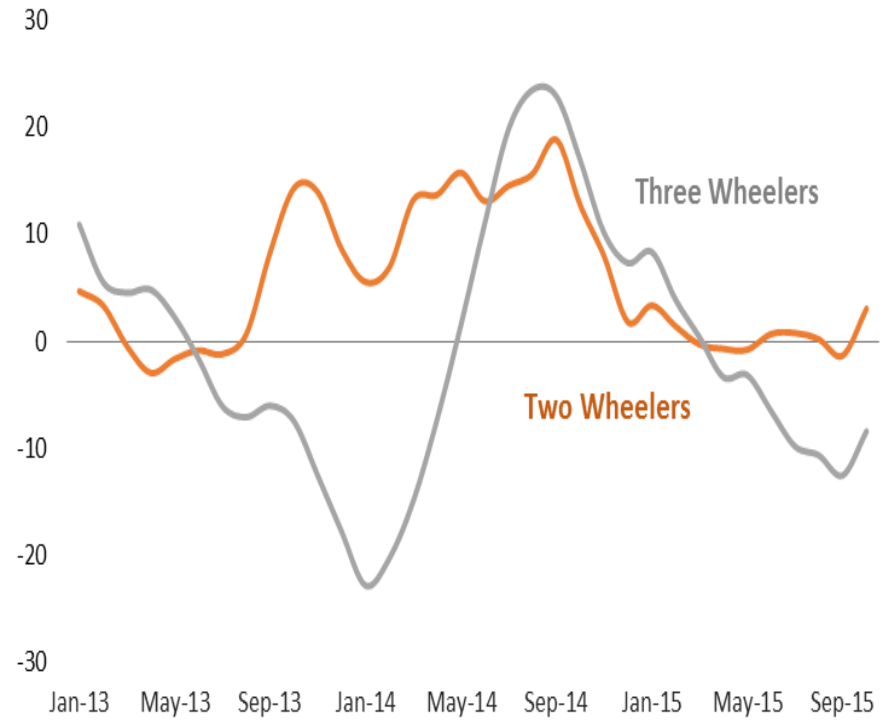
Vehicle Sales

(3mma, % year-on-year; units)



Vehicle Sales

(3mma, % year-on-year; units)



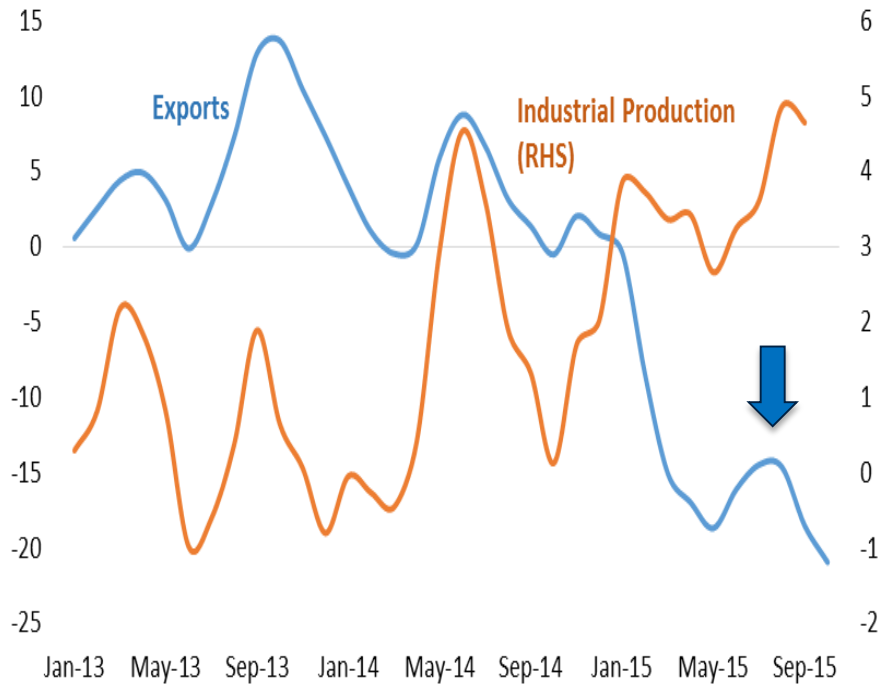
- **Rural consumption** impacted by slower wage growth, cutback in government's redistribution policies; Weak rainfall further risk
- **Urban discretionary spending** improving supported by lower interest rates, and improved real disposable incomes. However, spending on housing sales still remains muted.

But Pace of Recovery Remains Slow (3)

External Demand Continues to be a Drag on Overall Growth

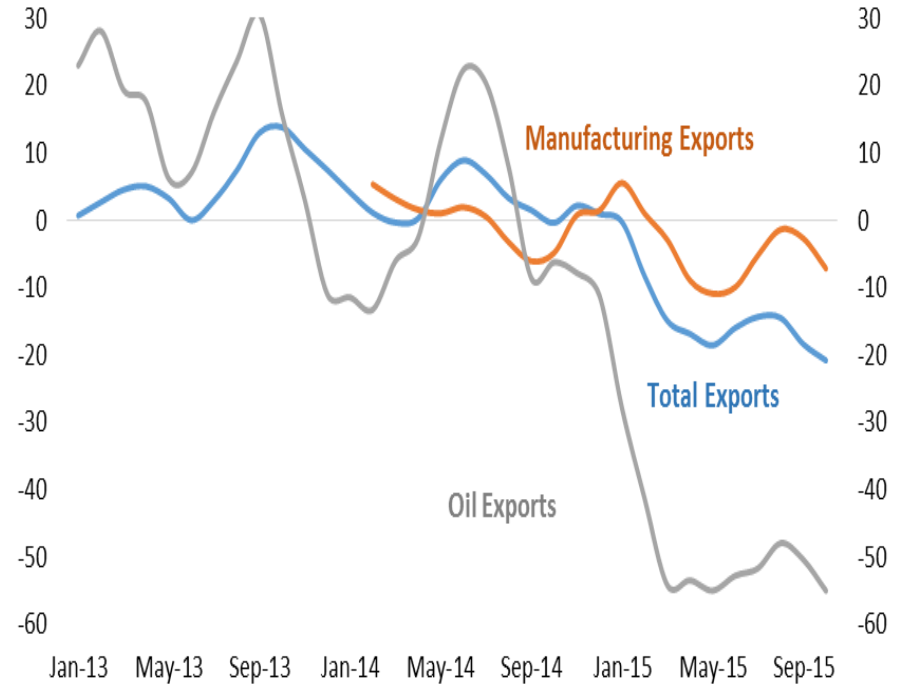
Exports & Industrial Production

(3mma, Percent year-on-year)



Exports Performance

(3mma, Percent year-on-year)

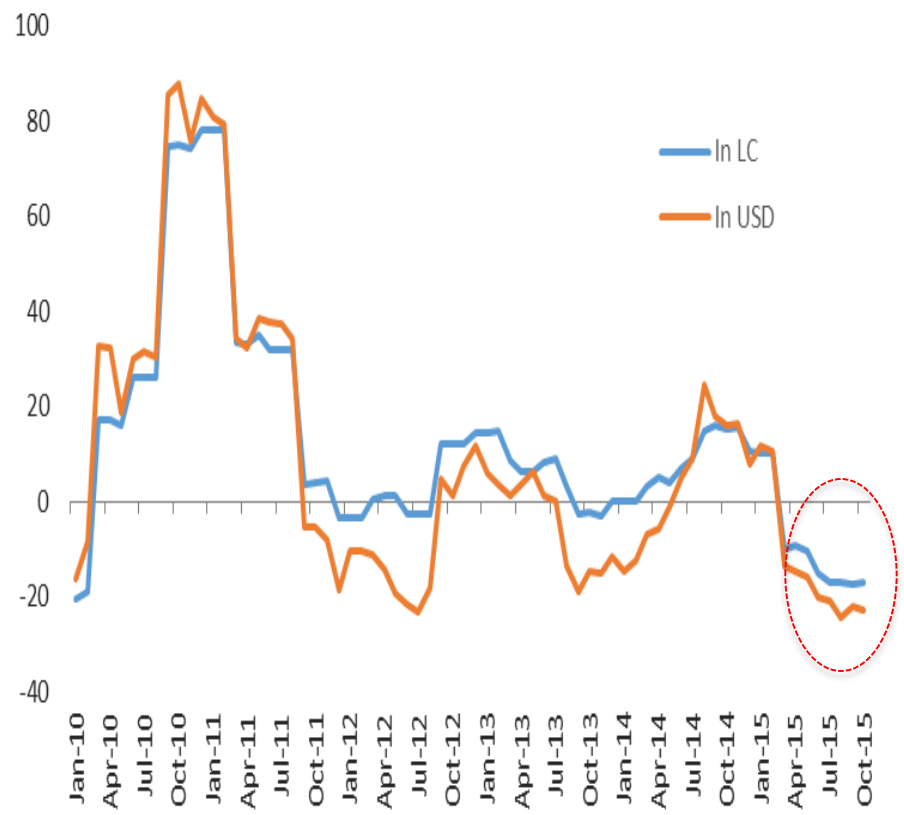


- **Exports contracting for ten consecutive months;** decline in both commodity and non-commodity exports. **Commodity exports share ~33%**
- Goods exports have been leading indicator of service exports performance
- Exports to EM account for 63% of total exports. Balance 37% to DM -- starting to stabilize with recovery in DM economies.

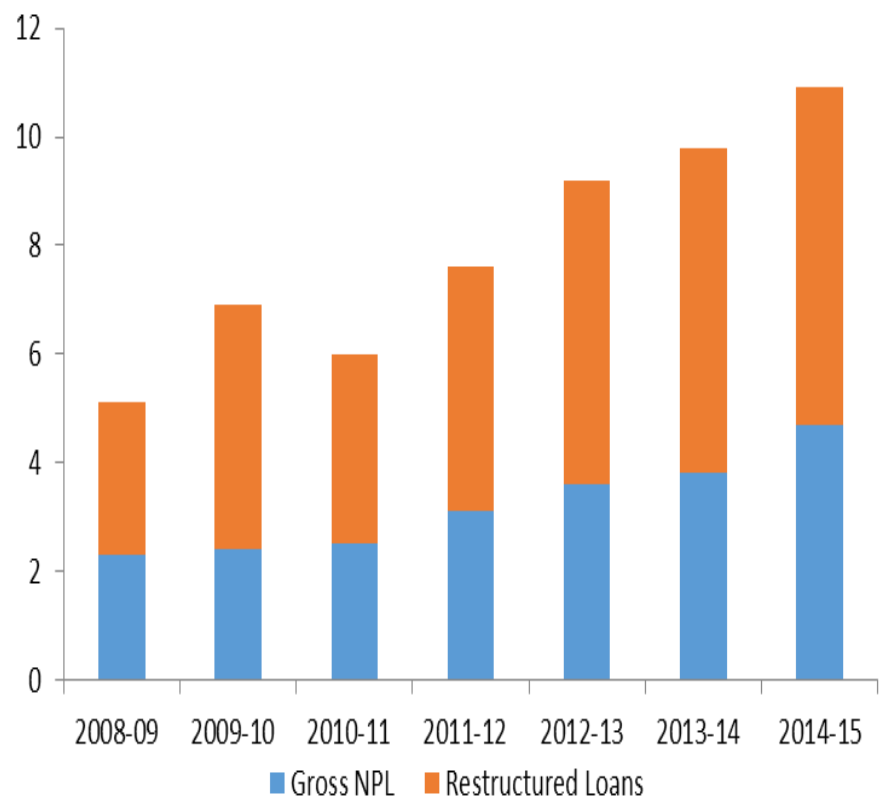
Indian Corporates

Lower Profitability with Higher Leverage – Some Feed Bank NPLs

India's Earnings Per Share
 (% YoY, Quarterly data from MSCI, as of Oct'2015)



Banking Sector NPLs
 (% of total assets)



- **Indian corporate profits are contracting**
- **Higher levels of leverage with banks reticent to lend, aggravates the situation**

Government Takes Key Steps to Reduce Vulnerabilities

But Pace of Reforms Unable to Generate Meaningful Rebound in Economic Activity



Overhauling the bureaucracy to hasten decision-making and improve the ease of doing business.

Clearances for stalled projects, reviving road projects, institutional changes to undertake resource allocation (coal auctions/mining)

Reviving Investment:

- **Liberalizing FDI rules** in sectors such as railways, defense, pensions, insurance and construction
- **Increased budget allocation for railways and road construction**
- **Transfer to states**

Reduction of fuel subsidies - deregulating gasoline and diesel prices

Signing an inflation targeting agreement with the RBI; Moderate support price increase

Push on financial inclusion – creating necessary infrastructure to enable transfers



Lack of material progress on the 'big-bang' reforms:

- **Land acquisition**
- **Goods and Services Tax (GST) implementation**

Reducing tax uncertainty

Political opposition and strong domestic headwinds (high corporate leverage, low capacity utilization, and high banking sector stressed assets) have dampened investment activity

Increased fiscal federalism, but upcoming risks from disinvestment proceeds, weak growth and pay commission

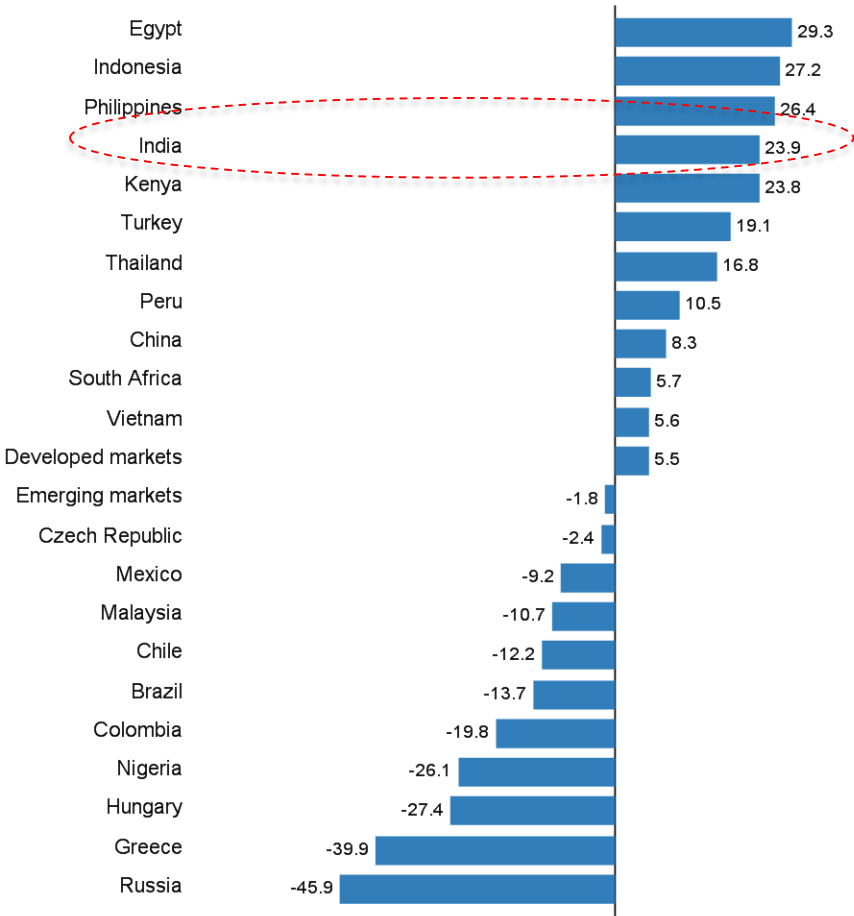
Modest pick up in on the ground activity

Continued Challenges for EM Equity

2015 – All EM on the Downside; India Manages With Moderate Pain

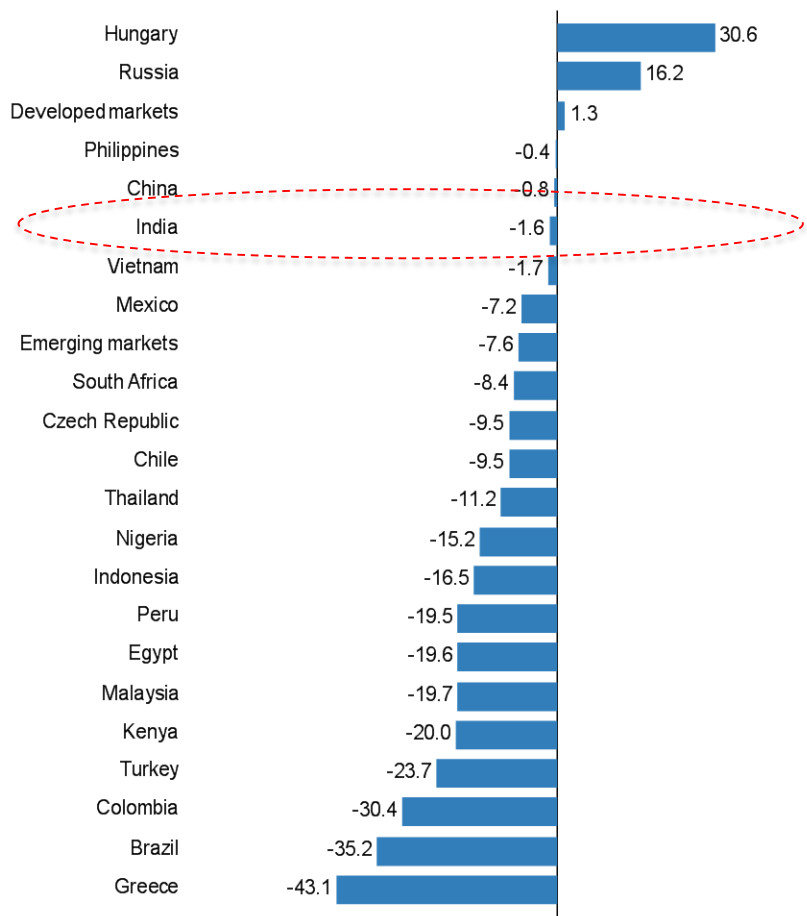
EM Equities 2014

(MSCI Country Indices, US\$ Total Return 2014, %)



EM Equities 2015 YTD

(MSCI Country Indices, US\$ Total Return YTD 2015, %)

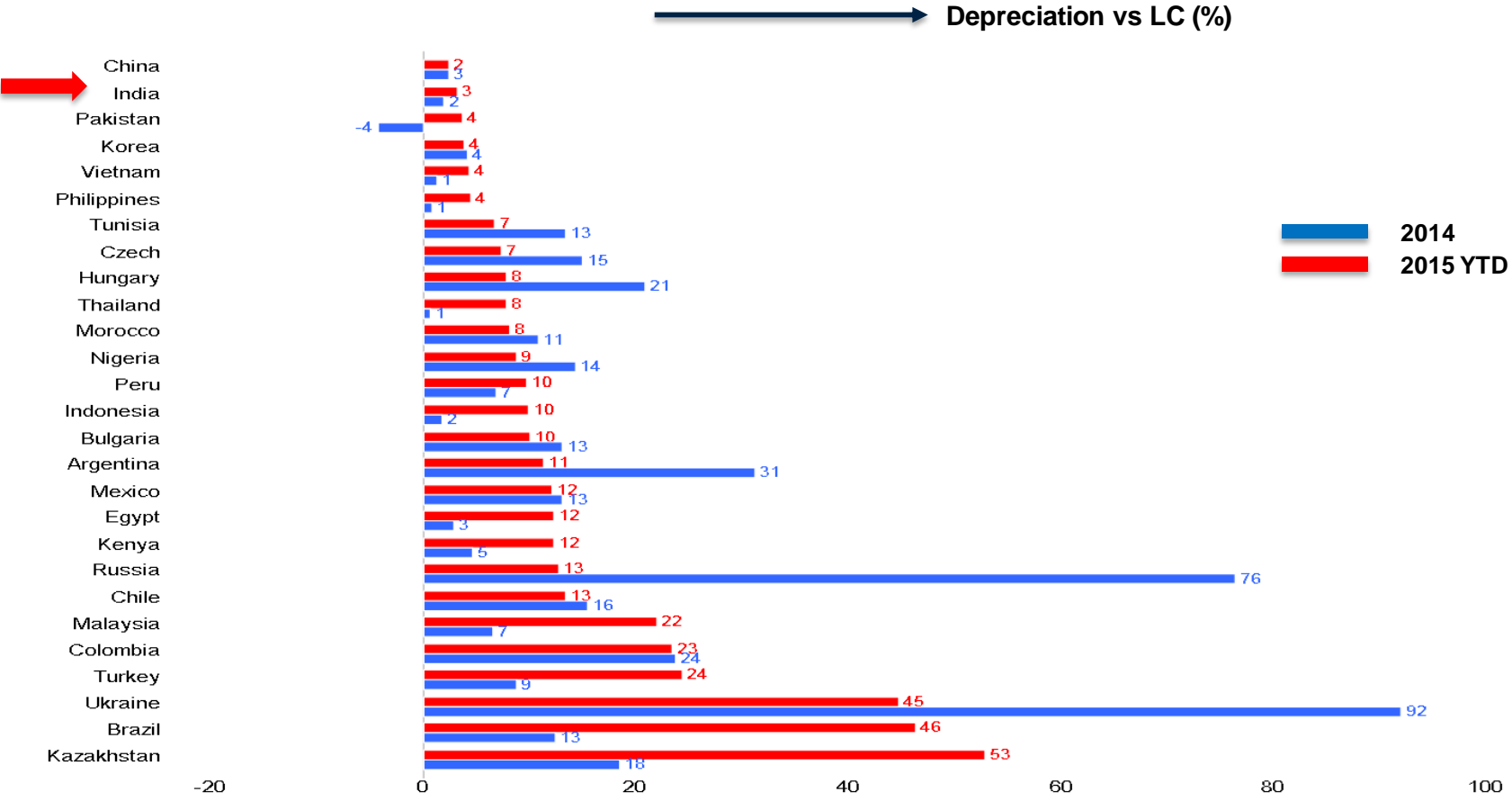


Broad Based EM FX Downturn

India So Far One of the Lesser Vulnerable One

EM FX 2014 & 2015

(LC vs USD, % Depreciation, as of October 27th 2015)



Source: Thomson Reuters Datastream

Challenges

Continue Reforms + Improve Liquidity → A Gradual Process

- **Pace of Policy Reforms Delivery**
 - Critical to address structural bottlenecks– inadequate infrastructure, taxation structure, labor laws, and overall ease of doing business – especially in times of weak growth
- **Revival in Private Capex**
 - Not enough ammunition for public spending, key to revive growth
- **External Environment**
 - Structural Change?
 - Impact on Capital inflows and Fx/equity market sentiment
- **New Political Headwinds ?**
 - Is Bihar a change in trend?

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