



## How Asia's Growth Transitions and Policy Experiments Are Shaping the Global Outlook

Asia has been a driving force behind global growth since the financial crisis. But the dynamics are changing as growth slows in China and Australia, and Japan pursues “hyperactive” monetary policy. In this issue of our Secular Outlook Series, portfolio managers Ramin Toloui, Tomoya Masanao and Robert Mead discuss how these developments are affecting the global outlook for the next three to five years and the implications for investors.

### **Q: What is PIMCO's secular outlook for Asia?**

**Toloui:** Asia has been the critical driver of the global economy during the past five years, providing by far the largest contribution to global GDP growth of any region. China has been at the center of Asia's growth story, so the most important question for Asia's secular outlook is: Can China maintain high rates of economic growth in the years ahead?

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Our view is that Chinese GDP growth will downshift, averaging 6%-7.5% annually for the next five years versus more than 9% on average for the past five. The reason is that the previous engines of Chinese growth – net exports and investment – are reaching their limits. Prospects for export-led growth are inhibited by China's large size in a global marketplace that remains deficient in aggregate demand due to high indebtedness in the developed world. Investment cannot play its previous role in driving growth because it has already risen to almost 50% of GDP – up from 35% in 2000 and from 42% in 2007 before the global financial crisis – an extraordinary ratio by historical standards.

To sustain growth, China's economy needs to shift to greater reliance on household demand. The good news is that the potential is extraordinary after more than a decade in which consumption has declined from 46% to 35% of GDP. Latent demand for not only consumer goods but also services such as health care is likely enormous. However, turning that potential into reality requires changes in economic policy that are wide-ranging and difficult, and also challenge vested interests among the political and industrial elite.

Slower growth in China means slower growth for the rest of Asia, and indeed the rest of the world. But the composition of China's growth will also have large and varying effects on different countries. Commodity exporters like Australia and Indonesia will be challenged by what is likely to be slower growth in Chinese demand for the raw material inputs to physical investment. At the same time, exporters in both northeast and southeast Asia involved in the production chains for electronics and other consumer goods may be positioned to benefit from a more robust emergence of the Chinese consumer.

### **Q: Is China at risk of financial stress over the secular horizon?**

**Toloui:** This is an important question for any serious discussion about China's outlook. The reason is that we have seen a massive expansion of credit in China in recent years, most recently through a set of off-balance-sheet vehicles collectively known as the "shadow banking system." Much of this financing has flowed to the property market and to local governments to finance infrastructure projects. The concern is

two-fold: First, the credit quality of these loans may be compromised by a lack of sufficient due diligence in an environment where the general assumption is that the government stands ready to bail out the system should it encounter problems; and second, the effectiveness of credit growth in generating economic growth is diminishing, which itself increases the risk that borrowers will be unable to repay their loans. Before the global financial crisis, each \$1 of new credit generated an average of about 60 cents of GDP; now that number is falling toward 20 cents.

So there are clearly risks, but just how big are the risks? We have analyzed this question by constructing a balance sheet of the entire Chinese financial sector, subjecting it to various "stress test" scenarios – assuming that non-performing loan ratios and the severity of loan losses rise – and measuring the fiscal cost to the government of having to recapitalize the Chinese banking sector in such scenarios. Our analysis shows that even under a severe set of assumptions, the costs are manageable at present. But when we make our model dynamic, projecting the future path of such recapitalization costs on the current trajectory, we observe that the potential costs of a banking bailout would rise dramatically in the coming years if the rapid growth of shadow credit continues.

This underscores the importance of a transition in China's growth model, away from the continued reliance on credit-fueled investment and toward household-led domestic demand. The longer the delay in making that transition, the greater the risks of financial stress during the secular horizon.

### **Q: Will the Bank of Japan's policy initiatives be effective over the long term? What are the potential consequences, both locally and globally?**

**Masanao:** Japan will likely see a cyclical economic recovery thanks to the boldest monetary policy in the postwar period, but the sustainability of growth will still likely be challenged by both internal and external dynamics.

Japan is back to the center stage as the Bank of Japan is finally joining the hyperactive monetary policy experiment. This is a necessary, if not sufficient, step for ending more than 10 years of deflation and is expected to flip expectations from deflation to inflation.

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Initial responses in asset markets have been quite positive and the near-term growth outlook has become hopeful. However, the sustainability of these gains will depend on the implementation of structural policy reforms, which will still likely be limited given the political vested interests involved. Japan's reflation policy may also be interrupted or complicated by reactions from its regional and global counterparts, unless Japan succeeds in growing the global pie as opposed to just eating someone else's share of the pie.

In Asia, Japan is perhaps the economy closest to the "T-junction" described in PIMCO's global secular outlook: The destination of Japan's journey looks increasingly uncertain, with multiple potential outcomes that could stabilize or destabilize the global economy and markets.

#### **Q: Australia fared relatively well after the financial crisis but signs now point to slowing growth. Has the New Normal finally reached Australia?**

**Mead:** Australia's economy has been rebalancing for the past couple of decades, as the manufacturing sector has been gradually shrinking and more recently, substantial investment was channeled into the mining sector (which we characterized as "Dutch Disease Lite" in an April 2012 Viewpoint). Since the financial crisis began, however, the Australian economy has been underpinned by the significant policy stimulus in China and the consequent demand for Australia's bulk commodity exports.

Also during this post-crisis period, Australia's "safe-haven" status, its relatively stronger economic growth rates and the hyperactive monetary policies implemented by many developed market central banks have all served to increase the value of the Australian dollar.

Looking forward, as the intensity of Chinese policy stimulus subsides and domestic growth outside the mining sector remains subdued (partly as a result of the elevated level of the Australian dollar) and fiscal policy remains constrained, we expect the New Normal to arrive in the Australian economy and markets. This economic backdrop implies a "new neutral" level for policy rates, which we believe should be lowered from 5.5% to about 3%, which takes into account higher end-borrowing rates, an elevated Australian dollar and lower potential growth rates.

#### **Q: How should investors be positioning for developments in Asia?**

**Masanao:** Our analysis of the regional and global macro outlook – combined with initial market valuations – suggests important guardrails for investment strategy in the region's markets. In a nutshell, investors should generally demand sufficiently high risk premiums and be selective, more than ever, given highly uncertain regional and global outlooks.

The risk-return profile of investing in Japanese government bonds is changing secularly. Until recently, such bonds were simultaneously a low-yielding and low-risk asset, offering stable returns. Looking forward, investors should be aware of the potential for multiple economic outcomes and therefore demand risk premiums for increased tail risks.

Given our thesis of the New Normal arriving in Australia, the burden of policy stimulus is likely to continue to fall on the shoulders of the central bank. Therefore, monetary policy is expected to be more accommodative. Investors should find Australian government bonds a relatively attractive asset for high incomes and capital gain potential.

The Japanese yen has depreciated significantly in anticipation of aggressive monetary reflation policy. Investors should continue to consider the Japanese yen as a funding currency versus attractively yielding assets in other currencies. On the other hand, we think that a diversified basket of emerging Asian currencies is likely to produce attractive total returns, thanks to a combination of higher yields and the potential for currency appreciation as global investors are diversifying away from lopsided allocations to developed countries and into emerging markets.

On the credit side, we think that the slow-growth landscape favors higher-quality credits and warrants caution on higher-yielding names that could become impaired in an environment where profits will be challenged. Similarly, in asset allocation, the emphasis should move away from risk assets that have benefited purely from the central bank liquidity wave in which valuations have become detached from fundamentals.

## BIOGRAPHIES

Mr. Toloui is an executive vice president in the Singapore office and global co-head of emerging markets portfolio management. Prior to joining PIMCO in 2006, Mr. Toloui spent seven years in the international division of the U.S. Department of Treasury, including as the director of the Office of the Western Hemisphere, managing a team of economists and advising senior U.S. government officials on financial policies in Latin America. He previously served as senior advisor to the Under Secretary for International Affairs during the crises in Brazil, Uruguay and Turkey in 2001-2003. He has 14 years of international finance experience and holds an undergraduate degree from Harvard University and a master's degree in international relations from Oxford University, where he was a Rhodes Scholar.

Mr. Masanao is a managing director in the Tokyo office and head of portfolio management Japan. He is also a core member of PIMCO's Asia-Pacific Portfolio Committee, responsible for the region's macroeconomic and investment analysis. Mr. Masanao joined PIMCO in 2001 as a global portfolio manager in the Newport Beach office and has been based in Tokyo since 2002, managing global and Japanese portfolios. Prior to joining PIMCO, he was an executive director and senior portfolio manager at Goldman Sachs Asset Management in London. He was also with Sumitomo Bank as a proprietary trader in London and a credit analyst in Osaka. He has 23 years of investment experience and holds an MBA from Boston University. He also holds a master's degree and an undergraduate degree, both in engineering, from Osaka University.

Mr. Mead is a managing director in the Sydney office. In addition, he is head of portfolio management in Australia and head of Asia-Pacific credit portfolio management. Previously, he was a portfolio manager in Munich and head of the European investment grade corporate bond team. Prior to joining PIMCO in 2003, he was global head of investment grade credit research and head of non-U.S. high grade fund management at Citigroup Asset Management in London. He has 24 years of investment experience and holds an undergraduate degree from University of Technology, Sydney and a graduate diploma in Applied Finance from Securities Institute of Australia.

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