

ECONOMIC ANALYSIS

ASIA | Gauging the impact of China's growth slowdown on emerging Asia

Sumedh Deorukhkar / Le Xia

Summary

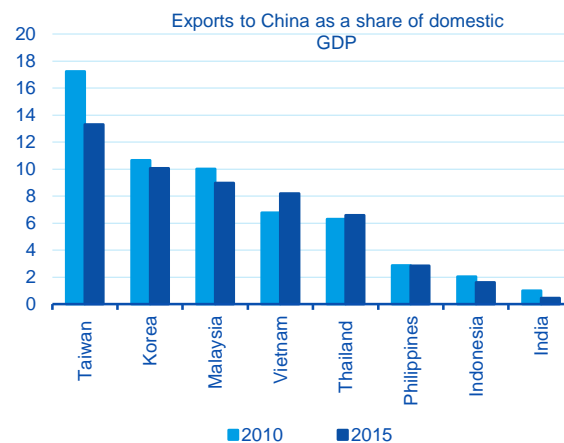
- Concerns that economic deceleration in China could be sharper and more disorderly than expected have increasingly unnerved investors over the spill-over effects of China's economic rebalancing and associated policy reactions on growth prospects and financial stability across emerging Asia. In this watch, we gauge the impact of China's transition on emerging economies in Asia amid on-going issues surrounding China's growth slowdown, the Yuan depreciation and financial market volatility.
- Amid China's economic rebalancing, a cautious outlook for export-oriented economies across EM Asia is characterised by two key developments – 1) China's growth slowdown is accompanied by the economy becoming less import intensive as its competitiveness improves and its services sector structurally outperforms the industrial sector, and that 2) China now poses greater export competition to other economies in the region as its exports move up the global value chain.
- We find Taiwan and Korea to be most vulnerable to a contraction in Chinese imports while Philippines, Indonesia and India are least affected. However, one should be cognizant of several offsetting effects to such a direct trade impact from 1) vertical trade integration with China, 2) export similarity, 3) country-specific movements along the global value chain and its impact on the trade structure and 4) producer decisions to shift manufacturing bases to achieve cost efficiency.
- Despite elusive trade gains, recent growth outturns for EM Asia have been stable and broadly improving on the margins, driven by resilient domestic demand as low oil prices boost real incomes while inflation remains under control, allowing monetary and fiscal policy to turn accommodative.

Figure 1
China is the powerhouse of global demand, led by basic, capital and intermediate goods



Source: BBVA Research, UNCTAD Database

Figure 2
Trade exposure to China is disparate across EM Asia, Taiwan, Korea and Malaysia lead the pack



Source: BBVA Research, Haver Database

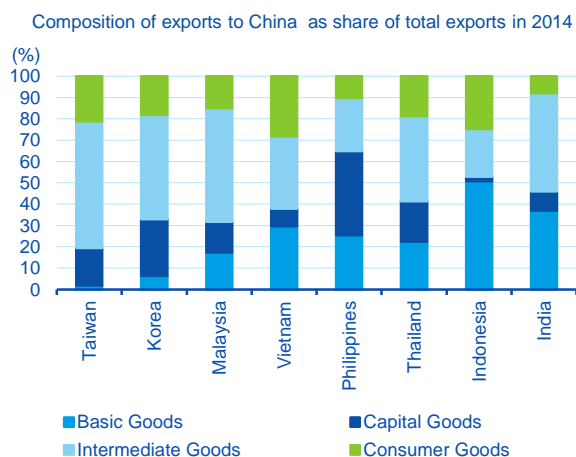
Bulk of emerging Asia derived disparate yet significant benefits from China's investment binge

Over the past two decades, China has emerged as a powerhouse of global demand. It accounted for 43% of world's total imports in 2014, a near three fold jump from just 15% in 2000 (See Figure - 1). For long, China's significance as the world's top importer has been led mainly by its demand for intermediate, basic, and capital goods¹ while much less so for final consumer goods. This, rather tenacious import structure reflects China's investment driven growth strategy and its predominant role as the world's low-cost manufacturing hub. China's debt financed investment binge fuelled a global commodity super cycle while rapid industrial growth drove import demand for capital and intermediate goods.

Emerging Asian economies rode on China's growth wave, although benefits accrued were differentiated by their trade profiles, comparative advantage and degree of export exposure to China (See Figure – 2 & 3). Commodity exporters such as Indonesia, Malaysia, Vietnam and India benefitted from the Chinese demand driven surge in international commodity prices. On the other hand, Philippines, Korea, and Thailand stepped up capital goods exports to China while a pick-up in intermediate goods imports from China augured particularly well for Korea, Taiwan and Malaysia, although in general for most EM Asian economies.

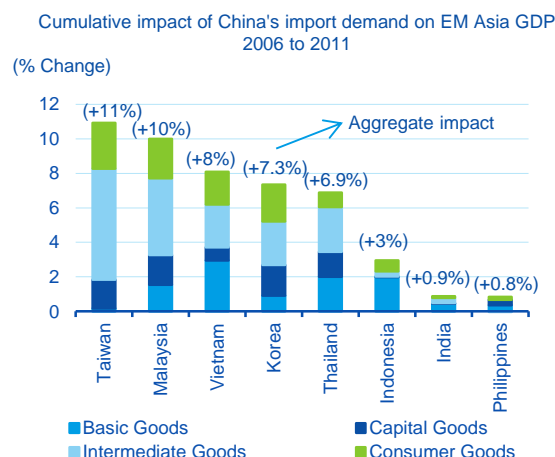
Our analysis (Figure - 4) of gains to EM Asia GDP growth from China's import demand alone underpins this disparity. We find that on a cumulative basis over 2006 to 2011 (the period after which China saw visible growth deceleration), Chinese import demand alone contributed 11 percentage points to Taiwan's nominal GDP growth in USD terms followed by Malaysia (10%), Vietnam (8%), Korea (7.3%), Thailand (6.9%), Indonesia (3%), India (0.9%), and the Philippines (0.8%).

Figure 3
Export profile to China varies amongst EM Asia from Taiwan (Intermediate) to Indonesia (Basic)



Source: BBVA Research, UNCTAD Database

Figure 4
Taiwan and Malaysia benefitted the most from surging Chinese imports between 2006 to 2011



Source: BBVA Research, UNCTAD Database

1: Using UNCTAD database, we classify 1) Basic goods : mineral fuels, ores, metal scraps and other crude materials; 2) Capital goods : Machinery & transport equipment, 3) Intermediate: Chemicals & manufactured parts, 4) Consumer Goods : Food, Beverages, Edible Oils, and Final consumer goods.

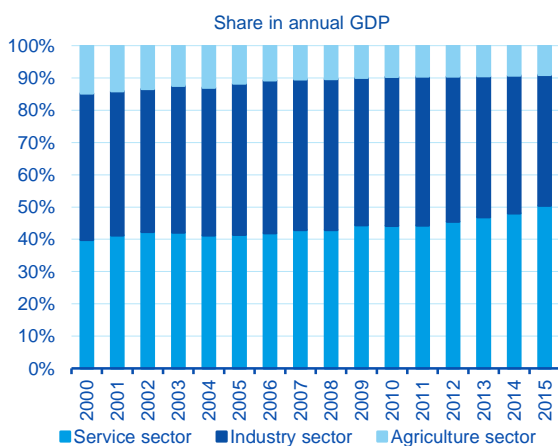
China's economic rebalancing has important implications for EM Asia

Over recent years, with China's traditional investment-led growth engine losing steam and concerns of a hard-landing gaining ground, the need to engineer a soft landing while sustaining long term growth has become paramount. In this context, policy efforts are being stepped up to 1) engineer a smooth economic transition of China from being predominantly investment driven to a consumption driven economy; 2) implement economic, financial sector, institutional and regulatory reforms aimed at improving resource allocation, promoting freer market play and mitigating risks emanating from a high debt overhang and 3) adopting an accommodative monetary and fiscal stance focused particularly on unconventional measures while promoting greater flexibility in exchange rate management. China's economic rebalancing remains on track despite structural constraints faced by policymakers to achieve such a major transition. The economy's soft-landing in Q4 2015 when GDP growth expanded 6.8% y/y was mainly driven by tertiary industry, which outperformed the primary and secondary industry, while registering strong growth of 11.7%y/y in 2015 and accounting for 50.5% of total GDP compared to 44% in 2010 (See Figure – 5).

From the expenditure side, growth was driven by stronger consumption, which along with a recessionary trade surplus has partly offset the slowdown in industrial growth and a sharp decline in net exports. China's recessionary trade surplus persisted in 4Q15 as the sharp contraction in imports growth offset weakening external demand. China's growth slowdown is set to continue going forward as its traditional growth engine, powered by government led investment spending and exports loses further steam, only partly offset by stronger consumption growth.

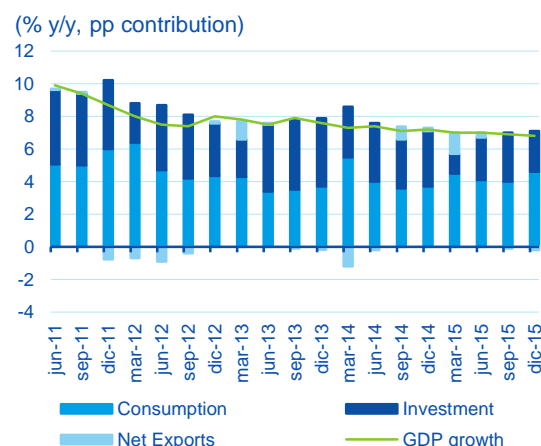
We peg China's 2016 and 2017 GDP growth at 6.2% y/y and 5.8% y/y respectively compared to 6.9% y/y in 2015 (See Figure – 6) (See our [China Economic Outlook for Q1 2016](#)). In the context of China's economic rebalancing, a cautious outlook for export oriented manufacturing economies across emerging Asia is characterised by two key developments – 1) China's growth slowdown is accompanied by the economy becoming less import intensive as its competitiveness improves and its services sector structurally outperforms the industrial sector, and that 2) China now poses greater export competition to other economies in the region as its exports move up the global value chain.

Figure 5
China's economic rebalancing remains on track



Source: BBVA Research, CEIC

Figure 6
China's GDP growth moderation to continue



Source: BBVA Research, CEIC

Temper expectations from China's new growth engine to support EM Asia's trade recovery

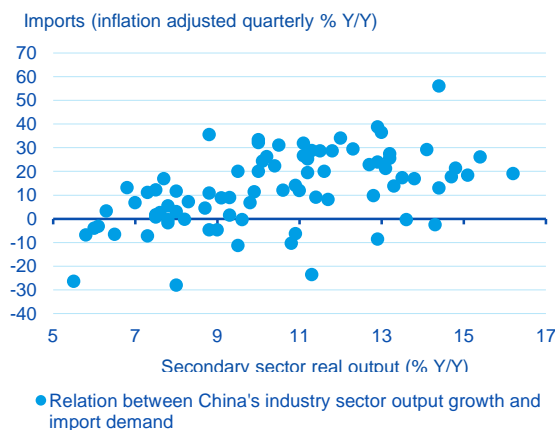
The sharp contraction in China's imports over the past year (See Figure - 7) despite strong services sector growth underscores the relatively closed nature of China's services sector. The relationship between China's imports and its services sector growth is weak (See Figure – 8 & 9). More so, China's services sector is growing at the expense of the import-intensive industrial sector. With China's services sector much less import intensive compared to the industrial sector, higher growth in the former will not offset the sharp slowdown in later.

Figure 7
China's import demand has slumped significantly since 2011...



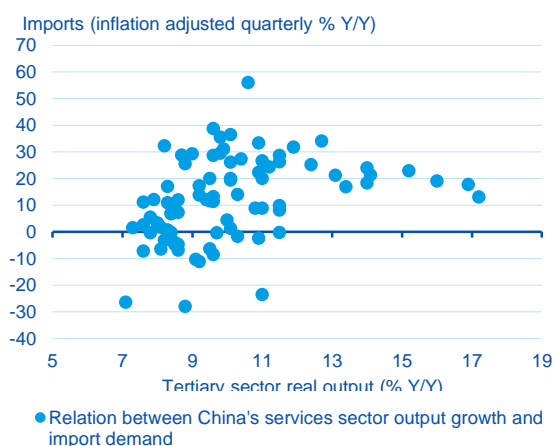
Source: BBVA Research, UNCTAD Database

Figure 8
China's industrial sector output depicts strong positive relationship with import demand...



Source: BBVA Research, Haver Analytics

Figure 9
...However, China's services sector is much less import intensive



Source: BBVA Research, Haver Analytics

Figure 10
China's import basket is less reflective of the ongoing economic rebalancing



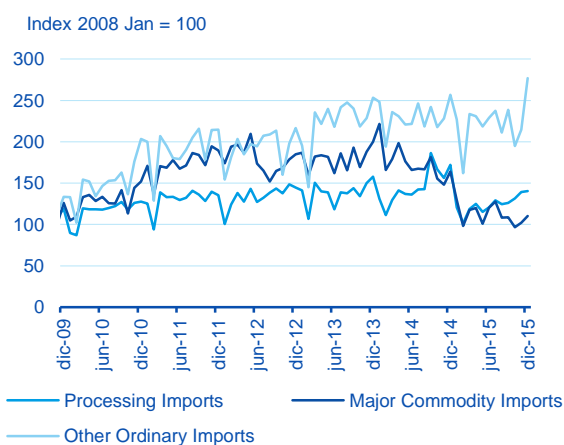
Source: BBVA Research, UNCTAD Database

Underscoring this tenuous relationship, we observe that China’s rebalancing efforts are less reflective in its import basket, which has undergone only a gradual transformation over the past five years (See Figure – 10). The share of China’s annual consumer goods imports to total imports has trended marginally higher, up from 14% in 2011 to 17% in 2014. The share of capital goods imports fell from 20% to 18% and basic goods imports share edged lower from 33% to 31%, while intermediate goods imports share remained stable at 34% during the same period, in turn leading to bleaker external demand outlook for China’s trade partners including those across emerging Asia.

Debt deleveraging to provide only a temporary fillip to investment driven growth in China’s import demand

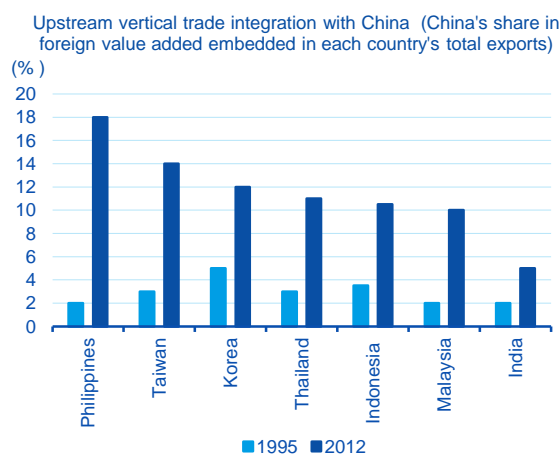
A key driver of China’s exceptionally strong services sector growth has been financial services, a bulk of which is fuelled by massive debt pileup by local governments and the corporate sector over the past several years alongside frothy capital markets. Going forward, as the pace of financial services growth slows in the wake of on-going deleveraging efforts, industrial output share in GDP is likely to get a fillip. In addition, recent policy measures including plans to invest USD 61.4 billion (400 billion Yuan) in Q1 2016 to fund local government’s infrastructure projects alongside the recent 50 bps cut in reserve requirement ratio would help buffer a sharper slowdown in China’s economic growth and support investment led import demand from its trading partners including those across emerging Asia. That said, we believe that the underlying shift in economic drivers towards services and consumption is tenuous enough to transcend the likely pick-up in infrastructure investments over the near to medium term. In this context, we would check for sustainability of the probable acceleration in imports demand from China going forward and thus remain restrained over prospects of a China led revival in emerging Asia exports going forward.

Figure 11
China’s use of domestically produced content in exports on rise – processing imports sluggish



Source: BBVA Research, Haver Analytics

Figure 12
China’s share in foreign value added embedded in EM Asian economies has risen significantly



Source: BBVA Research, IMF Database

Chinese exports climbing up the global value chain poses export competition to EM Asia

Over recent years, China has been making significant progress in moving up the global value chain from being the former low cost low technology manufacturing hub of the world to competing on exports across a broader spectrum of industries. This is accompanied by China’s low value added manufacturing relocating to other more efficient low cost producers within the region such as Vietnam. China is increasingly using

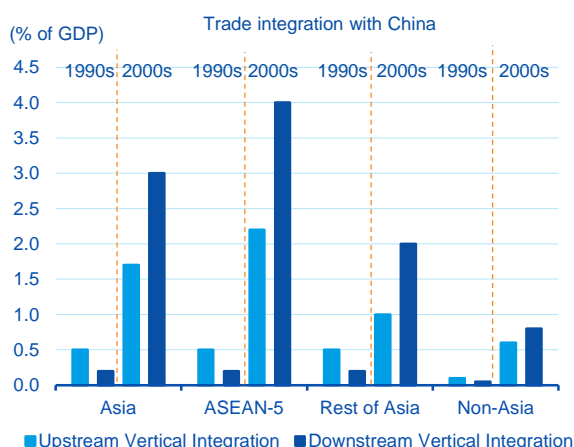
domestically produced content in its exports, as reflected by the fall in China's 'processing imports' share of exports since 2005 and the anaemic growth of processing imports compared to ordinary imports over recent years (See Figure - 11). This is also evident from the rise in China's share in foreign value added embedded in total exports of economies across emerging Asia (See Figure - 12). Such upstream vertical integration of China across emerging Asia has risen most significantly for Philippines, with China's share in total foreign value added in Philippines gross exports rising to 18% in 2012 from just 2% in 1995, followed by Taiwan, Korea, Thailand, Indonesia, Malaysia and India. Meanwhile, Chinese companies are increasingly investing abroad. China's strategy to encourage Chinese companies to invest overseas is also helping boost Chinese exports as these Chinese owned foreign firms look at home companies for supplies.

Rising prominence of global value chains have weakened the exchange rate-trade nexus although 'beggar thy neighbour' impact still dominates

The past decade has seen increased fragmentation of production – the global value chains – with each stage of production located in different countries, which has weakened the nexus between exchange rate changes and trade in intermediate products embedded in final goods exports of other countries. As economies trade in inputs and specialize in stages of production, the conventional thinking regarding depreciations being solely beggar thy neighbour (weaker Yuan increasing demand for Chinese goods and lowering demand for goods produced elsewhere) is less binding. Given close linkages between the production in China and its Asian supply chain partners, a weaker Yuan can make the supply chain's final product more competitive, in turn boosting demand for each stage of production – an offsetting outcome for the traditional beggar-thy-neighbour policy.

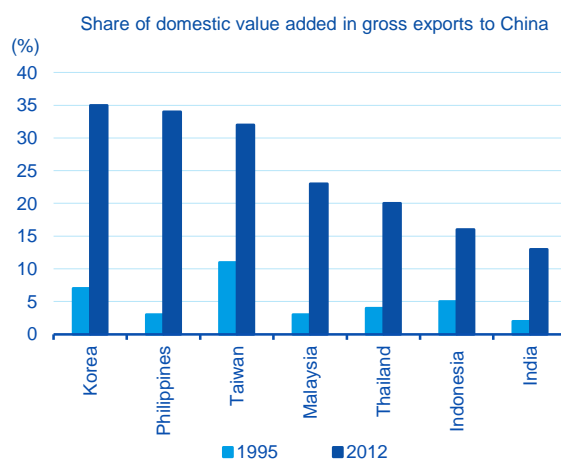
Global value chain related trade and production has increased significantly since 1995, particularly for ASEAN, where, according to IMF data, global value chain related exports (the sum of domestic value added in global value chains and foreign value added) as a share of GDP has increased from around 25% of GDP in 1995 to 36% in 2011. Asia as a whole has seen the sharpest increase from 8% of GDP in 1995 to 23% in 2011. Within EM Asia, since 1995, backward participation in global value chains - the share of gross exports

Figure 13
Trade integration² with China



Source: BBVA Research, IMF Database

Figure 14
Share of domestic value added in gross exports to China



Source: BBVA Research, IMF Database

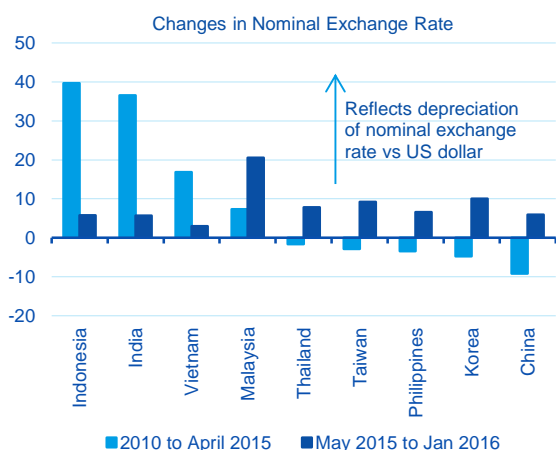
2: Source: IMF. Upstream vertical integration of China is defined as Chinese foreign value added content of country j's exports; and downstream vertical integration is defined as the country j's foreign value added content of China's exports.

consisting of inputs imported from abroad – has increased the most for Thailand, followed by India, China and Korea. Meanwhile, forward participation in global value chains – the share of exports consisting of intermediate inputs used by trading partners for production of their exports – has increased the most for Indonesia, followed by Korea, Thailand and India since 1995.

With regards to China and EM Asia, vertical trade integration between the two has increased significantly post 2000, concentrated mainly in downstream industries as China specializes in downstream activities such as assembling (See Figure - 13) although as stated earlier, upstream integration has also picked up since 1995 reflecting China’s rise in the global value chain. Within emerging Asia (See Figure – 14), downstream vertical integration with China is highest for Korea, which has a 35% share of domestic value added in its exports to China, followed by the Philippines (34%), Taiwan (32%), Malaysia (23%), Thailand (20%), Indonesia (16%), and India (13%). The high share of value added in total exports to China makes Korea, Taiwan and Malaysia particularly vulnerable to slowing import demand from China while India and Indonesia much less so. While Philippines has a high share of domestic value added in exports to China, its export exposure to China as a share of GDP is quite low at just around 3%, which supports the sovereign.

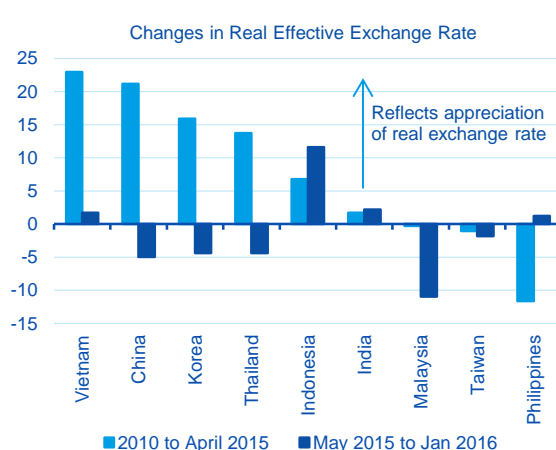
Despite its significant rise, the pace of growth of global value chains has slowed over the past five years; with non-global value chain related exports (traditional exports) still accounting for the bulk of around two third of EM Asia’s total exported domestic value added. One must note that, the impact of foreign value added on the size of trade balance is null as it appears both in gross imports as well as exports. A recent study by the IMF (Oct 2015 WEO) found that real currency appreciation not only reduced exports of domestic value added but also lowered imports of foreign value added, given that the latter is used as a complement with the former in domestic production of exports. The study confirmed that exchange rate movements still have sizable effects on exports and imports. In particular, it found that on average, 10% real effective exchange rate depreciation comes with a rise in real net exports of 1.5% of GDP, with bulk of the adjustment occurring in the first year.

Figure 15
Nominal exchange rates have depreciated markedly across Asia



Source: BBVA Research, Haver Analytics

Figure 16
On a REER basis, exchange rate is playing shock absorbing role for some but not all of EM Asia



Source: BBVA Research, Haver Analytics

Table 1
Vietnam and Malaysia have most similar export profiles to China

Countrywise top 10 export items to the world in 2014									
	China	Vietnam	Malaysia	Taiwan	Korea	Philippines	Thailand	India	Indonesia
1	Telecom Equip	Telecom Equip	Cathode tubes	Cathode tubes	Cathode tubes	Cathode tubes	ADP machines	Petroleum	Vegetable fats
2	ADP* machines	Footwear	Natural Gas	Petroleum	Petroleum	ADP machines	Motor Vehicles	Pearls & precious stones	Coal
3	Cathode tubes (4%)	Petroleum	Petroleum	Telecom Equip	Motor Vehicles	Wood manuf	Petroleum	Jewellery	Natural Gas
4	Furniture	Apparel & textile	Vegetable fats	Optical Instruments	Ships/boats	Machine parts	Cathode tubes	Medicament s	Petroleum
5	Jewellery	Furniture	ADP machines	Electrical circuits	Telecom Equip	Electricity distrib equip	Vehicle parts	Rice	Rubber
6	Footwear	Men's Clothing	Telecom Equip	Electrical machinery	Optical inst	Nickel Ore	Motor Vehicles	Aircraft Equip	Footwear
7	Electrical Machinery	Women's Clothing	Electrical circuits	Machine parts	Vehicle parts	Fruits & nuts	Rubber	Textile yarn	Paper
8	Apparel & textile	Mulluscks & related	Machine parts	Musical inst	Electrical Machinery	Ships/Boats	Rice	Motor vehicles	Motor Vehicles
9	Toys	Fish	Measuring apparatus	Nails/screw s	Hydrocarbo sn	Elect power m/c	Heating Equip	Apparal & textiles	Resid petroleum
10	Electrical Circuits	Coffee	Electrical machinery	Motorcycles	Electrical circuits	Vehicle Parts	Jewellery	Meat	Textile yarn

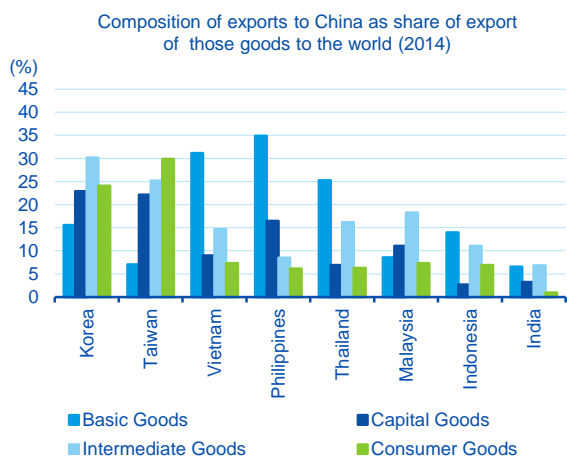
*ADP : Automatic Data Processing
Source: BBVA Research, Haver Analytics

The impact of Yuan depreciation on China's Asian trade partners – exchange rate is playing its shock absorbing role for some but not all of EM Asia

The last six months have seen the spill over effect of Yuan devaluation into broader currency depreciation across Asia (See Figure - 15). However, on a real trade weighted basis, except Malaysia, the recent depreciation across Asian currencies isn't quite pronounced (See Figure - 16). The Yuan has weakened 5% REER basis over the last year, which is weaker than most other EM economies in the region except the Malaysian Ringgit (-11%). On the contrary, the Indonesian rupiah has seen significant real appreciation since last year while the Vietnamese Dong and Indian rupee also remain relatively strong. Furthermore, most EM Asian currencies except the Philippines, Malaysia and Taiwan experienced significant appreciation in REER between 2010 and 2015, which adversely affected Asia's trade competitiveness and real net exports as a share of GDP. We find that Vietnam, Malaysia, Taiwan and Korea show strongest export similarity to China (See Table - 1) and thus their export performance is most sensitive within EM Asia to the relative currency depreciation of the Chinese Yuan. In an odd positive and a partly offsetting factor, we think that a weaker Yuan does to some extent help improve export competitiveness of Philippines', Taiwan and Korea, given their significant rise in upstream trade integration with China (China's share in foreign value added embedded in these economies total exports – See Figure 14). On balance, we do not expect the on-going

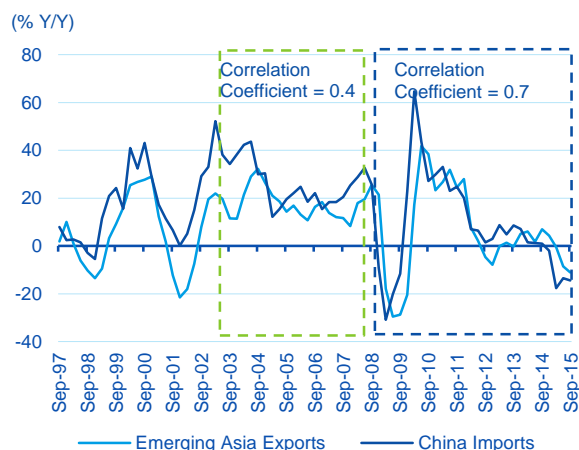
broad based nominal weakness in Asian currencies against the US dollar to aid a potential recovery in Asian trade – if any. In other words, the recent depreciation in REER of EM Asian economies does little to improve their trade competitiveness against the Chinese Yuan.

Figure 17
Exposure of EM Asia to China's is disparate



Source: BBVA Research, UNCTAD Database

Figure 18
A sharp slowdown in China's import demand has dragged on EM Asia exports



Source: BBVA Research, Haver Analytics

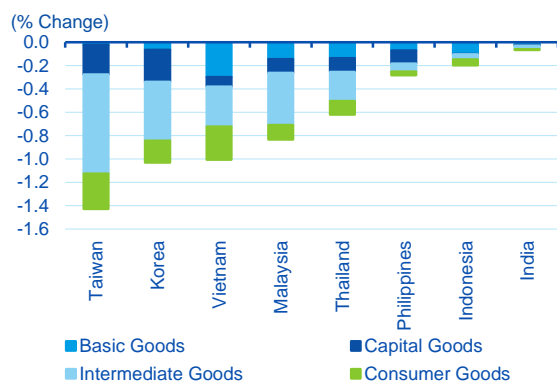
EM Asia growth outlook to remain stable despite feeling the heat from China

The past five years has seen a visible slowdown in China's GDP growth – from 9.6% in 2011 to 6.9% in 2015 - in the wake of declining capital efficiency, industrial overcapacity, rising labor cost and binding productivity constraints faced by Chinese State Owned Enterprises. Besides contributing to global risk premium and stoking financial stress, the deceleration in China's growth has 1) added to downside pressure on oil and commodity prices, particularly metals, in turn hurting earnings of the region's commodity exporters, and 2) directly affected emerging Asian economies through the trade channel depending upon their share of exports to China, the changes in their relative terms of trade vis-à-vis China in terms of their sectoral composition, their share of domestic value added in exports to China, and the similarity of their export basket with China in the wake of Yuan devaluation (See figure 17). The region as a whole has seen a protracted contraction in export growth, with the post-2009 crisis period depicting a closer correlation between EM Asia export growth and Chinese imports (See Figure - 18).

We find Taiwan and Korea to be the most vulnerable to a contraction in Chinese import demand while Philippines, Indonesia and India are the least affected (See Figure – 19). However, one should be cognizant of several offsetting effects to such a direct trade impact emanating from 1) vertical trade integration with China, 2) export similarity, 3) country-specific movements along the global value chain and its impact on the trade structure and 4) producer decisions to shift manufacturing bases to achieve cost efficiency. Underpinning such complexities, we observe that the impact of China's import demand has benefited Vietnam the most over 2011 to 2014 while most adversely affecting Taiwan (See Figure – 20).

Figure 19
Direct impact of weaker Chinese imports - Taiwan and Korea are hurt the most across EM Asia

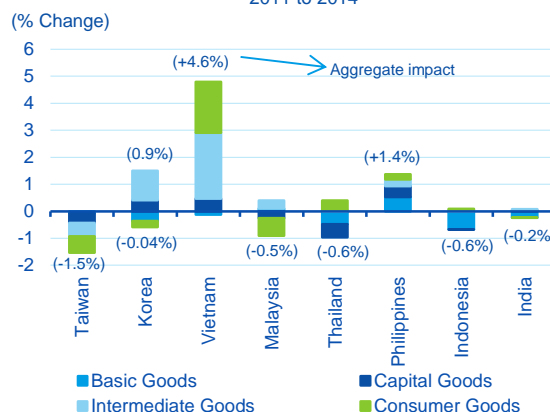
Impact on domestic GDP of a 10% contraction in exports to China in 2015



Source: BBVA Research, UNCTAD Database

Figure 20
Aggregate impact of China's import demand on EM Asia domestic GDP - 2011 to 2014

Aggregate impact of change in exports to China on domestic GDP - 2011 to 2014



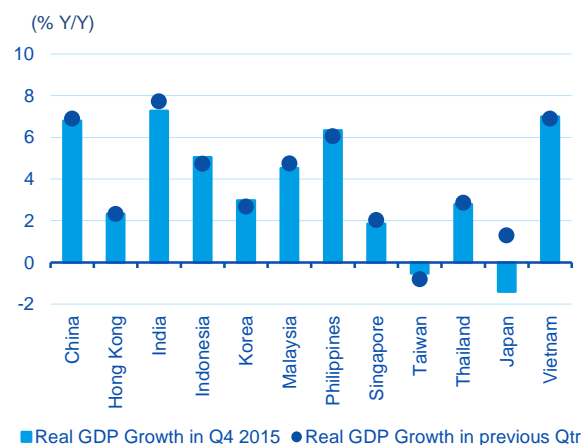
Source: BBVA Research, UNCTAD Database

Despite elusive trade gains, recent growth outturns for EM Asia have been relatively stable and broadly improving on the margins. This was mainly driven by resilient domestic demand as lower oil prices boost real income levels while inflation remains under control, allowing monetary and fiscal policy to turn accommodative (See Figure 21). As per our calculations, on a nominal GDP weighted basis, EM Asia excluding China grew 4.7% y/y in Q4 2015, largely flat compared to the previous three months. This was slightly lower from 5.0% y/y growth clocked in 2014 and 4.9% y/y average growth over the past four years. Individually, India topped the region's growth in Q4 2015, followed by Vietnam, Philippines and Vietnam while Taiwan's economy contracted, albeit by a less pace than the previous quarter. Authorities in the region, most notably in India, Indonesia, Thailand, Philippines and Korea have stepped up productive public spending, particularly infrastructure related. These are accompanied by a series of policy reform announcements alongside macro-prudential measures to mitigate liquidity risks, particularly in India and Indonesia, which has aided business and consumer confidence, although their effective implementation remains crucial. With regards monetary policy, EM Asian central banks will be cognizant of the pace of Fed rate hikes, domestic macro and financial stability and exchange rate movements. Barring significant external shocks, we see room for further rate cuts in India, Indonesia, Korea and Thailand in 2016.

Looking ahead, we remain cautiously optimistic over growth prospects in the region as a supportive domestic policy backdrop offsets external headwinds. The spillover effects on East Asian EMEs from a spike in global financial market volatility are inevitable going forward given the disruptive effects of China's economic transformation, US monetary tightening, lingering geopolitical risks and commodity currency interplay. With regards to China, in the short term, the portfolio rebalancing channel has been the key cause of concern for the region as investors remain unnerved over the effectiveness of China's policy reaction to the structural slowdown in China's economic growth, strains from a depreciating RMB, and fragilities in domestic financial markets, particularly the cracks appearing in shadow banking system and overall credit environment. Chinese authorities have openly blamed China's 'immature market, inexperienced investors, imperfect trading system, flawed market mechanisms and inappropriate supervision system' to the 'abnormal volatility' in Chinese equity markets at the start of 2016, which triggered a global equity market sell-off. Such China-led financial market tantrums have hit emerging market dependent assets hard, especially those linked to metals. Reassuringly, external vulnerability matrix for EM Asia has improved visibly over the past two years (See Table - 2) while bulk of these economies saw a surge in long term foreign direct investments

over the past year, reflecting confidence of strategic investors. This should help uphold the credit profile of EM Asia during times of stress (See our Economic Watch – [Can Asia avert a 1997-style crisis?](#)).

Figure 21
GDP growth across EM Asia has held up well



Source: BBVA Research, Haver Analytics

Table 2
External vulnerability matrix has improved for most of EM Asia over the past two years

	Fiscal Sustainability		External Sustainability		Liquidity Management	
	Central Govt Debt (% of GDP)		Current Account Balance (% of GDP)		Short Term External Debt as share of FX Reserves (%)	
	May 2013	Current	May 2013	Current	May 2013	Current
India	46.8	46.7	-4.7	-1.6	33.6	26.4
Indonesia	22.6	27.5	-4.2	-2.3	49.0	42.3
Philippines	50.1	39.6	4.4	1.0	23.2	20.3
Thailand	28.7	30.8	-6.2	7.7	38.6	35.3
Malaysia	54.7	52.1	1.7	2.6	71.5	98.0
Taiwan	33.9	33.4	11.0	15.1	30.5	37.3
Korea	42.1	44.1	7.0	8.6	37.9	33.4
Vietnam	55.0	50.4	4.6	1.0	47.1	38.1

Source: BBVA Research, Haver Analytics

The external demand challenge will be most pronounced for Taiwan, Korea, Malaysia and Thailand while authorities in India and Indonesia will be tested for their ability to uphold the reforms momentum. That said, the impact of China slowdown on India and Indonesia cannot be discounted. Prima facie, the relatively low export exposure of India and Indonesia to China – 0.4% of GDP and 1.6% of GDP respectively – should hold them in better stead against weakening Chinese import demand compared to rest of EM Asia pack. However, given their largely commodity driven export profiles (See Table – 1), the impact of China’s slowdown on India and Indonesia through the global commodity price channel is expected to be significant. While lower oil prices should have a positive impact on real incomes of consumers and ease cost of production of energy using firms, recent studies suggest that the negative effects of low oil prices on energy producing firms are felt more quickly.

Individually, Taiwan and Korea would be less affected by China’s slowdown than their export shares to China suggest. The highly levered household sector in Korea is likely to restrain consumption spending from increasing rapidly. Weakening external demand and associated competition issues have led to a build-up of excess capacity in Korea’s manufacturing sector, in turn leading to job losses, and consolidation efforts across affected heavy industries. However, we believe that Taiwan and Korea would be less affected by China’s slowdown than their export shares to China suggest. This is because the exports of these two economies are less reliant on the Chinese investment story. The bulk of Taiwan’s exports to China constitutes cathode tubes, optical instruments, electrical circuits and electrical machinery, which are mainly reliant on consumption growth that remains fairly resilient in China and is expected to improve, even if not as much, as economic rebalancing gains further traction (See table – 1).

For Thailand, political stability would be a key factor determining its overall credit profile. The bulk of Thailand’s exports to China is non-commodity merchandise goods, the prices of which have experienced softer declines compared to commodity items. This makes Thailand less vulnerable to slowing Chinese imports despite having a higher share of exports to China compared to EM Asian economies such as Indonesia. On the political front, while elections are unlikely before mid-2017 and the support for military

junta is relatively stable, return to a democratically elected government is crucial for Thailand to foster long term economic and social stability.

Economic diversification to offset negative impact of lower oil prices on commodity exporters in the region such as Malaysia: Notwithstanding the impact of political uncertainty, Malaysia's manufacturing sector would likely be aided by on-going currency weakness. We expect limited impact of low oil prices on Malaysia's growth outlook given its much diversified economy and its declining, although still high, share of energy revenue in total government revenue (from 40% to 30%) over recent years. Interestingly, despite being a predominant commodity exporter, particularly natural gas, nearly 33% of Malaysia's exports to China are Cathode tubes followed by edible oil (7%) and automatic data processing machines (6%). Furthermore, Malaysia is making adjustments on spending side to accommodate the lower receipts and private consumption remains strong despite the introduction of Goods and Services tax last year.

Vietnam will benefit the most in the region from China's climb up the value chain and rising labor costs as low cost manufacturers chose to move production base elsewhere from China. On the domestic front, we expect on-going efforts to liberalize Vietnam's State Owned Enterprises to continue unabated despite the change in guard at the centre based on the belief that policy making in Vietnam is largely consensus based. A healthy external profile, rising foreign exchange reserves, low external borrowings and a well-diversified export sector strengthen Vietnam's external fundamentals while government plays a dominant role in driving growth. On the flipside, we remain concerned over Vietnam's banking sector, which is riddled by weak asset quality, low capital adequacy levels and profitability concerns. In addition, the slow pace of banking reforms has raised concerns over its ability to fund much needed infrastructure development in the low income economy. Besides, improvements in policy framework, more flexible labor markets and a larger role for markets in driving growth would be a key positive for Vietnam going forward.

Growth prospects are relatively brighter for economies with higher domestic orientation such as Philippines, India, and Indonesia. The Philippines economy saw a modest acceleration in Q4 2015 on the back of robust domestic demand. Going forward, expectations of a budgeted increase in infrastructure investments in 2016 besides, relatively strong household balance sheets, high jobs growth and remittances should aid GDP growth in 2016. While Philippines has a very strong external position, characterized by high reserves and low external debt, investors will be closely watching the post presidential election phase (Scheduled May 9th 2016), for continuation of structural reforms, especially those aimed at improving foreign direct investments and capping the fiscal deficit.

India's high headline GDP outturns do mask relatively tepid growth under the hood, policy measures to improve overall business climate, rev up capital expenditure, attract foreign investments, encourage export oriented manufacturing activity, restore currency stability and enhance external buffers are steps in the right direction. In its bid to build sovereign credibility, India's FY17 (year ending March 2017) Union Budget, announced on February 29th reiterated its commitment towards quality fiscal consolidation by aiming to reduce its fiscal deficit to 3.5% from 3.9% of GDP in FY16. This provides room for further monetary policy easing in 2016, in line with our expectations. We peg a cumulative 50 bps of additional policy easing by the RBI over the rest of 2016 (current repo rate at 6.75%), with a high likelihood of 25 bps intermeeting rate cut before RBI's next meeting on April 5th 2016. Furthermore, the budget rightly focused on measures to boost a weak rural economy and step up productive public spending but was less forthcoming on implementation of crucial structural reforms such as the Goods and Services Tax and the Land Acquisition Bill, the progress on which is critical for India to deepen confidence of long-term foreign investors and bridge the funding gap to plug its infrastructure deficit. Key risks to India's growth prospects emanate from 1) political bickering delaying key reforms related to taxation and land acquisition, 2) a weak public sector banking sector proving

to be a drag on overall economic growth and investor sentiment, and 3) another year of sub-par monsoon rains stoking inflation pressures.

Meanwhile, for Indonesia, the past year has seen visible improvement in Indonesia's monetary and financial sector management, which has contributed to policy effectiveness. Announcement of broad-based economic measures to boost consumer purchasing power and attract investments, sound fiscal buffers and sufficient external buffers alongside Bank Indonesia's prudent monetary policy approach with a focus on anchoring inflation have augured well for Indonesia's credit matrix. In a word of caution, however, Indonesian authorities need to step up the quality of public sector expenditure, whose delivery remains below schedule. Furthermore, showcasing greater commitment towards implementing reforms aimed at making rigid labor laws more flexible, directly tackling red tape, increasing regulatory certainty, enabling effective coordination amongst authorities to make land acquisition easier and enforce the new legal framework that supports public private partnerships is crucial.

DISCLAIMER

This document and the information, opinions, estimates, forecasts and recommendations expressed herein have been prepared to provide BBVA Group's customers with general information and are current as of the date hereof and subject to changes without prior notice. Neither BBVA nor any of its affiliates is responsible for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, to undertake or divest investments, or to participate in any trading strategy. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. Other than the disclosures relating to BBVA Group, the contents of this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA or any of its affiliates and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. To the extent permitted by law, BBVA and its affiliates accept no liability of any type for any direct or indirect losses or damages arising from the use of this document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, derivatives, options on securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying securities. Investors should also be aware that secondary markets for the said instruments may not exist. Before entering into transactions in futures, derivatives, or options, investors should review all documents on disclosures for risks of investing in options and/or futures at the following websites:

Options - <http://www.finra.org/Industry/Regulation/Notices/2013/P197741>

Futures - <http://www.finra.org/Investors/InvestmentChoices/P005912>

BBVA or any of its affiliates' salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. More specifically, this document is in no way intended for, or to be distributed or used by an entity or person resident or located in a jurisdiction in which the said distribution, publication, use of or access to the document contravenes the law which requires BBVA or any of its affiliates to obtain a licence or be registered. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

The remuneration system concerning the analysts responsible for the preparation of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons").

This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.

BBVA Hong Kong Branch (CE number AFR194) is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong this report is for distribution only to professional investors within the meaning of Schedule 1 to the Securities and Futures Ordinance (Cap 571) of Hong Kong.

This document is distributed in Singapore by BBVA's office in this country for general information purposes and it is generally accessible. In this respect, this document does not take into account the specific investment goals, the financial situation or the need of any particular person and it is exempted from Regulation 34 of the Financial Advisors Regulation ("FAR") (as required in Section 27 of the Financial Advisors Act (Chapter 110) of Singapore ("FAA")).

Garanti Securities headquarters is in Istanbul, Turkey and is regulated by Capital Markets Board (Sermaye Piyasası Kurulu - SPK, www.spk.gov.tr)

BBVA, BBVA Bancomer, BBVA Chile S.A., BBVA Colombia S.A., BBVA Continental, BBVA Securities and Garanti Securities are not authorised deposit institutions in accordance with the definition of the Australian Banking Act of 1959 nor are they regulated by the Australian Prudential Regulatory Authority (APRA).

General Disclaimer for Readers Accessing the Report through the Internet

Internet Access

In the event that this document has been accessed via the internet or via any other electronic means which allows its contents to be viewed, the following information should be read carefully:

The information contained in this document should be taken only as a general guide on matters that may be of interest. The application and impact of laws may vary substantially depending on specific circumstances. BBVA does not guarantee that this report and/or its contents published on the Internet are appropriate for use in all geographic areas, or that the financial instruments, securities, products or services referred to in it are available or appropriate for sale or use in all jurisdictions or for all investors or counterparties. Recipients of this report who access it through the Internet do so on their own initiative and are responsible for compliance with local regulations applicable to them.

Changes in regulations and the risks inherent in electronic communications may cause delays, omissions, or inaccuracy in the information contained in this site. Accordingly, the information contained in the site is supplied on the understanding that the authors and editors do not hereby intend to supply any form of consulting, legal, accounting or other advice.

All images and texts are the property of BBVA and may not be downloaded from the Internet, copied, distributed, stored, re-used, re-transmitted, modified or used in any way, except as specified in this document, without the express written consent of BBVA. BBVA reserves all intellectual property rights to the fullest extent of the law.