

## Q&A

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### Chia-Liang Lian Discusses PIMCO's Secular Outlook and its Implications for Asian Economies and Investment Strategy



**Chia-Liang Lian**  
Vice President, Portfolio Manager

Mr. Lian is a Vice President and Portfolio Manager with a focus on the emerging markets in Asia. Prior to joining the firm in March 2005, he spent eight years as a sovereign debt strategist at JPMorgan Chase and Merrill Lynch. Mr. Lian started out his career with the Monetary Authority of Singapore, where he spent four years as senior economist responsible for formulating exchange rate policy. He currently serves as the Co-Head of PIMCO's Asian Economic Forum team. Mr. Lian holds a bachelor's degree from the National University of Singapore, and is a CFA charterholder.

*PIMCO's Secular Outlook is for continued global growth that will be increasingly driven by the developing world. In the interview below, Portfolio Manager Chia-Liang Lian discusses how developments in China and the rest of emerging Asia fit in with the Secular Outlook, and points out the potential risks and global inflation implications.*

**Q: PIMCO recently held its annual Secular Forum to formulate its views and strategy over the next three to five years. What were the major forum conclusions, and how do economies in Asia fit into the secular outlook?**

**Lian:** A key takeaway from our Secular Forum is that we are now anticipating global growth of between 4% and 5% per year, partly driven by emerging market economies. A good number of these emerging markets are in the Asia region. Specifically, we feel that growth in China and India, the two largest developing countries in Asia, will likely hold up and average at or near a double-digit pace over the secular horizon. This should offset the impact of moderating growth in the world's industrialized economies, and help underpin global growth.

China's rapid pace of GDP growth in recent years, of course, has been well advertised. What is less talked about is the favourable ripple effect it has on the rest of Asia. The so-called newly industrialized economies, including Hong Kong, South Korea, Singapore and Taiwan, have all benefited from the many comparative advantages that China offers. The result is increased integration of the region's manufacturing production grid. The electronics industry has been a case in point, where intra-regional trade involves predominantly intermediate components (such as semiconductors and disk drives), which flow to lower-cost locations for the final assembly of high-tech products that are shipped to the developed markets.

Elsewhere in Southeast Asian countries, such as Indonesia, Malaysia and Vietnam, we are also witnessing an acceleration of economic growth. At first glance, the emergence of China may appear to be a threat from the perspective of export competitiveness. In reality however, regional economies view China more as a customer and less as a competitor. This is especially true for commodity-rich countries such as Malaysia, Indonesia and Middle East oil producers. In addition, many have benefited from the lessons learned from China's experience of economic reforms that began in 1979. Furthermore, many smaller countries benefit from what comes to be known as the "China plus one" policy, as multinational corporations spread their direct

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investments across two or more locations to draw on individual economy's strengths, tap new markets and diversify risks.

The upshot is that this is part of a virtuous cycle in the entire region: the economic stability and surpluses from strong export-led growth in recent years is setting the stage for the next phase of internal demand growth. This should further boost intra-Asian trade and help support regional growth from within. While China continues to take centre stage, a broader array of countries are sharing the economic buoyancy, and that is creating significant demand for investments and ultimately for household consumption. Together, these dynamics set the stage for a constructive Secular Outlook for Asia as a region, and potentially, a significant impact of Asia on the rest of the world. This upbeat outlook, in turn, points to a modest pickup in inflation over the next three to five years.

### **Q: How far along is development of internal demand in Asia, and to what extent will it drive growth?**

**Lian:** To be sure, we are only at the very beginning of this. That said, nascent signs have emerged that internal demand is, slowly but surely, becoming part of the equation. One such indication is a growing middle-income class in China. This is anecdotally evident in the more prosperous coastal regions, which have benefited most from the economic boom of the past decade. Going back to the earlier point on the ripple effect outside of China, this group of spenders has provided support to the rest of Asia in terms of investment, consumption and tourism. Hong Kong's retail sector and Macau's gaming industry, to cite two examples, have been the obvious beneficiaries. Indeed, whereas the focus of the region's tourism strategy was previously centered on visitors from Japan, there appears to be a distinctive shift toward tapping the longer-term potential of the Chinese spender.

Turning to the recent stock market correction in China, there was a lot of interest and analysis about what type of spillover it would have for consumption in China. In our opinion, even though the run up in China stocks has been driven by domestic individual investors, the equity market in China is narrowly concentrated within a very small part of the population. But the fact that the Shanghai A index has now become a focus in the markets may be a sign that people are starting to think differently about China, and that domestic demand is now part of the equation when one thinks about global aggregate demand.

### **Q: You mentioned that PIMCO is calling for a modest increase in global inflation over the Secular time frame. Will wage and price trends in Asia be a factor in this global inflation uptick?**

**Lian:** Yes. Another key element of our forecast is for a modest pickup in global inflation which reflects our belief that Asia - China in particular - will be less of a global disinflationary force than it has been in recent decades.

One major reason for the shift in the influence of emerging Asia on global inflation is the progression of the economic development cycle. In China, for example, we still see major differences between top tier cities like Shanghai and Beijing, and second or third-tier cities. Income disparities follow these same regional patterns. The government's

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development policy is to narrow that gap by investing in these second and third tier cities, largely through accelerating infrastructure spending into these areas. This will result in growing demand for commodities, building materials and capital goods. And China isn't the only place this is happening – India, for example, is investing heavily in its under-developed infrastructure like roads, airports and energy projects. This will be very supportive for commodities and basic materials, such as metals, oil and cement.

Economic development will also be supportive for wages in Asia, which will lessen the disinflationary influence from the region. Currency appreciation will also increase internal consumer spending power and lift prices in export markets, both of which are inflationary. One area that is sometimes overlooked is the effect that increased wages and spending will have on food commodities. Food prices have been one of the most prominent drivers of consumer price pressure in China recently.

**Q: Does Japan's economic recovery have broader implications for emerging Asia?**

**Lian:** Japan is the world's second largest economy, and the Japanese recovery will undoubtedly be constructive for growth in the region. Japan, along with the U.S. and Europe, comprises the world's primary sources of demand for products from emerging Asian producers. Conversely, over the secular horizon, China and other parts of Asia will remain a very large market for Japanese capital goods, due to large scale investment in infrastructure and technology.

We have seen a depreciation of the yen versus other Asian currencies. This could have some dampening impact on foreign direct investment flows from Japan into the rest of Asia. On the other hand, it is worth noting that there have been significant portfolio inflows into the region's financial markets in recent years.

**Q: How does PIMCO's view of a cyclical U.S. slowdown affect the positive secular view for Asia?**

**Lian:** The U.S. housing-led slowdown remains a key concern for the region's economic outlook. The issue of reduced external demand from the U.S. is one part of that risk. An even bigger part is the risk that a potential financial fallout could adversely affect the region's financial markets.

That said, the concern about backlash from a broad reduction in risk appetites isn't as prevalent as it has been in the past. Fundamentally, Asian economies have improved considerably from where they were when the Asian financial crisis hit a decade ago. Critically, a significant buildup of foreign reserves that followed should provide a cushion to exogenous shocks and limit the extent of market contagion. This is demonstrated by the limited fallout, both in Thailand as well as the region, from the imposition of capital controls in Thailand last December.

**Q: Will politics influence the outlook for Asia?**

**Lian:** There are some political developments worth noting. Our key concern is a potential emergence of some form of protectionism stemming from assertions that China is not moving fast enough in allowing its currency to appreciate. We do not view protectionism as a base-case scenario because we believe China will hasten the pace

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of renminbi appreciation. The currency has already appreciated significantly since the revaluation of July 2005. In May, China widened the daily trading band for the renminbi from  $\pm 0.3\%$  to  $\pm 0.5\%$ . These policy changes are significant and demonstrate policy makers' commitment to move in the right direction. True, while they want to continue moving at a cautious and incremental pace, they have warmed up to the fact that currency appreciation is consistent with efforts to deal with the risk of economic overheating.

Another set of political events worth keeping an eye on is the busy election schedule over the next year. Overall, we view the outcomes as generally benign, as we expect a continuation of market-friendly policies in Asia. Nevertheless, some of the outcomes could have a set of secular implications for the region and we have to watch them carefully. South Korea will hold its presidential election in December. Both Pakistan and Thailand have national elections slated for the fourth quarter. In the early part of next year, Taiwan will hold legislative and presidential elections, while there is talk that Malaysia may hold its general election as early as next year. Indonesia's presidential elections will be further out, in 2009. This all comes against the backdrop of China's 17th Communist Party Congress this autumn, where officials will reappoint senior leadership for the next five years.

### **Q: What are the investment implications of PIMCO's Secular Outlook for Asia?**

**Lian:** At the latest Secular Forum, PIMCO shifted its view of the world economy from "glass half empty" to a "glass half full" where developing economies will have a larger influence in sustaining global growth. We see less of a risk from global imbalances than we have in the past. Our view is now of a more gradual adjustment, which will likely mean a weaker dollar over time. This combination of continued global growth and a gradually declining dollar is the basis of PIMCO's strategy to invest in developing local markets.

PIMCO's interest in local markets naturally extends into Asia, where we want to have exposure to currencies like the renminbi, the Korean won and the Singapore dollar, as well as other candidates such as the Indian rupee and the Malaysian ringgit.

On the hard currency side, where emerging market debt is denominated in dollars or euros, you typically don't get the same degree of yield pickup as in local markets. Still, there is a growing set of opportunities afforded by an increasing number of debut issuers, both sovereign and corporate. In this regard, there is room for further differentiation and distinction among Asian credits. We are attracted to credits that (1) exhibit strong standalone credit fundamentals, (2) are positioned to benefit from robust economic expansion in China and/or India, and (3) will likely benefit from sustained global demand for commodities.

**Q: Thank you, Chia-Liang. We look forward to hearing from you again after PIMCO's next Cyclical Forum in September.**

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