Regional Economic Outlook UPDATE
FALL 2014
Asia and Pacific Department

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Asia and Pacific Economic Outlook: October 2014 Update

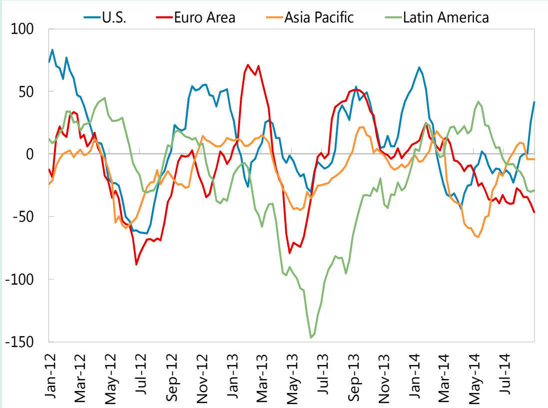
Despite a weaker-than-expected first half of the year, the outlook for the Asia and Pacific region remains solid. The ongoing global recovery, while tepid, should support Asia's exports. Meanwhile, favorable financial and labor market conditions, as well as broadly accommodative policies, will continue to underpin domestic demand. GDP is forecast to grow by 5.5 percent for the third consecutive year in 2014, rising slightly to 5.6 percent in 2015. Financial dislocations associated with higher global interest rates, and protracted weak growth in advanced and emerging market economies are the main downside risks to the outlook. A sharper-than-anticipated downturn in China's real estate sector and less-effective-than-envisaged Abenomics in Japan would also adversely affect regional growth prospects. Geopolitical tensions could also disrupt trade and financial flows, with adverse effects on growth. Policymakers in the region should capitalize on the outlook to gradually rebuild policy space and push ahead with structural reforms to deliver sustainable growth. While there is no one-size-fits-all approach, fiscal consolidation should generally continue in a calibrated manner, especially where debt levels are higher, and monetary normalization should proceed particularly where inflation pressures are high or building up.

A solid outlook amid an uneven global recovery

Despite a deceleration earlier this year, global growth is set to pick up in the second half of 2014 and into 2015, partly on accommodative monetary policies and a diminishing fiscal drag. Expectations of monetary policy normalization in the United States remain broadly unchanged amid an improving job market and some pickup in inflation, while disappointingly low growth and inflation in the euro area (**Figure 1**) have led the European Central Bank to announce new quantitative easing measures. Long-term rates have continued to decline, helped by a fall in term premia; stock markets are flirting with all-time highs in major advanced economies (United States and United Kingdom); and volatility in key markets, including in currencies, remains subdued (**Figure 2**). Against this backdrop, overall financial conditions have remained accommodative across Asia and even eased further in a few cases (e.g., Japan, Malaysia, and

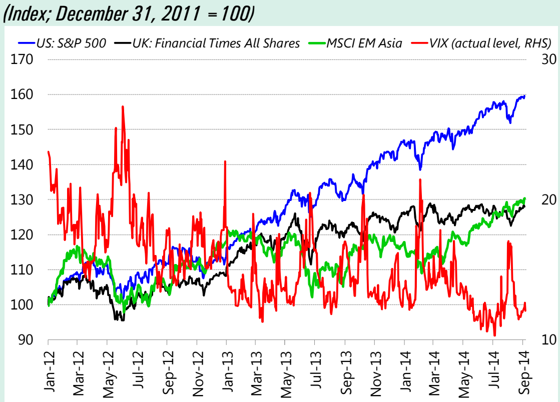
Note: Prepared by Roberto Guimarães-Filho under the guidance of Romain Duval. Jeremy Zook provided research support and Socorro Santayana assisted with the production.

Figure 1. Economic Surprise Indices
(Based on FX impacts of one-SD data release surprises; positive means better-than-expected outcomes)



Sources: Citigroup; and Haver Analytics.

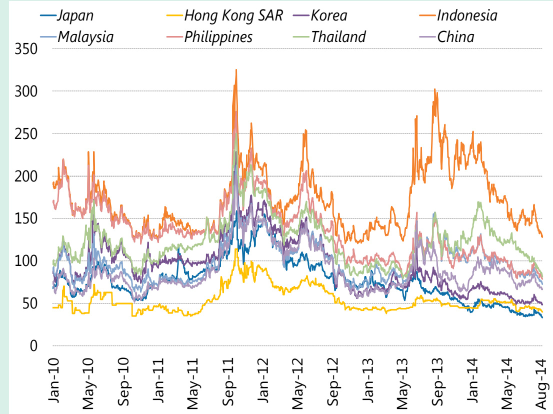
Figure 2. Advanced Economies and Emerging Asia: Stock Market Performance
(Index; December 31, 2011 = 100)



Sources: Bloomberg L.P.; Haver Analytics; and Thomson Reuters.

Thailand). Portfolio inflows have picked up significantly since last spring, with strong equity flows contributing to boost domestic stock markets. Long-term rates and sovereign CDS spreads have declined across the board (**Figure 3**). This helped sustain strong credit growth, as well as continued house price appreciation, with the most notable exception of China where the housing market is undergoing a correction.

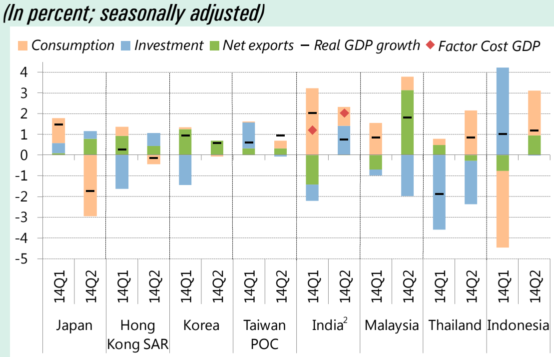
Figure 3. Selected Asia: Sovereign CDS Spreads
(In basis points)



Sources: CEIC Data Company Ltd.; Haver Analytics; and Thomson Reuters.

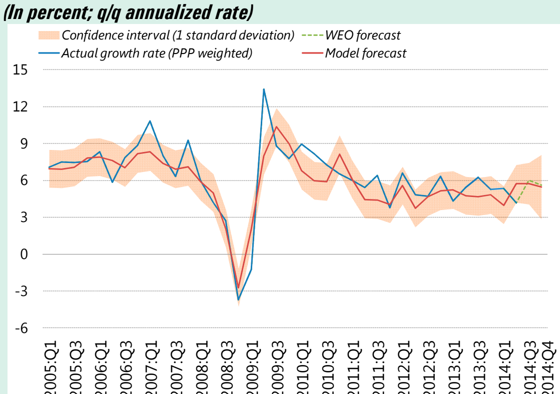
While activity slowed across most of the region in the first quarter of 2014, it has started to recover (Figure 4). Growth in the second quarter was propelled by stronger external demand from advanced economies and favorable financial conditions as well as idiosyncratic factors, which tended to bolster domestic demand. In China, targeted stimulus measures (including higher infrastructure investment) have helped stabilize domestic demand, which was sluggish earlier this year because of slowing growth in credit and investment, including in the real estate market. Growth in ASEAN-5 also accelerated in Q2, partly reflecting country-specific factors after a weak outturn in Q1 (e.g., stabilization of the political situation in Thailand). In India, growth (based on GDP at factor cost) has gathered steam as industrial production and other high-frequency indicators have started to turn around on the back of stronger business confidence. Meanwhile, Japan saw a sharper-than-envisaged downturn in Q2 following the consumption tax hike after strong growth in Q1. The IMF's short-term growth indicator model for Asia, which relies on regional high-frequency data, points to stronger momentum going into the fourth quarter (**Figure 5**).

Figure 4. Contribution to Quarter[1]
(In percent; seasonally adjusted)



Sources: CEIC Data Company; Haver Analytics; and IMF, *World Economic Outlook* database.
[1] Statistical discrepancy is not included above.
[2] For India, the data are based on GDP at market prices.

Figure 5. Indicator Model for Asia: Projected vs. Actual Real GDP Growth
(In percent; q/q annualized rate)



Source: IMF staff calculations.

Asia's outlook is expected to remain solid, helped by the ongoing global recovery and still broadly accommodative financial conditions and policies. GDP growth is forecast to reach 5.5 percent in 2014, accelerating slightly to 5.6 percent in 2015 (**Table 1**). The strong momentum in the United States and the gradual—yet fragile—global recovery should continue to provide an impetus to Asia's exports, while strong credit growth and relatively low interest rates propel domestic demand. Rising confidence, coupled with strong equity market valuations, is also expected to help investment in a number of economies. Domestic demand has also benefited from generally strong credit growth, and banks in the region are generally well capitalized and profitable (see for example, the IMF's *October 2014 Global Financial Stability Report and April 2014 Asia and Pacific Regional Economic Outlook*). With the exceptions of India, and to a lesser extent, Indonesia, inflation should remain generally low.

Table 1. Asia: Real GDP
(Year-on-year percent change)

	Actual Data and Latest Projections					Difference from April 2014 WEO		
	2011	2012	2013	2014	2015	2013	2014	2015
Australia	2.6	3.6	2.3	2.8	2.9	-0.1	0.2	0.2
Japan	-0.5	1.5	1.5	0.9	0.8	0.0	-0.5	-0.1
New Zealand	1.9	2.5	2.8	3.6	2.8	0.5	0.3	-0.2
East Asia	**8.4**	**6.7**	**6.9**	**6.8**	**6.6**	**0.2**	**0.0**	**-0.1**
China	9.3	7.7	7.7	7.4	7.1	0.0	-0.2	-0.2
Hong Kong SAR	4.8	1.5	2.9	3.0	3.3	0.0	-0.7	-0.6
Korea	3.7	2.3	3.0	3.7	4.0	0.2	0.0	0.2
Taiwan Province of China	4.2	1.5	2.1	3.5	3.8	0.0	0.3	-0.1
South Asia	**6.7**	**4.9**	**5.1**	**5.7**	**6.4**	**0.6**	**0.2**	**0.0**
Bangladesh	6.5	6.3	6.1	6.2	6.4	0.3	0.2	-0.1
India[1]	6.6	4.7	5.0	5.6	6.4	0.7	0.2	0.0
Sri Lanka	8.2	6.3	7.3	7.0	6.5	0.0	0.0	0.0
ASEAN	**4.9**	**6.0**	**5.3**	**4.7**	**5.4**	**0.1**	**-0.2**	**0.1**
Brunei Darussalam	3.4	0.9	-1.8	5.3	3.0	-0.5	-0.1	0.0
Cambodia	7.1	7.3	7.4	7.2	7.3	0.4	-0.1	0.0
Indonesia	6.5	6.3	5.8	5.2	5.5	0.0	-0.2	-0.3
Lao P.D.R.	8.0	7.9	8.0	7.4	7.2	-0.2	-0.1	-0.6
Malaysia	5.2	5.6	4.7	5.9	5.2	0.1	0.7	0.2
Myanmar	5.9	7.3	8.3	8.5	8.5	0.8	0.7	0.7
Philippines	3.7	6.8	7.2	6.2	6.3	0.0	-0.2	-0.2
Singapore	6.1	2.5	3.9	3.0	3.0	-0.2	-0.7	-0.6
Thailand	0.1	6.5	2.9	1.0	4.6	0.0	-1.5	0.8
Vietnam	6.2	5.2	5.4	5.5	5.6	0.0	-0.1	-0.1
Pacific island countries and other small states[2]	**5.4**	**1.9**	**1.3**	**2.1**	**4.7**	**-0.4**	**-0.3**	**0.6**
Emerging Asia[3]	**7.8**	**6.7**	**6.6**	**6.5**	**6.6**	**0.1**	**-0.2**	**-0.2**
Asia	**6.2**	**5.5**	**5.5**	**5.5**	**5.6**	**0.3**	**0.0**	**0.1**

Sources: IMF, *World Economic Outlook* database; and IMF staff projections.
[1]For India, data and forecasts are presented on a fiscal year basis and output growth is based on GDP at market prices. Corresponding growth forecasts for GDP at factor cost are 5.6 and 6.4 percent for 2014 and 2015, respectively.
[2]Simple average of Pacific island Countries cand other small states which include Bhutan, Fiji, Kiribati, Maldives, the Marshall Islands, Micronesia, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.
[3] Emerging Asia includes China, India, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.

- In China, GDP growth in 2014 H2 should remain at around 7.5 percent (year-on-year), helped by the targeted stimulus measures (boost to railway spending, support to agriculture, small- and medium-size enterprises, and social housing). The growth outlook for 2015 will hinge partly on government policies, which in turn will depend to an important extent on the (yet to be decided) growth target. Assuming continued efforts to rein in vulnerabilities (related to investment, credit, and local government finances) and the steady, if slow, implementation of reforms, growth should moderate to around 7 percent. The inflation outlook would remain benign.

- In Japan, while Abenomics continues to provide a boost to activity, GDP growth for 2014 is projected to slow to 0.9 percent—still above potential—following the larger-than-expected contraction in the second quarter in the wake of the consumption tax hike. Growth should remain broadly stable in 2015 as the effect of the planned fiscal adjustment on activity is partly offset by rising private investment. Headline inflation will decline next year as the impact of the recent increase in the consumption tax rate fades away, but underlying inflation should rise toward the official target of 2 percent over the medium term.

- India's growth outlook has improved since the last national election, helped by lower uncertainty and improved business confidence. These developments have been accompanied by rising capital inflows as well as a revival in investment and industrial activity. GDP growth appears to have bottomed out and is forecast to rise to 5.6 percent in 2014, accelerating further to 6.4 percent in 2015, despite headwinds from ongoing fiscal consolidation and a tighter monetary stance. India's high and persistent inflation remains a policy concern and is projected to decline only gradually, reaching 7.8 and 7.5 percent in fiscal years 2014 and 2015, respectively.

- Growth in Korea, Australia, and New Zealand is set to continue at a relatively solid pace. In Korea, while confidence indicators are lackluster, growth is still set to reach 3.7 percent in 2014 and 4.0 percent in 2015, helped by external demand and policy stimulus. In Australia, GDP growth is also stable, averaging 2.8 percent in 2014–15, as export volumes partly offset the unwinding of the investment cycle. New Zealand is set to benefit from reconstruction efforts and increasingly broad-based momentum; GDP growth is expected to reach 3.6 percent in 2014 before moderating to 2.8 percent in 2015.

- ASEAN-5 economies will experience a growth deceleration in 2014 and a rebound in 2015 as the global economy recovers and domestic policy uncertainty declines, particularly in Thailand where public and private domestic demand should see a rebound. After slowing to 5.2 percent in 2014, growth in Indonesia is set to rise to 5.5 percent in 2015 on improved confidence following the recent election. The economies of

Malaysia, the Philippines and, to a lesser extent, Singapore (which is experiencing transitory costs of ongoing reforms), should continue to experience solid growth in 2014–15, propelled by global trade and favorable financial conditions.

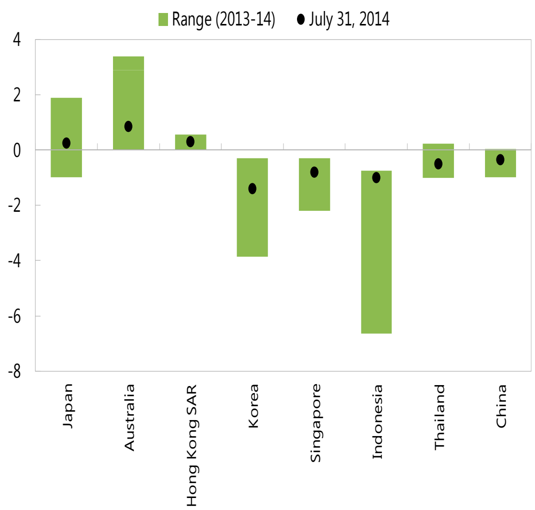
- Stronger trade, remittances, and tourism revenue should benefit *frontier and developing economies* as well as Small States and Pacific island countries. Growth is expected to pick up in 2014–15as these economies have been less affected by the past weakness in external demand and spikes in global volatility, but vulnerabilities associated with high fiscal and current account deficits and soft commodity prices have been rising in some cases (Mongolia and Lao P.D.R.).

However, downside risks are significant and important medium-term challenges remain

Global downside risks to the outlook have increased. Relative to April, the risk of sluggish global growth in advanced economies and emerging markets has come to the fore and geopolitical tensions have become more acute. Even so, valuations in global financial markets have been further stretched against the backdrop of still abundant global liquidity and greater risk appetite by investors (see again **Figures 2 and 3**). A disorderly reaction to the normalization of monetary policy in the United States could lead to a spike in global interest rates and sharp reversals in capital inflows. This would contribute to elevated asset price volatility and a decompression in term premia and spreads (sovereign and corporate), which would represent a large shock to financing costs. As discussed in the *April 2014 Asia and Pacific Regional Economic Outlook*, higher corporate leverage would amplify the adverse effect of higher interest rates on investment. Currency risk reversals also indicate that a number of regional currencies face a significant risk of a depreciation in the near term (**Figure 6**). As shown in recent "risk-off" episodes, economies that depend more on external financing or those with a large presence of foreign investors in their domestic financial markets are more subject to the risk of capital flow reversals. More broadly, countries with weaker fundamentals, such as higher current account and fiscal deficits, are more likely to be targeted.

Meanwhile, quantitative easing measures in Japan and the euro area might provide an offset, however, especially if they led to stronger capital flows into Asia than has been the case so far. In addition, economic resilience to global financial risks has increased in the region, including in Indonesia and especially in India, where policy actions to reduce vulnerabilities have helped lower external and domestic imbalances. In India, for instance, international reserves have risen and the current account deficit has been slashed, contributing to a significant reduction in gross external financing needs. Indonesia has also seen an increase in its foreign exchange reserves. Finally, while spillovers have been limited so far, international and domestic political tensions could also hurt the outlook, particularly if they were to prove persistent and weaken confidence, disrupt investment or trade, or cause a spike in energy or food prices.

Figure 6. Currency Risk Reversal
(Negative risk reversal implies disproportionate probability of depreciation of local currencies against the U.S. dollar)



Sources: Bloomberg L.P.; and IMF staff calculations.

In the near term, the region could also be adversely affected by a sharper growth slowdown in China or either a failure or delay in implementing structural reforms in Japan. In China, real estate has been a significant growth engine, but it has shown growing signs of imbalance and activity has softened this year. This could affect real and financial activity, given significant linkages between housing finance and nonbank financial intermediation (which has been growing rapidly). More broadly, declines in house prices elsewhere in the region would also adversely affect activity and private consumption. Econometric estimates suggest that house price declines, if sustained, could have large effects on activity in a number of emerging Asian economies—a 5 percent decline in the house price index could lower GDP (relative to the baseline path) by an average of 1.3 percent after one year.[1] In Japan, delay in implementing the "third arrow" of Abenomics could lead to slower growth and an overreliance on monetary policy, thereby hurting regional trade and growth prospects.

Growing medium-term risks outside of Asia compound the region's own challenges. For the region as a whole, potential growth has already declined and could weaken further if the investment outlook remains subdued or if much needed reforms are delayed or not fully implemented. A self-reinforcing spiral of insufficient aggregate demand and lower potential growth in advanced economies could have a further impact on emerging Asia's growth prospects. A simulation with the IMF's G20 model shows that an increase in the private saving rate by 0.2 percent of GDP with a concomitant decline in investment growth by about 1 percent in advanced economies could lower growth in Asia (relative to the baseline) by about 0.2 percentage point as a result of trade and financial spillovers.

[1] The 5 percent drop in house prices is in line with the median decline observed during housing market busts during the 1995–2013 period (see, for instance, Box 2.1 in the *April 2014 Asia and Pacific Regional Economic Outlook).* The econometric analysis is based on vector autoregressions estimated on a sample of selected emerging Asian economies (covering up to 1995–2013 in some economies). The recursive model includes GDP, CPI, real credit, a house price index, a short-term interest rate, and the nominal effective exchange rate.

Policy requirements: rebuilding buffers and implementing reforms

Clear and credible policy frameworks will remain at a premium, especially during "risk-off" episodes or when the visibility about the direction of the global economy remains low. While economies in the region have buffers in the form of international reserves and, in most cases, generally low fiscal deficits and inflation, macroeconomic policies should continue to focus on gradually rebuilding fiscal buffers and ensuring that inflation remains in check. This is particularly important in ASEAN, where output is currently above potential (e.g., Malaysia, the Philippines, and Singapore) or there is little slack in the economy (Indonesia). Safeguarding financial stability should also remain a critical policy priority, underscoring the need to further strengthen regulation and supervision, including of shadow banking intermediation. In this connection, micro- and macroprudential policies, which many Asian economies have used quite extensively during the last decade, including over the past year, will continue to complement the monetary-fiscal policy mix.

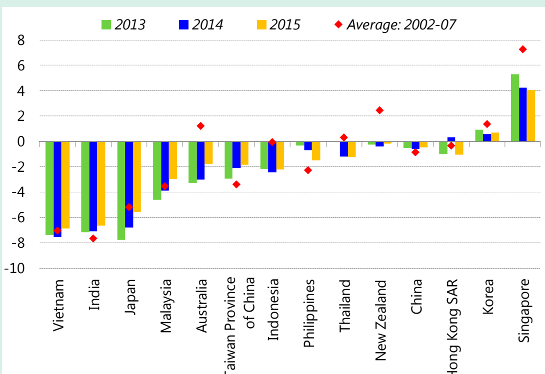
Strong policy frameworks can also mitigate the effects of higher volatility on the real economy. Existing buffers have not insulated Asia from the global capital flow shocks and spikes in asset price volatility. But recent episodes triggered by global financial shocks have shown that those economies with stronger fundamentals, or those that have undertaken significant adjustments to lower their inflation and external imbalances, can benefit from positive differentiation by global investors. Reforms to maintain high and sustainable growth will also help lower near-term vulnerabilities. For instance, policies to deliver higher growth and inflation in Japan, a more balanced growth path in China, and stronger investment and efficiency in India are important steps in this direction. Many other countries in the region, including frontier and developing economies and Pacific island countries, would also benefit from structural reforms to boost investment and lift potential growth.

Fiscal Policy

Gradual fiscal consolidation should remain a policy priority, capitalizing on the steady growth momentum.

- While budget deficits in the region are generally manageable, fiscal positions have deteriorated in many economies, even as growth has remained relatively strong. In light of this and Asia's solid outlook, fiscal policy should focus on gradually rebuilding buffers (**Figure 7**). First, with a few exceptions, fiscal positions have weakened relative to historical benchmarks (e.g., 2002–07 average) as the fiscal impulse in the wake of the global financial crisis has not been fully unwound. Second, in a few economies public debt levels are high (Japan), fiscal imbalances are large (India and Vietnam), and in some cases contingent liabilities could be a significant drain on fiscal resources in the event that downside risks materialize (Malaysia). Fiscal consolidation is also desirable in some frontier and developing Asian economies, particularly where external imbalances are large (Cambodia, Lao P.D.R., and Mongolia). Creating fiscal space would not only strengthen fiscal credibility, but would also allow for increased infrastructure investment, which would boost productive capacity. Recent and ongoing efforts to reform fuel subsidies (e.g., in India, Indonesia, and Malaysia) are important steps in this direction.

Figure 7. Selected Asia: Cyclically Adjusted Fiscal Balance
(In percent of GDP)



Sources: IMF, *World Economic Outlook* database; and IMF staff calculations.

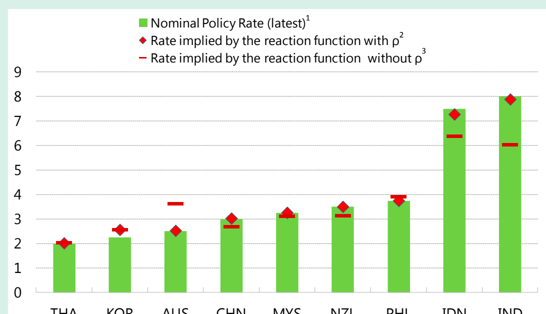
- The extent and pace of consolidation should vary with fiscal and cyclical positions, however. Country-specific mitigating factors can also matter—even where public debt is high (e.g., strong home bias in Japan), provided long-term measures to deliver credible and durable consolidation are taken. Finally, since there are, in general, no near-term sustainability concerns, automatic stabilizers should be allowed to operate.

Monetary Policy

Most economies in the region should start or continue a gradual tightening of monetary conditions.

- Considering their accommodative stance and limited slack in the economy, and in order to ensure that inflation expectations remain well anchored, a few central banks in the region started raising policy interest rates this year (Malaysia, New Zealand, and the Philippines). Meanwhile, with a relatively benign inflation outlook and slowing growth, some other central banks eased their stance (Korea and Thailand) and have room to wait until conditions are ripe for an interest rate hike—as shown by the generally appropriate interest rate levels given the output gap and inflation trends (**Figure 8**).

Figure 8. Estimated Central Bank Reaction Functions
(In percent)



Sources: Haver Analytics; and IMF staff estimates.
[1] As of September 8, 2014 with monthly data.
[2] Estimated as $i_t = \rho * i_{t-1} + (1-\rho)*(\alpha + \gamma_1 E_t[\pi_{t+1} - \pi^*] + \gamma_2 E_t OutputGap_{t+1} + \delta_1 REER_t + \delta_2 US\_3Myield_t) + \varepsilon_t$
[3] Estimated as $i_t = \alpha + \gamma_1 E_t[\pi_{t+1} - \pi^*] + \gamma_2 E_t OutputGap_{t+1} + \delta_1 REER_t + \delta_2 US\_3Myield_t + \varepsilon_t$

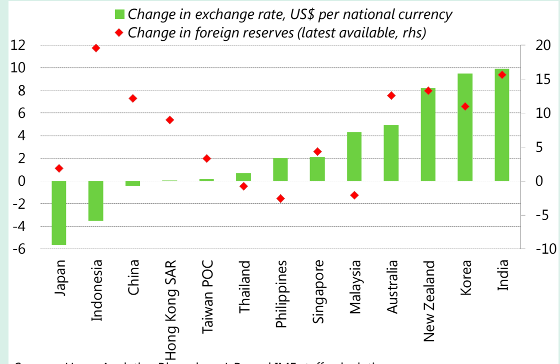
- While fundamentals are generally strong in other emerging Asian economies, in the cases of India and Indonesia, previous interest rate hikes and other policy measures are helping contain price pressures, and the full effect of past monetary tightening is yet to be felt. However, close vigilance is warranted, particularly in the event of large cost-push shocks or if there is evidence that inflation expectations become unmoored. In China, despite the relatively favorable inflation outlook, continuing efforts to curb credit growth will help rebalance the economy and address financial stability risks.

- In Japan, monetary policy should remain accommodative until inflation is entrenched and consistent with the current target. To ensure that both inflation expectations and underlying inflation measures continue to rise toward the target in a sustained manner, clear communication about the inflation objectives and the conduct of monetary policy will remain critical.

Exchange Rate and Macroprudential Policies

Exchange rate flexibility helped macroeconomic adjustment in the aftermath of the "taper tantrum" last year. It should remain a major shock absorber in the event of capital flow reversals. Foreign exchange intervention should remain aimed at smoothing volatility or providing foreign exchange liquidity in the event of market dislocations. Over the past year, primarily with capital flowing back into Asia since last spring, most countries have further accumulated reserves. Meanwhile, currencies have also generally appreciated (**Figure 9**), with the notable exceptions of Japan and Indonesia.

Figure 9. Selected Asia: Changes in Latest Bilateral Exchange Rates and Foreign Reserves Since August 2013
(*Percentage change*)



Sources: Haver Analytics; Bloomberg L.P.; and IMF staff calculations.
Note: Reserves data as of August 2014.

As discussed in detail in the *April 2014 Regional Economic Outlook*, policymakers in the Asia and Pacific region should continue to deploy macroprudential measures (housing, banking, and credit related) to address financial stability concerns, including those associated with the global financial cycle (for example, large increases in asset prices caused by capital inflows). Following several years of tightening, the stance of macroprudential policies is now tight in a number of economies. It should remain responsive to the domestic financial cycle; some further tightening could be warranted where financial risks continue to build up, while easing certain measures could be considered in the event of capital flow reversals and/or a downturn in the financial cycle. In any event, while macroprudential measures should remain a first line of defense to prevent the buildup of systemic risks, they should not be used to substitute for required macroeconomic policy adjustments or the implementation of structural measures.

Structural Reforms

The region should continue to take advantage of its solid outlook to address long-standing challenges. Structural reforms can lower vulnerabilities while at the same time preserving or enhancing Asia's medium-term growth prospects, which have deteriorated over the last few years.

- The agenda in the largest economies in the region varies significantly: the priority for China is to implement its comprehensive reform blueprint—including financial, fiscal, and state-owned enterprise reforms—in order to transition to a more balanced and sustainable growth path while addressing financial stability concerns. Japan needs to ensure the effective implementation of the third arrow of Abenomics (services and labor market deregulation) to boost potential growth. Although progress has been made, including with the recent consumption tax hike, undertaking further reforms is critical. India also needs to further remove structural impediments to investment, including by further liberalizing its FDI regime and labor market regulations. Energy sector policies are also needed in India to boost industrial activity.

- Other emerging and frontier economies would also benefit from reforms that increase productivity. These would include measures to promote investment in infrastructure, such as regulatory, land acquisition, and financial reforms, and measures to enhance labor market flexibility, which would encourage increased female labor force participation and formalization more generally. Reforms to reduce red tape and improve governance could also reduce incentives to rent seeking and boost investment in a number of emerging and frontier economies.

- Fiscal reforms can complement more traditional spending rationalization and revenue mobilization. These would include energy subsidy reforms in India, Malaysia, and Indonesia, and measures to better manage local government borrowing in China and improve the efficiency of state-owned enterprises in a number of countries (e.g., China and Vietnam).