I. Ensuring Stable Growth: Risks and Challenges

A. Signs of Stabilization during Global Uncertainty

Since September 2011, the economic fortunes of Europe and the United States have diverged, with European growth slowing sharply (Figure 1.1). While policy measures taken by the European Central Bank and the approval of a new financing package for Greece have alleviated the market disruptions of 2011:Q4, the central forecast for the region is still for a mild recession in 2012. On the other hand, as discussed in the April 2012 *World Economic Outlook* (IMF, 2012c), a string of encouraging economic indicators have emerged from the United States, including better employment numbers and rising business confidence. As a result, real gross domestic product (GDP) growth in the United States has been marked up to 2.1 percent in 2012 from the 1¾ percent projected in the September 2011 *World Economic Outlook* (IMF, 2011a).

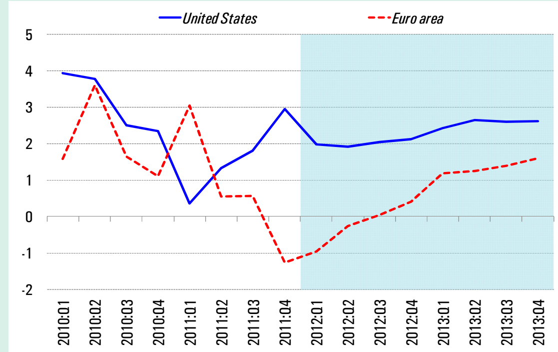
Growth in Asia slowed markedly in the last quarter of 2011, mainly due to weakening external demand (Figure 1.2). Export growth has lost momentum across the region, for both electronics and nonelectronic goods. The level of exports to the European Union has fallen increasingly below trend even as exports to the United States have recovered to their long-run trend after the global financial crisis (Figure 1.3). The region's trade surplus continued to shrink in the last quarter of 2011, with China playing a prominent role in this decline (Figure 1.4).

Weak exports and supply shocks have taken their toll on industrial production across Asia, but high-frequency indicators suggest that a turnaround may be in the cards. The Thai floods in October–November 2011 led to supply chain disruptions across the region, particularly in Japan, where an inventory drawdown and a decline in exports were responsible for a contraction of GDP in the fourth quarter of 2011. While the supply

Note: The main authors of this chapter are Shekhar Aiyar, Sylwia Nowak, and Olaf Unteroberdoerster, with contributions from Tsin Zhen Koh. Hye Sun Kim provided research assistance.

Figure 1.1. Real GDP Growth in the United States and the Euro Area

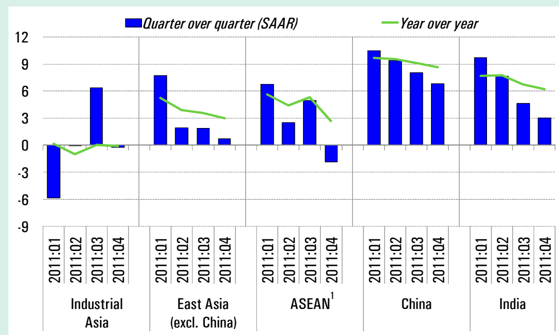
(Quarter-over-quarter percent change; SAAR)



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

Figure 1.2. Selected Asia: Changes in Real GDP at Market Prices in 2011

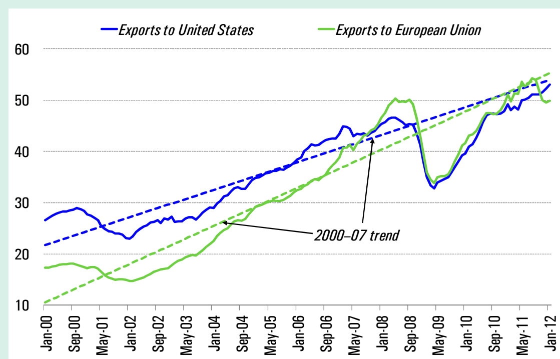
(In percent)



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.
[1] ASEAN includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

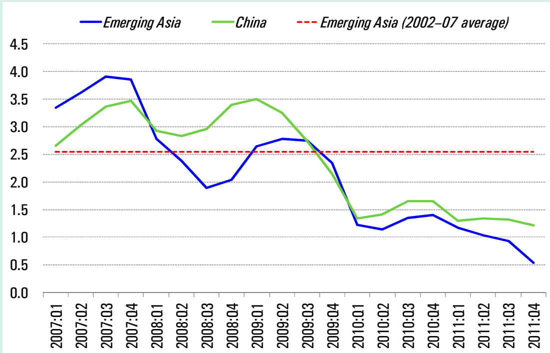
Figure 1.3. Selected Asia: Exports to the United States and the European Union

(Seasonally adjusted, three-month moving average; in billions of U.S. dollars)



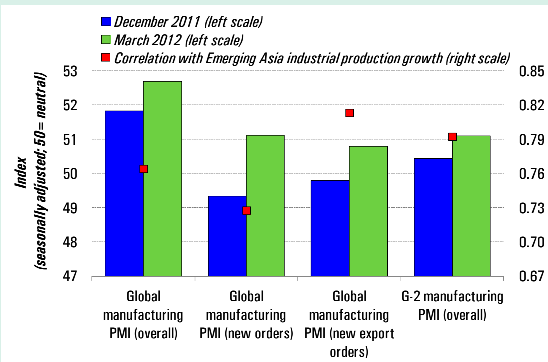
Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

Figure 1.4. Emerging Asia: Trade Balance
(12-month rolling sum, in percent of Emerging Asia GDP)



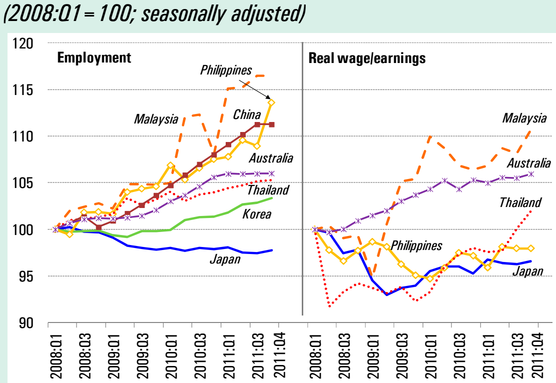
Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

Figure 1.5. Global Manufacturing PMIs and Its Correlation with Emerging Asia's Industrial Production Growth



Sources: Haver Analytics; and IMF staff calculations.

Figure 1.6. Selected Asia: Labor Market Conditions
(2008:Q1 = 100; seasonally adjusted)



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

chain disruptions are temporary, high-frequency indicators such as purchasing managers' indices (PMIs) and export orders improved in recent months, suggesting that activity might have bottomed out in the first quarter of 2012 in much of Asia. In particular, global manufacturing PMIs and export orders, and industrial countries' manufacturing PMIs—which have been highly correlated with industrial production in Asia in the past—have strengthened in the first quarter of 2012 (Figure 1.5).

Asian domestic demand has generally remained strong, buffering the impact of the weakening external environment. Capacity utilization has remained high, and regional labor markets have been tight on the back of strong employment growth and steadily rising real wages (Figure 1.6). Credit continued to grow faster than nominal GDP growth in many regional economies, particularly in the Association of Southeast Asian Nations (ASEAN) countries (Figure 1.7), and local bond markets continued to expand. Credit growth in China—while having fallen considerably from its peak level in 2009—remains in double digits, but is broadly commensurate with nominal GDP sgrowth.

Domestic demand has benefited from the continued easing of macroeconomic policy across most of the region. Many countries have either loosened monetary policy or paused the tightening cycle since activity slowed last October. For example, in Indonesia, the central bank has lowered its policy rate by 100 basis points since the last quarter of 2011, in addition to lowering the bottom end of its deposit standing facility rate, while Singapore reduced the slope of the exchange rate policy band in October. By contrast, in China the authorities have allowed for only a modest increase in liquidity through a 50 basis point reduction in reserve requirements since December, consistent with their targeted rate of credit growth. Moreover, in a number of regional economies the fiscal impulse remained positive in 2011(Figure 1.8), reflecting higher capital expenditure under medium-term infrastructure projects (for example, Hong Kong SAR), subsidies and transfers (for example, Malaysia), and repair work from natural disasters (for example, Japan and New Zealand). But fiscal consolidation continued in 2011 in quite a few other regional economies, including Australia, China, India, Korea,[1] the Philippines, and Vietnam.

Across Asia, inflation has been gradually climbing down from its peak in mid-2011. The decline has been propelled mainly by the normalization of commodity prices, particularly of food prices, with core inflation having declined generally by less than headline inflation in the region (Figure 1.9). Moreover, since the end of 2011, sequential headline inflation has been creeping upward in Indonesia, Korea, and Singapore, and most economies in the region have seen an increase in inflationary expectations (Figure 1.10).[2]

Capital flows to Emerging Asia have rebounded so far in 2012, following the sharp retrenchment in portfolio equity flows late last year (Figure 1.11). From August 2011 onward, global risk aversion spiked in response to escalating turmoil in the euro area, and investors fled to safe havens globally. In Emerging Asia, this caused a large withdrawal of foreign equity investments, plunges in regional stock markets, sharp currency depreciations, and a shortage of U.S. dollar funding. Stresses in local banking systems also emerged, with credit default swap spreads on some banks in Australia, China, Hong Kong SAR, and Japan increasing to record or near-record highs. With the decline in global market turbulence in 2012, capital inflows to Emerging Asia have resumed, and equity and currency markets have regained some of the ground lost in late 2011 (Figures 1.12 and 1.13). As a notable exception, the improvement of global financial conditions so far in 2012 caused a significant decline of the yen, the region's safe-haven currency.

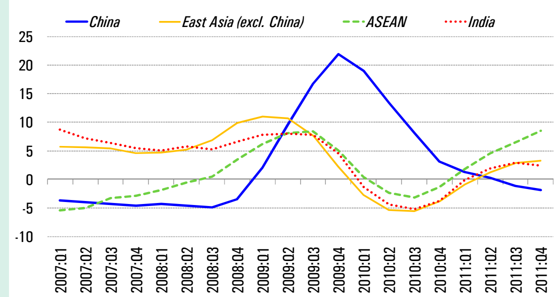
These regional trends mask considerable heterogeneity in different parts of Asia.

- In Industrial Asia, growth in Australia has been supported by continued strong demand for commodities (particularly from China) and sustained investment in mining, although the

[1] Throughout this report, "Korea" refers to the Republic of Korea.

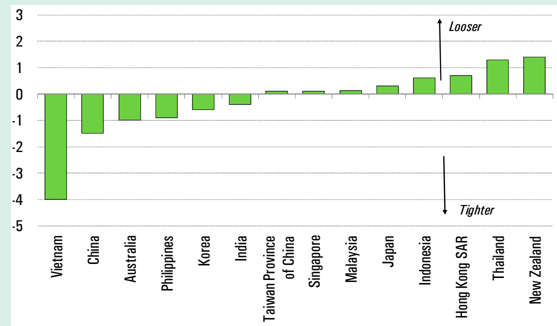
[2] Sequential inflation is defined as the three-month change in the seasonally adjusted three-month moving average of consumer price index.

Figure 1.7. Emerging Asia: Measure of Excess Credit Growth[1]
(In percentage points; four-quarter moving average)



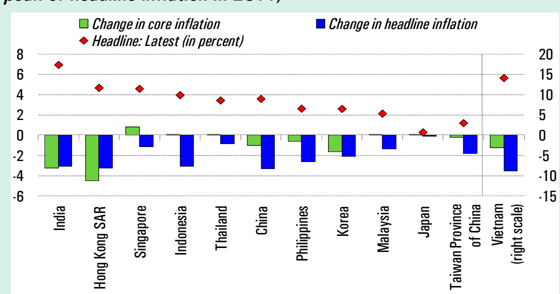
Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.
[1] Excess credit growth is represented by the difference in year-over-year growth rate between credit to the private sector and nominal GDP. ASEAN includes Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

Figure 1.8. Selected Asia: Fiscal Impulse in 2011[1]
(In percent of GDP)



Sources: IMF staff estimates.
[1] Change (relative to previous year) in structural fiscal balances related to measures taken in response to the crisis.

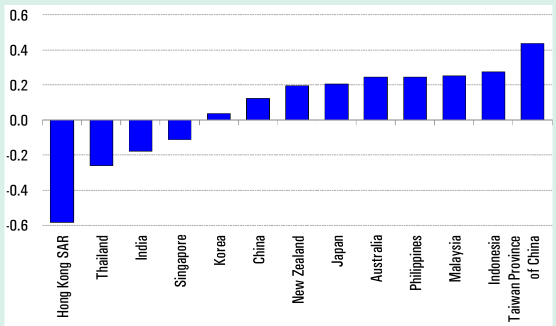
Figure 1.9. Selected Asia: Core and Headline Inflation
(In percentage points, except as otherwise indicated; change since peak of headline inflation in 2011)[1]



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.
[1] Latest data in the case of headline for China, Korea, Indonesia, the Philippines, Taiwan Province of China, Thailand, and Vietnam refer to March 2012. For others, data are as of February 2012 except for Malaysia (January 2012 for core inflation) and the Philippines (December 2011 for official data on core inflation).

Figure 1.10. Selected Asia: Change in One-Year Ahead Inflation Expectation since the End of 2011[1]

(In percentage points; as of March 2012)

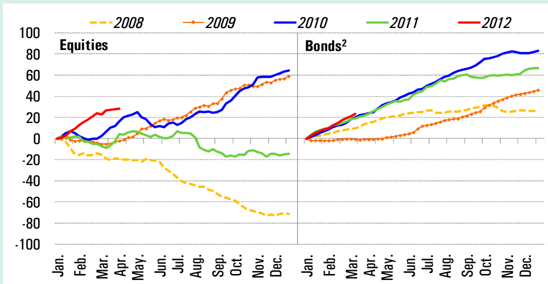


Sources: Consensus Economics Inc.; and IMF staff calculations.

[1] For India, change in expectations of average annual wholesale price inflation for fiscal year ending in March 2013.

Figure 1.11. Nonresident Investment in Selected Asian Markets[1]

(In billions of U.S. dollars; cumulative net flows)



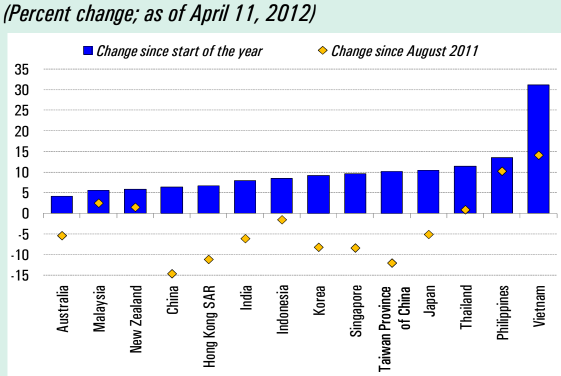
Sources: Bloomberg L.P.; CEIC Data Ltd.; and IMF staff calculations.

[1] The chart aggregates data for India, Indonesia, Korea, the Philippines, Taiwan Province of China (equities only), and Thailand.

[2] For Indonesia, net flows into government bonds only. For Thailand, data based on net purchases concept. Aggregate data for 2008 exclude Thailand due to data constraints.

Figure 1.12. Selected Asia: Stock Markets

(Percent change; as of April 11, 2012)



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

strong exchange rate and cautious household spending acted as a drag on activity. In New Zealand, still-elevated commodity prices and favorable agricultural conditions helped offset the impact of the 2011 earthquakes. In Japan business investment has picked up since the last quarter of 2011, helped by reconstruction spending and a weakening of the yen.

- In East Asia, the moderation of growth in China since September 2011 has reflected not only lower export growth, but also the continued withdrawal of the postcrisis fiscal stimulus and the move to a more prudent monetary policy stance. Moreover, the property market has cooled off in the face of concerted policy actions. Still, private investment has remained at high levels. In Korea the growth of domestic demand has been dragged down by gross fixed investment, which contracted in 2011 because of an overhang of unsold apartments, negative base effects from a surge in facilities investment in 2010, and the withdrawal of fiscal stimulus.

- In South Asia, domestic factors have also played a role in India's growth slowdown over the second half of 2011. Concerns about governance and slow project approvals by the government have weakened business sentiment, which in turn has adversely affected investment, along with cyclical factors such as global uncertainty and policy tightening, although the latter has loosened since then. Growth in Sri Lanka remained robust, but a surge in domestic demand, boosted by rapid credit growth, caused a sharp widening of the external current account deficit that put reserves under significant pressure in the second half of 2011.

- The pattern of moderating growth also extended to ASEAN economies, but Indonesia is the region's notable exception, as rapid credit growth and supportive monetary policy continued to boost domestic demand in the second half of 2011. In Thailand, just as the economy began to recover from the impact of the Japanese tsunami, massive floods in October–November 2011 brought the manufacturing sector to a near standstill.

Despite lower commodity prices in the second half of 2011 and weaker external demand, growth remained relatively buoyant in Asian low-income economies. Robust investment in the mining and energy sectors of economies such as Mongolia and Papua New Guinea supported activity, as did the relocation of production from more-advanced neighboring economies, as was the case for garment exporters in Bangladesh and Cambodia. An improvement in the business climate also spurred investment and activity in Myanmar, and buoyant remittance flows have helped boost activity in countries with significant migrant workforces such as Nepal. By contrast, stabilization policies have weighed on Vietnam's growth, notwithstanding continued gains in export market share. In Pacific Island economies, regional economic links, notably with Australia and China, continued to support the recovery (see Chapter 5).

B. A Turnaround in 2012 and a Stronger 2013

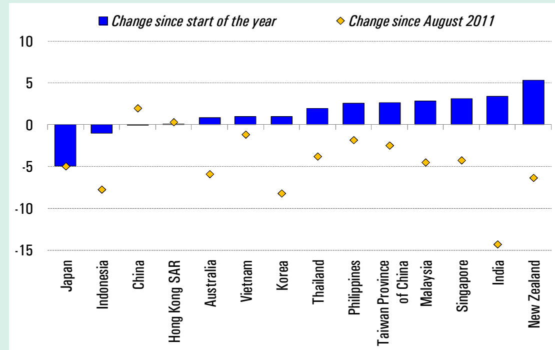
Looking ahead, the forecast for the Asia and Pacific region is essentially unchanged from the January 2012 *World Economic Outlook Update* (IMF, 2012a): growth in 2012 will continue at the same pace as in 2011, and then rebound in 2013. This forecast, however, reflects a combination of considerably lower growth in Emerging Asia—particularly in the first half of 2012 and in the more open and trade-dependent economies—and a sharp rebound in Industrial Asia (Table 1.1). Industrial Asia is projected to grow at about 2 percent in 2012, as Japan and New Zealand recover strongly from the natural disasters and favorable demand conditions for commodities provide a boost to Australia. But growth in Emerging Asia as a whole is expected to decline from 7½ percent in 2011 to below 7 percent in 2012, before recovering in 2013.

The slowdown in Emerging Asia's growth for 2012 mainly reflects the outlook for advanced economies and China. Growth prospects for advanced economies continue to be critical for Asia's overall exports dynamics, but regional and nontraditional markets are also beginning to play a more important role as a destination for Asian exports. In particular:

- While the April 2012 *World Economic Outlook* (IMF, 2012c) forecasts a rising growth trajectory for the United States, this is more than offset by projections for the mild contraction in the euro area in 2012 followed by growth of a mere 0.8 percent in 2013. This will have a nonnegligible impact on Asia's exports, as many regional economies have large direct and indirect (through

Figure 1.13. Selected Asia: Exchange Rates against the U.S. Dollar

(Percent change; decrease = depreciation; as of April 11, 2012)



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

Table 1.1. Selected Asia: Real GDP

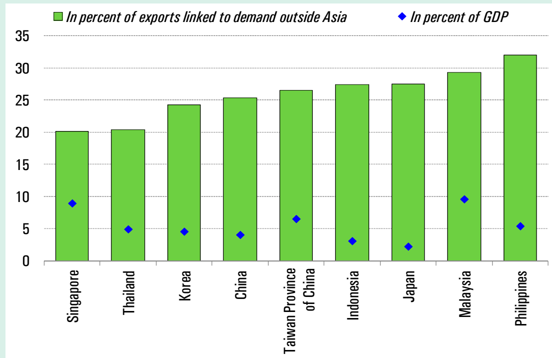
(Year-over-year percent change)

	Actual data and latest projections			Difference from January 2012 projections	
	2011	2012	2013	2012	2013
Industrial Asia	**–0.2**	**2.2**	**2.0**	**0.3**	**0.0**
Australia	2.0	3.0	3.5	0.0	–0.1
Japan	–0.7	2.0	1.7	0.4	0.1
New Zealand	1.4	2.3	3.2	–0.4	-0.2
East Asia	**8.2**	**7.3**	**8.0**	**0.1**	**0.0**
China	9.2	8.2	8.8	0.0	0.0
Hong Kong SAR	5.0	2.6	4.2	–0.1	0.2
Korea	3.6	3.5	4.0	0.0	0.0
Taiwan Province of China	4.0	3.6	4.7	0.3	0.3
South Asia	**7.1**	**6.8**	**7.2**	**–0.1**	**0.0**
Bangladesh	6.1	5.9	6.4	–0.3	–0.1
India	7.1	6.9	7.3	–0.1	0.0
Sri Lanka	8.2	7.5	7.0	0.5	0.5
ASEAN	**4.6**	**5.2**	**6.0**	**0.4**	**1.0**
Brunei Darussalam	1.9	3.2	1.6	0.8	–0.3
Cambodia	6.1	6.2	6.4	–0.3	0.0
Indonesia	6.5	6.1	6.6	0.0	0.0
Lao P.D.R.	8.3	8.4	7.1	0.0	0.0
Malaysia	5.1	4.4	4.7	0.4	0.2
Myanmar	5.5	6.0	5.9	0.3	0.0
Philippines	3.7	4.2	4.7	0.0	0.0
Singapore	4.9	2.7	3.9	0.0	0.1
Thailand	0.1	5.5	7.5	0.8	2.7
Vietnam	5.9	5.6	6.3	0.0	0.0
Emerging Asia[1]	**7.4**	**6.9**	**7.5**	**0.0**	**0.1**
Asia	**5.9**	**6.0**	**6.5**	**0.1**	**0.1**

Source: IMF staff projections.

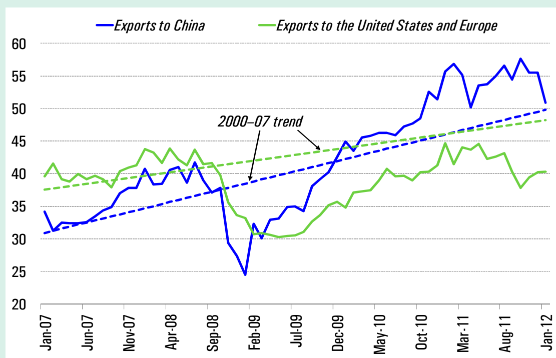
[1] Emerging Asia includes East Asia, India, Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

Figure 1.14. Selected Asia: Share of Exports Linked to Demand from Europe, 2010
(Value-added basis)



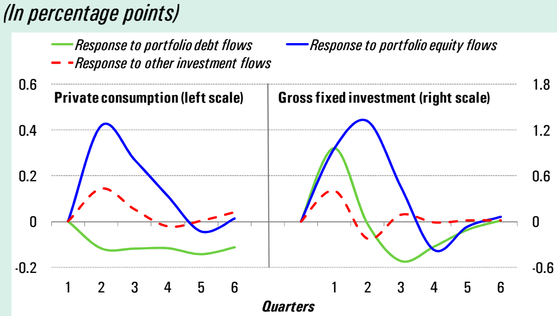
Sources: United Nations, *Comtrade* database; and IMF staff calculations.

Figure 1.15. Selected Asia (excl. China and Japan): Exports to China, Europe, and the United States
(In billions of U.S. dollars; seasonally adjusted)



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

Figure 1.16. Emerging Asia: Response of Real Private Consumption Expenditure and Real Gross Fixed Investment to Non-FDI Inflows[1]
(In percentage points)



Source: IMF staff estimates.
[1] Includes India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand. Response of quarter-over-quarter annualized growth to 1 percentage point of GDP increase in net inflows of each type. See Box 1.5 in October 2010 *Regional Economic Outlook*, Asia and Pacific (IMF, 2010b) for details.

the regional supply chain) export exposure to the euro area. The IMF staff estimates that, on average in 2010, demand from Europe accounted for about one-fourth of the Emerging Asia exports that can be linked to demand from outside the region, a share almost as large as that linked to the United States (Figure 1.14). The impact of the weaker external environment is likely to be greater for highly open economies specializing in cyclically sensitive goods such as Hong Kong SAR, Singapore, and Taiwan Province of China, and to be lower in economies more reliant on domestic demand, such as India and Indonesia.

- At the same time, China's growth is expected to slow to 8.2 percent in 2012 as the authorities' efforts to engineer a soft landing and support more balanced growth take effect alongside the fall in external demand, before rebounding to 8.8 percent in 2013. Given China's greater role as a source of external demand for many regional economies, this is expected to have knock-on effects in the region. Indeed, staff estimates suggest that China's domestic demand has explained about 60–70 percent of the recovery of Asia's (excluding China and Japan) exports to China to the peak above precrisis trends in 2011(Figure 1.15). In particular, the region's commodity exporters, including Australia and Indonesia, continue to benefit from China's investment-led growth.

Growth in the region is expected to gain momentum by the second half of 2012 and into 2013. External demand is projected to improve in line with better growth performance in the euro area from the third quarter of this year. At the same time, the fundamentals for domestic demand, including strong labor markets, are expected to remain solid across the region. A resumption of strong capital flows to Emerging Asia over 2012 and 2013 is expected to sustain private consumption and investment across the region, by boosting confidence and contributing to a loosening of financial conditions. Estimated impulse response functions for Emerging Asia suggest that domestic demand reacts particularly strongly to a surge in equity inflows (Figure 1.16).

In addition to these general trends, our forecasts reflect a series of country-specific factors:

- In Industrial Asia, Japan's recovery in 2012 is driven by reconstruction spending and further monetary easing, but growth will level off in 2013 as the acceleration of exports and private domestic demand only partly offsets lower public spending. Reconstruction activity is also expected to boost growth in New Zealand, while continued strong commodities demand and prices will sustain activity in Australia.

- In East Asia, Korea's growth in 2012 and 2013 is expected to benefit from a strong recovery in private investment, particularly in the construction sector as the housing sector overhang gradually unwinds, while the recently approved free-trade agreement with the United States is expected to sustain exports.

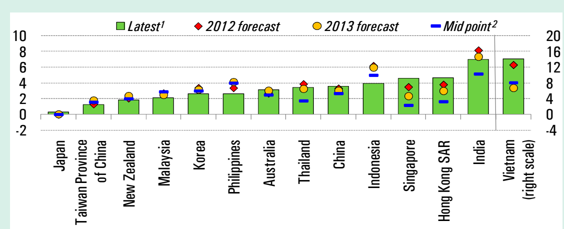
- Among ASEAN economies, reconstruction activity is expected to provide a strong spur to domestic demand in Thailand, boosting growth in both 2012 and 2013. Despite the drag from weaker external demand, growth in 2012 is also expected to accelerate in the Philippines, reflecting stronger government spending, robust remittances, and the initiation of public-private partnership projects. The gradual implementation of investment projects under the Economic Transformation Plan is expected to boost growth in Malaysia.

- In India, the lowered growth outlook in 2012 owes much to a slowdown of investment which partly reflects structural factors. In particular, apart from some financial reforms and measures to broaden the use of public-private partnerships announced in the 2012/13 budget, the implementation of reforms related to infrastructure is likely to proceed slowly.

- Growth is expected to remain healthy in low-income countries in Asia in 2012 and 2013, owing mainly to sustained receipts from tourism and remittances, and strong foreign direct investment (FDI) (see Chapter 5). Growth is set to remain particularly robust in the resource-rich economies (the Lao People's Democratic Republic, Mongolia, and Papua New Guinea) where economic activity is being propelled by investments in large resource projects. In Cambodia, growth will pick up in 2012, as agricultural production rebounds from the flood damage in late 2011. Stronger garment exports and firming remittances are expected to support higher growth in Bangladesh, where investment is also set to strengthen on improvements in energy supply and normalizing credit conditions. New momentum in political and economic reform is creating a more favorable growth environment in Myanmar (Box 1.1). However, the impact of macroeconomic stabilization policies is expected to continue dampening Viernam's growth in 2012.

Inflation is expected to decline modestly in 2012 across the region. The April 2012 *World Economic Outlook* (IMF, 2012c) projects stable oil prices in 2012 and 2013, but a decline in other commodity prices, with the nonfuel index falling by 10 percent in 2012 and 2 percent in 2013. The normalization of commodity prices and somewhat less accommodative monetary policy conditions will contribute to lower inflation in 2012, including in low-income economies. Nonetheless, in many economies, such as Hong Kong SAR, India, Indonesia, Singapore, Thailand, and Vietnam, the forecast for headline inflation in 2012 remains well above the midpoint of the inflation target range (or above the historical average for those economies that do not target inflation explicitly) (Figure 1.17). This reflects sustained demand pressures but also ad hoc factors like the potential increase of energy prices in Indonesia.

Figure 1.17. Selected Asia: Headline Consumer Price Inflation
(Year over year; in percent)



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF, WEO database and staff projections.

[1] Latest data for China, Korea, Indonesia, the Philippines, Taiwan Province of China, Thailand, and Vietnam refer to March 2012. Others are as of February 2012 except for Australia and New Zealand (December 2011).

[2] Mid point refers to the center of the inflation target band (headline for Australia, Indonesia, Korea, New Zealand, and the Philippines; core inflation for Thailand; and average headline inflation over 2005–07 for other economies). Wholesale prices used for India.

Box 1.1. Myanmar—Improved Outlook as Reform Momentum Picks Up

Real GDP growth in Myanmar is projected to increase to 6 percent in FY2012/13, from an estimated 5½ percent in the current year, driven by commodity exports and higher investment on the back of improved business confidence. However, inflation, which has been moderating mainly due to lower food prices and less deficit monetization, running at an estimated 4 percent this fiscal year, is expected to pick up to 5¾ percent in FY 2012/13, as the recent drop in food prices phases out. Even though export growth is expected to fall short of fast import growth linked to large FDI projects in the energy sector, gross official reserves, at US$7.1 billion in September 2011, are expected to remain comfortable at about 9½ months of imports in FY2011/12.

Myanmar's long-term economic potential is high. With appropriate reforms, Myanmar could turn to its advantage its rich natural resources (natural gas, gems, minerals, and forestry products), a young labor force, and proximity to some of the most dynamic economies in the world, lifting growth and improving living standards.

Myanmar's favorable economic outlook and longer-term prospects hinge on vigorous implementation of reforms. Priorities include establishing the market infrastructure to enhance monetary and foreign exchange policy, fiscal reform to end monetization of deficits and enhance public financial management, and financial and other structural reform to promote private-sector led growth.

- **Exchange market**. The economy has been burdened with complex exchange restrictions that give rise to multiple currency practices. As a first step toward unification, the authorities adopted a managed float as their new exchange rate regime on April 1, 2012 and have introduced foreign currency auctions and an interbank market. This initial step would need to be complemented by gradually removing all remaining exchange restrictions on current international payments and transfers to unify the various informal market rates used by the private sector.

- **Fiscal management**. The new government's first budget targets a smaller deficit, declining from 5½ percent of GDP in FY2011/12 to about 4½ percent of GDP in FY2012/13. However, spending on education and health is expected to increase from 5½ percent of total expenditures to 7½ percent. The consolidated nonfinancial public sector deficit would also decline due to higher net transfers from state economic enterprises (SEE), primarily from gas exports, following the introduction of market-based exchange rates for SEE exports and imports. Going forward, reform priorities include improving public financial management.

- **Monetary framework.** The central bank of Myanmar cut the administratively set interest rates by a cumulative four percentage points since September 2011, the first cuts since 2007. It has also revised the fixed interest rate structure to provide financial incentives for banks to hold treasury bonds, and as a consequence, deficit monetization is projected to decline to about half of the fiscal deficit in FY2011/12.

- **Bank intermediation.** Modernization of the financial sector should start with phasing out pervasive administrative controls on bank activities and gradually liberalizing interest rates. While formal intermediation remains depressed, the authorities relaxed the requirements on deposit taking, expanded the administratively set collateral list, eased controls on extending branch networks, and allowed some flexibility in setting the deposit rates as part of the recent interest rate cuts. As a result, private sector credit growth has accelerated, albeit from a very low base.

- **Private sector led growth.** The authorities have also taken some steps to promote rural growth and increase competition. Harvest loans to farmers have been doubled, FDI rules have been relaxed, and imports of gasoline and palm oil have been liberalized. The broader goal of promoting private sector development would require additional efforts to improve the business climate by reducing administrative controls and the cost of doing business.

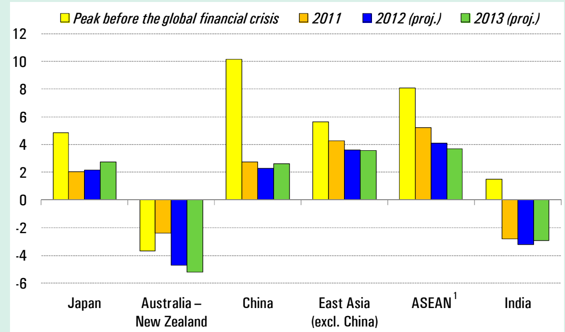
Note: The main author of this box is Sergei Dodzin.

Asia's current account surplus is expected to bottom out in 2012, at just above 1½ percent of regional GDP, and then increase to just below 2 percent in 2013 (Figure 1.18). That said, it remains uncertain whether the extent to which the decline in Asia's overall current account since precrisis peaks reflects progress toward comprehensive rebalancing. In Japan, a lower current account surplus in 2011 mainly resulted from the transitory impact of the earthquake, which curbed export supply and boosted energy-related import demand (Box 1.2). In China, the decline in current account surplus has helped narrow global imbalances and mainly reflected a worsening in the terms of trade as well as robust import growth. But the latter was largely linked to even higher investment, as China continued to develop its infrastructure network, rather than greater consumption as a share of output, which will need to rise further to make this progress sustainable in the future, in line with the authorities' 12th Five Year Plan (see Chapter 4). By contrast in several ASEAN economies, including Indonesia, the Philippines, Singapore, and Thailand, the lower current account balances reflected mainly a welcome increase in investment-to-GDP ratios, which might help strengthen domestic sources of growth in a more sustainable way. Overall, the progress made across the region is important and can be built on with continued reforms in the coming years.

C. What Are the Main Risks to the Outlook?

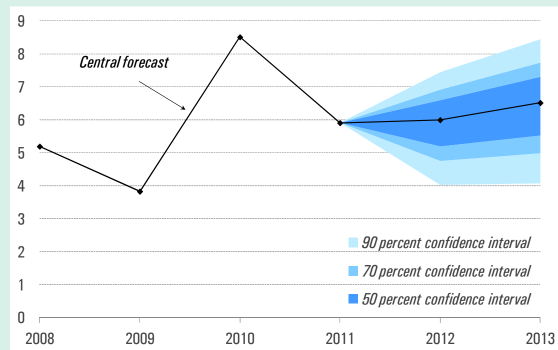
Risks to this forecast have lessened somewhat relative to January, but remain tilted to the downside (Figure 1.19). As discussed in the April 2012 *Global Financial Stability Report* (IMF, 2012b), important policy steps since last fall have brought much-needed stabilization to the euro area financial markets, causing sovereign spreads to decline, bank funding markets to reopen, and equity prices to recover. Risks to global growth, highlighted in the April 2012 *World Economic Outlook* (IMF, 2012c), have therefore receded since last January's update. However, the global economy remains unusually vulnerable, and fresh setbacks could still occur, with great repercussions for Asia.

Figure 1.18. Selected Asia: Current Account Balances
(In percent of GDP)



Sources: IMF, WEO database and staff calculations.
[1] ASEAN includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

Figure 1.19. Asia: Real GDP Growth
(Central forecast and selected confidence intervals; in percent)



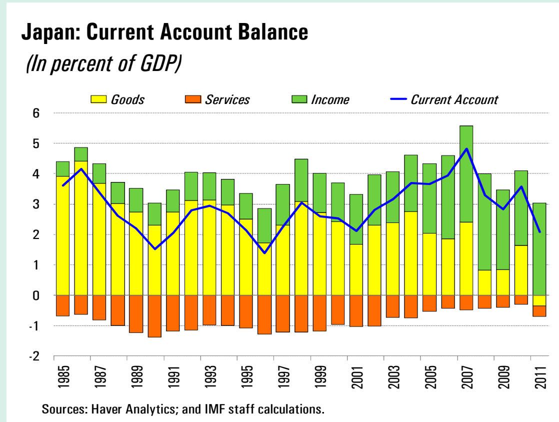
Source: IMF staff projections.

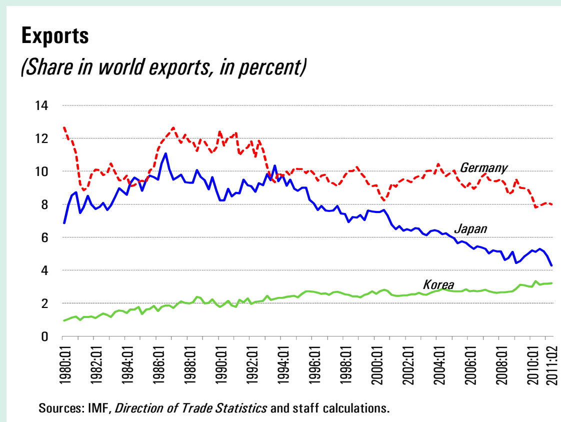
A key downside risk for Asia is renewed escalation of the euro area debt crisis, which could result in a much larger and more-protracted bank deleveraging. European banks are under pressure to reduce the size of their balance sheets as they continue to cope with sovereign risks, weak economic growth, high rollover requirements, and the need to strengthen capital cushions to regain investor confidence. An escalation of the crisis with a disorderly, large-scale, and aggressive trimming of balance sheets could have a serious impact on Asia:

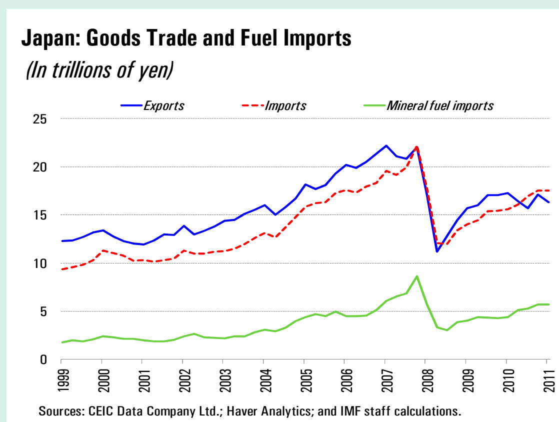
- Although Asian economies on average rely less than comparator regions on euro area and U.K. banks, these banks nonetheless have a substantial presence in several Asian economies (Figure 1.20). They are important sources of credit in two ways: (i) direct lending, including in the area of trade finance, to private sector agents in the region,

Box 1.2. What Explains the Recent Decline in Japan's Current Account Surplus, and What Lies Ahead?

In the two decades prior to the global recession, Japan's current account recorded a steady surplus of 3 percent of GDP, the result of a positive goods trade balance and a stable investment income account surplus. In 2011, however, the current account declined to about 2 percent of GDP, well below the peak in 2007 and the lowest since 2001. Moreover, the goods trade balance recorded a deficit for the first time since 1980. A combination of temporary and permanent factors explains the recent shift in the trade balance, including:







- **The Great East Japan Earthquake and Thai floods.** The earthquake in March 2011 and Thai floods in late 2011 affected automobile and electronics production, which accounts for roughly 40 percent of exports. The affected plants were back in operation by December 2011, but the two events are estimated to have reduced exports by about ¼–½ percent of GDP.

- **A decline in export shares.** Even before the earthquake, exports had not recovered to levels seen prior to the Lehman shock, partly due to weak external demand. Japanese exports are sensitive to demand conditions in advanced economies, particularly for consumer durables, and growth remained subdued in the United States and Europe. In addition, while the share of its exports going to Asian countries has increased over time, Japan was less successful in penetrating markets in the region's emerging economies than its competitors.

- **Exchange rate appreciation.** The yen strengthened following the Lehman shock, as a result of the unwinding of carry trades and the subsequent safe haven flows, which contributed to a weak recovery in exports.

- **Rising energy imports.** Energy imports rose to about one-third of total imports in 2011, compared with an average of about one-quarter of total imports over the past decade. The increase reflects higher world oil prices and increased volumes (especially of liquefied natural gas), as almost all nuclear power plants have been closed for regular safety inspections. Uncertainty surrounds the outlook for energy supply and imports, as it is unclear whether the nuclear plants will reopen and to what extent alternative sources of energy or conservation efforts will aid the adjustment.

Note: The authors of this box are S. Pelin Berkmen and W. Raphael Lam.

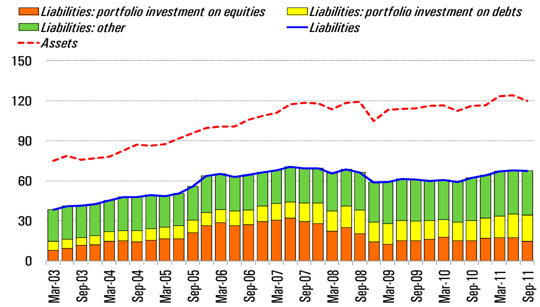
Japan has maintained a sizable income account surplus over the past decade, which reached ¥14 trillion (about 3 percent of GDP) in 2011. Nearly 70 percent of net investment income comes from portfolio investment assets abroad, with the remainder mostly from direct investment income.

Stable income account surpluses reflect large foreign reserves and sizable private assets held abroad. Net foreign assets increased markedly in the five-year period leading up to 2008, exceeding 50 percent of GDP, because of strong current account surpluses. Despite sizable valuation losses in 2008/09, net foreign assets have remained relatively stable in recent years.

Geographically, Japan receives most of its investment income from the United States, mainly from equity and debt securities. Investment income from Asia has grown to 20 percent of total income over the last decade, while income from Europe has fallen since March 2010, as Japanese financial institutions reduced their exposure.

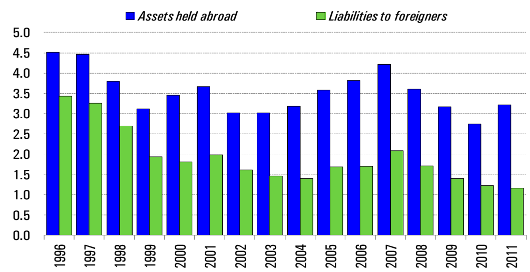
A key factor contributing to the income surpluses has been the higher return on assets than on liabilities. The average return on assets held abroad in the income account has been higher than the return on liabilities owed to foreigners by almost 2 percent over the past decade. In 2011, the rate of return on gross foreign assets recovered to more than 3 percent, but was still below the levels of the mid-2000s. The rate of return on direct investment and equities increased sharply to 7–8 percent in 2011. On the liabilities side, large safe haven inflows since the global financial crisis have been invested in short-term debt securities (such as bills and notes) and money market instruments. The return on these portfolio investment liabilities, however, has fallen in recent years to just over 1 percent in 2011, due to declining Japanese government bond yields and a sluggish domestic equity market.

Japan: International Investment Positions
(In percent of GDP)



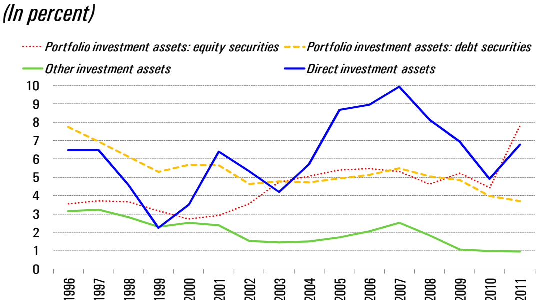
Sources: Bank of Japan; Haver Analytics; and IMF staff calculations.

Japan: Estimated Rate of Return on External Assets and Liabilities[1]
(In percent)



Sources: Bank of Japan; Deutsche Bank; and IMF staff calculations.
[1] Rate of return estimated by each category of investment income divided by corresponding stock levels obtained from international investment positions.

Japan: Estimated Rate of Return on External Assets[1]
(In percent)



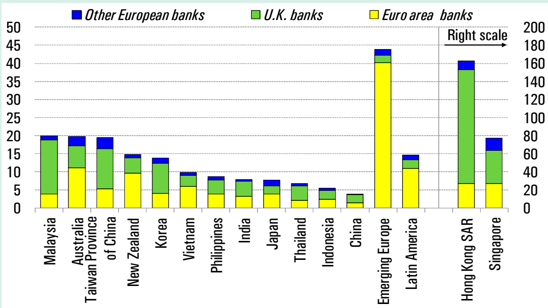
Sources: Bank of Japan; Deutsche Bank; and IMF staff calculations.
[1] Rate of return estimated by each category of investment income divided by corresponding stock levels obtained from international investment positions.

The trade balance is expected to return to a small surplus in the near future because of the recovery of exports from the earthquake and Thai floods, despite higher energy imports. Over the medium term, trade deficits may reemerge, assuming a continued decline in world export market share and a gradual recovery in private demand.

Importantly, the current account is likely to maintain a surplus of about 2 percent of GDP over the medium term. This is because net investment income is expected to remain healthy at 2½–3 percent of GDP, assuming global interest rates eventually increase to historically normal levels and the trend increase in outward FDI from Japan continues.

through cross-border transactions and lending by local subsidiaries and branches; and (ii) indirectly, through their role in the wholesale funding of regional banks, particularly in Australia, Hong Kong SAR, Korea, New Zealand, Singapore, and Taiwan Province of China (see Chapter 3).

Figure 1.20. Consolidated Foreign Claims of European Banks on Asia[1]
(In percent of GDP; as of 2011:Q3)



Sources: Bank for International Settlements; CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.
[1] Claims are on immediate borrower basis. Uses sum of quarterly GDP in U.S. dollars between 2010:Q4 and 2011:Q3.

- So far, the impact on Asia of the deleveraging process, which began gradually in the third quarter of 2011, has been manageable. In several Asian economies lending by local subsidiaries and branches is a large part of overall European bank claims. As noted in the April 2011 *Global Financial Stability Report* (IMF, 2011e), to the extent that local claims are funded by local deposits, the pressure to retrench these claims is reduced. In Malaysia, for example, U.K. bank claims are largely locally funded. Moreover, an important buffer against a credit supply shock emanating from euro area deleveraging are the relatively healthy balance sheets of large regional banks, which allows them to partly substitute for withdrawn European credit. Indeed, Japanese and Australian banks appear to have expanded their lending to the Asian region recently, which may have offset some of the recent pullback by euro area and U.K. banks.

- But much of Asia is still exposed to sharper deleveraging in the event of a reescalation of the euro area crisis and spillovers to other advanced economy banks. As seen during the Lehman episode, this could comprise a significant shock to domestic credit supply, even if the shock is less than in comparator regions (see Chapter 3). Some systemically important regional banks could see their capital ratios deteriorate significantly if they were to attempt to fully make up for the decline in foreign lending. Thus some overall tightening of credit is likely.

- Trade finance appears particularly vulnerable, as exposures can be rolled off quickly. Moreover, euro area banks could prove hard to replace in some specialized areas, such as project finance. Wholesale funding to local banking systems and derivatives markets would be affected, and dollar funding shortages could emerge again. Financial centers like Hong Kong SAR and Singapore could transmit financial contagion around Asia.

Trade and financial spillovers to Asia would combine to hit the region severely. In addition to the negative consequences for Asia from a disorderly bank deleveraging scenario, the region would be affected by renewed stress in asset markets and a decline in global risk appetite. Chapter 2 shows that the sensitivity of Asian financial markets to external shocks has increased over the last decade, and that while better fundamentals (in particular lower fiscal debt and higher reserves ratios) may provide some cushion against external shocks, this buffer is much weaker when the shock is severe. A sharper-than-expected recession in the euro area, with output falling there by about 4 percentage points of GDP below the current baseline (a scenario described in the April 2012 *World Economic Outlook,* IMF, 2012c) would therefore severely hurt Asian economies. In the absence of policy responses, and after taking into account faltering demand from other regions and knock-on effects on domestic demand, IMF staff estimate that growth across Asia would decline by between 2 and 5 percentage points relative to the baseline. Smaller open economies would be hardest hit, but the sharp fall of investment in the tradables sector and the worsening of banks' asset quality would also hit China severely.

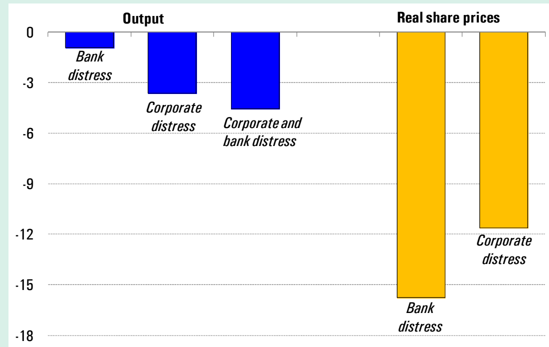
However, there are also upside risks for growth in Asia. If conditions in the euro area were to normalize more rapidly than expected, this could drive a generalized decline in risk aversion, make carry trades more attractive, and generate stronger and more persistent capital inflows into Asia than currently built into these forecasts. Such developments would carry the risk of heightening the credit cycle in many regional economies and reinflating bubbles in property and credit markets, in the absence of an appropriate policy response.

While developments in the euro area continue to represent the most important source of risks for Asia, the region also faces two other risk factors:

- *A hard landing in mainland China.* Although a low probability event, a sharp correction in China's real estate market represents an important downside risk. A 30 percent decline in house prices from their peak in 2011 could hit private sector balance sheets severely in a scenario where the property bust impairs a sizable portion of credit to local government financial platforms, the real estate sector, and small and medium-sized enterprises (SMEs) (Figure 1.21). Although conservative mortgage loan-to-value ratios and healthy bank balance sheets might buffer the banking system to some extent, the likely tightening of financial conditions and attendant corporate sector distress would result in a significant slowdown of the Chinese economy. IMF staff estimates suggest that in this scenario, output in China could fall to as much as 4 percent below baseline after two years, with likely substantial trade and financial spillovers to the region, especially Hong Kong SAR, Indonesia, and Singapore. This assumes no policy intervention and thus likely overstates the impact on activity, although the Chinese government's ability to respond to the property bust through an expansion of credit as in late 2008 would be limited by the deterioration of bank balance sheets.

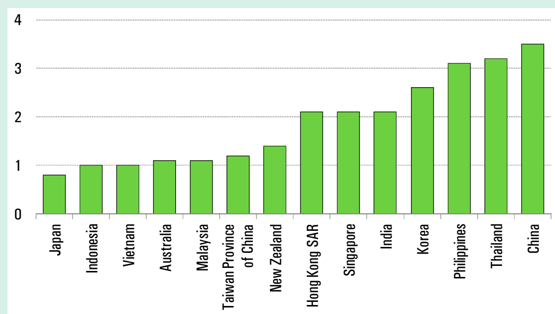
- *Higher commodity prices.* Geopolitical tensions could push oil prices sharply higher given low global inventories and spare capacity. Although most economies in the region are net oil importers, the impact would vary for each country according to its dependence on oil, its approach to stabilizing domestic energy prices and ensuring adequate alternative supplies, and the strength with which its inflation expectations are anchored. For most Asian economies the pass-through from global energy prices to domestic food and energy prices is substantial, ranging from just under a tenth in Japan, to over a third in China (Figure 1.22).

Figure 1.21. China: Potential Effects of Property Downturn
(In percent, change relative to baseline)



Source: N'Diaye and Ahuja (forthcoming).

Figure 1.22. Asia: Pass-Through from Global Energy Prices to Domestic Food and Energy Prices[1]
(In percentage points)



Source: IMF staff estimates.
[1] Impact of a 10 percent increase in global energy prices obtained from regressions of domestic food and energy prices on current and lagged values of global prices in domestic currencies and output gaps. Wholesale prices used for India.

Several emerging and low-income countries would face difficult trade-offs between containing budgetary risks from fuel-related subsidies and inflationary pressures, given a relatively higher share of energy and food in their consumer price indices. There would also be a substantial impact on output: a 50 percent increase in global oil prices above the baseline would lower growth in Asia's net oil importers by between ¼ and 1 percentage point. However, in a few other oil-exporting economies, including Brunei and Malaysia, a positive windfall of similar magnitude would result.

D. The Policy Challenge: How Much Insurance Is Still Needed?

Against this background, Asian policymakers face the difficult task of calibrating the amount of insurance needed to support stable, noninflationary growth. Delaying the return to more neutral macroeconomic policy stances after the aggressive postcrisis easing has been prudent, given the severe downside risks to Asia from the fragile global economy. Those risks are still looming, and thus policymakers in Asia need to remain vigilant against signs of renewed deterioration in external conditions, which may require easing policies in those countries with the requisite policy space. But with acute financial tensions in key global financial markets easing in early 2012, and signs that the slowdown is bottoming out in most of Asia, policymakers in the region should also stand ready to normalize macroeconomic policies at a faster pace than expected earlier this year.

Asian central banks should stand ready to normalize monetary policy if core inflation remains sticky and signs of overheating begin to resurface. In most economies, real policy rates are well below precrisis levels and cuts have been fully transmitted to lower lending rates in the economy (Figure 1.23). A Taylor rule variant incorporating interest rate smoothing indicates that rates in most countries are already at a level consistent with the historical reaction function, while a variant in which policy is more forward looking suggests that many countries may need to increase policy rates, including India, Indonesia, Korea, the Philippines, and Thailand (Figure 1.24). In the event of an oil price shock, tightening may also be warranted to help preempt second-round effects from higher oil prices, especially in those economies where inflation expectations are less well anchored. Of course, a change in the policy stance will need to be tailored to the needs of each individual economy. In particular:

- In Japan, further monetary easing may be needed to boost growth and exit deflation. With inflation pressures likely remaining subdued over the next two to three years, the Bank of Japan may need to undertake additional asset purchases to bring inflation closer to the price stability goal in the medium to long term, which is set at 1 percent for the time being.

- In China, authorities will need to fine tune monetary conditions appropriately and strike the correct balance between the need to provide modest support to a slowing economy while managing a credit overhang (and attendant risks to the banks) created by the exceptional postcrisis credit stimulus.

- In Indonesia, given the considerable recent easing of monetary policy, lags in monetary policy transmission and still strong domestic demand, the central bank should stand ready to tighten policy in the face of improving global investor sentiment and be prepared to limit the second-round impact of potential increases in fuel prices. In India, a series of policy rate increases since 2010 and the gradual decline in inflation (which remains at an elevated level) have returned real policy rates closer to neutral.

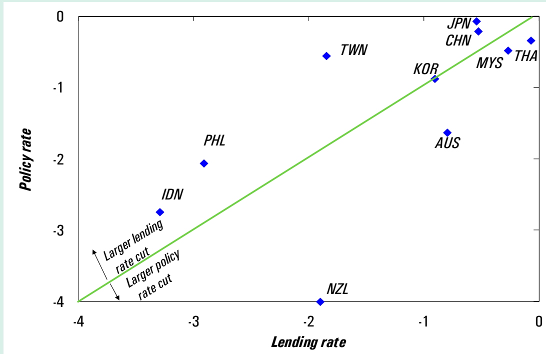
- Monetary policy in Asia's low-income countries will also need to be calibrated to their widely differing individual circumstances. In some—especially those with booming resource sectors, such as Bhutan and Mongolia—the challenge is to rein in an overheating economy. In others, such as Bangladesh and Sri Lanka, further monetary tightening is needed to help absorb external pressures on the economy and bring down inflation. In Vietnam, while the significant tightening of monetary policy in 2011 is beginning to yield a desired easing of inflation and exchange rate pressures, the scope for an easing of monetary policy is constrained by the need to preserve confidence. In several low-income countries, for example, Cambodia and Timor Leste, the scope for active monetary policy is more constrained, placing the burden of macroeconomic management on fiscal policy.

Financial policies are critical to increasing Asia's resilience to further volatility in global financial conditions. In the event of a sharp European deleveraging, governments should be ready to combine monetary and fiscal policies with a range of measures aimed at stabilizing financial systems. As described in Chapter 3, it is likely that this combination of policy measures in 2008 was successful in mitigating Asia's credit supply response to the crisis, relative to other regions of the world. Measures to maintain credit supply could include time-bound deposit guarantees and schemes to protect trade finance and lending to SMEs. Ensuring ample liquidity in the banking system could also require running down foreign exchange buffers, activating swap lines with the Federal Reserve, and making use of increased regional pooling arrangements. At the same time, as discussed in the October 2010 *Regional Economic Outlook: Asia and Pacific* (IMF, 2010b), macroprudential policies should be pursued to strengthen the resilience of domestic financial systems to pressures from increased capital inflows.

Greater exchange rate flexibility in Asia could usefully complement the policy toolkit under this report's baseline outlook. Since the global financial crisis, real effective exchange rates have undergone episodic shifts across the region, in particular during the surge of capital inflows to emerging markets in 2010, increasing by more than 20 percent (trough to peak) in India, Indonesia, and Korea (Figure 1.25). Despite these movements, Emerging Asia's exchange rates have remained generally more stable, and reserves have grown at a faster pace, than in other regions (Figure 1.26). As shown in Chapter 2, higher reserve ratios may help reduce the economy's exposure to external financial shocks, but this effect is likely to be lower after a certain threshold. In the presence of renewed pressures from large capital inflows, allowing two-way flexibility in exchange rate movements would help discourage speculative portfolio and bank inflows, by making the payoff from interest-rate differentials more uncertain. Similarly, in the event of undue demand pressures, currency appreciation would help rein in inflation.

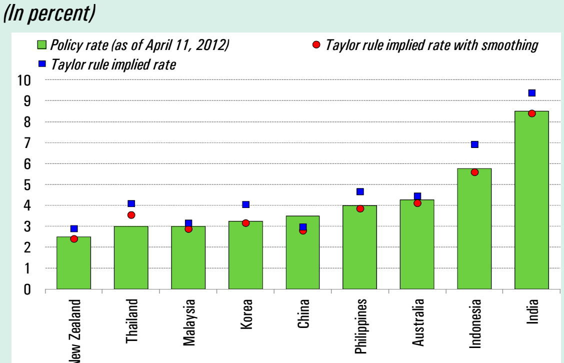
The thrust of fiscal policies in Asia should be to rebuild space and reorient spending toward faster economic rebalancing and inclusive growth, through a greater focus on investments in social safety nets and critical infrastructure projects. As cyclically adjusted

Figure 1.23. Selected Asia: Real Interest Rates
(As of March 2012; relative to 2002–07 average)



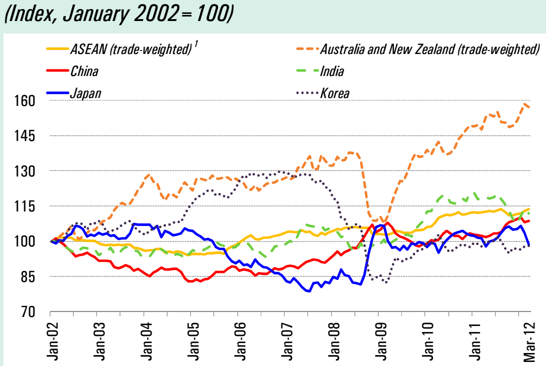
Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

Figure 1.24. Selected Asia: Nominal Policy Rates and Taylor Rule Implied Rates
(In percent)



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF, WEO database and staff estimates.

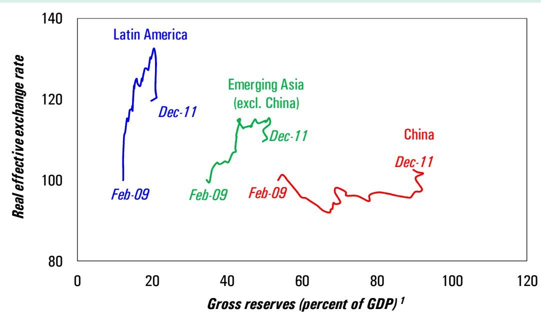
Figure 1.25. Asia: Real Effective Exchange Rates
(Index, January 2002 = 100)



Source: IMF staff calculations.
[1] ASEAN includes Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

Figure 1.26. Emerging Asia and Latin America: Real Exchange Rates and Reserves

(February 2009=100; market GDP weighted)

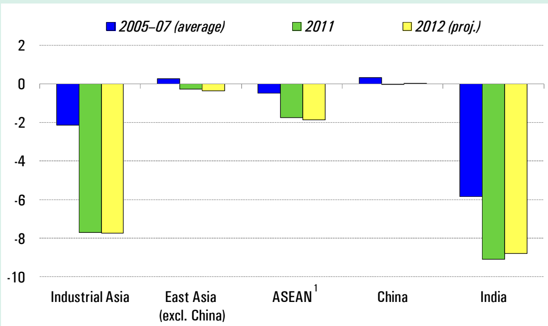


Sources: IMF, *International Financial Statistics* database and staff calculations.

[1] Gross international reserves as a share of 2006–08 average GDP. Weighted average using market GDP.

Figure 1.27. Selected Asia: Cyclically Adjusted General Government Balances

(In percent of GDP)



Sources: IMF, WEO database and staff projections.

[1] ASEAN includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

deficits have not yet returned to their pre-2008 levels (Figure 1.27), a resumption of fiscal consolidation across the region is warranted in the central case of a rebound in activity in the latter half of 2012. In fact, on current budget plans for calendar year 2012, a modest further consolidation is envisaged only in selected economies (such as India and Indonesia), implying a limited withdrawal of fiscal stimulus across the region (Figure 1.28).

That said, the pace of fiscal consolidation should also be tailored to the evolution of economic conditions, and take into account regional heterogeneity. The case for fiscal consolidation is strongest in economies that still have large cyclically adjusted deficits and elevated public debt profiles. This may require the introduction of clear medium-term adjustment plans as well as stronger institutional frameworks that would allow greater control over public spending and service delivery. Moreover, consolidation will also have to rely on improvements in revenue mobilization, including in a number of low-income economies with ongoing public financial management reform programs (for example, Cambodia, Lao People's Democratic Republic, and Nepal).

- In Japan, the overriding concern is the adoption of a comprehensive and credible consolidation plan that includes an increase in the consumption tax along with reforms to cap social security expenditure and to curb discretionary spending. Greater efforts are needed toward implementing tax reforms that help promote private investment and boost long-term growth prospects in the face of adverse demographic change.

- In India and Indonesia, fiscal consolidation is the key to containing inflationary pressures and creating space for priority development needs. Hence, consolidation efforts should focus on limiting nonpriority spending, including fuel-related subsidies, while providing more room for public investment and health and education.

- By contrast, consolidation plans in China for 2012 have been rightly deferred in response to slower growth, while greater outlays for public investment in several ASEAN economies would contribute to eliminating supply bottlenecks and supporting their economic rebalancing toward domestic sources of growth.

- At the same time, should the downside risks to growth materialize, most Asian economies still have ample space to deploy fiscal stimulus, especially when compared with advanced economies (Figure 1.29). Economies with more limited fiscal space should allow automatic stabilizers to operate and reprioritize spending toward those areas with higher impact on economic activity. In China, residual concerns about credit quality and bank balance sheets from the 2009–10 stimulus make a fiscal response to downside risks the principal line of defense, but the fiscal package should be consistent with the need to boost consumption.

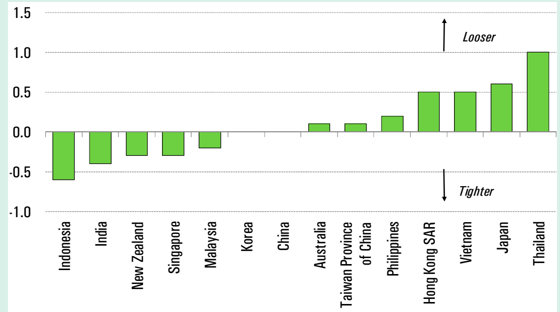
Reprioritizing budgets would become more difficult in the event of sharply higher oil prices. Direct and indirect subsidies are in place in many Asian economies to cushion the impact of volatile fuel prices on consumers. As highlighted in the October 2011 *Regional Economic Outlook: Asia and Pacific* (IMF, 2011b), foregone tax revenues and outright subsidies can result in substantial budgetary costs, in some cases comparable to social priority expenditures. Greater efforts will therefore be needed, particularly in Emerging Asia (for example, India and Malaysia) and low-income economies (for example, Bangladesh and Vietnam) to preempt further wasteful spending and to better target subsidies to the most vulnerable households.

E. Laying the Foundations for Sustainable Growth

Sustainable growth over the medium and long term will require implementing diverse policy agendas in different parts of Asia. In China, economic rebalancing and strengthening of household income and consumption remain crucial. Since mid-2011, the renminbi has appreciated 6 percent in real effective terms, and the pace of reserve accumulation has slowed. However, sustaining the recent decline in the current account surplus will require further real appreciation of the renminbi as well as continued progress in the broad range of reform areas identified in the 12th Five Year Plan—including increasing household income and expanding the service sector, investing in social safety nets, and accelerating progress toward financial liberalization.

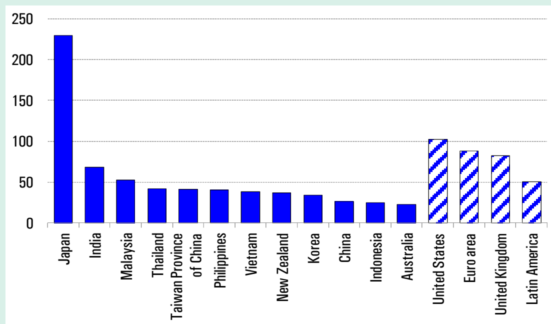
Much will depend not only on China but also on Asian exporters' ability to adjust to a changing economic environment. As highlighted in Chapter 4, domestic imbalances in China continue to cast a shadow on its ability to act as a sustained source of demand in the region. While China is by far the single most important destination for Asia's capital goods exports, it still only accounts for less than 2 percent of global consumer goods imports (Figure 1.30). As

Figure 1.28. Selected Asia: Fiscal Impulse in 2012[1]
(In percent of GDP)



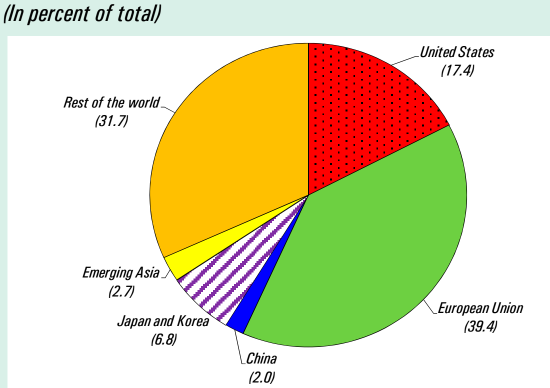
Source: IMF staff estimates.
[1] Change (relative to previous year) in structural fiscal balances related to measures taken in response to the crisis.

Figure 1.29. Gross Public Debt, 2011[1]
(In percent of GDP)



Sources: IMF, WEO database and staff calculations.
[1] Excludes Singapore and Hong Kong SAR, where public debt arises mainly from non-fiscal operations.

Figure 1.30. Share in Global Consumer Goods Import Demand, 2010
(In percent of total)



Sources: United Nations, *Comtrade* database; and IMF staff calculations.

highlighted in Chapter 4, whether China will be a sustained source of growth in the region will depend not only on China's ability to move to consumption-led growth, but also on Asia's ability to cater more to Chinese consumers.

In India, renewed efforts are needed to revive the flagging structural reform agenda. These include measures to improve the investment climate, remove infrastructure bottlenecks, and further expand education opportunities. It is also important for India to make progress in reducing barriers to trade, in order to maximize the potential of its continuing demographic dividend (see Box 1.3). Raising female and old-age labor force participation to cope with demographic change will be key to strengthening growth prospects in more-advanced Asian economies, such as Japan and Korea.

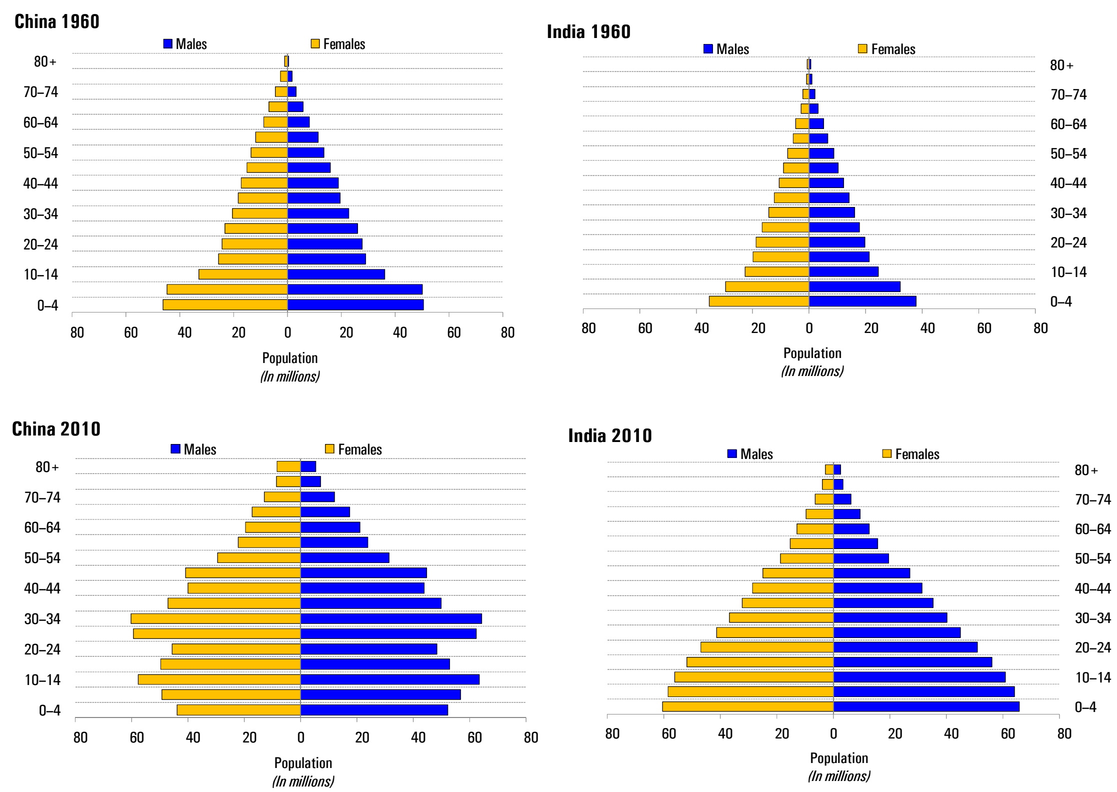
In many ASEAN economies, strengthening domestic demand will require improving the conditions for private investment. Higher investment ratios relative to precrisis levels suggest that ASEAN economies are addressing an important medium-term priority of accelerating the accumulation of physical capital and addressing the "infrastructure gap" that persists between these economies and the rest of the world. To some extent, this progress reflects government-sponsored and -financed projects, which by relieving infrastructure bottlenecks might help crowd-in private investment and lift productivity and potential growth (see the April 2010 *Regional Economic Outlook: Asia and Pacific,* IMF, 2010a). But the pattern of investment in the region could also be influenced by reforms that make external funding more accessible to firms in the nontradables sector (see Box 1.4).

Box 1.3. Harnessing India's Demographic Dividend

An increase in the share of a country's working-age (15–64) population in the total population can generate faster economic growth. The working-age population is generally more productive and saves more, increasing domestic resources for investment. This so-called demographic dividend has been regarded as a key explanatory factor for the remarkable economic growth performance in East Asia. Regression analysis in Bloom and Finlay (2009) suggests that demographic factors contributed significantly to economic growth in East Asian countries from 1965 to 2005.

China and India: Population Distribution

(By age group, in years)



Source: United Nations, *World Population Prospects* (2009).

In many Asian countries, aging populations are now causing, or about to cause, a decline in the working-age ratio. The Japanese workforce has been shrinking since 1995, and the Korean workforce will start to decline beginning in 2015. Most significantly, China has almost completed its transition to a "mature" age distribution structure, as illustrated in the population pyramids above. According to United Nations' projections, China's working-age ratio will peak in 2013 and then decline by a substantial amount in the next few decades.

Amid concerns that aging workforces will take their toll on medium-run growth prospects, the second-most populous country in the region (and the world) affords grounds for cautious optimism. India's demographic transition is presently well underway, and, unlike in China, the age structure of the population there is likely to evolve favorably over the next two to three decades. United Nations' projections suggest that a peak working-age ratio of 67 percent will be attained in about 2035, up from 64 percent in 2011.

Note: The main authors of this box are Shekhar Aiyar, Rahul Anand, and Ding Ding.

Box 1.3. ***(concluded)***

Using state-level data, Aiyar and Mody (2011) show that in India both the level and the growth rate of the working-age ratio have exercised a significant positive impact on per capita income growth. In fact a substantial part of the acceleration in economic growth since the 1980s can be ascribed to demographic trends. Aiyar and Mody estimate that the continuing demographic dividend could add about 2 percentage points per annum to India's per capita GDP growth over the next two decades. Moreover, since further growth in the working-age ratio is likely to be concentrated in some of India's poorest states, demographic changes may be a powerful internal force for income convergence in the future.

That said, the demographic dividend will be fully realized only if India is able to create gainful employment opportunities for this working-age population. This will require enabling reforms, and the experience of East Asia in the 1960s suggests that trade reforms could play an important role (Bloom and Sevilla, 2003). In particular, China capitalized on the demographic dividend through trade liberalization in the 1960s (Garnaut and Song, 2006). Meanwhile, the absence of liberalization in Latin America in the early 1980s cost the region an average 0.9 percent growth per year (Inter-American Development Bank, 2000).

Bloom and Canning (2004) find that openness can double the size of a country's demographic dividend. For countries relatively more open to trade, the shift in age structure toward a higher working-age ratio is more likely to be translated into higher saving (Behram, Duryea, and Székely, 1999). This is partly because of the increase in productivity brought about by trade liberalization. If high productivity coincides with a low dependency ratio, the opportunity arises to raise savings rates dramatically. Furthermore, the decline in unemployment along a country's average age profile is much steeper for countries more open to trade. This suggests that trade policy might help to release some pressure from labor markets at a time when large shares of the population are entering working age. Moreover, there is evidence to suggest that the beneficial impacts of trade liberalization are likely to be enhanced by easing labor laws.

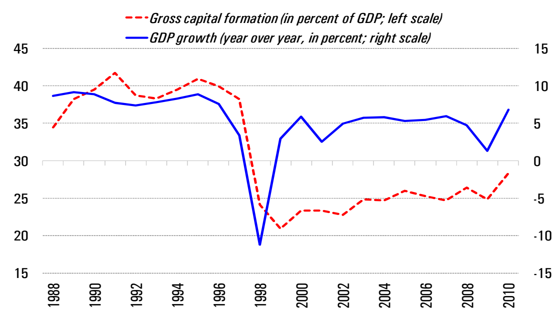
India could harness its potential demographic dividend by expanding both intraregional trade within South Asia and trade with new regions. This could be achieved by policies aimed at (i) reducing trade restrictiveness and (ii) improving trade facilitation.

Trade restrictiveness in South Asia is high: the weighted average tariff is greater than in East Asia and also compares unfavorably to other Group of Twenty countries. Integrated South Asian markets would improve scale economies for domestic firms, especially in manufacturing, and attract higher investment. Hoekman and Nicita (2008) have found that a 10 percent reduction in the cost associated with importing (exporting) would increase imports (exports) by about 5 percent. Trade facilitation consists of reforms to make the movement of merchandise from one country to another faster, cheaper, and easier, and is crucial in realizing higher trade potential (Portugal-Perez and Wilson, 2010). India lags ASEAN economies on trade facilitation measures, and progress in this area could yield large dividends. For example, a World Bank study has found that a 10 percent improvement in export customs procedures would enhance merchandise export performance by 15 percent and manufacturing export performance by 17 percent (Broadman, 2007).

Box 1.4. Explaining the ASEAN-3 Investment Puzzle: A Tale of Two Sectors

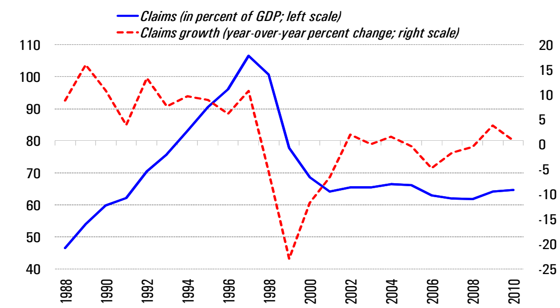
After the late 1990s financial crisis, economic activity in Emerging Asia quickly rebounded to near precrisis levels. Investment, however, never fully recovered, and has remained at a low level ever since. On average, in three emerging ASEAN economies (Indonesia, Malaysia, and Thailand, or ASEAN-3 for the purposes of this box), investment ratios in 2010 are still about 10 percent of GDP below their 1996 levels (figure, below left). In the same economies, credit to the private sector (as a share of GDP) also never recovered from the fall during the financial crisis of 1997–98, as it stands on average at about 70 percent of GDP in 2011 against almost 100 percent in 1996 (figure, below right).

ASEAN-3: Investment and GDP Growth[1]



Sources: IMF, WEO database and staff calculations.
[1] ASEAN-3 includes Indonesia, Malaysia, and Thailand.

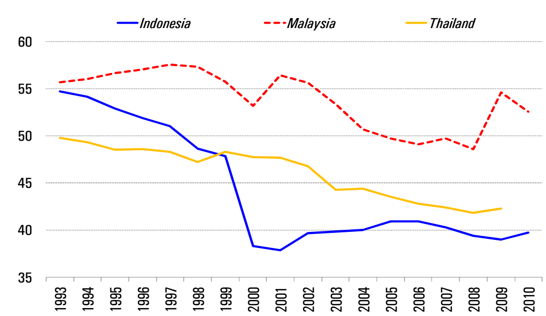
ASEAN-3: Credit to the Private Sector[1]



Sources: IMF, WEO database and staff calculations.
[1] ASEAN-3 includes Indonesia, Malaysia, and Thailand.

The fall in investment ratios has been considered, at least in part, to be a correction of the precrisis lending and investment overhang. However, during the last decade, many emerging Asia economies have reduced the structural overcapacity inherited from the crisis and significantly strengthened their economic and financial fundamentals. Different explanations have been proposed, including a weak investment climate; risky investment environment; institutional and regulatory factors; a shift to knowledge-based growth strategies, with a related decline in the stock of physical capital needed; and increased competition from China, with a reallocation of physical capital from the rest of the region into China. All in all, the prolonged low level of investment in Emerging Asia has remained something of a puzzle.[1]

ASEAN-3: Nontradables Sector Output[1]
(In percent of GDP)



Sources: Haver Analytics; and IMF staff calculations.
[1] ASEAN-3 includes Indonesia, Malaysia, and Thailand.

Another explanation might be found by looking at the sectoral composition of output and credit in the region, and in particular at the difference between tradables and nontradables sectors.[2] In the ASEAN-3 economies, the share of nontradable output in GDP dropped sharply—by 5 percentage points on average from 1996 to 2007 (figure, above).

Note: The main author of this box is Yong Sarah Zhou.

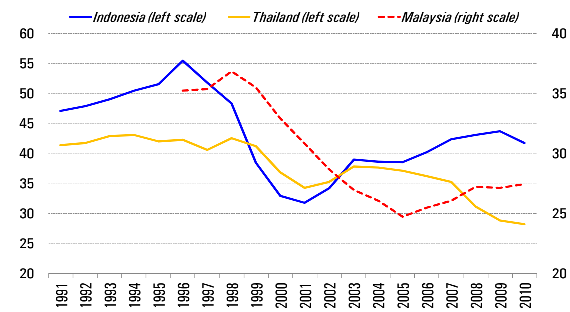
[1] Hori (2007) argues that the post-Asian-crisis investment slump has been more severe and prolonged compared with investment declines following similar crisis episodes elsewhere. Chinn and Ito (2005), Eichengreen (2006), and IMF (2005a, 2005b, 2006) note that investment in Emerging Asia is lower than predicted by fundamental factors.

[2] Nontradables sectors here include construction; service; wholesale and retail trade; transport, storage, and communication; hotel and restaurant; and electricity, gas, and water supply.

Box 1.4. *(concluded)*

This is in stark contrast to trends in advanced economies, where the share of nontradables sectors in GDP has steadily risen (April 2010 *Regional Economic Outlook: Asia and Pacific*, IMF, 2010a). At the same time, loans to the nontradables sector experienced a disproportionate decline relative to GDP in the ASEAN-3, with their share in total loans dropping by around 10 percentage points between 1997 and 2007 (figure, right).

ASEAN-3: Loans to the Nontradables Sector[1]
(In percent of total loans)



Sources: Haver Analytics; and IMF staff calculations.
[1] ASEAN-3 includes Indonesia, Malaysia, and Thailand.

This suggests that the postcrisis credit slump in Emerging Asia has affected firms in different sectors asymmetrically. The tradables sector, typically large and able to pledge export receivables as collateral, has greater access to domestic and international capital markets, in addition to domestic bank lending. By contrast, nontradables firms, usually small and domestically focused, tend to face more asymmetric information problems in credit markets and thus rely predominantly on bank credit. In addition, firms in nontradables sectors benefited little from the exchange rate depreciation after the financial crisis, and made slower progress in balance sheet restructuring than larger, export-oriented corporations. As a result, the financial crisis at the end of the 1990s may have begun a reallocation of bank lending from nontradables firms to large tradables firms, with the former ultimately forced to pass up investment opportunities that cannot be implemented with internal funds alone.

Indeed, IMF staff analysis shows that there is a significant positive correlation between output and credit in ASEAN-3 nontradables sectors, after controlling for other determinants of output (real interest rate, uncertainty, terms of trade, and real exchange rate). Moreover, while investment levels in these economies depend on the amount of internal funds for all firms, the sensitivity is significantly higher for those in the nontradables sector. Finally, for nontradables firms in ASEAN-3 economies, debt and leverage ratios have a greater negative effect on investment.[3]

Removing financing constraints to firms in nontradables sectors may thus help increase investment levels in Emerging Asia, with potential positive implications on productivity growth and also for social welfare and income equality, as the nontradables sector plays an important role in the creation of jobs. For example, it would be important to alleviate information asymmetry in credit markets, by improving and extending the coverage of credit registries in credit bureaus. Malaysia's credit bureau is a good example in terms of providing comprehensive credit information and ratings on small and medium enterprises. Moreover, developing further capital market structures (for example, improving legal and corporate governance frameworks in corporate bond markets) (Goswami and Sharma, 2011), and changing legal frameworks to widen the range of assets that can be used as collateral, would promote financing on risk-based terms and venture capital. These policies would also help promote lending to small- and medium-sized enterprises, which account for a large share of firms in the nontradables sector. Deregulating and opening the nontradables sector to foreign capital (for example, by reducing restrictions on foreign investment in the service sector) could also boost investment in regional nontradables sectors.

[3] More details on these results can be found in Zhou (forthcoming). They are based on analysis of both aggregate and listed firm-level data in ASEAN-3 economies from 1991 to 2007.