Executive Summary

Asia remains the most dynamic part of the global economy but is facing severe headwinds from a still weak global recovery, slowing global trade, and the short-term impact of China's growth transition. Still, the region is well positioned to meet the challenges ahead, provided it strengthens its reform efforts. To strengthen its resilience to global risks and remain a source of dynamism, policymakers in the region should push ahead with structural reforms to raise productivity and create fiscal space while supporting demand as needed.

Growth in the Asia-Pacific economies is expected to decelerate slightly to about 5¼ percent during 2016–17, partly reflecting the sluggish global recovery. As external demand remains relatively subdued and global financial conditions have started to tighten, domestic demand is expected to be a major driver of activity across most of the region. Domestic demand, particularly consumption, will continue to be propelled by robust labor market conditions, lower commodity prices, and disposable income growth, along with, in some economies, macroeconomic stimulus.

Downside risks continue to dominate the economic landscape. Slower-than-expected global growth and tighter global financial conditions combined with high leverage in the region could have an adverse effect on regional growth. In particular, the turning of the credit and financial cycles amid high debt poses a significant risk to growth in Asia, especially because debt levels have increased markedly over the past decade across most of the major economies in the region, including China and Japan.

Moreover, although China's economic transition toward more sustainable growth is critical over the medium term for both China and the global economy, adverse spillovers could emerge in the near term. Chapter 2 assesses potential spillovers from China's rebalancing on regional economies and financial markets. Overall, the region has become more sensitive to the Chinese economy. While China's rebalancing will have medium-term growth benefits, there are likely to be adverse short-term effects, though the impact will be relatively more positive for economies more exposed to China's consumption demand. Financial spillovers from China to regional markets—in particular equity and foreign exchange markets—have risen since the global financial crisis and are stronger for those economies with stronger trade linkages.

Chapter 3 examines how China's rebalancing has affected advanced economies that are upstream in production or value chains, and commodity exporters. It offers evidence that the former have lost market shares for some products, as China has onshored the production of previously imported intermediate goods and started exporting them. Commodity consumption growth has also slowed with China's rebalancing, but only some exporters have seen their export volume growth decline substantially. Many exporters have been more affected by global commodity price declines, only part of which can be attributed to China's rebalancing.

The region faces other important downside risks, including natural disasters and trade disruptions. While Abenomics has been supportive, durable gains in growth in Japan have so far not materialized. A further growth slowdown there could lead to an overreliance on expansionary monetary policy. More broadly, domestic political and international geopolitical tensions could cause significant trade disruptions, leading to a generalized slowdown. Finally, natural disasters are a major perennial risk to most Asian and Pacific economies. Because of their poorer infrastructure and their geographical susceptibility to natural disasters and climate change, low-income, frontier, and developing economies as well as Pacific island countries are particularly at risk.

On the upside, regional and multilateral trade agreements could provide a boost to trade and growth. Further progress on these agreements, including, for example, a broadening of the Trans-Pacific Partnership, could benefit many economies in the region.

What is the role of policies in helping Asia to address its challenges and maintain its leadership in the global economy? Harnessing Asia's potential will require supporting demand, cushioning the blow from external shocks, and implementing a wide-ranging policy agenda. Structural reforms, aided by macroeconomic policies, should support economic transitions and bolster potential growth. While gradual fiscal consolidation is desirable for most economies, in order to rebuild policy space, it should generally be undertaken together with adjustments to the composition of spending to allow, where needed, for further infrastructure and social spending. Monetary policy should remain focused on supporting demand and addressing near-term risks, including from large exchange rate depreciations and deflationary shocks. Recent bouts of financial volatility underscore the need for flexible and proactive monetary and exchange rate policies. Effective communication of policy goals can also play a role in bolstering confidence and lowering market volatility. Policies to manage risks associated with high leverage and financial volatility will play an important role, including exchange rate flexibility, targeted macroprudential policies, and, in some cases, capital flow measures.

Pushing ahead with structural reforms will be critical to ensure that Asia remains the global growth leader. Structural reforms are needed to help rebalance demand and supply, reduce vulnerabilities, and increase economic efficiency and potential growth. In a number of economies, reforms can also help address climate change and improve the environment, particularly in large countries that rely heavily on fossil fuels. Past reforms have shown themselves to have been highly effective, including by fostering economic and trade diversification and facilitating Asia's entry into global markets, but a new wave of high-impact reforms is needed, ranging from state-owned enterprise reform in China to labor and product market reforms in Japan and reforms to remove bottlenecks in India and elsewhere in the region.

Reforms will also be needed to foster more inclusive growth, including by reducing income inequality, which in contrast to other regions has risen in most of Asia. Chapter 4 finds that, unlike in the past, fast-growing Asian economies have been unable to replicate the "growth with equity" miracle. The chapter argues that it is imperative to address inequality of opportunities, in particular to broaden access to education and health and promote financial and gender inclusion. In this connection, fiscal policy is an important tool to address rising inequality, including by expanding and broadening the coverage of social spending and improving tax progressivity.