1. Asia's Momentum Is Set to Continue

Introduction and Main Findings

The main findings of the analysis in this chapter are as follows:

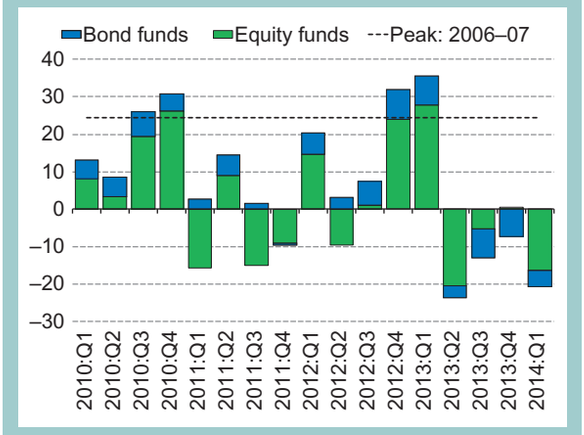
- The outlook for Asia is one of steady growth. GDP growth is forecast to improve slightly in 2014–15 to 5.5 percent, helped by stronger growth in advanced economies, healthy labor markets, and robust credit growth (see forecasts for individual economies below).
- An unexpected tightening of global liquidity remains the main external risk, particularly for emerging economies. On this front, recent policy actions taken to address vulnerabilities (for example, in India and Indonesia) have started to bear fruit, as evidenced by the more muted reaction of regional financial markets to the bout of global volatility in early 2014.
- Asia is also facing various risks originating from within the region. These include a sharper-than-envisaged slowdown and financial sector vulnerabilities in China, less effective Abenomics, and political tensions and uncertainty.
- The initial impact of *Abenomics* has been strong but appears to be waning. The third arrow of Abenomics—structural reforms—is essential for Japan to avoid the risk of falling back into lower growth and deflation, a further deterioration in the fiscal situation, and an overreliance on monetary stimulus, with negative consequences for the region.
- *China's planned reforms,* against the background of rising vulnerabilities, are far-reaching and have the potential to transform the economy. Implementation will be key. The reforms could enhance *welfare* by boosting private consumption and making growth more sustainable, although the economy could initially slow down somewhat. While the near-term impact on the rest of Asia is generally expected to be small, most economies in the region would benefit from the rising consumption in China.
- The recent growth slowdown in *ASEAN-5* has been more cyclical than structural and has reflected domestic factors more than external ones. The pickup in global demand will play a supportive role going forward.
- Against this background, in most economies, the normalization of monetary conditions can wait but should be considered as economic slack diminishes and risks recede. Rate hikes should continue where inflation remains high. On the fiscal front, a gradual fiscal consolidation remains appropriate in most economies across the region. Macroprudential and capital flow measures could also be considered to ensure financial stability and address disruptive asset price movements. In the event of adverse shocks, the policy response will differ based on countries' fundamentals and vulnerabilities.

Recent Developments: Steady Growth Amid Financial Volatility

Portfolio flows into Asia, which had reached record highs a year ago, saw a sharp *and persistent* reversal in the wake of the May 2013 "tapering episode" (Figure 1.1). As risk aversion spiked, sentiment quickly turned especially against emerging market (EM) economies perceived to have weaker fundamentals. During this period, most economies in the region made only limited use of their reserves to counter the currency pressures (Figure 1.2). Indeed, for most countries, reserves are now higher than they were a year ago, with the main

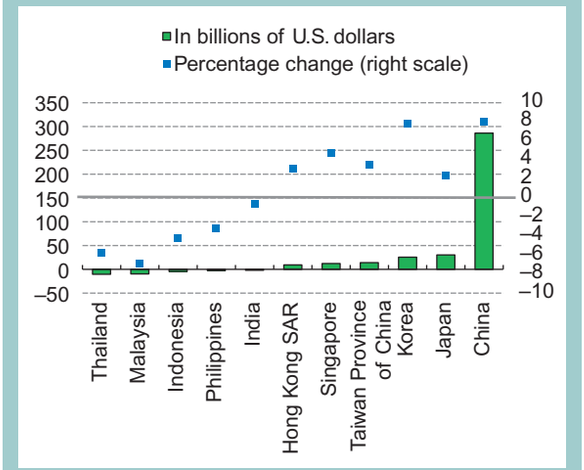
The main author of this chapter is Roberto Guimarães-Filho. Sidra Rehman and Dulani Seneviratne provided research assistance.

Figure 1.1
Asia: Equity and Bond Funds—Quarterly Net Flows During 2010–14[1]
(In billions of U.S. dollars)



Source: Haver Analytics.
[1] Includes exchange traded fund flows and mutual fund flows for Emerging Asia, Australia, New Zealand, Singapore, Hong Kong SAR, Taiwan Province of China, and Korea. 2014:Q1 is based on monthly data available between January–March 2014.

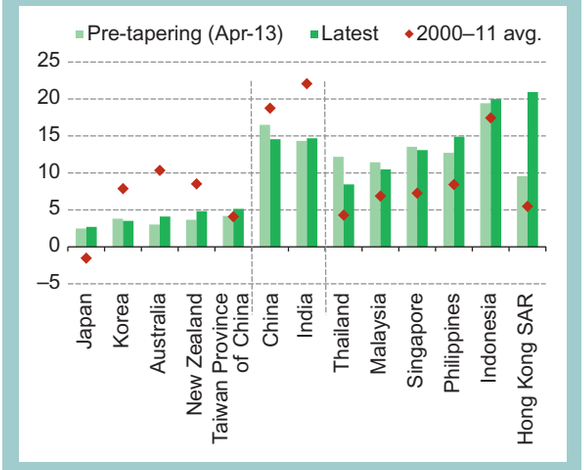
Figure 1.2
Selected Asia: Foreign Exchange Reserve Accumulation
(Change since April 2013)



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

exceptions of Indonesia and Thailand. Along with other emerging markets, emerging Asian economies also faced large capital outflows in January 2014, although they proved more resilient to this latest bout in global volatility.

Figure 1.3
Selected Asia: Private Sector Credit Growth
(Year-over-year; in percent)



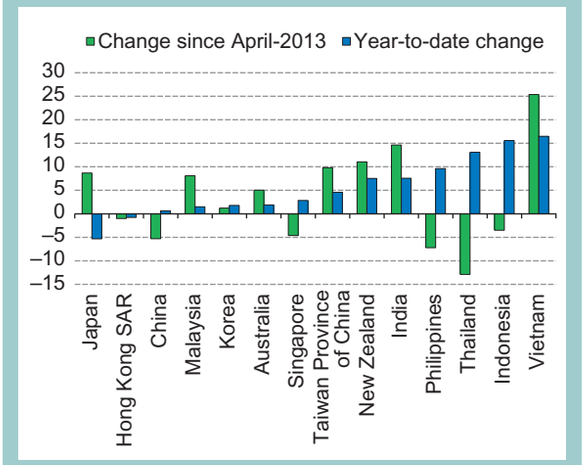
Sources:CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

While the financial environment for emerging markets has been challenging, financial conditions across Asia have remained broadly conducive. Domestic credit growth and corporate bond issuance have been strong (Figure 1.3); indeed, corporate leverage for the region as a whole has risen, as companies tried to take advantage of still favorable global liquidity conditions (see Chapter 2). Equity markets rebounded from their spring 2013 lows as global and regional economic prospects improved (Figure 1.4). In a number of cases, weaker exchange rates also contributed to keep financial conditions accommodative. Foreign bank lending to emerging Asia, on the other hand, did lose some of its momentum during the course of the year (Figure 1.5).

Activity across Asia picked up in the second half of 2013. GDP growth improved across most of the region during the past year, and recent high-frequency indicators, while somewhat mixed, point to a solid expansion continuing into 2014 (Figure 1.6). There have been two important drivers:

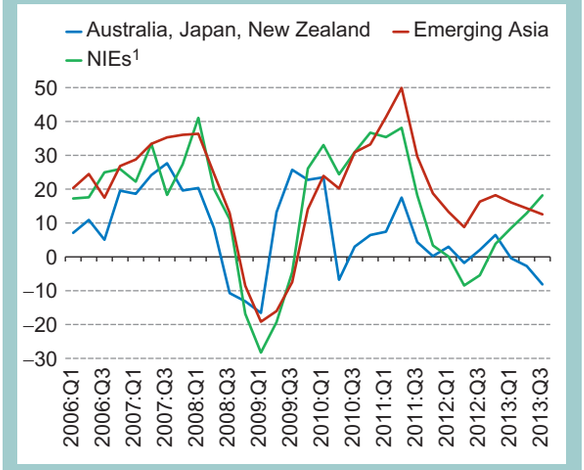
- *Exports*, particularly of electronics destined for the United States and the Euro area, have gained momentum over the last year

Figure 1.4
Asia: Stock Markets
(Change of stock market index; in percent)



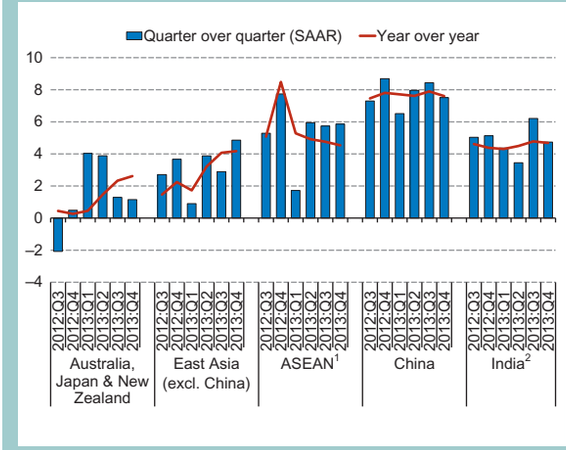
Source: Bloomberg L.P.; and IMF staff calculations.

Figure 1.5
Consolidated Foreign Claims
(Immediate risk basis; year-over-year change; in percent)



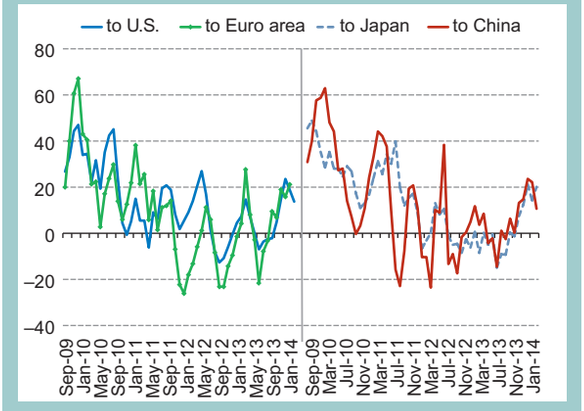
Sources: Bank for International Settlements; and IMF staff calculations.
[1] NIEs include Korea, Hong Kong SAR, Singapore, and Taiwan Province of China.

Figure 1.6
Asia: Changes in Real GDP at Market Prices
(In percent)



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.
[1] ASEAN includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.
[2] India's GDP is at factor cost.

Figure 1.7
Selected Asia: Exports to Major Destination[1]
(3-month percent change of 3-month moving average; SAAR)



Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.
[1] Selected Asia includes Japan, Malaysia, Thailand, the Philippines, Singapore, and East Asia. Vietnam excluded due to data lag.

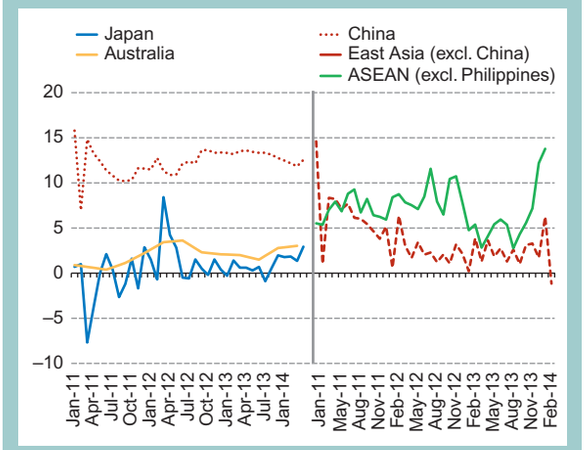
(Figure 1.7). In China and Korea, where the share of more sophisticated products has been on the rise, exports have done particularly well. However, some "hollowing out" is still taking place in higher-cost economies and among those that have been slow to innovate and move up the value chain (for example, Malaysia and the Philippines). Improving exports meant that, for most of the region, external positions strengthened in 2013. However, for some of the ASEAN economies (Malaysia and Indonesia) worsening terms of trade had contributed to lower their current account balances.

- *Domestic demand* has been generally solid and retail sales across much of Asia have picked up, especially in the second half of 2013 (Figure 1.8). In Japan, in particular, wealth effects from rising equity prices have supported private consumption.

Amid flat or declining global commodity prices, and with some slack remaining in most economies, inflation has generally been low across most of the region (Figures 1.9 and 1.10). India and Indonesia have been notable exceptions, although even there inflation has started to recede, particularly once adjustment is made for increases in administered fuel prices. Nevertheless, in both countries, high food inflation remains a significant economic and social issue. Malaysia, the Philippines, and Hong Kong SAR saw a modest pickup in inflation as activity growth continued to reduce slack in their economies, but inflation fell in Vietnam, Singapore, and Thailand while remaining generally low elsewhere in Asia.

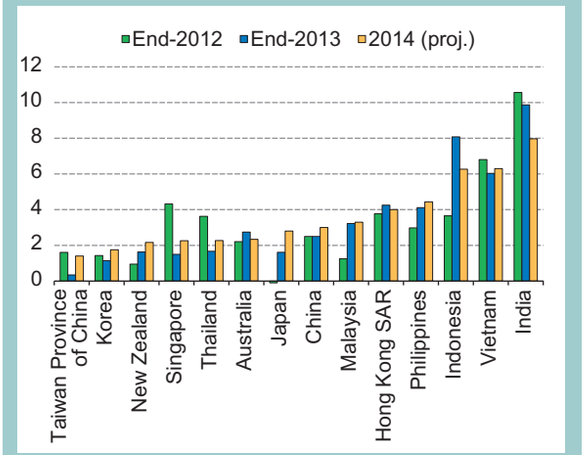
Current account balances have generally improved on the back of stronger global demand and, in some cases, import compression (Figure 1.11). In India, measures aimed at curbing gold imports, as well as weaker domestic demand, helped strengthen the trade balance. Exports were also supported by a more competitive rupee. Indonesia has also started to see an improvement in its current account balance as policy tightening and other measures compressed imports. In Korea, the increase in the current

Figure 1.8
Selected Asia: Retail Sales Volumes
(Year-over-year change; in percent)[1]



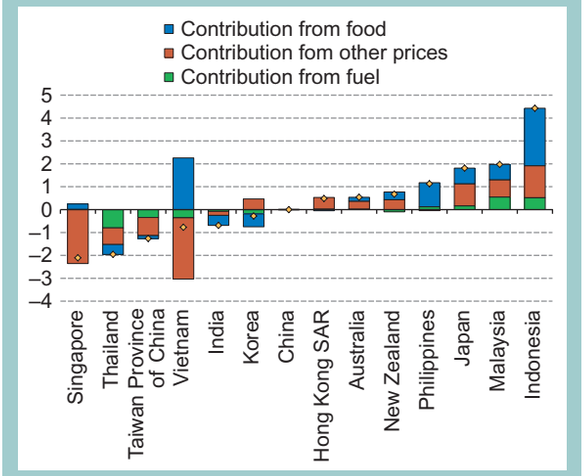
Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.
[1] Linear interpolation applied on quarterly data for Australia.

Figure 1.9
Asia: Headline Inflation
(Year-over-year; in percent)



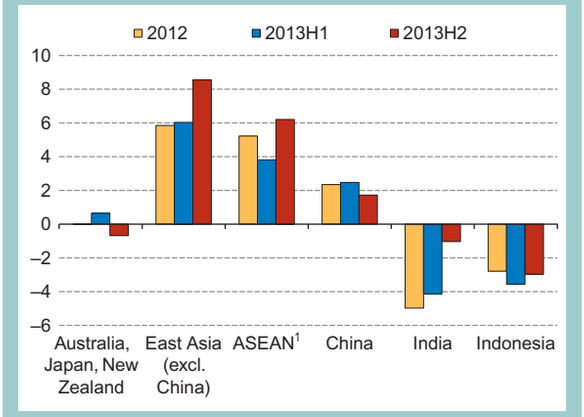
Sources: CEIC Data Company Ltd.; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.

Figure 1.10
Asia: Contributions to Change in Headline Inflation in 2013
(In percentage points)



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

Figure 1.11
Asia: Current Account Balances
(In percent of GDP)



Sources: CEIC Data Co. Ltd.; Haver Analytics; IMF, *World Economic Outlook* database; and IMF staff calculations.
[1] ASEAN includes Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

account surplus was helped by stronger global demand and improvements in productivity, which kept unit labor costs low (despite the appreciation of the won vis-à-vis the Japanese yen, in particular). China has bucked regional trends, with its current account balance declining slightly by 0.2 percentage points to 2.1 percent of GDP.

Regional Outlook: Growth Should Remain Robust and Inflation Generally Low

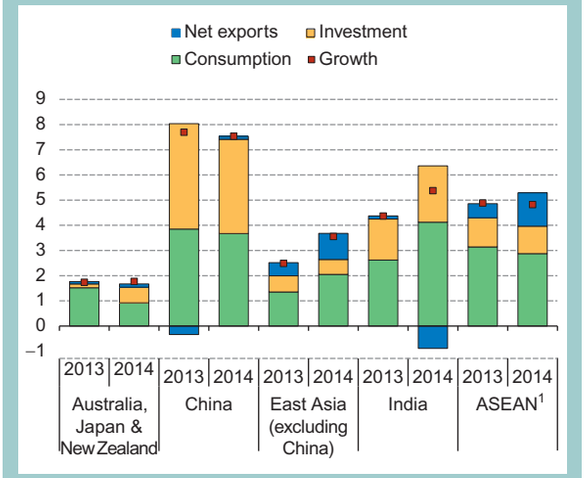
Asia should experience robust growth throughout 2014 and 2015. GDP growth is forecast at 5.4 percent in 2014 and 5.5 percent in 2015 (Table 1.1), a modest improvement over 2013. Stronger growth in advanced economies and generally more competitive exchange rates will help propel Asia's exports. Domestic demand across the region is expected to continue to be underpinned by healthy

Table 1.1. Asia: Real GDP
(Year-over-year change; in percent)

	Actual Data and Latest Projections					Difference from 2013 Oct Update		
	2011	2012	2013	2014	2015	2013	2014	2015
Australia	2.6	3.6	2.4	2.6	2.7	0.0	–0.2	–0.2
Japan	–0.5	1.4	1.5	1.4	1.0	–0.4	0.1	–0.2
New Zealand	1.9	2.6	2.4	3.3	3.0	–0.2	0.3	0.6
East Asia	**8.2**	**6.5**	**6.7**	**6.8**	**6.7**	**0.0**	**0.2**	**0.2**
China	9.3	7.7	7.7	7.5	7.3	0.1	0.3	0.3
Hong Kong SAR	4.8	1.5	2.9	3.7	3.8	0.0	–0.6	–0.6
Korea	3.7	2.0	2.8	3.7	3.8	–0.1	0.0	–0.2
Taiwan Province of China	4.2	1.5	2.1	3.1	3.9	–0.1	–0.6	0.0
South Asia	**6.7**	**4.9**	**4.5**	**5.5**	**6.4**	**0.5**	**0.3**	**0.1**
Bangladesh	6.5	6.1	5.8	6.0	6.5	0.0	0.0	0.0
India	6.6	4.7	4.4	5.4	6.4	0.6	0.3	0.1
Sri Lanka	8.2	6.3	7.3	7.0	6.5	1.1	0.3	0.0
ASEAN	**4.7**	**5.8**	**5.1**	**5.0**	**5.3**	**0.2**	**–0.4**	**–0.1**
Brunei Darussalam	3.4	0.9	–1.2	5.4	3.0	–2.7	–0.8	–4.4
Cambodia	7.1	7.3	7.0	7.2	7.3	0.0	0.0	0.0
Indonesia	6.5	6.3	5.8	5.4	5.8	0.5	–0.1	–0.2
Lao P.D.R.	8.0	7.9	8.2	7.5	7.8	–0.1	–0.3	0.2
Malaysia	5.1	5.6	4.7	5.2	5.0	0.0	0.3	–0.2
Myanmar	5.9	7.3	7.5	7.8	7.8	0.7	0.9	0.9
Philippines	3.6	6.8	7.2	6.5	6.5	0.4	0.4	1.0
Singapore	6.0	1.9	4.1	3.6	3.6	0.5	0.2	0.0
Thailand	0.1	6.5	2.9	2.5	3.8	–0.2	–2.8	–1.2
Vietnam	6.2	5.2	5.4	5.6	5.7	0.1	0.2	0.3
Pacific Island countries and other small states[1]	**5.4**	**3.5**	**2.6**	**3.5**	**4.6**	**–0.6**	**–0.1**	**0.1**
Emerging Asia[2]	**7.9**	**6.7**	**6.5**	**6.7**	**6.8**	**0.2**	**0.2**	**0.1**
Asia	**5.9**	**5.3**	**5.2**	**5.4**	**5.5**	**0.1**	**0.1**	**0.1**

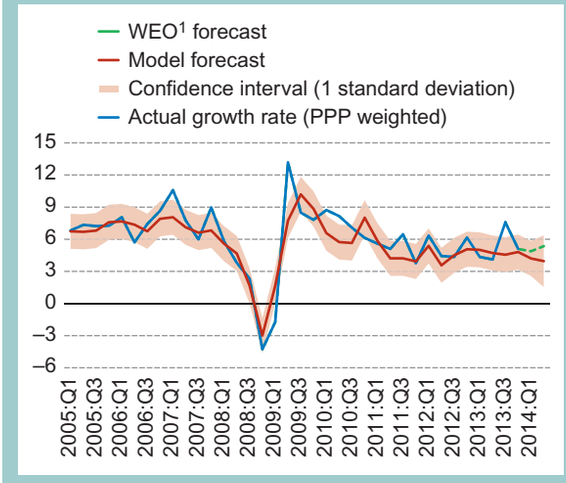
Source: IMF staff projections.
[1] Simple average of Pacific Island countries and other small states which include Bhutan, Fiji, Kiribati, Maldives, Marshall Islands, Micronesia, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.
[2] Emerging Asia includes China, India, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam. India's data is reported on a fiscal year basis.

Figure 1.12
Selected Asia: Contributions to Projected Growth
(Year-over-year; in percentage points)



Sources: IMF, *World Economic Outlook* database; and IMF staff calculations.
[1] ASEAN includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

Figure 1.13
Indicator Model for Asia: Projected Versus Actual Real GDP Growth
(Quarter-over-quarter annualized; in percent)

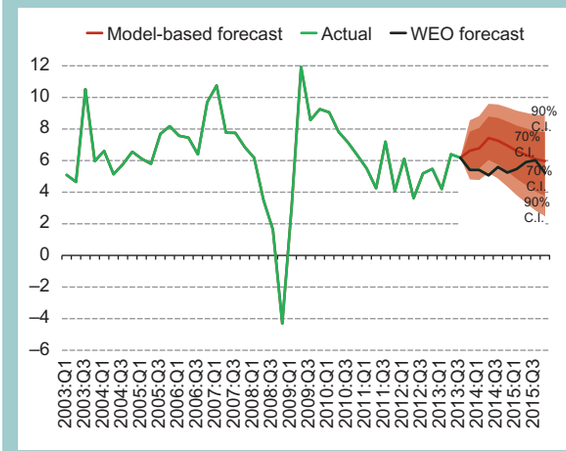


Source: IMF staff calculations.
[1] IMF, World Economic Outlook database.

labor markets and, particularly in ASEAN (see Theme 4 below), solid credit growth (Figure 1.12).[1] The slowing pace of capital inflows may be a countervailing factor, although its impact on credit growth is less than its effect on asset prices (Box 1.1 and Box 1.2). Recent indicators are consistent with this outlook, showing a modest upturn going into 2014 (Figure 1.13). This is also borne out by estimates of future growth rates extracted from equity prices (Figure 1.14).

Inflation is expected to remain contained across much of the region (Figure 1.15). Output gaps are expected to close only gradually across Asia and commodity prices are forecast to remain soft in the near term (April 2014 *World Economic Outlook*). Indeed, in Korea, Thailand, and New Zealand, inflation is expected to remain well below the official central bank target. As in 2013,

Figure 1.14
Gordon Equity Price Model for Asia: Projected Versus Actual Real GDP Growth[1]
(Quarter-over-quarter annualized; in percent)

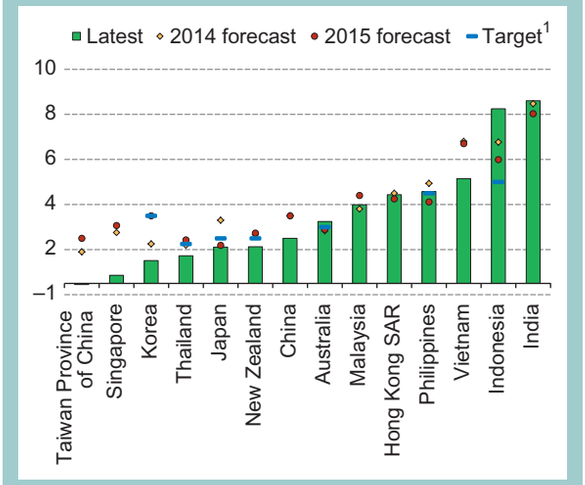


Source: IMF staff calculations.
[1] C.I. = confidence interval; WEO = IMF, World Economic Outlook database.

India and Indonesia are likely to confront relatively high inflation rates, but price pressures are expected to be on a downward path, in part due to the recent tightening of monetary policy.

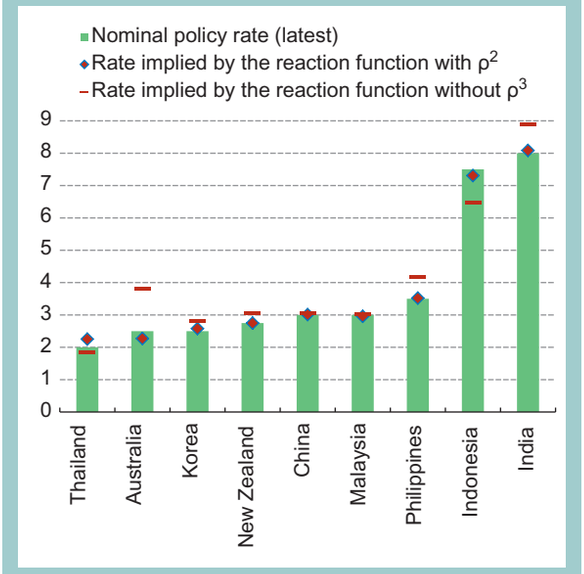
[1] With the exception of business confidence in Japan, (consumer and business) sentiment indicators have moved mostly sideways across most countries in the region. However, their link with the cycle appears generally weak.

Figure 1.15
Asia: Headline Consumer Price Inflation
(Year over year; in percent)



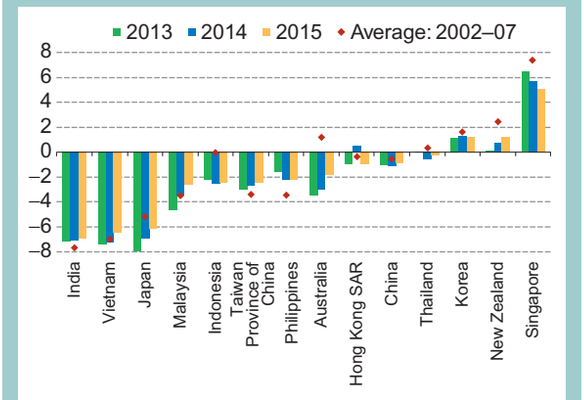
Sources: CEIC Data Company Ltd.; Haver Analytics; country authorities; IMF, World Economic Outlook database; and IMF staff projections.
[1] Target refers to the midpoint of the headline inflation target band (Australia, Indonesia, Japan, Korea, New Zealand, and the Philippines). Core inflation and core inflation target band midpoint (Thailand).

Figure 1.16
Asia: Estimated Central Bank Reaction Functions[1]
(In percent)



Sources: Haver Analytics; and IMF staff estimates.
[1] Estimated as of January 2014 with monthly data.
[2] Estimated as $i_t = \rho^* i_{t-1} + (1-\rho)^*(\alpha + \gamma_1 E_t[\pi_{t+1} - \pi^*] + \gamma_2 E_t \text{OutputGap}_{t+1} + \delta_1 \text{REER}_t + \delta_2 \text{US\_3Myield}_t) + \varepsilon_t$.
[3] Estimated as $i_t = \alpha + \gamma_1 E_t[\pi_{t+1} - \pi^*] + \gamma_2 E_t \text{OutputGap}_{t+1} + \delta_1 \text{REER}_t + \delta_2 \text{US\_3Myield}_t + \varepsilon_t$.

Figure 1.17
Selected Asia: Cyclically Adjusted Fiscal Balance
(In percent of GDP)



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

Monetary and fiscal policies are expected to remain broadly accommodative. On the monetary front, policy rates are currently in line with levels implied by past behavior of central banks (Figure 1.16). Reflecting subdued inflation and limited demand pressures, monetary policy is expected to remain generally accommodative in 2014, although in a few cases (Indonesia, and to a lesser extent India) interest rate hikes are likely to weigh on growth. On the fiscal front, policies will be mostly neutral in 2014 with underlying fiscal balances mostly unchanged compared with 2013 (Figure 1.17). Only Japan and Malaysia are expected to undergo a relatively more noticeable fiscal tightening in 2014 (which will continue into 2015).

Macroeconomic developments will differ across the region.

- In *China*, the unveiling of the government's reform agenda in 2013 has boosted sentiment but progress on economic rebalancing remains incomplete and investment continues to be a major growth driver (see Theme 3 below). However, there are some burgeoning signs that consumption is set to play a larger role in the economy and efforts to cool down credit growth, raise the cost of capital, and dampen investment growth should continue. Growth is expected to slowly decelerate to

Box 1.1

Are Capital Flows and Global Risk Aversion Driving Asset Prices in Asia?[1]

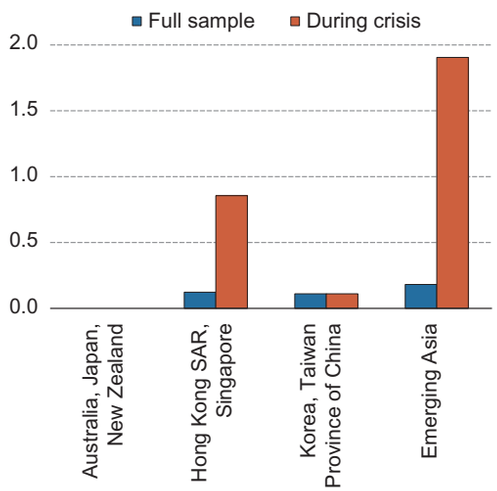
Since the mid-2000s, capital flows to Asia have become increasingly large and volatile.[2] At the same time, asset prices in Asia have also experienced large swings, in many instances coinciding with episodes of capital flow surges and reversals and underscoring the potential vulnerability to global bouts of volatility. This box estimates the effects to which capital flows are impacting asset returns and volatility of equities, bonds, and currencies using a Multivariate GARCH (MGARCH) model. The model accounts for the time-varying nature of asset price volatility as well as interdependencies between those volatilities. The results point to significant effects of capital flows and shifts in global risk sentiment on asset returns and volatility, especially during crisis periods.

To quantify the impact of capital flows and global risk aversion on asset prices, an MGARCH model is estimated on stock returns, bond yields, and exchange rates for 13 Asian economies. The MGARCH model, which allows for time-dependent volatility, is appropriate in this case as it is well-established that asset returns exhibit a significant volatility clustering—that is, higher volatility tends to be followed by high volatility. To measure capital flows, weekly EPFR portfolio flow data from 2004 to 2013 are used along with the Chicago Board Options Exchange Volatility Index (VIX) to control for global risk aversion. The model also allows for a shift in volatility during August 2008 to June 2009.

The estimation results show that capital inflows generally have an economically significant impact on financial asset returns, especially during the global financial crisis.

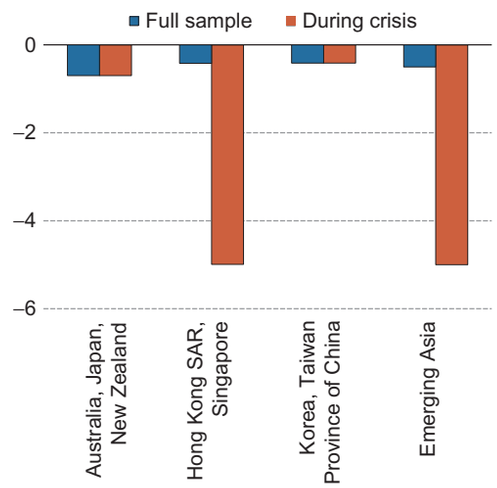
- In the case of the *stock market*, the average impact of foreign equity flows in industrial Asia (Japan, Australia, and New Zealand) seems to be small. However, in the rest of Asia, a one standard deviation increase of equity inflows is associated with a 0.2 percentage point increase (on average) in stock returns. Furthermore, this impact rose sharply during the global financial crisis (Figure 1.1.1), which could be due to a number of factors (*not* captured in the model specification), including changes in liquidity and investor base.
- In the *bond market*, the average effect of foreign bond flows on yields is generally smaller compared with that of equity returns, but also tends to increase substantially during the global financial crisis (Figure 1.1.2) for emerging Asia, Hong Kong SAR, and Singapore.

Figure 1.1.1
Impact of Equity Inflows on Equity Return[1]
(Percentage point change in equity returns per one-standard-deviation increase in equity flows)



Source: IMF staff estimates.
[1] Emerging Asia includes China, India, Indonesia, Malaysia, the Philippines, and Thailand.

Figure 1.1.2
Impact of Bond Inflows on Change in Bond Yields[1]
(Basis point change in bond yields per one-standard-deviation increase in bond flows)



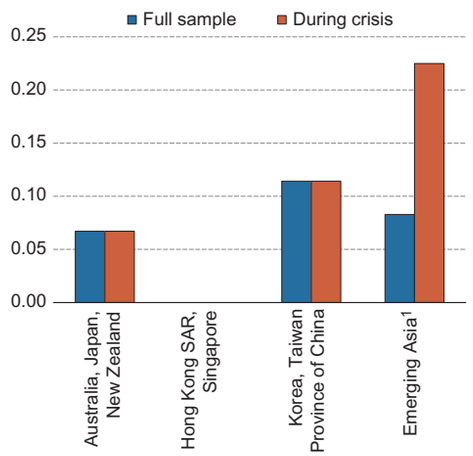
Source: IMF staff estimates.
[1] Emerging Asia includes China, India, Indonesia, Malaysia, the Philippines, and Thailand.

[1] The main authors are Nasha Ananchotikul and Longmei Zhang.
[2] See IMF *Regional Economic Outlook: Asia and Pacific,* April 2011, for details.

Box 1.1 *(continued)*

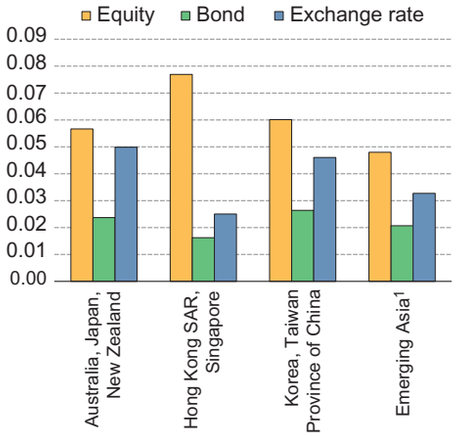
- For *exchange rate*s, the effect of portfolio flows in *emerging* Asia is comparable to the other country groups considered in noncrisis periods (Figure 1.1.3). In addition, the effect is significantly larger during the crisis (subsample) period, driven mainly by India and Indonesia. There is also some evidence that equity flows have a bigger impact on exchange rate movements than bond flows.[3]
- Global risk aversion has a significant effect on the level and volatility of Asian asset prices (Figure 1.1.4). There is also differentiation: a rise in risk aversion (as measured by the VIX) benefits the yen but leads to weaker EM Asian currencies; the impact on local equity market volatility depends on the degree of financial openness (Figure 1.1.5); and the impact on bond market volatility is linked to the level of domestic inflation (Figure 1.1.6). This suggests that financial conditions in countries with weaker fundamentals might be more exposed to changes in global risk aversion. The effect of capital flows on asset prices is also likely to depend on the exchange rate regime; indeed, the effect of capital flows (and global volatility) on equity returns and volatility appears particularly large in Hong Kong SAR and Singapore.

Figure 1.1.3
Impact of Portfolio Flows on Exchange Rate
(Percentage point appreciation per one-standard-deviation increase in portfolio flows)



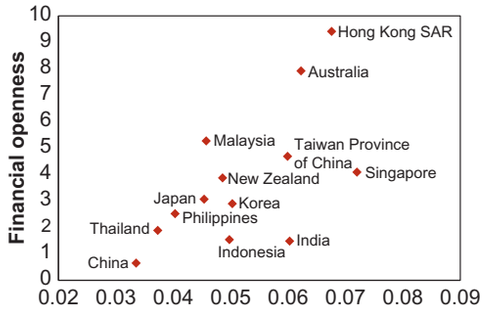
Source: IMF staff estimates.
[1] Emerging Asia includes China, India, Indonesia, Malaysia, the Philippines, and Thailand.

Figure 1.1.4
The Coefficient of the VIX on Variance of Asset Returns



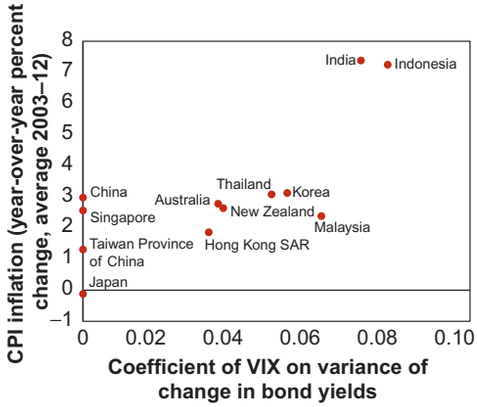
Source: IMF staff estimates.
[1] Emerging Asia includes China, India, Indonesia, Malaysia, the Philippines, and Thailand.

Figure 1.1.5
Impact of VIX on Equity Volatility versus Financial Openness[1]



Source: IMF staff estimates.
[1] Financial openness is measured as absolute size of portfolio liabilities to GDP, 2003–12 average.

Figure 1.1.6
Impact of VIX on Bond Volatility versus Inflation



Source: IMF staff estimates.

[3] This is also supported by empirical analysis when the impact of equity and bond inflows on exchange rate are studied separately.

Box 1.2

Have Capital Inflows Boosted Credit in Asia?[1]

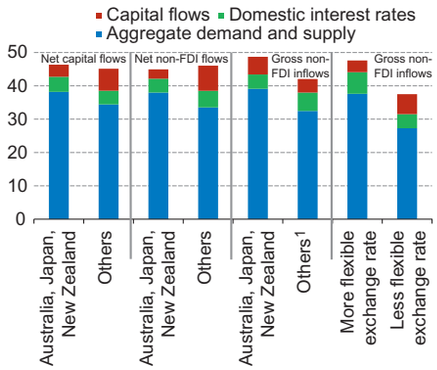
Between the early 2000s and mid-2013 capital inflows to Asia were buoyant—with a sharp, but brief, downswing at the time of the global financial crisis. During this period credit growth has also boomed across most of the region. However, the literature on the link between the two is somewhat inconclusive and the empirical correlation between inflows and credit growth is weak.[2]

Here a VAR model for 14 Asian economies is estimated at quarterly frequency between 2000 and 2013.[3] The results suggest that:

- The contribution of capital flows to the variation in credit growth is generally small: only 9 percent of the variation in real credit growth is explained by net capital flows after four quarters (Figure 1.2.1). This result holds when FDI flows are excluded from the net capital flows measure as well as when gross inflows are used (instead of net flows as in the baseline specification). Broadly consistent results are also obtained using a similar model estimated with monthly data (EPFR), as shown in Figure 1.2.2.[4]
- The contribution of capital flows to the variation in credit growth is higher at 14 percent for ASEAN economies (excluding Singapore). In particular, the contribution of net capital flows to domestic credit growth is negligible in Hong Kong SAR and Singapore (likely reflecting their roles as international financial centers).
- In general, the impact of capital flows on credit growth is smaller for those with more flexible exchange rates, consistent with the evidence in Magud, Reinhart, and Vesperoni (2012).

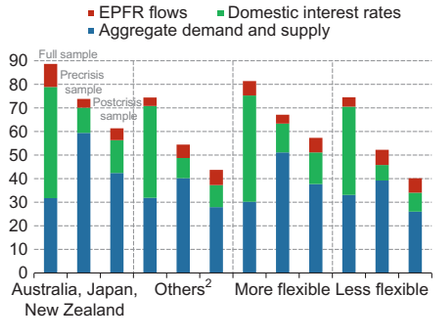
The analysis also suggests that domestic (demand and financial) conditions will continue to play an important role in determining credit developments. But going forward, because capital flows—including gross bank flows— have become more volatile, they could be playing a bigger role in determining domestic credit conditions. The declining share of flows that is being intermediated through the banking system, with a shift in composition to portfolio flows, could also increase the importance of capital flows "shocks" in explaining credit growth. Finally, the results do not imply that capital flows are not having a broader impact on domestic financial conditions in Asia. Instead, the effects of capital flows are likely increasingly being transmitted through their impact on bond and equity prices, rather than domestic credit.

Figure 1.2.1
Variance Decomposition of Real Credit Growth to the Private Sector
(In percent, after four quarters)



Sources: CEIC Co. Ltd.; Haver Anaytics; IMF, International Financial Statistics and World Economic Outlook databases; and IMF staff calculations.
[1] Others include China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, Thailand, and Vietnam.

Figure 1.2.2
Variance Decomposition of Real Credit Growth to the Private Sector[1]
(In percent, after 12 months)



Sources: CEIC Co. Ltd.; Haver Anaytics; IMF, World Economic Outlook database; and IMF staff calculations.
[1] Universe of funds limited to those reporting in 2005.
[2] Others include China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, Thailand, and Vietnam.

[1] The main authors are Sidra Rehman and Edda Zoli.
[2] Sizable capital inflows have been found to be good predictors of credit booms (Mendoza and Terrones, 2008; IMF, 2011b) but the limited empirical evidence on credit growth determinants in Asia suggests that domestic factors are more important drivers (Elekdag and Han, 2012).
[3] The baseline VAR includes the following variables: real GDP growth, the inflation rate, short-term interest rates, growth in real credit to the private sector, net capital flows in percent of GDP, and the VIX as exogenous variable. Shocks were identified using the Cholesky decomposition, with the five endogenous variables ordered as listed. Results are robust to alternative orderings.
[4] Monthly GDP is estimated using the Chow-Lin method and industrial production series. Combined equity and bonds EPFR flows (in percent of GDP) are used as a proxy for capital flows. The VAR also includes the nominal effective exchange rate as additional endogenous variable. Results are robust to alternative ordering of the variables.

7.5 percent in 2014 and 7.3 percent in 2015 to a more sustainable path. The inflation outlook is expected to remain benign (with headline inflation averaging 3 percent in 2014 and 2015), but concerns about overinvestment and credit quality should mean a continuation of the steady withdrawal of monetary support for the economy. This should imply slower credit growth and higher interest rates during the course of the year.

- *Japan's* GDP growth picked up to 1.5 percent in 2013 and industrial production, retail sales, and consumer confidence have been strong. While wage growth has remained low, asset prices and expanding credit have helped underpin domestic demand. A weaker yen has benefited exports, albeit less than expected so far. Going forward, fiscal consolidation will be a growing headwind and supportive measures (including higher public investment and corporate tax cuts) will partly offset the impact of the consumption tax hike and the phasing out of past stimulus. However, a weaker currency and strong monetary support should ensure relatively loose financial conditions that will support private domestic demand. Overall, GDP growth is expected to remain above potential but would slow to 1 percent in 2015. Headline inflation will rise to 2.8 percent this year (around 1 percent of which is due to the consumption tax hike) and moderate to 1.7 percent in 2015. Underlying measures of inflation and inflation expectations are expected to stay in the 1–2 percent range.
- *India*'s growth remained subdued in 2013–14 with GDP at factor cost projected to grow by 4.4 percent. The slowdown has become generalized across sectors of the economy as supply bottlenecks continued to bind. In 2014–15 growth should improve to 5.4 percent (still below trend) as approved investment projects are implemented, exports benefit from improved competitiveness and global growth, and business and consumer confidence have been lifted by recent policy actions. However, inflation will remain an important challenge even though it is expected to moderate (reaching 8.5 percent year-over-year by end-2014 and 7.5 percent by end-2015).
- *Australia's* economy is likely to grow below trend as the investment phase of the mining boom passes its peak and begins to decline. Growth is expected to remain broadly stable at 2.6 percent in 2014, with a modest pickup going in 2015. New Zealand, in contrast, should accelerate in 2014 as post-earthquake reconstruction gathers steam, with private consumption and external demand strengthening.
- *Korea's* economy continued to struggle with a two-speed economy in 2013 with a robust performance by exporters but moribund domestic demand. In 2014–15 the recovery should continue with growth accelerating to 3.7 percent as exports are further lifted by trading partner demand and domestic demand, although still subdued, benefits from past fiscal stimulus and accommodative monetary policy.
- *ASEAN's* growth momentum lost some steam in 2013, impacted by higher inflation and rising interest rates in Indonesia and political uncertainties in Thailand (see Theme 4). Developments in *ASEAN* are likely to remain uneven. *Indonesia* will slow (to 5.4 percent) this year as higher real interest rates weigh on the domestic economy even as the current account improves from a weaker currency. In *Thailand*, political tensions have hurt sentiment and will slow the economy in the first half of 2014 as private demand weakens and public investment plans are delayed. However, *Malaysia* and *the Philippines* are on a more positive trajectory with growth expected to remain robust in 2014–15.
- In *frontier and developing economies* (FDEs), the economic outlook is for continued solid growth underpinned by the ongoing recovery in world trade. In *South Asian* FDEs, growth is projected to average 6.5 percent in 2014–15, with domestic demand in *Bangladesh* recovering as activities normalize following a year of political unrest. However, in *Cambodia*, political tension about the electoral process may hurt sentiment and hold back investment in 2014 even though

the impact has been limited so far. In addition, growing macroeconomic imbalances (partly driven by high credit growth) in *Lao People's Dem. Rep.* and *Mongolia* are an important ongoing risk (Figure 1.18).[2] Excluding Papua New Guinea, where rapid growth has been fueled by an LNG boom, average growth in *PICs* and *Small States* is expected to remain steady in 2014–15 but staying well below the regional average.

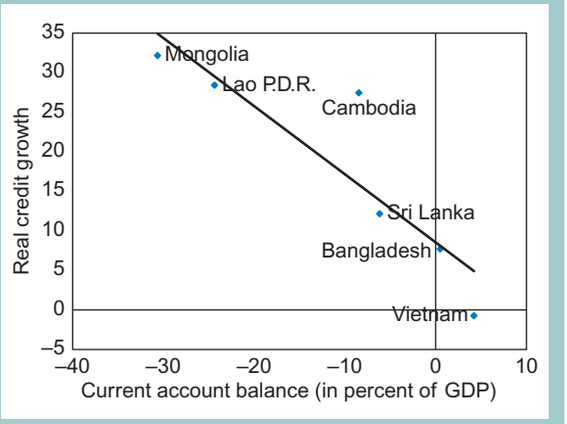
The region's fundamentals appear resilient.

- *The financial stability heat map suggests relatively moderate risks.* Asset prices do not appear greatly out of line with fundamentals. There are, however, pockets of concern—including elevated housing prices in Hong Kong SAR, and high credit growth in Malaysia and Singapore (Figure 1.19) as well as in FDEs.

Figure 1.18

Current Account and Real Credit Growth

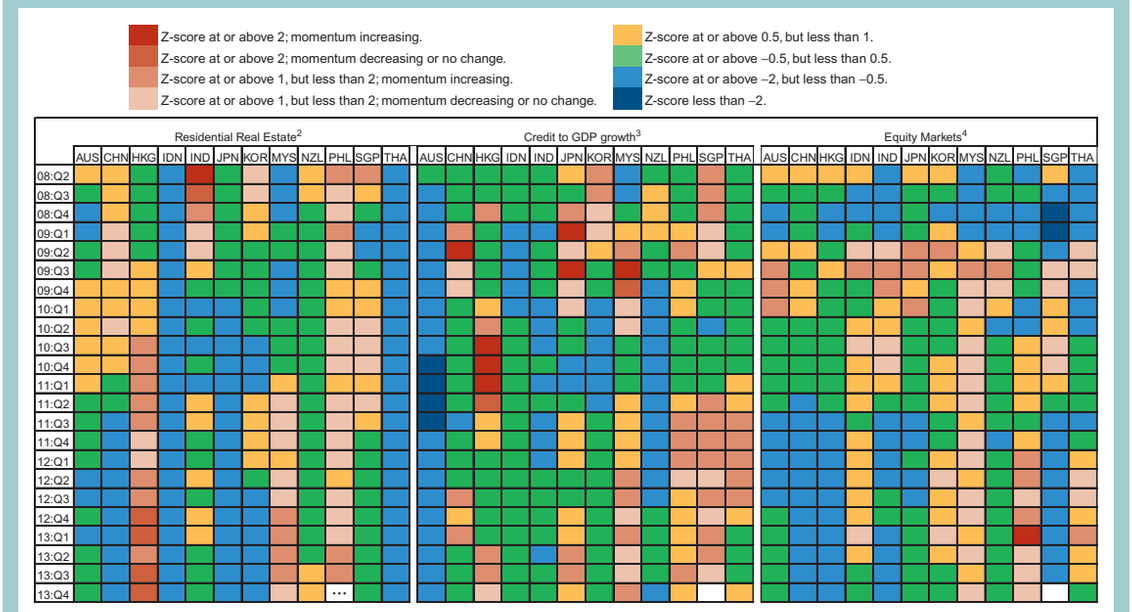
(In percent, average over 2011–13)



Sources: IMF, World Economic Outlook and International Financial Statistics databases; and IMF staff estimates and calculations.

Figure 1.19

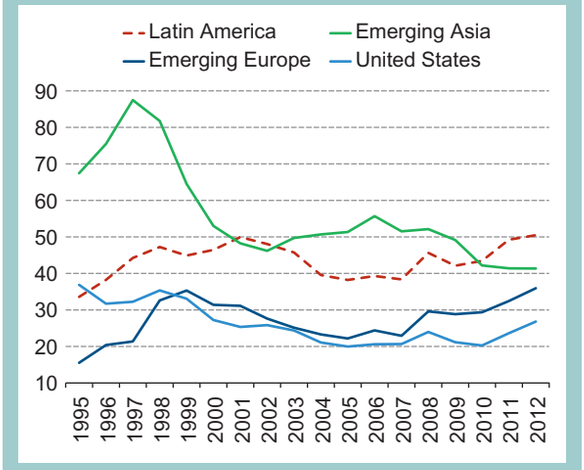
Asia Financial Stability Heat Map[1]



[1] Colors represent the extent of the deviation from long-term median expressed in number of median-based standard deviations (median-based Z-scores). Medians and standard deviations are for the period starting 2000:Q1, where data is available.
[2] Estimated using house-price-to-rent and price-to-income ratios.
[3] Year-on-year growth of credit-to-GDP ratio.
[4] Estimated using price-to-earnings and price-to-book ratios.

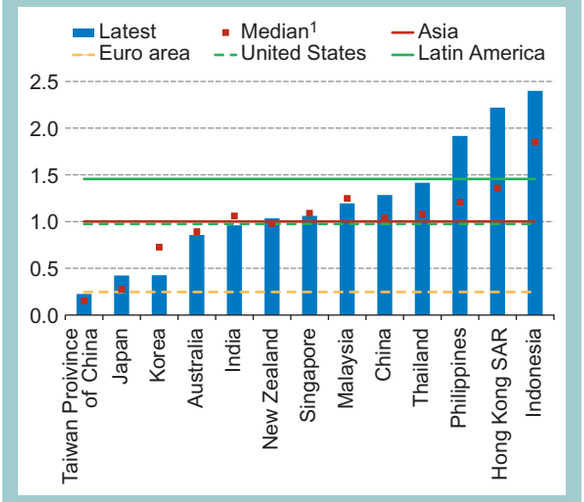
[2] There is a strong association between real credit growth and current account deficits in the major FDEs and causality tests indicate that credit growth has been a major predictor of current account imbalances.

Figure 1.20
Debt-to-Equity Ratio
(In percent; median)



Source: IMF, Corporate Vulnerability Utility.

Figure 1.21
Selected Asia: Return on Bank Assets
(In percent)



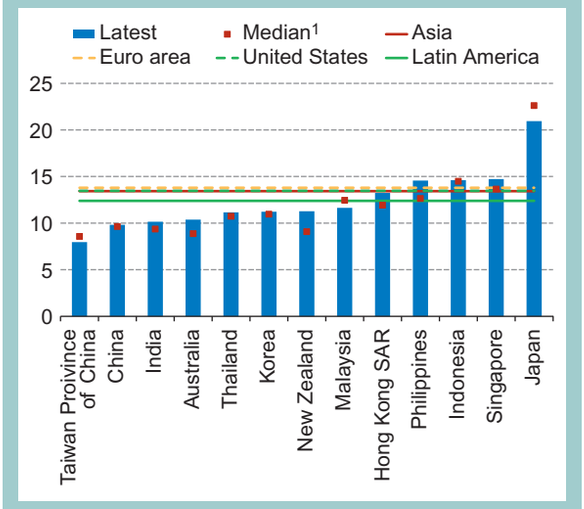
Sources: Bankscope; and IMF staff calculations.
[1] Median for 2000–12. Latest values available since 2012 are used.

- *Corporate vulnerabilities appear manageable.* Average corporate leverage, especially in emerging Asia, has started to increase in the aftermath of the global financial crisis, as bank credit to non-financial firms and corporate issuance have picked up.[3] But this rise is modest in comparison to the spike in leverage observed in the mid-1990s (Figure 1.20). There are, however, concerns largely related to the concentration of leverage among weaker firms in India and Indonesia and the potential for greater corporate strains in China as borrowing costs rise and growth slows (see Chapter 2).
- *Household debt has increased, but also appears manageable.* Credit to households has risen rapidly in Korea, Malaysia, and Thailand, and household debt-to-GDP ratios now stand above 60 percent in these countries (as well as in Hong Kong SAR and Singapore). The strength of household balance sheets in these economies is dependent on house price prospects, and across most of Asia, housing valuation ratios do not appear to be out of line with historical levels (see Chapter 2). There are exceptions to these trends, however, including Hong Kong SAR, New Zealand, and Singapore where high house price increases have led policymakers to introduce or tighten macroprudential measures (see Chapter 4 and Box 2.1).
- *Banks have continued to strengthen their balance sheets* (Figures 1.21–1.24). Tier 1 capital levels have increased across many countries, although they remain below those in other regions, including Latin America. Bank liquidity, as conventionally defined, has declined in Malaysia, Indonesia, Singapore, and India and is below average levels in other regions.[4] Banks' profitability has improved as growth has boosted non-interest revenues (with the notable exception of Korean banks). Finally, non-performing loans—which, however, are a backward-looking indicator—have been declining across the region.

[3] While the simple average of the leverage ratio in emerging Asia increased by 8 percentage points in 2012, the median increased by less than 1 percentage point during the same period. Other measures (for example, using debt weights) also show a moderate increase in the average leverage (Chapter 2).

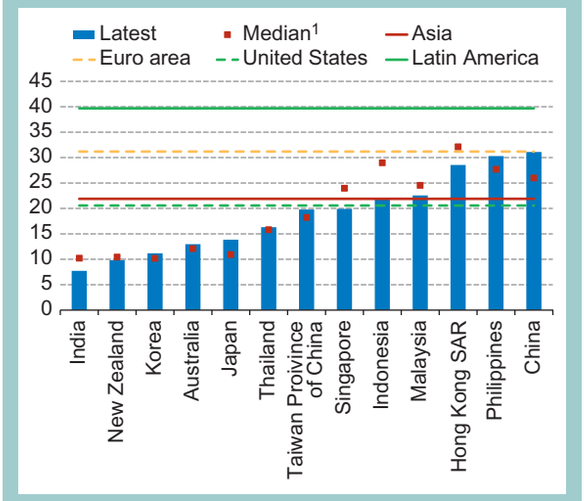
[4] In India, for instance, assets for the purpose of meeting the statutory liquidity requirement stand at about 26 percent of net liabilities.

Figure 1.22
Selected Asia: Tier 1 Capital Ratio
(In percent)



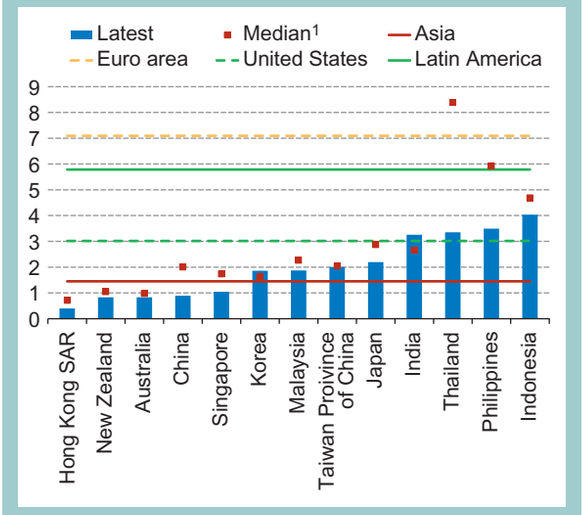
Sources: Bankscope; and IMF staff calculations.
[1] Median for 2000–12. Latest values available since 2012 are used.

Figure 1.23
Selected Asia: Liquidity Ratio
(In percent)



Sources: Bankscope; and IMF staff calculations.
[1] Median for 2000–12. Latest values available since 2012 are used.
Total liquid assets/total deposits + short-term borrowing + other short-term liabilities. In India's case, assets used for the purpose of meeting the statutory liquidity requirement are about 26 percent of net liabilities.
The estimates shown in this chart exclude such assets.

Figure 1.24
Selected Asia: Nonperforming Loans Ratio
(In percent)



Sources: Bankscope; and IMF staff calculations.
[1] Median for 2000–12. Latest values available since 2012 are used.
The coverage may differ significantly from core financial soundness indicator data reported to the IMF.

Theme 1: Preparing for the Risks Ahead

The external environment is uncertain, particularly for emerging markets, and Asia is facing various idiosyncratic domestic risks. There are four broad risks confronting the region in 2014 and 2015:

- *A continued tightening of global liquidity.* As growth in the United States improves, global interest rates will rise and Asia will face a further tightening in financial conditions. Bouts of capital flow and asset price volatility are likely along the way with exchange rates, equity prices, and government bond yields affected by changes in global risk aversion and capital flows (see Box 1.1). Economies with weaker fundamentals, higher inflation, and a greater reliance on global finance and trade are likely to be the most affected. In some cases, the impact could be amplified by domestic

financial vulnerabilities arising from leverage among firms and households or balance sheet risks in the banking system, although these are generally manageable (Chapter 2). For households, higher market interest rates could coincide with declines in housing prices, wealth, and, ultimately, consumption. For firms, the effect of weaker exchange rates on unhedged foreign exchange liabilities could lead to financial distress and lower investment.

- *A sharper-than-envisaged slowdown and financial sector vulnerabilities in China.* Risks associated with recent rapid credit growth and increasing disintermediation into the nonbank financial system may come to the fore, particularly as the cost of capital rises and overall growth slows. Nonbank financial intermediation continues to grow rapidly and nonbank financial intermediaries' assets account for about 25 percent of GDP.[5] This represents an important source of systemic risks, and strains have already been seen in the default of some trust products. High local government debt is another potential systemic issue that could amplify vulnerabilities and lead to a deterioration of banks' asset quality. Looking ahead, there is likely to be continued news of credit problems among the trusts or potential debt servicing problems among local governments. As in recent months, this could spark adverse financial market reaction both in China and globally. While structural reforms hold the promise of sustainable, balanced growth (see Theme 3 below), their transitional costs could also weaken activity in the near term. A sharper-than-envisaged slowdown in China would also have significant spillovers for the rest of the region, especially in economies linked to the regional supply chain and commodity exporters.

- *Less effective Abenomics.* In Japan, there is a risk that policy measures could prove less effective than envisaged in terms of supporting growth, failing to increase nominal wages, sustaining the recent increase in inflation expectations, or boosting private investment (see Theme 2 below). Economies with strong trade and FDI linkages with Japan, such as Korea, Thailand, and Indonesia, are likely to be among the most exposed to such an outcome.

- *Political/geopolitical tensions and uncertainty.* Domestic and global political tensions could cause trade disruptions or weaken growth. Some countries in the region will have elections (India and Indonesia) while, in others, domestic political tensions have affected investment and activity (Thailand and Bangladesh). Strong intraregional trade integration, which has contributed to greater business cycle synchronization and spillovers over the years (Chapter 3), could transmit geopolitically related disruptions along the regional supply chain. Regional integration and policy coordination efforts could also be adversely affected.

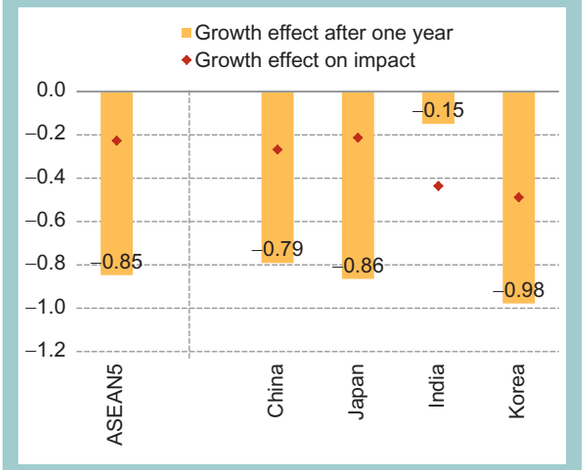
Policy simulations and event studies are consistent with a significant effect on Asian economies of an *unexpected* tightening in global liquidity.

- Simulations show that a positive U.S. growth shock, which would induce higher U.S. interest rates as a result of *tighter monetary* policy, would benefit Asia's growth.[6] However, if the rise in long-term U.S. yields went beyond what would be justified by a stronger U.S. economy, the growth of Asian economies might instead weaken. For instance, the *combination* of a 1 percent positive growth shock in the U.S. with a 100 bps shock to long-term government bond yields (beyond that driven by the response of U.S. monetary policy to higher U.S. growth) could generate a moderate growth slowdown in most Asian economies, reflecting

[5] This is based on the definition of the Financial Stability Board; the data are from the IFS and consists of claims of nonbank financial corporations on other depository corporations at the end of 2012. In China's case, it includes, for example, trust loans, entrusted loans, and undiscounted bankers' acceptances.

[6] The simulations are run using the *IMF's Flexible Suite of Global Models (FSGM)* and an alternative *Global Vector Autoregression (GVAR)* model. Figure 1.25 and associated text are based on the GVAR results.

Figure 1.25
Impact of a Combined 1 Percent U.S. Growth and 100 Basis Points Interest Rate Shock on Asia
(In percentage points)



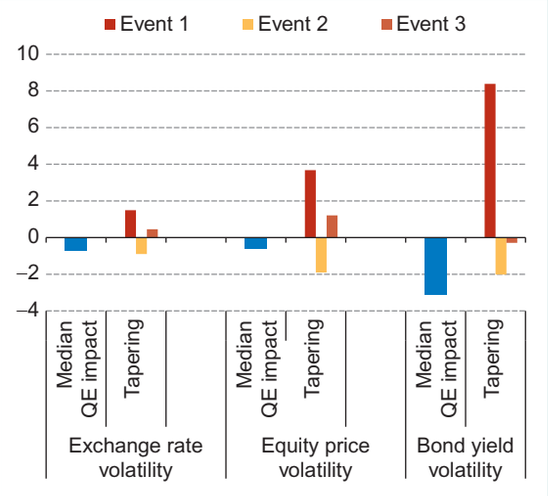
Source: IMF staff estimates.

weaker domestic demand as well as trade (including through third-market countries) and commodity-price linkages (Figure 1.25).[7] That slowdown would be sharper in economies that attempt to resist the exchange rate depreciation that would normally occur in such a scenario.

- *Event studies* also suggest significant effects of unexpected news regarding tapering on asset prices. QE announcements have tended to reduce implied volatilities in equity returns, bond yields, and exchange rates (Figure 1.26). By contrast, the May 2013 tapering episode increased financial volatility in all three major asset markets across Asia. Subsequent announcements have led to lower market volatilities, perhaps reflecting market anticipation of these policies. QE announcements were also generally associated with an increase in the size of the upside tail of the distribution of future equity prices (based on options markets), while the May 2013 tapering increased the downside tail risk (Figure 1.27).

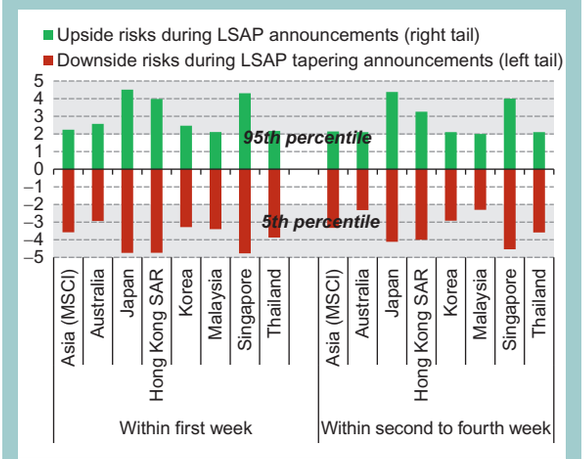
[7] See Cashin and others (2012) for a description of the methodology and an application.

Figure 1.26
Impact on Volatility of Quantitative Easing and Tapering Announcements During First Three Months[1]
(In percentage points)



Sources: Bloomberg L.P.; and IMF staff calculations.
[1] QE = quantitative easing. QE tapering events 1, 2, and 3 correspond to May 2013, September 2013, and January 2014 (median of weekly changes since the events are shown).

Figure 1.27
Estimated Impact of Unconventional Monetary Policies on Asian Equity Prices[1]
(Maximum t-statistic during LSAP 1–3 and tapering events)



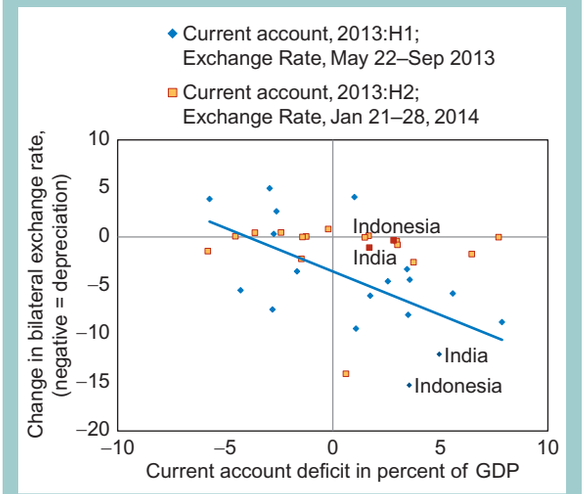
Source: IMF staff estimates.
[1] LSAP = large-scale asset purchase. Maximum upside and downside risks during the specified periods are shown.

How should policies preempt and respond to these downside risks?

The policy response to adverse shocks will differ based on countries' fundamentals and vulnerabilities. Over the past year, countries in the region have tackled the challenges associated with rising global interest rates and slowing growth due to structural impediments. Actions taken have included policy rate hikes, increases in fuel prices, and other supply-side measures in India and Indonesia as well as a significant fiscal adjustment in Malaysia (encompassing tax increases, spending cuts, and fuel price adjustments). These efforts have started to pay dividends in Indonesia and India, as inflation is on a downward trend and the current account deficits in both countries are on a declining path. Despite greater financial volatility, Asian markets have weathered the January 2014 spike in global risk aversion well, unlike other EMs that had delayed policy adjustments (Figure 1.28). However, the transition remains unfinished. Going forward, continuing to improve fundamentals and ensuring a coherent, well-communicated macroeconomic policy mix will be key to reducing the fallout from global financial shocks; it will also allow for a positive differentiation for Asian economies by investors and sustain Asia's resilience and growth leadership.

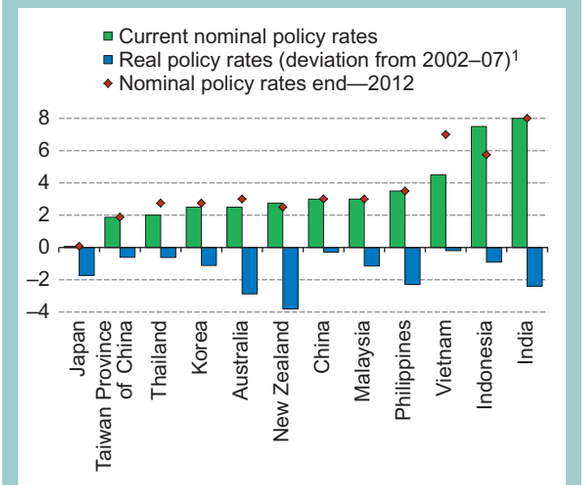
- *Monetary policy.* Across most of *emerging* Asia, given the relatively benign near-term inflation outlook, countries appear to have space to maintain the current supportive stance of monetary policy. However, a gradual normalization of monetary conditions should be considered as economic slack diminishes and risks recede (Figure 1.29). In *India*, further increases in the policy rate will likely be needed to put inflation firmly on a downward path, while *Indonesia* should stand ready to further increase policy rates to fend off potential inflationary pressures. In both countries, if balance of payments pressures re-intensify, a policy tightening would help reduce vulnerabilities and contain the inflationary impact of any exchange rate depreciation. Elsewhere in emerging Asia, in the event of an abrupt tightening of global financial conditions, many of the region's central banks

Figure 1.28
Exchange Rate Change Versus Current Account Deficit
(In percent)



Sources: Bloomberg L.P.; IMF, World Economic Outlook database, and Global Data Source; and IMF staff calculations.

Figure 1.29
Selected Asia: Policy Rates
(In percent)



Sources: CEIC Data Company Ltd.; Haver Analytics; Consensus Economics; and IMF staff calculations.
[1] Real policy rate is based on 1-year ahead inflation forecast from Consensus Economics. For Japan the uncollateralized overnight rate is used.

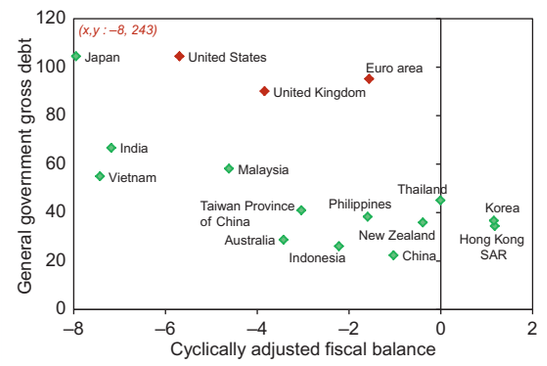
could capitalize on low inflation and their policy credibility to loosen monetary policy and cushion the blow on growth—as some of them did in 2013. In *Japan*, the inflation momentum is expected to slow this year given fiscal adjustment. Risks of an incomplete exit from deflation means that monetary policy actions will remain focused on raising inflation expectations. In *China*, the challenge is to slow the growth of credit, especially in the shadow banking sector, and minimize the buildup of risks in the financial sector without causing a steep deceleration in growth. This warrants continued interest rate liberalization and slower M2 growth, even if growth were to modestly undershoot the official target. In many FDEs, particularly *Mongolia*, *Lao People's Dem. Rep.*, and *Cambodia,* tightening monetary policy to curb credit growth will also be important to help reduce external imbalances.

- *Exchange rate and FX intervention policies*. Over the past year, countries have generally pursued flexible exchange rates and used foreign exchange intervention only sparingly in the face of capital flow volatility. This strategy should continue, particularly in the event that balance of payments pressures resume. In countries with more than adequate reserves, some intervention to smooth volatility may also be appropriate.

- *Macroprudential policies*. Macroprudential policies (MPPs) having been used more extensively in Asia than in other regions both before and after the global financial crisis. This has resulted in a tight stance that has helped foster financial stability. The current stance appears broadly justified given the baseline outlook of a steady growth recovery, continued strong credit growth in many countries, and pockets of elevated asset prices (particularly housing prices, see Box 2.1). If there were sharp, unexpected swings in credit or asset prices (either up or down) there is still scope to respond in a countervailing way with a range of MPP tools. In particular, if asset prices or the financial accelerator begin to work in reverse, this may necessitate an easing of some of the measures that were taken in recent years to curb upward pressures in credit or asset prices (Chapter 4).

- *Fiscal policies*. For most countries in Asia, a gradual fiscal consolidation remains appropriate, alongside reforms to raise tax revenues and change the composition of spending so as to prioritize infrastructure and social spending (see IMF, 2013c). This would rebuild the fiscal space needed to cope with future downturns and promote inclusive growth by boosting productivity and helping lower income inequality. Structural fiscal positions are weaker than before the global financial crisis and public debt is high in Japan, India, and to a lesser extent Malaysia (Figure 1.30). In *Japan*, recent fiscal consolidation measures are a welcome step but a concrete medium-term fiscal consolidation strategy beyond 2015 is still needed. In *India*, while public debt and deficits are high, the former is on a sustainable downward trajectory; adhering to the government's path for fiscal adjustment would support confidence and free resources for public investment and social spending. Central government debt in *China* is low, but the size of public debts and deficits

Figure 1.30
Selected Countries: Public Debt and Fiscal Balance
(In percent of GDP; 2013)



Source: IMF, World Economic Outlook database.

is significant once local government debt and off-balance sheet spending are incorporated. There is a need to reverse the upward trajectory of local government debt, accompanied by a reform of intergovernmental fiscal relations that bridges the gap between local government revenue and expenditure responsibilities. Malaysia's medium-term adjustment plan will lessen its fiscal vulnerabilities while Vietnam ought to take the opportunity of a positive near-term growth outlook to address its fiscal deficit so as to tackle bank and state-owned enterprise (SOE) reforms.

- *Structural reforms.* Potential growth in Asia is still higher than in other regions, and for many economies the quality of specialization and the sophistication of industry and exports bode well for medium-term growth (Box 1.3). Nonetheless, productivity has decelerated in recent years and the region needs a new wave of reforms to boost potential growth and to

Box 1.3

Productivity Growth and Production Structure: The Role of Trade Diversification and Services[1]

Medium-term growth prospects for emerging Asia have recently become a focus of economic debates in the region. Various statistical approaches in IMF (2013c) indicate that the slowdown in potential growth in India and China is partly attributable to a decline in trend total factor productivity (TFP) growth. Given that TFP growth in key Asian economies has decelerated or reached a plateau (ASEAN, with an exception of the Philippines), accelerating TFP growth seems key to boosting potential growth.

An important driver of productivity growth, including in Asia, is the sophistication of exports of both goods and—increasingly with the ICT revolution—services. More sophisticated exports may facilitate structural transformation and moving up the value-added chain, which in turn is a key feature of economic development. Hausmann and Klinger (2006) and Hidalgo (2009) develop a model of structural transformation and empirically show that the speed of structural transformation depends on current goods exports being closely related to other, more sophisticated goods involving higher value-added. In their model higher sophistication and diversification can lead to higher productivity (Hausmann, Hwang, and Rodrik [HHR], 2007).

To assess the effect of sophistication on Asian TFP growth, TFP growth is regressed on measures of sophistication in both services and manufacturing. Other control variables from the productivity growth literature and measures of industry trade diversification are also included. The data consists of a non-overlapping five-year panel of 123 countries from 1991–2012.[2]

Results suggest that (see Table 1.3.1):

- Institutional quality, services export sophistication, and trade diversification are significant drivers of productivity growth.
- While the value of goods trade or sophistication does not seem to matter, goods export diversification appears to be important, potentially because it provides a basis for discovery of productive capacities.[3]

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[1] The main authors are Shanaka J. Peiris and Rahul Anand (APD).
[2] TFP growth is obtained from the Total Economy database 2013 and the results are broadly applicable to using labor productivity data from the WDI database from the World Bank. Goods and services exports sophistication measures are computed as in HHR (2007) and Anand and Peiris (2014), while export diversification is measured by a Theil index calculated by Papageorgiou and Spatafora (2012) using product data at the four-digit SITC level.
[3] The use of the Economic Complexity Index (ECI) rather than export goods sophistication proposed by Hidalgo (2009) is not significant.

(continued)

Box 1.3 *(continued)*

- Services export sophistication is an important driver of productivity growth, probably reflecting the revolution in ICT and the rapid growth in modern services exports in India, the Philippines, and Singapore.
- China and Thailand's current degree of export diversification bodes well for their future TFP growth.

Table 1.3.1

VARIABLES	TFP	TFP	TFP	TFP	TFP	TFP
Initial per capita income relative to U.S.	–0.101***	–0.130***	–0.157***	–0.103***	–0.103***	–0.122***
	0.020	0.027	0.029	0.020	0.020	0.020
Service export sophistication	3.490**			3.134*	3.321*	2.980*
	1.275			1.315	1.326	1.166
Goods export sophistication	–1.450			–1.456	–1.5	
	1.321			1.320	1.317	
Years of schooling	–0.573	0.137	–0.053	–0.569	–0.594	–0.517
	0.375	0.367	0.367	0.375	0.376	0.360
Private bank credit to GDP	–0.0271***	–0.014	–0.012	–0.0278***	–0.0257**	–0.0223**
	0.007	0.008	0.008	0.007	0.008	0.007
Initial agriculture value added to GDP	–0.006	–0.004	0.003	–0.006	–2.30E–3	–0.004
	0.010	0.014	0.013	0.010	0.010	0.010
Government effectiveness	0.0457*	0.0669**	0.0770**	0.0407*	0.0433*	0.0528**
	0.018	0.023	0.024	0.018	0.018	0.017
Old age dependency ratio	–0.16	–0.202	–0.304*	–0.153	–0.145	–0.177
	0.111	0.144	–0.142	0.111	0.113	0.108
Export diversification	–0.880**			–0.880**	–0.837**	
	0.289			0.288	0.289	
ECI	0.539	–0.505	–0.454	0.521	0.507	0.888
	0.598	0.746	0.791	0.598	0.602	0.579
Trade-to-GDP		0.009				
		0.012				
Employment share of industry			–0.154*			
			0.060			
Employment share of services			0.046			
			0.038			
FDI				0.063		
				0.598		
Banking crises					–0.056	
					0.331	
Constant	–6.024	3.235	8.882*	–2.643	–4.122	–17.76*
	12.01	2.825	3.549	12.40	12.46	8.617
Observations	271	298	267	271	267	287
R-squared	0.324	0.169	0.256	0.329	0.318	0.280
Number of countries	75	77	75	75	74	77

Source: IMF staff estimates.
Standard errors are in the second line for each variable.
*** p < 0.01, ** p < 0.05, * p < 0.1

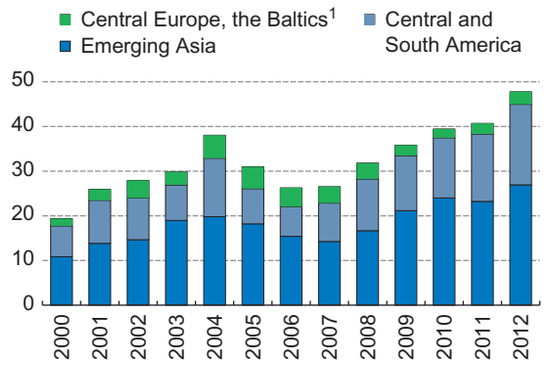
continue to attract inward investment (see Box 1.4). The agenda varies across economies. In *India, Frontier Asia,* and *ASEAN*, it involves removing structural impediments to growth through regulatory reforms and higher infrastructure investment. In *China*, reforms to liberalize the financial system and raise the cost of capital are key to improving resource allocation, reducing the dependence of the economy on credit, and rebalancing growth

Box 1.4

Motives for Foreign Direct Investment in Asia[1]

In 2012, emerging Asia attracted about a quarter of world FDI flows (Figure 1.4.1). In contrast with emerging Europe, FDI inflows had risen sharply since the global financial crisis. FDI inflows to emerging Asia also contributed to an increasing share of global FDI flows into developing economies.

Figure 1.4.1
Emerging Market Economies: Inflows from Foreign Direct Investment, 2000–12
(In percent of world foreign direct investment inflows)



Source: UNCTAD.
[1] The group includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

Better export performance is considered to be one of the main benefits from FDI, and one of the major reasons why countries compete to attract FDI (Kinoshita, 2011). Greater export intensity tends to be associated with those Asian economies that have larger stocks of FDI (such as Malaysia, Thailand, or Vietnam). In addition, increased integration via supply chain links is associated with a greater presence of FDI in the manufacturing sector, which has been associated with higher potential growth.[2]

In addition, while potential growth in Asia is still higher than in the rest of the world, productivity growth across much of the region has slowed in recent years. Against this backdrop, the region needs to continue to push ahead with reforms to improve its institutions and business climate, which would help offset the effects of rising wages on FDI and continue to make Asia an attractive FDI destination.

This box examines the determinants of FDI in 11 Asian countries during 2000–12.[3] The main findings are (see Table 1.4.1):

- Trade openness, institutional quality, and wage costs are important determinants of FDI in Asia;
- Institutional quality is particularly important for FDI in the manufacturing sector;

[1] The main author is Yuko Kinoshita (OAP).
[2] The data include Bangladesh, Cambodia, China, India, Indonesia, Malaysia, Myanmar, the Philippines, Sri Lanka, Thailand, and Vietnam.
[3] Positive spillovers from FDI to exports may be weaker in countries that receive FDI mainly in the primary and/or tertiary sectors.

(continued)

Box 1.4 *(continued)*

- Low wages are complementary to institutional quality. In the absence of good institutions, low wages alone do not seem enough to attract FDI; and
- Low wages and information and communications technology infrastructure are substitutes. Even if a country has relatively high wages, it can offset the adverse impact on FDI through good ICT infrastructure.

Table 1.4.1 Selected Asia: Determinants of FDI, 2000–12[1]

Dependent variable = log (FDI/GDP)

	(1) FE	(2) FE	(3) FE	(4) FE	(5) FE	(6) FE	(7) FE	(8) FE	(9) FE	(10) FE
	All	All	All	All	All	All	All	All	ASEAN5+ China	ASEAN5+ China
Log (GDP)	0.143	0.0783	1.739	0.323	0.284	–0.0632	0.0898	1.640	3.619	–4.996*
	(0.117)	(0.0642)	(1.290)	(0.262)	(0.228)	(–0.0515)	(0.0737)	(1.209)	(1.121)	(–1.889)
Log (GDP per capita)	1.450	1.542	0.0169	1.241	1.275	1.684	1.474	0.147	–1.847	6.915***
	(1.200)	(1.281)	(0.0129)	(1.012)	(1.027)	(1.383)	(1.225)	(0.112)	(–0.594)	(2.909)
Log (inflation)	–0.0354	–0.0344	–0.0288	–0.0369	–0.0375	–0.0351	–0.0373	–0.0266	0.0622	–0.0162
	(–0.728)	(–0.711)	(–0.609)	(–0.759)	(–0.772)	(–0.726)	(–0.771)	(–0.561)	(0.992)	(–0.242)
Trade openness	0.406**	0.386**	0.408**	0.398**	0.414***	0.330*	0.383**	0.376**	0.799*	0.232
	(2.544)	(2.539)	(2.629)	(2.488)	(2.665)	(1.939)	(2.522)	(2.535)	(1.891)	(0.492)
Institution	0.487	0.498*	3.516***	0.509*	0.499*	0.543*	0.513*	3.436***	12.54***	1.116**
	(1.638)	(1.675)	(2.833)	(1.707)	(1.677)	(1.813)	(1.729)	(2.738)	(4.258)	(2.407)
Log (private credit/GDP)	0.150	0.142	0.109	0.176	0.160	0.159	0.168	0.123	–0.276	0.120
	(1.297)	(1.174)	(0.953)	(1.484)	(1.304)	(1.375)	(1.373)	(1.043)	(–1.096)	(0.503)
Log (wage)	0.908***	0.906***	0.197	0.959***	0.945***	0.994***	0.985***	0.212	–1.372*	1.473***
	(3.987)	(3.980)	(0.549)	(4.109)	(4.074)	(4.197)	(4.155)	(0.582)	(–1.707)	(4.377)
Infrastructure	0.138		0.145	–0.146		–0.340				1.736**
	(0.740)		(0.802)	(–0.430)		(–0.812)				(2.023)
ICT infrastructure		0.0966			–0.0140		–0.170	0.0534	0.0559	
		(0.749)			(–0.0786)		(–0.650)	(0.421)	(0.248)	
Log (wage)* Institution			0.666**					0.647**	2.359***	
			(2.510)					(2.407)	(3.859)	
Log (wage)* Infrastructure				–0.0784	–0.0535					0.384*
				(–1.000)	(–0.898)					(1.770)
Log (wage)* ICT Infrastructure						–0.0897	–0.0745			
						(–1.272)	(–1.169)			
Year Dummy	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.623	0.623	0.646	0.627	0.626	0.629	0.628	0.645	0.805	0.756
Number of countries N	11 125	11 125	11 125	11 125	11 125	11 125	11 125	11 125	6 71	6 71

[1] Bangladesh, China, Cambodia, India, Indonesia, Malaysia, Pakistan, the Philippines, Sri Lanka, Thailand, and Vietnam.
t-statistics in parentheses
*** p < 0.01, ** p < 0.05, * p < 0.1

away from investment. In *Japan*, a concrete medium-term fiscal consolidation plan beyond 2015 and further product and labor market reforms remain priorities. In the small states, particularly the Pacific Island countries, reforms should focus on improving the business environment, attracting FDI, and increasing integration with the rest of the Asia Pacific region more broadly (Box 3.2 in Chapter 3).

Theme 2: Abenomics—Temporary Stimulus or a Break with the Past?

About 18 months have elapsed since Prime Minister Shinzo Abe announced his economic revival plan to lift Japan out of decades-long deflation and low growth. So far, "Abenomics"—as his plan has been dubbed—has delivered a significant pickup

in growth and raised inflation. However, private investment has yet to recover decisively and wage growth, a key yardstick to gauge success in re-inflating the economy, has remained modest.

So far, a significant weight in the Abenomics policy package has been geared toward providing fiscal and monetary stimulus, in the expectation that this will kick-start growth and allow Japan to exit from deflation. To what extent, then, do recent achievements reflect merely the impact of stimulus or can be attributed to a broader regime shift toward a self-sustaining recovery and higher long-term growth? This section takes stock of policy actions and the outcomes so far. It concludes by outlining the remaining policy challenges Japan faces going forward.

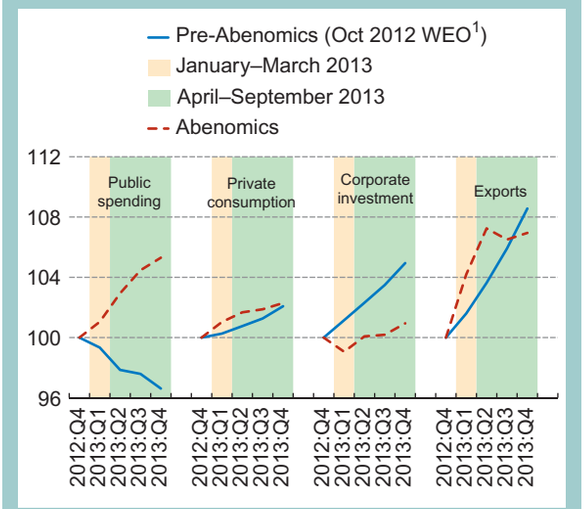
The policy actions:

- *Aggressive monetary easing*. Efforts by the Bank of Japan's Quantitative and Qualitative Monetary Easing (QQME) have included adopting a 2 percent inflation target and aiming to double the monetary base in about two years to 50 percent of GDP through large-scale asset purchases. The goal of these policies has been to eliminate deflation and move the economy onto a path of sustained positive inflation. Judged against this objective, the policy efforts have been largely successful in raising inflation and inflation expectations.
- *Fiscal policy*. The strategy has involved short-term stimulus combined with a path to medium-term fiscal consolidation. Stimulus spending in 2013 reached 0.7 percent of GDP and, in 2014, first steps to fiscal consolidation will be taken with a withdrawal of fiscal support of around 1¼ percent (largely a result of the hike in the consumption tax rate and a rolling off of past stimulus measures). The government has also reaffirmed its target of achieving a primary balance by 2020. The near-term fiscal strategy has been effective but a clear, detailed and concrete consolidation plan that goes beyond 2015 is not yet in place.
- *Supply-side reforms*. Policies to raise private investment and potential growth will ensure that the economic recovery is sustained, even as fiscal and monetary support is scaled back. A few concrete measures have been announced—including the passage of legislation for Special Economic Zones, farmland consolidation (which will improve agricultural productivity and may pave the way for lower subsidies to farmers), and engagement in discussions on the Trans-Pacific Partnership (TPP). But further steps, including implementation of announced measures, are needed.

The initial impact of Abenomics has been strong but it appears to be waning:

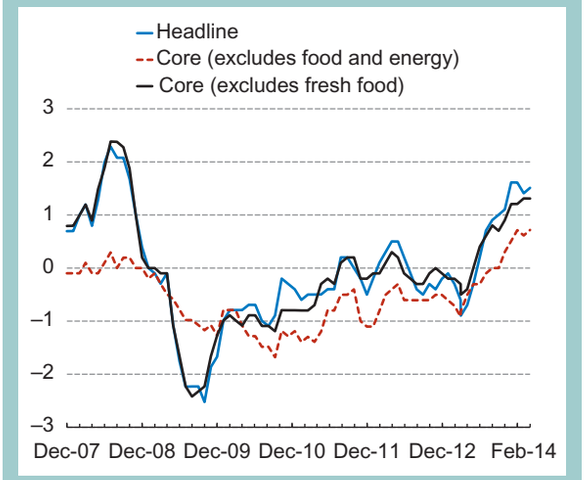
- *GDP growth* accelerated sharply in the immediate aftermath of Abenomics, rising to just over 4 percent in the first half of 2013—thanks to sizable stimulus spending, robust private consumption growth (underpinned by stronger sentiment and wealth effects from soaring equity prices), and stronger exports (benefiting from a weaker yen) (Figure 1.31). However, recent data hint that this economic momentum may be losing steam as fiscal stimulus winds down, and the effects of higher stock prices and a weaker currency start to fade.
- Significant progress has been made on raising *headline inflation*, which reached 1.7 percent year-over-year in March. While initially the

Figure 1.31
Japan: Components of Real GDP
(Index, 2012:Q4 =100)



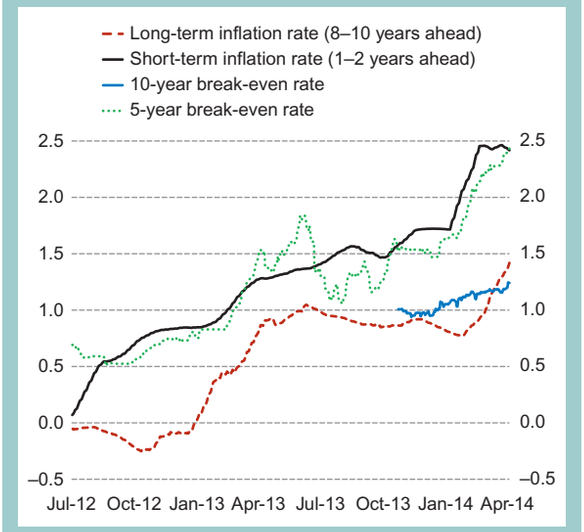
Sources: Haver Analytics; and IMF staff calculations.
[1] WEO = IMF, World Economic Outlook database.

Figure 1.32
Japan: Year-over-Year Inflation
(In percent)



Sources: CEIC Data Company Ltd.; and IMF staff estimates.

Figure 1.33
Japan: Inflation Expectations[1]
(Year-over-year; in percent)



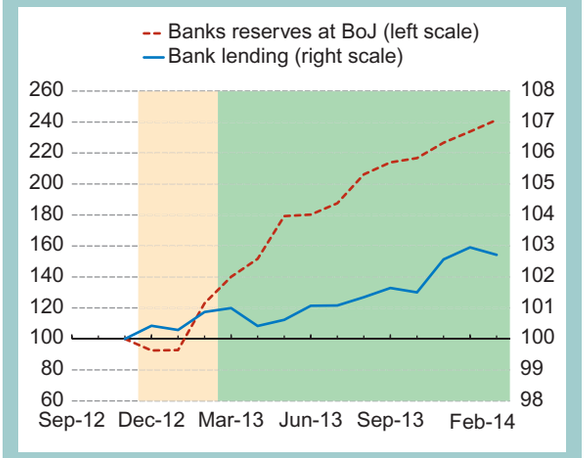
Source: Bloomberg L.P.
[1] Inflation rate estimated as 1-month moving average of implied CPI index based on inflation swap bid and ask points. Break-even rate calculated as the difference between the nominal yield on a fixed-rate instrument and the real yield (fixed spread) on an inflation-linked instrument of similar maturity and credit quality.

increase reflected mainly higher energy costs, more recently core inflation has also picked up (Figure 1.32). Most importantly, various indicators point to an increase in inflation expectations (Figure 1.33). However, the rise in inflation expectations appears to be leveling off, perhaps due to uncertainty about the direction of policies including the commitment to tackle the fiscal and structural challenges facing Japan.

- Despite higher inflation and a tightening of the labor market, *wage growth* remains anemic. Basic wages have continued to decline and earnings have risen modestly but only due to bonus payments and overtime pay. Wage growth is also being held back by structural factors, including the ongoing shift from full-time to part-time workers. The sluggishness in wage growth may reflect caution by employers and the still-weak cyclical position of the economy. In this regard, the outcome of the wage bargaining round in the spring of 2014 will be of critical importance.
- *Portfolio rebalancing* has yet to take off. A critical transmission mechanism of QQME is to induce more bank lending and create incentives for greater investment into riskier yen instruments and foreign assets. After the announcement of QQME in April 2013, several large banks and institutional investors announced plans to diversify their portfolios, and Japanese government bond (JGB) holdings have declined as a share of domestic banks' assets. Since then, though, bank reserves at the Bank of Japan have increased and bank lending has picked up only moderately since early 2013 (Figure 1.34). Also, so far there has been no major wave of private portfolio reallocation into foreign currency assets, and overseas lending by Japanese banks has only risen in line with historical trends (Figure 1.35).

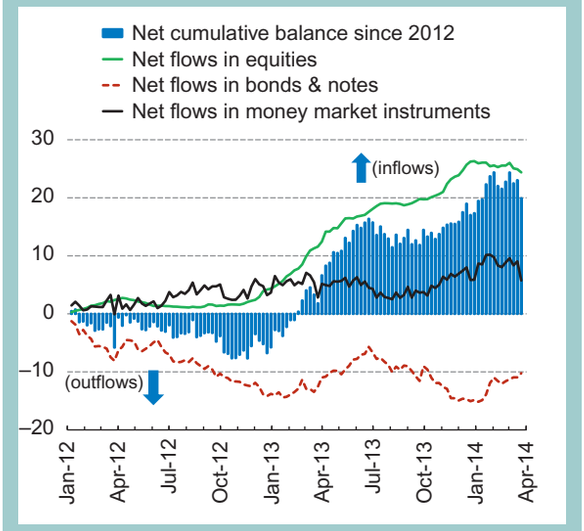
To sum up, the first phase of Abenomics has gone well—monetary and fiscal stimulus and exchange rate depreciation have helped growth and caused inflation expectations to pick up. However, a successful transition to self-sustained, deflation-free growth remains uncertain. Without additional reforms Japan risks falling back into lower growth and deflation, a further deterioration in the fiscal situation, and an overreliance on monetary stimulus with negative consequences for the region (see Box 1.5).

Figure 1.34
Japan: Bank Lending and Reserves
(Index, Dec. 2012 = 100)



Source: Haver Analytics.

Figure 1.35
Japan: International Transaction in Securities
(In Trillion Yen)



Source: Japan Ministry of Finance.
[1] Cumulative position since January 2012.

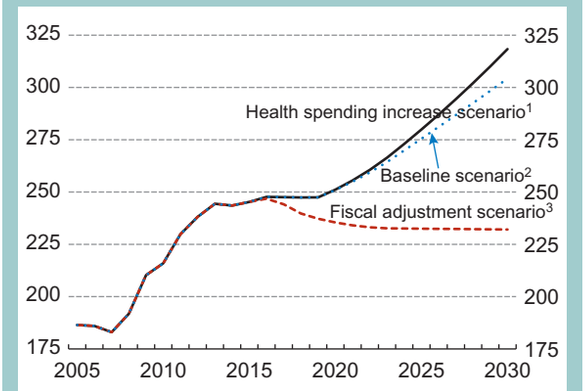
Policy priorities ahead include:

- *Monetary policy.* The Bank of Japan could emphasize or adapt its forward guidance to put a greater priority on progress toward the inflation target being sustained, while de-emphasizing that the target will be achieved in about two years.

- *Fiscal policy.* After implementation of the two stages of the consumption tax increase, the gross debt-to-GDP ratio will stabilize but in the absence of further fiscal consolidation it would start rising again after 2019. Higher health care spending has the potential to further weaken the fiscal position and debt dynamics (Figure 1.36). In light of this, the second consumption tax hike should proceed as planned without resorting to multiple rates. A further priority should now be to outline a detailed medium-term consolidation plan, based on both revenue and spending measures, that outlines how primary balance will be achieved by 2020. Policy measures could include further increases to the consumption tax as well as pension and health care reforms.

- *Supply-side reforms.* A successful launch of a broad range of structural reforms would reignite investment and help sustain growth. Investment could be supported by tax reforms, market deregulation, and corporate governance reforms. The new framework legislation on

Figure 1.36
Japan: Gross Public Debt
(In percent of GDP)



Sources: Cabinet Office, Japan; and IMF staff estimates and projections.
Note: Gross debt of the general government, including the social security fund.
[1] An increase in health spending as estimated is assumed. See Kashiwase, Nozaki, and Saito (2013) for details.
[2] Automatic withdrawal of fiscal stimulus and consumption tax increase to 10 percent in 2015 are assumed.
[3] Policy adjustment scenario assumes an 11 percent of GDP improvement (baseline scenario + 5½ points) in the structural primary balance between 2011 and 2020, which would put the debt-to-GDP ratio on a sustainable path.

Box 1.5

Successful Abenomics: Good for Japan, Good for Asia[1]

The transmission of the effects of "Abenomics" to other countries is complex. Spillover channels are likely to operate mainly through the exchange rate, higher growth in Japan, financial interlinkages, and product supply chains.

Previous IMF analysis suggested that a complete package of reforms—that includes a credible and concrete medium-term fiscal consolidation strategy and ambitious structural reforms—would create positive spillovers to most of Japan's trading partners by increasing demand for their exports and encouraging capital flows into these countries.[2] However, these effects were found to vary across economies, with those facing more direct competition from Japanese producers benefiting less (such as Korea).

Relative to these model predictions, spillover effects within Asia so far have been modest:

- The pace of Japan's export recovery has been slower than initially forecast given the magnitude of the yen depreciation. At the same time, most neighboring countries' exports have remained strong. While hard to disentangle, the slower export growth in Japan could be attributable to longer-than-usual lag (J-curve) effects, geopolitical tensions with China, increased overseas production by Japanese firms, or an expectation by firms that the depreciation is temporary (weakening the impact of yen depreciation on exporters' prices). Also, a decline in the attractiveness of Japanese products relative to competitors might have been at work.
- Despite the yen depreciation, the growth in Japan's imports has been strong and broad-based. Initially, higher imports were concentrated in energy but they have increasingly included consumer and investor goods, reflecting the expansion in domestic activity.
- So far, portfolio outflows have been small. In fact, there has been a significant foreign inflow into Japanese equity markets (see Figure 1.35 in the main text), offsetting a modest pickup in bond outflows to advanced economies.
- Outward foreign direct investment and overseas bank lending have increased, including to Indonesia, Thailand, and Vietnam, but essentially in line with past trends. This appears to be driven more by proximity to fast-growing markets rather than any direct effect of Abenomics or the movements in the currency.

However, if negative real wage growth in Japan persists it could create adverse spillovers to the region. Model simulations using the IMF's Flexible System of Global Models (FSGM) show that negative real wage growth in Japan, by itself, should not have major implications provided it does not undermine consumer and investor confidence (Scenario I in Figure 1.5.1 and Figure 1.5.2). However, if lower real wages are accompanied by declining investor sentiment,[3] growth in Japan would be substantially weaker. Spillovers to Asia could occur through a stronger yen and reduced demand for imports amid possibly tighter financing conditions in Japan. The exchange rate channel matters most for key competitors (China and Korea), while Japan's growth is the key factor for other trading partners. Thus, if declining confidence was accompanied by yen appreciation, the net effect on trading partners would be small or even positive for some countries (Scenario II). And if longer-term interest rates were to rise in Japan (because of increased fiscal sustainability concerns) then growth would fall further, with negative spillover effects on trading partners (Scenario III).

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[1] The main authors are Dennis Botman, Joong Shik Kang (both APD), and Zoltan Zakab (RES).

[2] See the IMF's 2013 Spillover Report for further discussion about potential spillover effect in the medium to long term (http://www.imf.org/external/np/pp/eng/2013/070213.pdf).

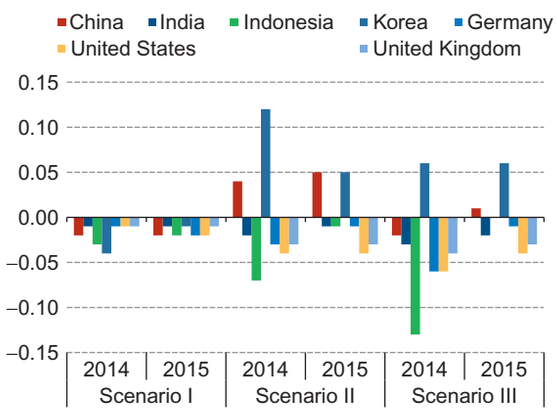
[3] Modeled through a 33 percent decline in stock prices.

Box 1.5 *(continued)*

Figure 1.5.1

Impact on GDP of Growth in Trading Partners

(In percentage points)

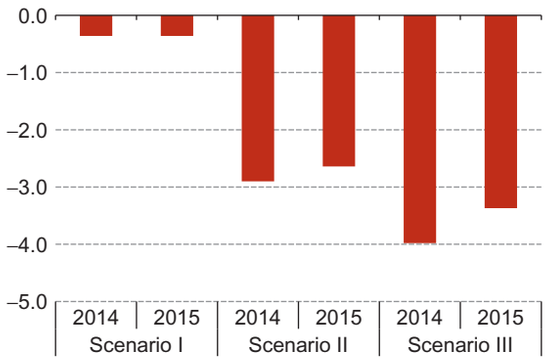


Source: IMF staff calculations.

Figure 1.5.2

Impact on Japan's GDP Growth

(In percentage points)



Source: IMF staff calculations.

In sum, there remain positive spillovers from Japan to the rest of Asia that are, as yet, unrealized. Successful completion of the wage-bargaining round in the spring and ambitious action on fiscal and structural reforms have the potential to improve confidence and stimulate investment and consumption. This would raise growth in Japan and increase the scope for positive spillovers to the rest of Asia.

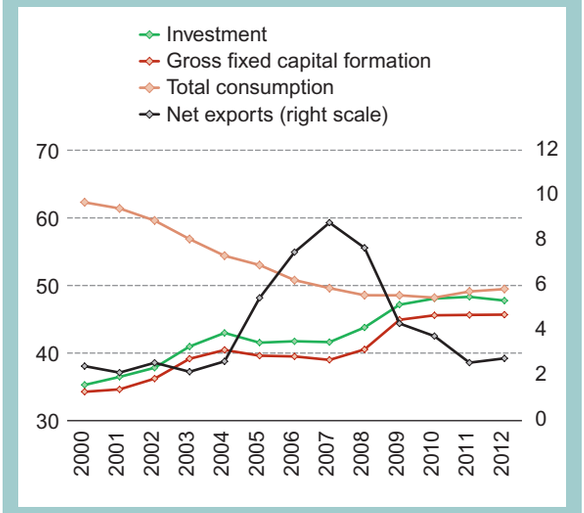
special zones also needs to be fleshed out. Measures should also be taken to reduce labor market duality and make non-regular workers more productive, encourage female employment, and relax immigration requirements to address labor shortages. Unconventional labor policies—including wage growth incentives or a hike in minimum wages—could also be useful in catalyzing a faster pace of nominal wage growth.

Theme 3: How Will China's Reforms Shape China and Asia?

China's policy making has entered a new reform cycle in 2014. China's Third Plenums have often marked important turning points in economic direction. The most recent one was no different and lays out a comprehensive and ambitious reform agenda, which will help accelerate economic rebalancing toward private consumption and deliver more sustainable growth. In some areas, while concrete measures have already been put in place, more time is needed to convert the reform blueprint into policies. Going forward, *implementation* will be key to ensure the success of the reforms. So far, rebalancing efforts have yielded mixed results: investment has remained a major growth driver, even after growth decelerated, and the share of consumption in GDP has barely increased (Figure 1.37).

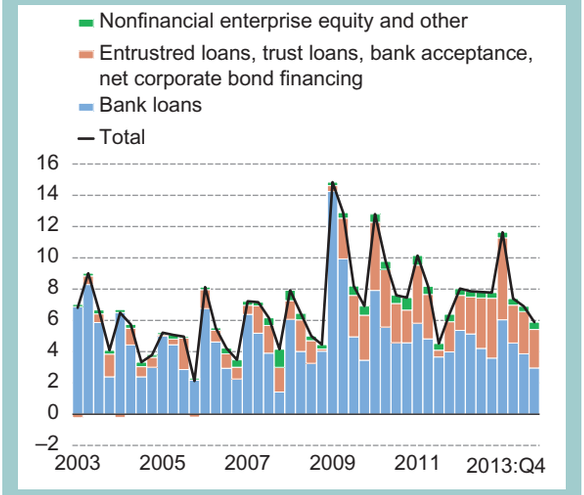
Fiscal reforms aim to strengthen local government finances, align subnational governments' revenues and expenditure responsibilities, adopt a medium-term fiscal plan, and reform the tax system (with greater reliance on indirect, property, and environmental taxes). Social security reform also features prominently in the agenda, with a goal of improving the coverage and portability of pensions and health insurance while ensuring actuarial soundness of social security funds (including

Figure 1.37
China: GDP Expenditure Components
(In percent of GDP)[1]



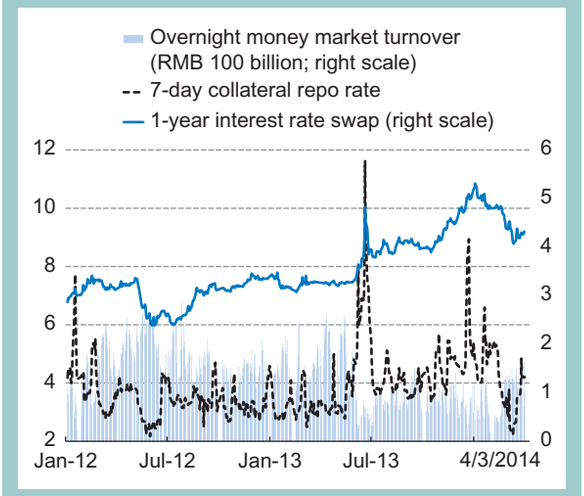
Source: IMF staff calculations.
[1] Expenditure-based GDP.

Figure 1.38
China: Social Financing Flows
(In percent of GDP)[1]



Sources: CEIC Data Company Ltd.; and IMF staff calculations.
[1] In percent of four-quarter rolling sum of quarterly GDP.

Figure 1.39
China: Interest Rate Structure
(In percent; pa)



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

through parametric reforms such as raising the retirement age).

Financial reforms are a step away from quantitative controls on credit and toward letting interest rates play a more important role in resource allocation. The financial reform agenda envisages allowing private investors to own small and medium-sized commercial banks, accelerating interest rate liberalization, establishing a deposit insurance system, and strengthening financial supervision and the resolution framework. Promoting bond market development is also a priority to reduce the reliance on credit (Figure 1.38). While some financial measures could create some near-term volatility in China's capital markets (Figure 1.39), the authorities will likely address money market volatility by injecting liquidity during the transition period, with room for maneuver reinforced by the benign inflation outlook.

While implementation will be critical, major structural reforms in the Third Plenum blueprint are expected to transform the economy:

- *Deregulation of SOEs and private sector participation*: Private sector participation is expected to increase across the board as barriers to entry are lowered in several segments of the services sector, including health care, urban transport, environmental protection, and financial services. This should boost productivity, lower the price of nontradables and stimulate consumption.

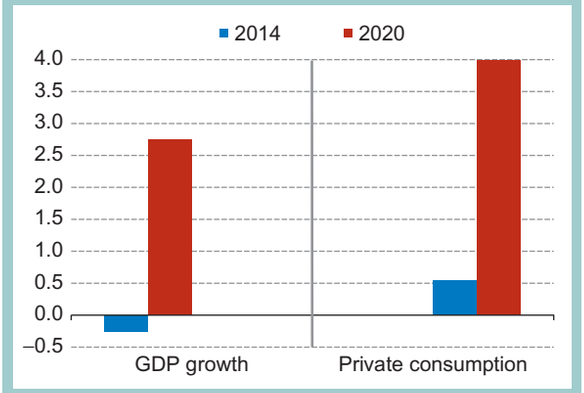
- *Pricing reforms*: The price of natural gas as well as water user charges are planned to be liberalized, including by introducing fees for industrial use and tiered pricing in some areas. Prices for utilities and transportation are also expected to be adjusted to reflect market conditions more closely.
- *Hukou, demographics, and urbanization:* The reforms encompass some relaxation of the residency policies, benefiting small- and medium-sized urban centers. Local governments are expected to relax the one-child policy for some groups of families (where one member of the couple is the only child), which should lower the saving rate substantially and increase rural and urban consumption, while paying (demographic) dividends down the road.
- *Environment*: Additional private sector investment in equipment and provision of environmental protection services are expected. Improvements in energy efficiency and air quality in major cities should also help boost private sector involvement.

Illustrative model-based simulations of the reforms show some rebalancing toward private consumption over the medium term.[8] The main reforms considered include:

- *Fiscal reforms.* An increase in government consumption for health care and general transfers for education is assumed. It is financed by a reduction in public investment and corporate taxation. Reflecting this, there is a gradual reduction in the private saving rate relative to baseline.
- *Financial system reforms.* With increased competitiveness in the financial system, the cost of capital faced by *private* sector firms is assumed to be reduced relative to that faced by SOEs. Foreign exchange intervention policy is gradually phased out, most likely leading to a reduction in export price competitiveness.
- *Reforms to boost productivity and labor force participation.* Structural reforms are assumed to lift economy-wide productivity by 1.5 percent and productivity in nontradables by a further 1.5 percent. The labor force participation rate rises by 3 percentage points.

The results suggest that reforms would be *welfare* enhancing by making growth more sustainable and boosting private consumption, which would also foster economic rebalancing. Assuming full implementation of these reforms, growth would slow in the near term as public investment is reduced (Figure 1.40). Largely as a result, the current account strengthens initially. But productivity gains boost growth in the medium term, raising household income and consumption (which is also supported by higher government spending and transfers, and lower consumer taxes). Private consumption (as a share of GDP) would rise over the medium term as a result, reaching nearly 37.5 percent of GDP—4 percentage points above the baseline, supporting domestic and external rebalancing and making growth more sustainable.

Figure 1.40
China: Illustrating Impact of Reform Implementation
(Deviation from baseline; GDP growth: year-over-year percentage change; private consumption: in percent of GDP)



Source: IMF staff estimates.

[8] In addition to the reform assumptions outlined in the text, in the simulations export subsidies are cut, and consumption taxes are lowered to offset the fiscal impact. Over time, the stronger real exchange rate boosts the consumption of tradables while the higher cost of capital lowers investment, creating a countervailing force on the current account balance.

The near-term impact of Chinese reforms on the rest of Asia is generally small. The simulation results suggest that exports and current account balances across most countries in the region benefit from the rising consumption in China. However, the magnitude of the effect of the reforms on exports and current account balances in other countries is dependent on the extent of their trade linkages with China and the sensitivity of exports to an appreciation of the Chinese renminbi. Over a longer horizon, falling domestic savings in China increases global interest rates, causing some reduction in investment and GDP growth in the rest of the world, including for most of Asia.

Theme 4: What Is Happening to Growth in ASEAN?

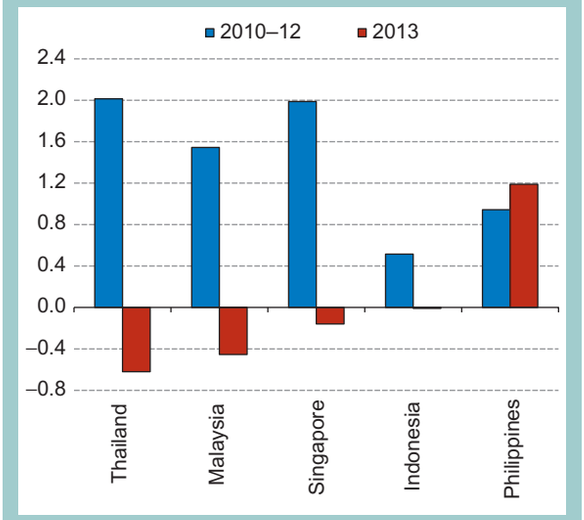
Growth has slowed in the last few years in many emerging market (EM) economies, both within (China, India) and outside (Brazil and Russia) Asia.[9] ASEAN economies also decelerated, and trends within ASEAN have diverged. After staging an impressive recovery following the global crisis, growth in the ASEAN-5 economies (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) moderated, dropping by an average of nearly one percentage point in 2013 compared with the 2010–12 period, with the exceptions of the Philippines and Indonesia. The decline in real GDP growth was mainly due to the lower contribution of investment and private consumption, particularly in Thailand and Malaysia, but weak exports were also a drag on growth.

Policy developments in ASEAN-5 have been partly responsible for divergent growth dynamics, and other cyclical factors will continue to play an important role going forward:

- In *Indonesia,* risks have receded and tightening measures aimed at addressing external imbalances have started to bear fruit. Export growth has picked up in the fourth quarter of 2013, helped in part by the weaker exchange rate. Together with the front-running of mineral ore exports (ahead of restrictions on them starting in January 2014), and import compression partly due to weaker activity, the current account balance has improved. Recent policy tightening will continue to weigh on investment demand throughout 2014. Administered fuel price hikes lifted headline inflation in late 2013, but their impact has already peaked. Vulnerabilities remain, including pockets of leverage in the corporate sector.
- *Malaysia* has also taken decisive action to address its comparatively high public debt, but robust private domestic demand and a benign inflation environment will help keep growth on a steady path. A tightening of monetary conditions may be needed to prevent second-round effects from recent fuel price hikes or a rise in inflation expectations.
- While *Thailand's* outlook will remain clouded by political uncertainty, fiscal and external balances are likely to improve in 2014, particularly as the economy slows and government spending is delayed in the first half of 2014, creating space for further policy accommodation if needed.
- In *the Philippines*, supply constraints caused by the latest hurricane did not dent growth prospects, but food price pressures have created risks to monetary policy, and the peso depreciation could also impact core inflation, especially if domestic demand stays strong. Official goals of rapid and inclusive growth will likely provide a boost to growth as infrastructure spending is ramped up in a context where the near-term fiscal deficit target remains manageable.
- In *Singapore,* growth will also be partly shaped by fiscal efforts to "restructure and redistribute." As with the 2013 budget, fiscal efforts in 2014 will likely include measures to help small and medium-sized enterprises and boost social spending on health and education. Given fiscal measures and a labor market straining at full employment, real wages at the lower end could rise, boosting domestic

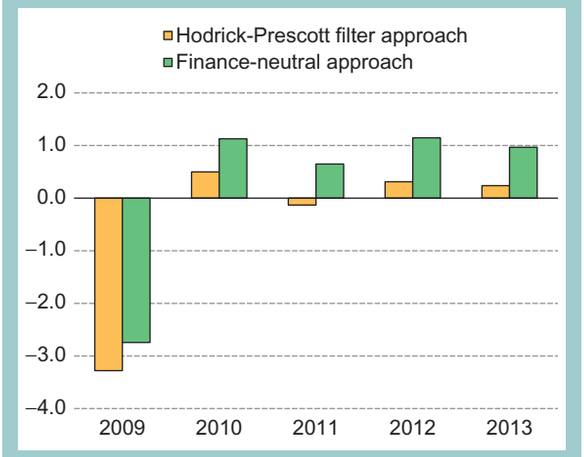
[9] Growth in China, India, Brazil, and Russia in 2013 fell by 1.7 percentage points on average compared with 2011, and by 4.6 percentage points compared with the precrisis period (2005–07).

Figure 1.41
Cyclical Growth in ASEAN-5 Economies
(In percent)



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

Figure 1.42
Output Gap Estimates, ASEAN-5 Average
(In percent)



Source: IMF staff estimates.

demand and helping cushion the blow from the slowdown in the housing market.

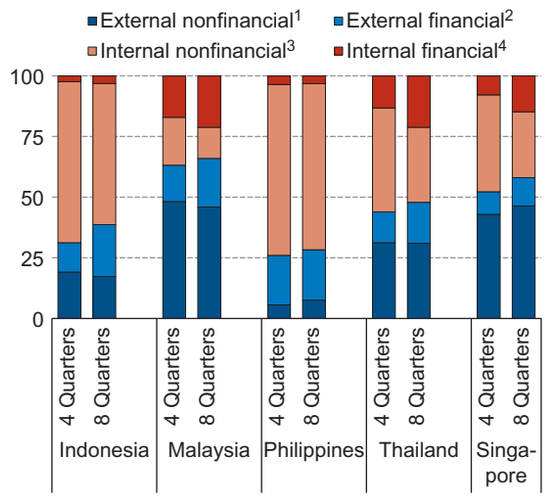
More broadly, much of the slowdown in 2013 appears to have been cyclical. A trend (potential) growth for each economy is estimated using conventional filtering methods but explicitly allowing for the impact of the credit cycle, whose influence on the cyclical position may not be adequately captured by standard estimates of the output gap.[10] The estimates indicate that the financial cycle indeed has acted as an amplifier of the economic cycle in ASEAN-5. The "finance-neutral" estimates of potential output, even more than standard statistical filters, show a large contribution of the cyclical component to growth after the global financial crisis. In particular, the cyclical component of activity also accounted for a large share of the slowdown in 2013, broadly consistent with the moderation in the credit cycle. This pattern is more pronounced in Malaysia and Singapore where the slowdown was particularly sharp (Figure 1.41) and credit expansion had been remarkably strong. The findings also suggest that the cyclical position of ASEAN-5 economies might be stronger than conventionally estimated when the financial cycle is accounted for (Figure 1.42).

Furthermore, the recent cyclical slowdown seems to have reflected idiosyncratic domestic factors more than common external factors. According to econometric models incorporating external and internal factors, the latter have been the main culprit for the recent slowdown.[11] Historically, based on the variance decomposition of output,

[10] Standard approaches include, for example, the Hodrick-Prescott (HP) filter or multivariate estimates based on inflation dynamics. Following Borio, Disyatat, and Juselius (2013), the analysis extends the HP filter approach by incorporating real credit to the output gap equation to extract information about the output gap itself and trend GDP. The idea is to incorporate information about the financial cycle based on the notion that a financial accelerator plays a key role in explaining the cyclical variation of output. Because of data limitations and to ensure comparability across economies, only the real credit (demeaned) was included in the trend-cycle model, but in principle other financial variables can be included.

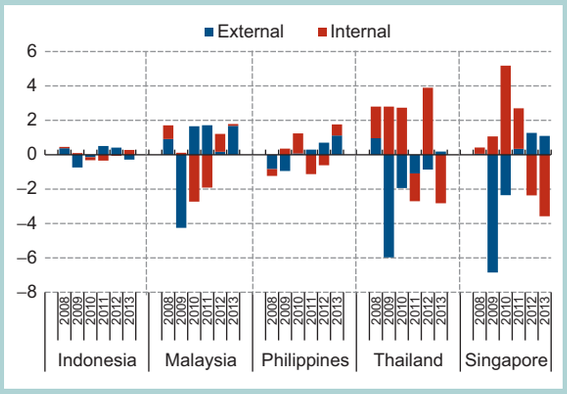
[11] Recursive vector autoregressions (VARs) are estimated and variance decompositions are calculated to gauge the importance of external variables. External variables include a global commodity price index, trade-weighted world output, the U.S. short-term interest rate, and the VIX index. Domestic variables include domestic real GDP, the price level, the short-term interest rate, and the nominal effective exchange rate.

Figure 1.43
Variance Decomposition of Output in ASEAN-5
(Percentage contribution to total output variation)



Source: IMF staff estimates.
Note: The model is identified using country-specific vector autoregression at quarterly frequencies during 1992:Q1–2013:Q4 with a recursive ordering (Cholesky). Lag length is based on standard information criterion.
[1] Commodity prices and trade-weighted world output.
[2] U.S. short-term rate and VIX.
[3] Domestic real output and price level.
[4] Domestic short-term rate and the nominal effective exchange rate.

Figure 1.44
Historical Decomposition of Output Deviation
(In percent)



Source: IMF staff estimates.

domestic factors appear to explain a large share (60–75 percent) of fluctuations in activity in Indonesia, the Philippines, and Thailand (Figure 1.43), while for Singapore and Malaysia external factors are more important. Generally, foreign demand is more important than external financial conditions, but domestic financial factors appear to play a significant role in Malaysia and Thailand (explaining close to a fifth of output fluctuations). Since 2008, external factors have generally contributed negatively to ASEAN growth, with domestic factors mostly offsetting their impact as fiscal and monetary stimulus were deployed (Figure 1.44). In 2013, however, as stimulus was withdrawn, the positive contribution of domestic factors fell, and even became a net drag on growth in Thailand and Singapore.

In summary, with the exception of the Philippines where growth picked up, ASEAN growth has slowed most recently on account of cyclical factors. These have been mostly domestic, but external factors have also played an important role. Going forward, the anticipated upturn in global demand conditions should become more of a supportive factor, particularly in Malaysia and Singapore.