Executive Summary

The outlook for the Asia-Pacific region remains robust—the strongest in the world, in fact—and recent data point to a pickup in momentum. The near-term outlook, however, is clouded with significant uncertainty, and risks, on balance, remain slanted to the downside. Medium-term growth faces secular headwinds, including from population aging and sluggish productivity. Macroeconomic policies should continue to support growth while boosting resilience, external rebalancing, and inclusiveness. The region needs structural reforms to address its demographic challenges and to boost productivity.

The recent growth momentum in the largest economies in the region remains particularly strong, reflecting policy stimulus in China and Japan, which in turn is benefitting other economies in Asia. More broadly across the region, forward-looking indicators such as the Purchasing Managers' Index suggest continued strength in activity into early 2017.

Against this backdrop, growth is forecast to accelerate to 5.5 percent in 2017 from 5.3 percent in 2016. Growth in China and Japan is revised upward for 2017 compared to the October 2016 World Economic Outlook, owing mainly to continued policy support and strong recent data. Growth is revised downward in India due to temporary effects from the currency exchange initiative and in Korea owing to political uncertainty. Over the medium term, slower growth in China is expected to be partially offset by an acceleration of growth in India, underpinned by key structural reforms.

While additional stimulus in the United States and stronger growth in China could provide short-run support, the risks to the outlook, on balance, are still tilted to the downside. In the near term, tighter global financial conditions could trigger capital flow volatility, which could interact with and exacerbate balance sheet weaknesses in a number of economies. More inward-looking policies in advanced economies would significantly impact Asia, given the region's trade openness. A bumpier-than-expected transition in China would also have large spillovers. Geopolitical tensions and domestic political uncertainties could burden the outlook for various countries. Over the medium-term, growth faces secular headwinds, including from population aging in some countries and slowing productivity catchup, topics covered in Chapters 2 and 3.

Chapter 2 highlights the demographic challenges facing Asia—namely that parts of Asia risk “growing old before becoming rich.” The speed of aging is especially notable compared to the experience in Europe and the United States. For many countries in the region, on current trends, per capita income (benchmarked against the United States) will be much lower than that reached by most advanced economies at a similar peak in their aging cycle. The drag on future growth from aging could be significant especially in relatively old Asian countries.

Chapter 3 finds that productivity growth has slowed since the global financial crisis, with limited catchup (“convergence”) toward the United States and other countries at the technological frontier. The slowdown has been most severe in the advanced economies of the region and in China. Many factors behind the productivity slowdown identified elsewhere apply to Asia as well, including sluggish investment, little impetus from trade, slowing human capital formation, reallocation of resources to less productive sectors, and the aging population. Without reforms, productivity growth will likely remain low for some time, with headwinds from rapid aging becoming increasingly important.
On policies, appropriate demand support and structural reforms are needed to reinforce growth momentum where it is weak. Monetary policy should generally remain accommodative, given that inflation is below target and there is slack in most economies in the region. However, some central banks should stand ready to raise the policy rate if inflationary pressures gather pace. Some others need to tighten macroprudential settings and gradually raise interest rates to slow credit growth. Fiscal policy should support and complement structural reforms and external rebalancing, where needed and fiscal space is available. At the same time, countries with closed output gaps should start rebuilding fiscal space. Delivering on medium-term fiscal consolidation plans is also critical in some countries, especially where debt levels are high and fiscal credibility needs to be enhanced. Structural reforms are needed to help reduce external imbalances, mitigate domestic and external vulnerabilities, and promote faster and more inclusive growth. The appropriate policy mix varies across economies, depending on the output gap, policy space, and reform priorities, as well as the need for external rebalancing.

In addition, addressing vulnerabilities while safeguarding against external shocks will help preserve financial stability. Exchange rate flexibility should generally remain the main shock absorber against a sudden tightening in global financial conditions or a shift toward protectionism in major trading partners. Policymakers should continue to rely on macroprudential policies to mitigate systemic risks associated with high corporate and household leverage and rising interest rates, while over time addressing underlying balance sheet vulnerabilities. Macroprudential policies could also be used to increase the resilience to shocks, including shocks associated with reversal of capital flows.

To sustain long-term growth, structural reforms are needed to deal with challenges from demographic transition and to boost productivity. Given the rapid pace of demographic transition, policies aimed at protecting the vulnerable elderly, raising labor force participation (especially for women and the elderly), and boosting potential growth take on a particular urgency. Priority structural reforms to tackle these challenges include labor market and pension system reforms. Macroeconomic policies should adjust early on before aging sets in, particularly with a view to safeguarding debt sustainability. The other major policy challenge is to raise productivity when external factors might not be as supportive as in the past. Overall, the empirical results stress the importance of openness and foreign direct investment (FDI), in boosting productivity, particularly for emerging and developing economies. In these economies, the priority should be to capitalize on recent achievements, including with respect to increased FDI inflows, through further increases in absorptive capacity and domestic investment. Advanced economies should focus on strengthening the effectiveness of R&D spending and taking measures to raise productivity in the services sectors, as well as supporting trade integration and liberalization in services.