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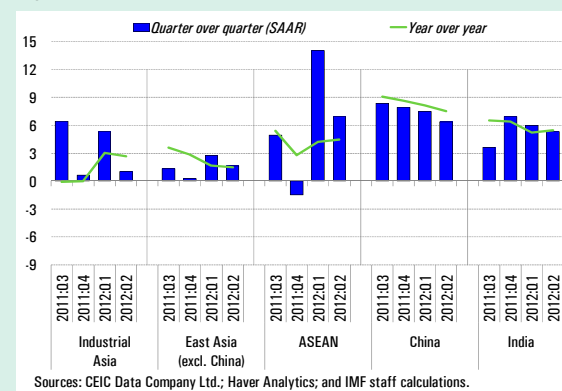
### Asia and Pacific Regional Economic Outlook—October 2012 Update

*Growth in the Asia-Pacific region has slowed. External headwinds played a major role, as the recovery in advanced economies suffered setbacks. Weaker momentum in China and India also weighed on regional economies. For Asia as a whole, GDP growth fell to its lowest rate since the 2008 global financial crisis during the first half of 2012. With inflationary pressures easing, macroeconomic policy stances remained generally supportive of domestic demand and in some cases were eased further in response to the slowdown. More broadly, financial conditions remain accommodative, and capital inflows have resumed. Going forward, growth is projected to pick up very gradually, and Asia should remain the global growth leader, expanding over 2 percentage points faster than the world average next year. However, considerable downside risks remain, in particular with regard to the euro area crisis. The priorities for policymakers are to support noninflationary growth, maintain financial stability, and remain responsive to weaker-than-expected outcomes. Refocusing structural and fiscal reform efforts toward sustained and more inclusive growth remains a priority.*

#### *Growth in Asia has been somewhat lower than previously projected on setbacks to the global recovery*

Although a rebound from earlier natural disaster disruptions helped spur growth in the first quarter of 2012, that activity has now slowed markedly (Figure 1). Adverse trade spillovers from weakness in the euro area and beyond have taken their toll on Asian exports. For Asia as a whole, real GDP growth averaged 5½ percent (year over year) in the first half of 2012, well above the global average, but the lowest rate since the 2008 global financial crisis. Domestic factors also contributed to the slowdown in China and especially in India, reflecting deliberate efforts to engineer a soft landing in the former and weakening investor sentiment adding to supply constraints in the latter. In Japan, a slowdown in consumption drove the recent deceleration in growth after the policy-driven pickup in early 2012. Several Association of Southeast Asian Nations (ASEAN) economies, led by Indonesia, Malaysia, the Philippines, and Thailand, have bucked regional trends, with growth remaining close to potential, in

**Figure 1. Asia: Changes in Real GDP at Market Prices (In percent)**



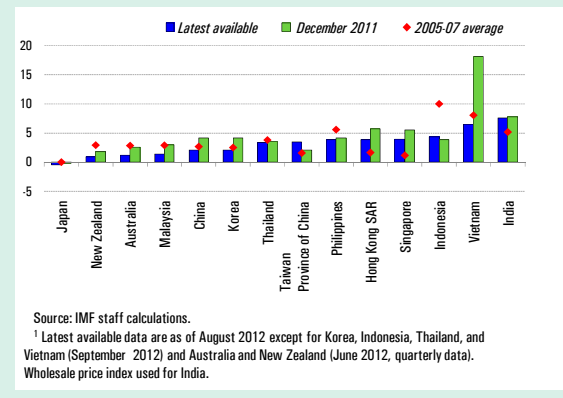
part supported by public investment. Australia has also weathered global headwinds relatively well, in particular as mining-related investment expanded strongly.

Against the backdrop of weaker activity and declining global commodity prices, headline inflation fell further during the first half of 2012, in many cases within comfort zones (Figure 2). As a result, central banks in the region have either left unchanged or

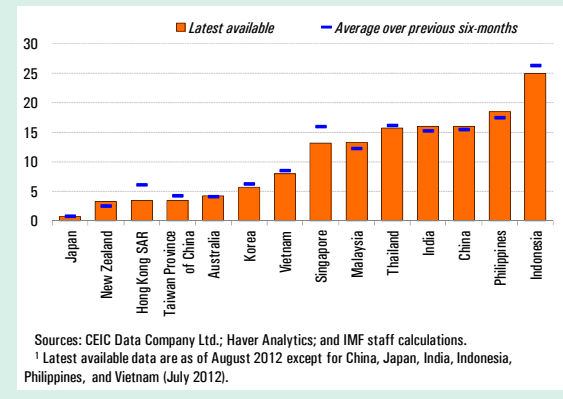


begun cutting policy rates. Largely accommodative monetary policy stances, with real policy and lending rates still 150 basis points below the pre-2008 levels on average, have thus helped maintain favorable conditions for domestic demand. In addition to robust retail sales growth, continuing even at double-digit rates in China, private sector credit growth has remained steady (Figure 3), in particular in many ASEAN economies where credit-to-GDP ratios are above trend. Unemployment, while edging up, has remained close to its pre-2008 lows.

**Figure 2. Asia: Headline Consumer Prices<sup>1</sup>**  
(Year-over-year percent change)



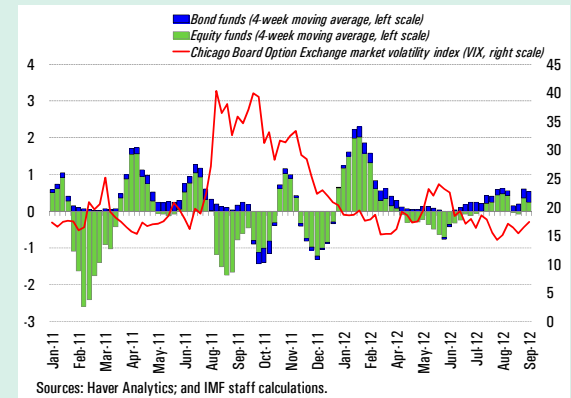
**Figure 3. Asia: Credit to Private Sector<sup>1</sup>**  
(Year-over-year percent change)



Capital inflows have resumed since the beginning of the summer, reflecting an easing of global financial tensions after a period of heightened volatility in the first half of 2012 (Figure 4). While shifts in portfolio flows were driven by swings in volatile equity flows, Asia’s local bond markets have consistently attracted foreign investors, suggesting a relative strength in

fundamentals and a dearth of alternative safe stores of value. Indeed, sovereign bonds and CDS spreads have mostly returned to their post-crisis lows. Moreover, the impact of European bank deleveraging in Asia, which appears to have paused in the first quarter of 2012, has had a manageable impact on regional financial systems so far. Claims of European banks are generally moderate relative to other emerging market regions, and funded in many cases by a large domestic deposit base. Growing cross-border activity afforded by healthy balance sheets from banks in the region (including Japan and Australia) has provided an additional buffer.

**Figure 4. Emerging Asia: Equity and Bond Funds Net Flows**  
(In billions of U.S. dollars)



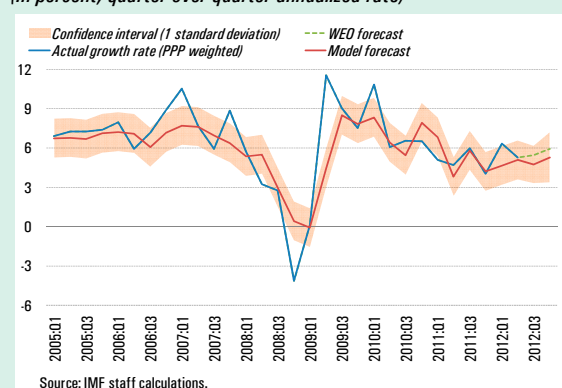
*The near-term outlook remains subdued, while downside risks may be elevated for longer*

Asia’s growth is unlikely to pick up in the second half of 2012 as was expected in the April 2012 Asia and Pacific *Regional Economic Outlook*, given the recent deterioration of a broad range of indicators encompassing activity variables from industrial Asia, the large emerging Asia growth leaders, and the smaller export-dependent economies (Figure 5). Overall, after having slowed in 2011, Asia’s growth is forecast to moderate further in 2012 to 5½ percent, about ½ percentage point below 2011 and our April 2012 forecast. That said, Asia will remain the global growth leader, expanding over 2 percentage points faster than the world average. A modest growth pickup to about 6 percent in 2013 could result mostly from strengthening external demand—itsself helped

by the recent actions taken by leading central banks—with accommodative macroeconomic policy stances across the region also playing a role (Table 1). Japan would be a major exception, as the lift from exports would be outweighed by the waning impulse from reconstruction spending. Lower-income economies would enjoy significantly stronger growth than Pacific island countries, which continue to face the challenge of building resilience to global and regional developments.

**Figure 5. Indicator Model for Asia: Projected vs. Actual Real GDP Growth**

(In percent; quarter-over-quarter annualized rate)



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

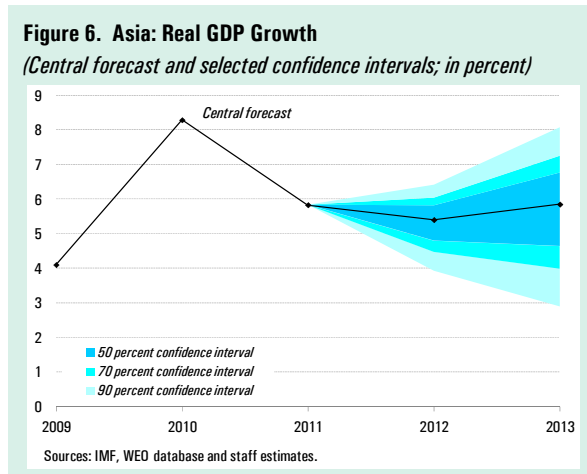
Asia: Real GDP (Year-over-year percent change)	Actual data and latest projections				Difference from April 2012 WEO	
	2010	2011	2012	2013	2012	2013
<b>Industrial Asia</b>	<b>4.1</b>	<b>-0.2</b>	<b>2.4</b>	<b>1.6</b>	<b>0.2</b>	<b>-0.5</b>
Australia	2.5	2.1	3.3	3.0	0.3	-0.5
Japan	4.5	-0.8	2.2	1.2	0.2	-0.5
New Zealand	1.8	1.3	2.2	3.1	-0.1	-0.2
<b>East Asia</b>	<b>9.9</b>	<b>8.2</b>	<b>6.8</b>	<b>7.4</b>	<b>-0.6</b>	<b>-0.6</b>
China	10.4	9.2	7.8	8.2	-0.4	-0.6
Hong Kong SAR	7.1	5.0	1.8	3.5	-0.7	-0.8
Korea	6.3	3.6	2.7	3.6	-0.9	-0.3
Taiwan Province of China	10.7	4.0	1.3	3.9	-2.3	-0.8
<b>South Asia</b>	<b>9.8</b>	<b>6.9</b>	<b>5.0</b>	<b>6.0</b>	<b>-1.8</b>	<b>-1.2</b>
Bangladesh	6.4	6.5	6.1	6.1	0.2	-0.3
India	10.1	6.8	4.9	6.0	-2.0	-1.3
Sri Lanka	7.8	8.3	6.7	6.7	-0.7	-0.3
<b>ASEAN</b>	<b>7.6</b>	<b>4.6</b>	<b>5.1</b>	<b>5.5</b>	<b>0.0</b>	<b>-0.5</b>
Brunei Darussalam	2.6	2.2	2.7	1.5	-0.5	-0.1
Cambodia	6.1	7.1	6.5	6.7	0.2	0.3
Indonesia	6.2	6.5	6.0	6.3	-0.1	-0.3
Lao P.D.R.	8.1	8.0	8.3	8.0	-0.1	1.0
Malaysia	7.2	5.1	4.4	4.7	0.0	0.0
Myanmar	5.3	5.5	6.2	6.3	0.2	0.4
Philippines	7.6	3.9	4.8	4.8	0.7	0.1
Singapore	14.8	4.9	2.1	2.9	-0.6	-1.0
Thailand	7.8	0.1	5.6	6.0	0.1	-1.5
Vietnam	6.8	5.9	5.1	5.9	-0.5	-0.4
<b>Emerging Asia<sup>1</sup></b>	<b>9.6</b>	<b>7.4</b>	<b>6.1</b>	<b>6.8</b>	<b>-0.8</b>	<b>-0.7</b>
<b>Pacific Island Countries</b>	<b>1.7</b>	<b>3.6</b>	<b>2.5</b>	<b>2.6</b>	<b>-0.2</b>	<b>0.1</b>
<b>Asia</b>	<b>8.4</b>	<b>5.9</b>	<b>5.4</b>	<b>5.9</b>	<b>-0.6</b>	<b>-0.7</b>

Source: IMF staff projections.

<sup>1</sup> Emerging Asia includes East Asia, India, Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

Partly reflecting the positive growth differential between the region and the rest of the world and the recent appreciation of a number of real effective exchange rates, the overall current account surpluses of both emerging and industrial Asia—while still rather elevated—would remain lower in 2013 than in 2011.

Risks to this outlook remain considerable. They are also tilted to the downside, although accommodative global monetary conditions also raise the possibility that growth in Asia might surprise on the upside if European and U.S. policymakers fully deliver on their commitments. Stronger external demand next year is premised on a gradual easing of financial pressures emanating from Europe and the avoidance of a “fiscal cliff” in the United States. However, the IMF staff’s fan chart for Asia—which uses financial and commodity market data and analyst forecasts to gauge risks—suggests there is now a one in seven chance of Asia’s growth falling below 4 percent in 2013, close to the rate last observed in 2009, the year after the Lehman shock (Figure 6). About two-thirds of emerging Asia’s exports (on a value-added basis) are linked to demand from Europe and the United States alone (see April 2012 Asia and Pacific *Regional Economic Outlook*). Therefore, trade-channel effects, including through the second-round impact of lower investment and employment in export-oriented sectors, would exert a powerful downward drag on Asia’s most open economies in the event of a severe global slowdown resulting from a further escalation of the euro area crisis or a fiscal shock in the United States. While relatively strong economic and policy fundamentals have helped buffer Asian economies against adverse financial market spillovers, aggressive deleveraging by euro area banks and flight of capital to traditional safe havens could also severely disrupt Asian financial systems. ASEAN and East Asian (excluding China) economies would likely be most affected as their financial markets have showed higher financial sensitivities to shocks in systemic advanced economies in the past.



A sudden rise in food or oil prices could also pose downside risks by weakening domestic demand and limiting the scope for monetary policies to support growth. There are already some signs that inflation may be bottoming out following the recent spike of global food prices, although the latter remains much smaller and less broad-based than in 2007/2008.

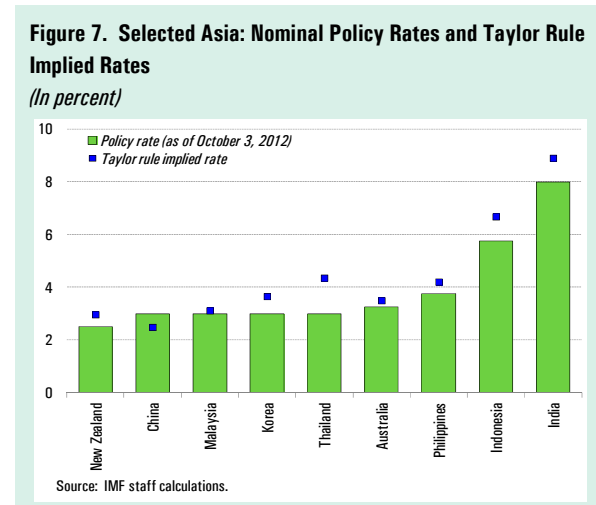
So far, inflation expectations have remained well anchored in most of Asia, helped by relatively stable local rice prices. However, in the event of a further broad-based increase in food prices, the potential for adverse second-round impacts is significant in a number of countries, either due to robust domestic demand, such as in ASEAN economies, or a high share of food and fuel in CPI baskets, including in India and Asia's low-income economies. In these cases there could also be significant budgetary risks from energy and food subsidies, as well as social implications, such as in Pacific Island economies where past gains in poverty reduction would be threatened. For many economies in the Asia-Pacific region, IMF staff estimates put the pass-through from higher global food prices to CPI inflation at 10–20 percent a year after the shock.

A hard landing in China remains a low probability, but high-impact risk for the region. China has become an important engine of growth for the region and a hard landing would have a significant impact on regional economies and beyond. As highlighted in our 2012 spillover report on China, each one percentage-point decline of investment growth in China would lower

GDP growth by more than half of a percentage point over four quarters in those economies with the closest regional supply chain links to China, including Korea, Malaysia, and Taiwan Province of China.

*Policymakers need to support stable noninflationary growth, maintain financial stability, and lay the foundations for sustained and shared prosperity over the medium term*

The current monetary stances are generally more accommodative than is suggested by Taylor rule estimates, and thus provide appropriate insurance against downside risks (Figure 7). Moreover, compared with rate cuts after the Lehman shock, there is still ample policy space in most Asia-Pacific economies to cut nominal rates in the event of a severe global downturn.



The balance of risks, and therefore the scope for monetary policy action differs substantially across Asian economies. In Japan, the most recent monetary easing measures are welcome and should help support economic growth and an exit from deflation. However, further easing of monetary policy may be needed to accelerate achievement of the Bank of Japan's inflation goal of 1 percent, and would likely be more effective in the context of a broad structural reforms and fiscal adjustment.

Elsewhere in the Asia-Pacific region, should activity fail to pick up as projected, further easing may be

warranted where inflation is well within comfort zones and monetary stances are closer to neutral (e.g., Korea and Malaysia). On the other hand, still-high inflation (e.g., India and Vietnam), and strong past or recent credit growth (e.g., Indonesia) may limit the room for policy maneuver in some economies, although credit growth has generally slowed in recent months and has remained broadly commensurate with nominal GDP growth. In order to address financial stability concerns, macroprudential measures, like efforts in China to rein in real estate lending and local government-financing vehicles, remain an essential complement to monetary policy. Similarly, food price-related risks warrant careful monitoring and may limit monetary policy space should they manifest themselves as second-round effects.

The pace of fiscal consolidation will also need to be calibrated depending on country circumstances. Higher structural deficits than before the crisis imply the need to rebuild fiscal space in many Asian economies (with the notable exceptions of China and Korea). Expected improvements in structural fiscal balances across most of the region for 2013 are therefore welcome under the baseline projection. However, automatic stabilizers should be allowed to play as a first line of defense if economic activity were to weaken further. And because such stabilizers remain generally small in emerging Asia (Figure 8), countries with more fiscal space should also set up and be ready to implement discretionary plans if global economic conditions were to take a turn for the worse.

Fiscal reforms will also remain a policy priority to achieve greater economic resilience and inclusive growth, including by reorienting government budgets toward investments in social safety nets and critical infrastructure. Strengthening and improving the efficiency of government revenues will also remain a priority. This is the case in many low-income countries, to finance growing development-spending needs, but also in Japan where the recent Diet approval of a doubling of the consumption tax rate by 2015 is a crucial first step toward a credible longer-term fiscal strategy to achieve public debt sustainability.

Sustained high rates of growth over the medium term cannot be taken for granted, and the magnitude of the recent slowdown in some large Asian economies has raised concerns that it might not be just cyclical. Structural reforms have played a key role in strengthening Asia's economic fundamentals and allowing the region to lead the global recovery and weather the global economic turbulence of recent years. However, many Asian economies have now reached a development stage that exposes them to the risk of falling into the "middle income trap," which is the phenomenon of hitherto rapidly growing economies stagnating at middle-income levels and failing to graduate into the ranks of high-income countries. To sustain economic growth over the medium term and make growth more inclusive, a diverse policy agenda will be required in different parts of Asia, ranging from economic rebalancing to strengthening the sources of private sector-led investment, to reforms in goods and labor markets, and meeting the opportunities and challenges from rapid demographic change. Collective action will also help, particularly the maintaining and furthering of strong regional trade integration.

**Figure 8. Automatic Stabilizers**  
(Correlation between output gaps and cyclical fiscal balances)

