The global economy shows signs of improving as major tail risks emanating from advanced economies have receded. Asia also faces better prospects. After a year of subdued economic performance, growth in Asia is set to pick up gradually in the course of 2013, to about 5¾ percent, on strengthening external demand and continued robust domestic demand. Consumption and private investment are expected to be supported by favorable labor market conditions—unemployment is at multiyear lows in several economies—and relatively easy financial conditions. The latter reflect a combination of accommodative monetary policies; rapid credit growth, particularly in China and some ASEAN economies; and the rebound of capital inflows since the summer of 2012. Asia is also expected to benefit from intraregional demand spillovers; they mainly reflect growing Chinese demand and the near-term fiscal stimulus in Japan but also, in the case of ASEAN economies, growing integration in final consumer goods trade. Consistent with the moderate pickup in growth and absent shocks to global food and commodity prices, inflation is expected to remain broadly unchanged from 2012 and generally within central banks’ explicit or implicit comfort zones.

Risks to the outlook have become more balanced since the October 2012 Asia and Pacific Regional Economic Outlook Update (IMF, 2012d), mainly because the risk of an acute euro area crisis has diminished and the U.S. “fiscal cliff” has been alleviated. However, the potential impact of external shocks on Asia’s open economies remains considerable, and risks and challenges from within the region have come into clearer focus in recent months. To begin with, financial imbalances and rising asset prices, fueled by strong credit growth and easy financing conditions, are building in several economies. A number of other regional risks are more difficult to anticipate but could prove disruptive given Asia’s highly integrated supply-chain network and growing dependence on regional demand and finance. These include trade disruptions from a natural disaster or geopolitical tensions, a loss of confidence in Japan’s efforts to restore economic health, or an unexpected slowdown in China.

Asia’s policymakers face a delicate balancing act in the near term: guarding against a buildup of financial imbalances and managing a transition to rebuilding policy space while delivering appropriate support for growth. Against the backdrop of uncertain growth prospects, Asian central banks in 2012 maintained their already low policy rates or reduced them further. With inflation remaining low and stable, this accommodative stance has been welcome. But financial imbalances are often persistent and cannot be easily unwound, and output levels are close to or slightly above trend in most economies; hence, monetary policymakers should stand ready to respond early and decisively to any prospective risks of overheating. However, the need and direction for future monetary policy action differs substantially across economies, mainly in line with differing exposures to shifting growth risks and risks to financial stability from past stimulus. In emerging Asia, macroprudential measures will also have to play an important role where credit growth remains too rapid and could pose problems for financial stability, especially if accompanied by persistently strong capital inflows. In general, Asia has buffers to cope with such risks, as banking and corporate sector balance sheets remain generally sound, but these imbalances require careful monitoring and adequate supervision.

(continued)
Country circumstances—including the need for demand rebalancing and the available policy space—will also determine the appropriate pace of fiscal consolidation. In many Asian economies, structural deficits that are higher than precrisis levels imply the need for greater efforts to rebuild fiscal space, especially as projected improvements in structural fiscal balances remain small on current policy. Some fiscal consolidation could also help preempt the potential overheating pressures from continued strong capital inflows. With risks more balanced than they were six months ago, automatic stabilizers should provide a sufficient first line of defense if, and as long as, growth were to disappoint only somewhat.

Strengthening fiscal space and frameworks is also needed to achieve sustained inclusive growth over the medium term. As highlighted in Chapter 2, bold discretionary action in Asia during the global recession was emblematic of the region’s increasingly effective fiscal management over the past decade in responding to shocks and thereby in helping to smooth GDP fluctuations. However, there is the growing need to make revenue and expenditure policies more growth-friendly, make growth more resilient through automatic stabilizers, and ensure that Asia’s growing prosperity is shared across all income groups.

Furthermore, as flagged in Chapter 3, emerging Asia is potentially susceptible to the “middle-income trap,” a phenomenon whereby economies risk stagnation at middle-income levels and fail to graduate into the ranks of advanced economies. To sustain high rates of per capita income growth across the region, the policy agenda will have to vary by jurisdiction across a range of priorities, including economic rebalancing, strengthening infrastructure investment, reforms in goods and labor markets, and meeting the challenges from rapid demographic change.