Asia and Pacific Economic Outlook: October 2013 Update

Asia has not been spared by the recent re-pricing of financial assets in emerging markets, encountering a wave of capital outflows in the past few months. The overall impact has, so far, been manageable although some countries have been subject to greater stress. Tighter global liquidity— and homegrown structural impediments in some countries—will weigh on growth, but for most economies the impact should be partly offset by a gradual pickup in exports to advanced economies and resilient domestic demand. If, however, conditions tighten further we are likely to see even greater differentiation across the region. Those with strong fundamentals and policy credibility will be able to offset imported tightening through lower policy rates and fiscal support. Others that have delayed reforms, left fiscal vulnerabilities untackled, or tolerated too-high inflation may be forced to respond with a procyclical policy tightening. Announcing credible medium-term reforms would rebuild confidence and ease policy trade-offs.

A more complex global environment

Since the April 2013 Regional Economic Outlook (REO), many Asian economies have found themselves in a more complex global context as expectations of Fed tapering ignited capital outflows from many emerging markets. As a result, domestic financial conditions have tightened somewhat across emerging Asia (Figure 1) as equity prices fell and yield curves steepened (Figure 2). The Fed’s September decision to delay tapering has eased outflow pressure and markets have bounced back somewhat, although generally remaining below May levels. The adjustment process has mostly been orderly. However, India and Indonesia have seen more concerted pressure and, to support their currencies, have responded with increases in policy rates, tightening liquidity conditions and, in India’s case, further opening up to capital inflows. In general, central banks have been sparing in their use of international reserves.

Figure 1. Asia: Financial Conditions Index (FCI) (Index; increase – loosening of financial conditions)

Figure 2. Changes in Bilateral Exchange Rates vs. Equity Prices

Sources: Bloomberg L.P.; and IMF staff calculations.
While the reversal of capital flows has reflected increasing yields and more attractive investment opportunities in advanced economies, factors from within the region—notably weaker growth prospects throughout emerging Asia, maturing credit cycles, and country-specific vulnerabilities—have also played a role:

- **Growth prospects are weaker throughout emerging Asia.** Activity lost impetus during the first half of 2013. Tepid external demand from advanced economies and a slowdown in China dampened industrial activity throughout much of emerging Asia. Despite robust labor markets and generally supportive financial conditions, domestic demand has also softened. At the same time, a broader structural shift is under way with increasingly binding supply bottlenecks in India and declining returns to investment in China. Potential growth in the major emerging Asian economies has declined steadily (Figure 3).

- **Maturing credit cycles.** Emerging Asia has witnessed strong credit growth and asset price appreciation for the past several years, which has built up some financial imbalances and created pockets of overheating in a few markets (Figure 4).

- **Declining external surpluses.** Until recently, with growth struggling in the United States and Europe and the economic cycle in Asia moving ahead of the advanced economies, current account positions across the region have weakened. However, significant structural surpluses remain in many countries—which in some cases still exceed levels warranted by medium-term fundamentals and desirable policies.

- **Idiosyncratic vulnerabilities revealed.** In the past few months, some weakening of underlying fundamentals that had been obscured by half a decade of abundant global liquidity has been brought into sharper relief. This has been most evident in India and Indonesia, which are running large current account deficits and facing uncomfortably high inflation (including from food prices)—although reinforced in Indonesia recently by a subsidized fuel price hike that was desirable. Elsewhere, there have been some concerns over fiscal positions (Malaysia), the strong credit growth of recent years (Thailand, the Philippines, and ASEAN more broadly), and overly stimulative macro-economic policies in some low-income countries (Lao P.D.R, Mongolia).

While market volatility has risen, looking at the bigger picture, the impact of Fed tapering talk has been generally manageable, and the Fed’s decision to delay the taper in September has further reduced stress. In fact, although capital outflows have been sizable since May 22, they have been much smaller than cumulative inflows experienced between September and April. Furthermore, exchange rate depreciations have been orderly and
weaker currencies, over time, will help strengthen their economies’ competitiveness and support growth. So far, there have been no visible signs of balance sheet stresses in either corporate or banks from the movements in currencies and interest rates. In a few ASEAN economies and Hong Kong SAR, weaker net capital inflows will help abate concerns related to credit booms, sharp increases in asset prices and the buildup of financial imbalances. For Australia, the recent capital outflows have also reduced the extent of currency overvaluation and eased the pressure on monetary policy. Korea stood apart from the regional trend of capital outflows and currency depreciation, underlining the importance of strong fundamentals and credible policy frameworks as the best defense in the face of global liquidity shocks.

Despite the changing global environment, growth should remain solid

Tighter external funding conditions and homegrown structural impediments in a few countries will weigh on growth in emerging Asia, but counteracting forces include stronger growth in advanced economies, weaker currencies, and robust domestic demand—underpinned by still rather favorable financial conditions and resilient labor markets. Growth for Asia as a whole is forecast to be around 5 percent in 2013 and about 5¼ percent in 2014, while emerging Asia is projected to grow at around 6¼–6½ percent in these two years (Table 1). In the latter case, the downward revision of close to 1 percentage point relative to the April REO forecasts largely reflects the combination of the recent tightening of financial conditions and deeper supply-side factors in China and India.

Such a growth path, combined with a benign picture for global commodity prices should imply that headline inflation rates will remain within the comfort zones of central banks (Figure 5). India, Indonesia, and some lower-income countries (Sri Lanka, and Vietnam) are notable exceptions as they continue to face high and persistent inflation.
These general trends, however, mask considerable heterogeneity across the region:

- China has been largely insulated from the recent financial market volatilities. While activity could benefit from improving external demand, continued measures to slow credit growth from its fast recent pace and work through the excesses of past years should put the economy on a slower trajectory. Growth is projected to decelerate to 7.6 percent in 2013 and 7.3 percent in 2014 as structural forces move China steadily onto a lower growth plane. Excess capacity in a number of industries and stable food prices should mean inflation will remain unproblematic.

- Japan’s growth upswing has been a bright spot in the region as Abenomics has reignited the economy and is starting to lift the country out of chronic deflation. Financial conditions have eased markedly as a result of the exchange rate depreciation and the asset price rally triggered by Quantitative and Qualitative Monetary Easing. Inflation and inflation expectations have increased, albeit remaining well below the Bank of Japan’s target of 2 percent. Growth is likely to reach 3.5 percent year on year in the fourth quarter of 2013, driven by robust domestic demand and a better export picture supported by a weaker yen and recovering industrial country demand. Looking forward, growth is forecast to decelerate to 1.2 percent in 2014, owing to waning reconstruction spending, and the planned consumption tax increase, with the latter temporarily raising headline inflation to 2.9 percent. A new fiscal stimulus will be announced in December and poses an upside risk to the growth forecast.
• Prospects in other advanced economies in the region vary. Korea has shrugged off the global market volatility and the economy, spurred by fiscal and monetary stimulus, is set for a modest recovery. In Australia, a slowdown in the resource investment boom will drag down growth but in New Zealand continued low interest rates and the acceleration of post-earthquake reconstruction will provide a boost to the economy.

• In India, the fallout from recent financial stress has likely contributed to greater vulnerability of corporate and bank balance sheets and a further downward revision of growth forecasts, which were already very low in historical context. This reflects persistent supply constraints and slow progress on structural reforms. Despite weak demand, however, food prices will likely keep headline inflation close to double digits.

• In Indonesia, growth is expected to slow given tighter financing conditions and weakening investment, before some stabilization next year. In most other ASEAN economies, growth should pick up somewhat. External demand will improve while domestic demand is likely to prove resilient to tighter domestic financial conditions, partly reflecting stronger public infrastructure spending (Thailand).

• For the most part, low-income economies in Asia have generally been spared from recent volatility, though given limited international financial linkages second-round effects could emerge in the coming months through trade channels. Rapid credit growth, often on the back of easy macro-economic policies, is boosting growth but also raises concerns in some cases (Cambodia, Lao P.D.R, Mongolia, Nepal), while banking sector weaknesses remain a challenge in Vietnam.

• With the exception of commodity producers, growth prospects in most Pacific islands have continued to be undermined by structural impediments and, in some cases, external and fiscal imbalances are growing.

...but there are risks of further rounds of capital outflows and increases in term premia

A further tightening of global funding conditions is possible and could trigger renewed portfolio outflows, falling asset prices, and tighter financial conditions. A larger impact is likely to be felt by those Asian economies with weaker fundamentals and exposures, particularly where they are combined with mismatches on corporate or bank balance sheets (Figure 6). While trade channels will help over time as the U.S. economy strengthens, the immediate effect in Asia is likely to be net negative for growth.

Figure 6. Effect of 100 bp Rise in U.S. 10-Year Treasury Yield on GDP
(Average impulse response across seven Asian emerging markets)

Risks originating from within the region are largely idiosyncratic. One potential source of vulnerability is the buildup of financial imbalances across emerging Asia documented
in the April 2013 Regional Economic Outlook. Indeed high-yield corporate borrowing has increased in recent years (Figure 7), spreads have been compressed to unusually low levels, and lack of adequate data, for example, on the extent to which foreign currency borrowing has been hedged, creates further uncertainty. For the most part, healthy corporate and bank balance sheets should provide a defense against possible shocks but a return of borrowing costs and market access to historical norms will create pockets of strains. A second potential source of risk would come from a steep investment decline, not least in China and India. Given Asia’s high regional integration, an unexpected slowdown in any of its larger economies, particularly China, would be damaging, particularly for Korea, Taiwan Province of China, and much of ASEAN. In Japan, unless credible fiscal consolidation and structural reforms were fully implemented, the new macro-economic framework could prove less effective in raising growth and inflation expectations and monetary policy might become overburdened, with adverse net effects also on the rest of Asia.

Exchange rate policy

Flexible currencies, alongside guarded use of FX intervention to smooth volatility and ensure orderly market functioning, should be viewed as a principal line of defense in the face of concerted capital outflows.

Monetary policy

- In economies with subdued inflation and slowing activity, current monetary stances—which are slightly more accommodative than implied by past, in some cases already supportive, central bank behavior (Figure 8)—provide some insurance against downside risks. In some economies (Thailand and the Philippines), the recent reversal of previous capital inflows has acted as a substitute for monetary tightening, helping to tackle the buildup of financial imbalances and allowing monetary policy tightening to be deferred. Low inflation and policy credibility enable countries in this group to contemplate lowering policy rates should growth slow and financial conditions tighten further.

Figure 7. High-risk Corporate Borrowing

![Graph showing high-risk corporate borrowing as a percentage of GDP for various countries between 2009 and 2013.](image_url)

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

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Positioning for a bumpier ride

The tighter and more uncertain global financial environment has strengthened, and the differentiated impact of recent capital outflows has confirmed, the need for coherent macro-economic frameworks (monetary policy, fiscal policy, macro-prudential tools as well as any capital flow measures) that are clear, credible, and well communicated. The recent episode has shown that a large reserve war chest has been insufficient to ward off financial market volatility where fundamentals are misaligned. For much of the region, further support from macro-economic policies is constrained by the potential for fueling capital outflows, high inflation, concerns about credit quality, or fiscal weaknesses. This places a premium on structural reforms as the principal means to reenergize growth.
Where inflationary pressures are already elevated and there is a reliance on foreign inflows (India, Indonesia) or where credit growth has been overly expansionary (Lao P.D.R, Mongolia), monetary policy will likely need to be further tightened in the coming months. This will become more pressing if balance of payment pressures intensify.

In Japan, inflation expectations have started to rise but fall short of the 2 percent target. Careful communication is essential to further raise expectations and lower real interest rates. To strengthen monetary transmission, steady implementation of the Bank of Japan’s asset purchase program needs to continue to facilitate portfolio rebalancing by investors towards riskier assets with a greater growth impact and more lending.

In China, slowing the growth of credit, especially in the shadow banking sector, is a priority. This will need to be supported by a progressive move towards using interest rates as the main monetary policy instrument.

Financial policy

As the tide of global liquidity washes out, macroprudential policies—of which Asian economies have made a growing use over the years (Figure 9)—should continue to play a role in safeguarding financial stability, as a complement to sound macro-economic policy frameworks. Indeed, in many cases risks from leverage and asset price inflation that these measures were intended to address will become more manifest as interest rates move up. While the constraint that macroprudential policies place on financial intermediaries will likely become less binding as financial conditions tighten, there is little motivation to weaken these measures. Strong regulation and supervision combined with micro-prudential efforts are also likely to prove especially valuable in protecting financial systems as global funding conditions tighten. In that regard, the recently announced roadmap to improve the resilience of the Indian banking system is welcome.

In China, the priority is to advance financial reforms to prevent a further buildup of risks, foster a more efficient allocation of investment, and boost household capital income. Key steps include deposit rate liberalization, strengthening regulation and supervision (including of shadow banks), and
resolving the moral hazard problem rooted in
the perception of widespread implicit
guarantees with the introduction of deposit
insurance and a formal resolution mechanism
for failing institutions.

Capital flow management measures
(CFMs)

Although some had introduced controls on
inflows as international capital spilled in,
implementing controls on capital outflows as
global conditions tighten may backfire—at
least outside of extreme situations, where there
could be a temporary role for CFMs as part of
a broader package that also addresses the
fundamentals. Consideration could be given
instead to rolling back previously imposed
controls on inflows and further liberalizing
restrictions on the more stable sources of
inflows.

Fiscal policy

Structural fiscal balances are generally weaker
than prior to the global financial crisis and, in
general across the region, a moderate pace of
fiscal consolidation is warranted with scope to
allow automatic stabilizers to operate or even
provide fiscal support only should an adverse
scenario materialize. However, for some
countries (India, Japan, and Vietnam) high
debt and deficits mean there is little scope for
countercyclical policy and significant fiscal
consolidation is a priority. In Japan, concrete
measures should be adopted to contain fiscal
risks; raising the consumption tax rate further
to 10 percent as planned by October 2015 and
maintaining a uniform rate are key ingredients.
In many emerging and low-income
economies, there remains major room for
structural fiscal reforms to promote sustained
and inclusive growth, primarily by reorienting
government budgets away from inefficient
taxes and poorly-targeted subsidies toward
investments in social safety nets and critical
infrastructure. India, Indonesia, and Malaysia
in particular have recently reduced energy
subsidies from their high levels, and should
continue doing so. In China, strengthening the
management, transparency, and overall
governance framework of local government
finances would help contain the risks from
growing local government debts and quasi-
fiscal operations. Finally, given their high
vulnerability to external shocks, Pacific Island
countries should continue rebuilding fiscal
buffers and improve the composition of public
spending with regard to education, health, and
infrastructure in order to foster inclusive
growth.

Structural policy

As Asia’s growth moves to a lower gear on
lower total factor productivity growth and
investors increasingly discriminate across
countries according to their fundamentals, the
case for structural reforms to boost
technological catch-up and weather future
economic turbulence is becoming ever clearer.
The agenda varies across economies, ranging
from ambitious reductions in barriers to entry
in product markets and job protection reforms
to curb labor market dualism in many cases,
energy sector and subsidy reform in India and
Malaysia, broad institutional reforms to boost
infrastructure spending in India and the
Philippines, rebalancing towards
consumption-based growth in China. Decisive
progress on these various fronts would go a
long way toward fostering more sustainable,
balanced, and inclusive economic growth over
the future.