Executive Summary

Asia is well positioned to meet the challenges ahead provided it stays the course on reforms. The region has strengthened its resilience to global risks and will continue as a source of global economic dynamism. Recent actions taken to address vulnerabilities are starting to bear fruit. However, with the risk of further bouts of volatility ahead, policy complacency will be penalized. Asia's reform momentum must therefore be nurtured so as to secure the region's position as the global growth leader.

Growth in Asia is projected to remain steady at 5.4 percent in 2014 and 5.5 percent in 2015. External demand is set to pick up alongside the recovery in advanced economies, and domestic demand should remain solid across most of the region. With the expected upcoming tightening of global liquidity, Asia will face higher interest rates and potential bouts of capital flow and asset price volatility. Nevertheless, despite some tightening, financial conditions should remain supportive, underpinned by still-accommodative monetary policies, strong credit growth, and exchange rates that remain weaker than they were a year ago.

External risks remain. A sudden or sharper-than-anticipated tightening of global financial conditions remains a key downside risk. Economies with weaker fundamentals would be the most affected, similar to what happened a year ago when market participants abruptly revised their expectations of U.S. Federal Reserve tapering. Since then, though, policymakers in Asia have taken policy actions to address vulnerabilities and we now see those actions starting to bear fruit. As an indicator of this improving resilience, India, Indonesia, and other Asian emerging markets were able to better weather the bout of global financial volatility in January.

Asia also faces several risks originating from within the region. A sharper-than-envisaged slowdown in China—due to financial sector vulnerabilities and the temporary cost of reforms along the transition toward a more sustainable growth path—would have significant adverse regional spillovers. In Japan, there is a possibility that Abenomics-related measures could prove less effective in boosting growth than envisaged unless strongly supported by structural reforms. Domestic and global political tensions could also create trade disruptions and weaken investment and growth across the region. In some frontier economies, high credit growth has led to rising external and domestic vulnerabilities.

Domestic vulnerabilities could magnify some of these risks. For the bulk of Asia, financial stability risks appear contained and bank balance sheets have scope to absorb negative shocks. However, as global interest rates and term premiums move higher, vulnerabilities stemming from pockets of high corporate and household leverage could become more salient. If economic conditions become less hospitable, corporate defaults may occur and investment by highly leveraged firms could take a hit. However, with the size of debt owed by distressed firms being relatively small as a share of GDP, corporate sector risks do not appear systemic (see Chapter 2).

Growing regional integration is propelling Asia's growth but could also amplify the impact of global and regional shocks. Events over the past year have been a reminder of Asia's exposure to policy decisions in advanced economies. As highlighted in Chapter 3, trade and financial channels are a growing source of interconnectedness causing greater output co-movement across the region.

(*continued*)

Intraregional business cycle synchronization has grown, and Asia is twice as exposed as other regions to growth shocks originating from China. Financial integration in Asia lags well behind trade integration, but it is still capable of exacerbating cycles during negative global events. Insofar as trade and financial integration continue to grow, policymakers need to seek out ways to maximize the growth benefits while preparing to manage the vulnerabilities arising from the expanding channels for spillovers.

In order to cope with risks from financial interconnectedness, Asian policymakers have been active in deploying macroprudential policies (see Chapter 4). These tools are neither a silver bullet nor a substitute for warranted macroeconomic policy adjustment, but they have served the region well. Some of these macroprudential measures, particularly those related to restraining housing market excesses, are found to have had a measurable effect in lowering credit growth, slowing house price inflation, and dampening leverage. Macroprudential tools should continue to be used as a *complement* to mitigate the effects of volatile capital flows—particularly if they were to decisively turn around—and potentially disruptive movements in asset prices.

How can other policies help Asia strengthen its resilience to risks and retain its growth leadership? For much of the region, a continuation of recent macroeconomic policies appears to be the right recipe. This would involve a gradual fiscal consolidation while, with inflation pressures staying muted across most of Asia, maintaining monetary policies at their current supportive stance and normalizing gradually as economic slack diminishes and risks recede. However, economies where inflation outturns are high and above their central bank's comfort zones may need to hike rates in the coming months to ensure that inflation is firmly on a downward path. Any volatility in capital flows should be met with exchange rate adjustment and sparing use of foreign exchange intervention.

Finally, there is also ample scope for structural reforms in Asia. The agenda varies, involving, inter alia, regulatory reforms and higher infrastructure investment in India, ASEAN, and frontier Asia; financial system liberalization and measures to rebalance growth away from investment in China; labor and product market reforms in Japan; and tax and spending reforms in many economies. These reforms are critical not only to sustain Asia's growth leadership over the medium term, but also, in some cases, to maintain investor confidence and secure financial stability in the near term.