Executive Summary

The economic outlook for Asia and the Pacific remains favorable, with the region projected to remain the global growth leader over the medium term. While the pace of expansion has moderated since the global financial crisis, robust consumption helped to cushion the blow from weaker external demand. As a region of oil importers and supply chain participants, Asia is set to benefit from the recent decline in world oil prices and the ongoing recovery in advanced economies. However, real and financial volatilities could disrupt this favorable outlook, and further delays in structural reforms could hold back growth. Therefore, policies should remain focused on building resilience and enhancing productive capacity.

Growth in the Asia and Pacific region is expected to hold steady at 5.6 percent in 2015 and to ease slightly to 5.5 percent in 2016. Domestic demand is forecast to continue to drive growth, supported by the windfall boost to real incomes from lower world oil prices and strong labor market conditions. These factors are expected to offset the effect of tighter financial conditions from capital flow reversals triggered in part by the prospect of monetary tightening by the Federal Reserve. Net exports are also expected to add only marginally to growth. Across the region, lower oil prices will temporarily push down headline inflation and, with a large part of the windfall expected to be saved, current account balances will increase.

Nonetheless, considerable heterogeneity is apparent across the region. China is slowing to a more sustainable pace; Japan is expected to see growth pick up following a year of stagnation; exporters of non-oil commodities whose prices have fallen sharply (Australia, Indonesia, Malaysia, and New Zealand) will be adversely affected by the terms-of-trade swing; elsewhere, however, growth is expected to stabilize or increase. In addition, effective exchange rates across the region have diverged, reflecting several factors: (1) in the context of asynchronous monetary policies in major advanced economies, including Japan, some currencies have remained more closely tied to the U.S. dollar, while others have allowed more flexibility; (2) the differential impact of large changes in the terms of trade on net commodity importers and exporters; and (3) capital is flowing into some countries but reversing from others. This regional diversity could lead to increased volatility.

While the Asia and Pacific outlook remains solid, the balance of risks is tilted to the downside. First, significantly slower-than-expected growth in China or Japan would impact the rest of the region and the world given these economies’ large size and deep trade and financial linkages. Countries with strong supply chain linkages as well as commodity exporters to these large economies would be especially affected. Second, persistent U.S. dollar strength against the euro and the yen would likely exert an autonomous tightening of domestic financial conditions in the region and impose higher debt service costs for firms with sizable U.S.-dollar-denominated debt. In addition, a stronger dollar relative to other major currencies could erode export market shares for economies whose currency displays limited flexibility against the U.S. dollar. Third, the rapid buildup of debt across the region could heighten the sensitivity of growth to global financial and inflation conditions. Tighter financial conditions in the United States would raise domestic borrowing costs, while lower global inflation—if imported into Asia—would increase the level of real debt. The resulting increase in the carrying cost of debt could impinge on domestic spending, while higher debt could weaken the credit channel of monetary policy.

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On the other hand, lower world oil prices present an important upside risk for Asia’s growth. Notwithstanding the projected increase in the world price beginning later this year, over the longer term oil prices are expected to remain significantly below the average of recent years. Additional support to growth could materialize if the supply contribution to the price decline is larger or more persistent than currently envisaged, or if the propensity to spend from the oil price windfall is larger than currently anticipated.

While debt has risen across much of Asia and the Pacific, reaching high levels in some economies, financial sector risks have been contained by sustained income growth and supportive financial conditions. However, risks are evident in the real estate sector, and although bank credit-to-GDP ratios have been increasing more slowly in most economies, previous rapid credit growth has generated sizable positive credit gaps in several economies. Notwithstanding these developments, banks’ balance sheets have generally strengthened across Asia and the Pacific.

Going forward, Asia’s pace of potential growth is likely to remain below precrisis levels. Mirroring developments in realized growth, potential growth has slowed across much of the region. The decline reflects primarily decelerating total factor productivity, although slower growth in labor’s contribution due to aging was a major factor in several economies. Slower total factor productivity growth may reflect diminishing returns from participating in global value chains (see Chapter 2), which could limit productivity gains in the absence of structural reforms. Over the medium term, the region would also benefit from deeper regional financial integration, which has lagged trade integration (see Chapter 3). Furthering financial integration holds the promise of more efficient allocation of regional savings to meet the region’s large investment needs while also supporting financial inclusion.

What is the role for policy in this environment? Most countries in Asia and the Pacific are in the enviable position of having adequate interest rate and fiscal policy space to supply additional temporary stimulus if needed. However, based on growth and inflation forecasts, current policy interest rates are appropriate across the region, although concerns about fiscal sustainability and financial stability, as well as the risk of renewed global financial volatility, may warrant somewhat tighter stances in several countries. Moreover, policymakers will also need to contend with several countervailing forces, including the temporary fall and subsequent increase in the price of oil, potential capital flow volatility, and rising asset prices. Macroprudential policies and foreign currency intervention can assist to contain financial stability risks and address sporadic disorderly conditions in the foreign exchange market, but permitting exchange rate flexibility to absorb shocks. On the fiscal front, the decline in oil and food prices provides a window of opportunity to further reform or phase out subsidies, thereby improving spending efficiency and shielding public spending from future commodity price fluctuations. Further fiscal consolidation is appropriate in countries where public debt remains elevated. Structural reforms remain critical to boost productivity growth across the region, including state-owned enterprise and financial sector reforms in China, initiatives to raise services productivity and labor force participation in Japan, and measures to address supply bottlenecks in India, the Association of Southeast Asian Nations, frontier economies, and small states.