

Asia at the Forefront: Growth Challenges for the Next Decade and Beyond

1. Overview

Asia has achieved remarkable economic success over the past five decades. Hundreds of millions of people have been lifted out of poverty, and successive waves of economies have made the transition to middle-income and even advanced-economy status. And whereas the region used to be almost entirely dependent on foreign know-how, several of its economies are now on the cutting edge of technological advance. Even more striking, all of this has happened within just a couple of generations, the product of a winning mix of integration with the global economy via trade and foreign direct investment (FDI), high savings rates, large investments in human and physical capital, and sound macroeconomic policies.

Overall per capita income in Asia still substantially lags that in the United States and Europe, but in growth terms, the region is very much at the forefront of the global economy, accounting for more than 60 percent of world growth and projected to grow at 5.6 percent in 2018 and 5.4 percent in 2019. There are signs, however, that the synchronized global recovery of the past few years is starting to fade, and risks to the Asian and global forecast are now tilted to the downside, reflecting increased financial market volatility, rising trade tensions, and slowing momentum in China.

In addition to these short- and medium-term risks, Asia faces important challenges to its long-term growth prospects. One of these relates to trade. While it is difficult to predict how the current situation will unfold, policymakers now confront the possibility of a pronounced and protracted slowdown in trade. If tariffs spiral upward and economies slip toward autarky, global growth would take a substantial hit, and Asia—which already needs to rebalance its trade-driven growth

model given weaker medium-term prospects in advanced economies—would be vulnerable.

Population aging is another important long-term challenge. Some countries, such as India, Indonesia, and the Philippines, still enjoy a young population and a growing labor force, but Japan, Korea, Thailand, and several other economies are well past their demographic dividend. As the April 2017 *Regional Economic Outlook: Asia and Pacific* showed, many Asian economies face the risk of “growing old before they grow rich,” in that they will not yet have converged to the income frontier by the time the demographic tide begins to turn against them.

Slowing productivity growth is another key challenge for Asia, as it is for other regions. The April 2017 *Regional Economic Outlook: Asia and Pacific* documented the slowdown in Asia since the global financial crisis and identified its main drivers, including declining research and development (R&D) investment, trade openness, and FDI. But firm-level dynamics—the misallocation of resources across firms of differing productivity—can also be an important factor.

Finally, Asia is at the forefront of digitalization, which promises a radical transformation of the global economy, and indeed of society itself, while at the same time threatening substantial disruptions and dislocation. For instance, workers worry that robots will make them obsolete, while financial supervisors are concerned about the risks to financial stability posed by the latest fintech innovations. Handling the possibly bumpy transition to an increasingly digital future will be yet another major challenge for policymakers during the coming decades. At the same time, digitalization may well be a key driver of productivity growth and improved welfare over the long run.

Thus, while Asia is at the forefront of the global economy today, it confronts some fundamental

challenges that may require a shift in the region's growth model. This report and its four background papers take up these issues, suggesting that, with the appropriate policy responses, Asia will be able to meet its challenges and secure its growth prospects. The next section offers a brief description of the current conjuncture, and the following sections analyze trade, productivity, and the digital economy, respectively, presenting highlights of the fuller analyses offered in the background papers. The main policy recommendations are as follows:

- First, **strengthen macro building blocks.** As described in the conjunctural background paper (IMF 2018a), macro policies in Asia have generally been prudent and will need to remain so. Against the backdrop of low inflation and increasing downside risks to a still-strong growth outlook, most economies can afford to keep monetary policy accommodative, while fiscal policy will increasingly need to focus on building buffers, and exchange rates should be kept flexible. Some economies, where inflation is on the rise or capital flows remain volatile, should maintain a tight monetary stance.
- Second, **liberalize trade and investment.** Model simulation exercises in the background paper on trade (IMF 2018b) suggest that recent tariff actions and proposals could weigh heavily on growth. The impact on China's output could be up to 1.6 percent over the first two years, and for the region as a whole, GDP could drop by up to 0.9 percent, although short-term policy stimulus is expected to offset much of the impact, and the effects would fade over time. But more fundamentally, policymakers could take the opportunity to offset the decline in external demand by liberalizing their own trade and investment regimes, particularly in the services sector, so as to boost global and intraregional trade and thus develop a new driver of regional growth. There will be winners and losers, and effecting such reforms will be

difficult and will take time, but the aggregate welfare gains would be substantial.

- Third, **strengthen productivity prospects.** As shown in the background paper on productivity growth (IMF 2018c), a decline in firm dynamism, along with growing financial constraints such as excessive leverage, has been an important driver of the slowdown in Asia's productivity growth. Policymakers should ensure active entry and exit so that nonviable "zombie" firms do not absorb resources that could be better deployed in other enterprises, help firms address their debt overhang, and take steps to foster innovation and trade openness.
- Finally, **seize the opportunities of, while addressing the spillovers from, the digital economy.** As discussed in the background paper on the digital economy (IMF 2018d), Asia is already reaping major benefits from digitalization. Digital innovation has accounted for nearly one-third of Asia's per capita growth over the past two decades, e-commerce appears to be associated with higher firm productivity, and digitalization is helping to improve both revenue collection and expenditure targeting. At the same time, aggregate labor dislocations have been less pronounced than what some had feared. That said, policies to soften the labor market impact of new technologies will be of critical importance, as will policies to enhance financial stability. Furthermore, measures to improve education, infrastructure, and regulatory environments may permit digitalization to become an even more important engine of growth in the future than it already is.

In sum, Asia's growth faces some fundamental challenges, but with continued proactive and sound policymaking, the region should have good prospects for staying at the forefront over the coming decade and beyond.