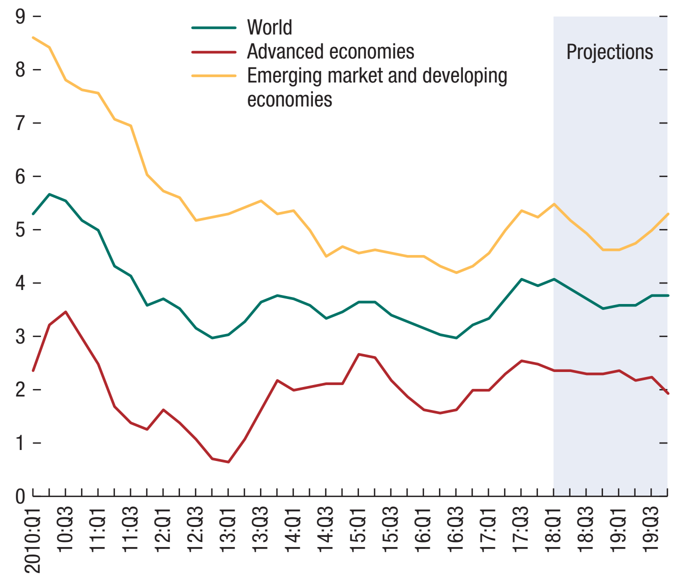
2. Asia as the Cycle Matures

Global Context

The global expansion that began two years ago appears to have peaked and become less synchronized across economies. While economic activity moderated in advanced economies during the first half of 2018 compared to 2017, it remained steady in most emerging economies (Figure 1). Growth was lower than expected in the euro area, Japan, and the United Kingdom. Meanwhile, in the United States, domestic demand continued to be buoyant, underpinned by low unemployment and a historically large, temporary fiscal expansion. Among emerging market economies, growth remained strong in emerging Asia but weakened in Argentina, Brazil, and Turkey. Several downside risks highlighted in the April 2018 *World Economic Outlook* (WEO) have increased or partially materialized, such as rising trade tensions and capital outflows from emerging economies with weaker fundamentals. With this more mixed global growth picture, there are already signs that trade is slowing.

Looking ahead, global growth for 2018–19 is projected at 3.7 percent, 0.2 of a percentage point lower than projected in the April 2018 WEO. The baseline forecast assumes gradually tightening financial conditions and relatively healthy trade growth (since only tariff actions that have already been approved are incorporated in the forecast). Advanced economies are projected to grow at 2.4 percent in 2018 before easing to 2.1 percent in 2019 as output gaps close and monetary policy becomes less accommodative. Emerging market and developing economies are projected to grow at 4.7 percent in both 2018 and 2019. In addition to the revisions to the baseline, risks have shifted to the downside—tied particularly to tightening financial conditions and rising trade tensions, as discussed below—and individual country prospects have changed on account of the differential impact of higher oil prices, tighter financial conditions, and idiosyncratic domestic factors.

Figure 1. Real GDP Growth
(Percent change, year over year)



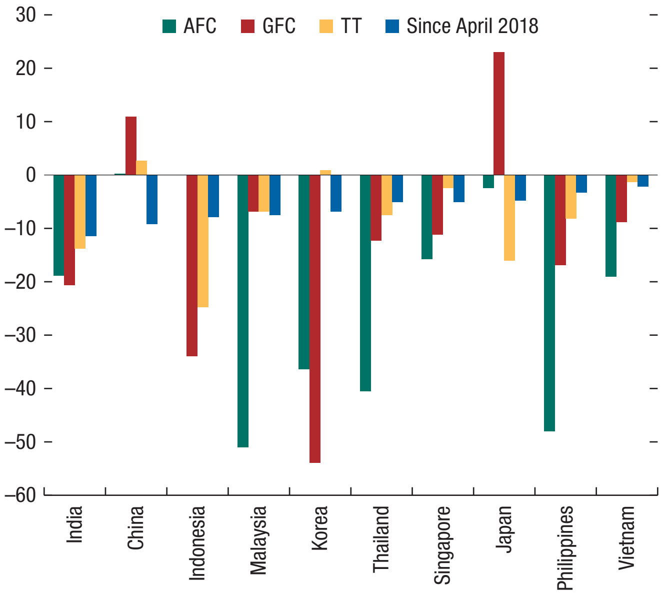
Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Recent Developments in the Region

Growth in the first half of 2018 was softer than in 2017, especially in advanced economies. In contrast, growth remained robust in emerging market economies and broadly in line with expectations. After rising to 6.9 percent in 2017, growth in China continued to be strong into the first half of 2018 but has likely slowed since, given the latest high-frequency indicators, including weakening investment growth. In Japan, after exceeding potential for two years, growth dropped into negative territory in the first quarter of 2018 before rebounding sharply in the second quarter. In India, growth continues to recover steadily after the disruptions related to demonetization and the rollout of the goods and services tax in the last fiscal year.[1] And in ASEAN-4 economies (Indonesia, Malaysia, the Philippines, Thailand), growth generally lost momentum in the first half of 2018, except in Thailand. Turning to price pressures, headline inflation inched up in several economies on account of higher oil prices and currency depreciation. Export growth generally

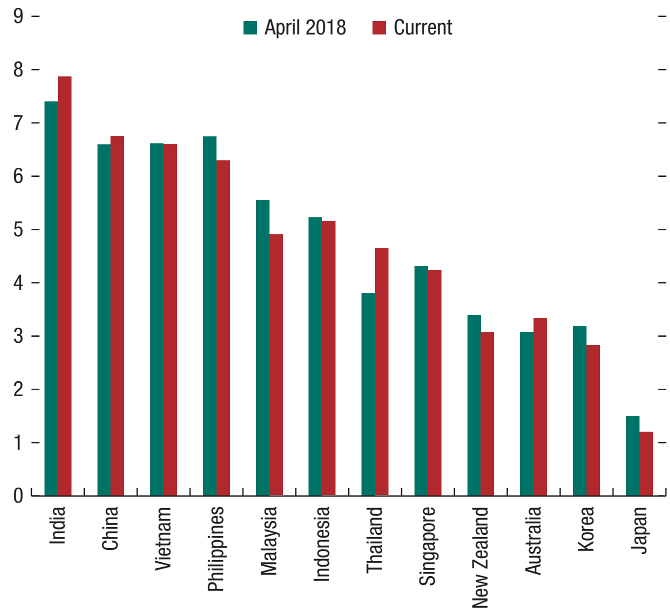
[1]Further country details are available in IMF (2018a).

Figure 2. Bilateral Exchange Rate Movements against US Dollars
(Percent change; positive = local currency appreciation)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: AFC = Asian financial crisis; GFC = global financial crisis; TT = taper tantrum.

Figure 3. Selected Asia: Real GDP Growth
(Percent change; year over year, 2018:H1)



Source: IMF, World Economic Outlook database.
Note: H1 = first half.

slowed in early 2018 but remains strong, while current account balances have narrowed on higher oil prices. Nonetheless, most economies, except China, Indonesia, and the Philippines, have increased their holdings of foreign reserves so far this year.

Financial conditions tightened, especially in Asian emerging market and developing economies, in response to US policy normalization, rising global trade tensions, and the recent volatility in some large emerging market economies. Cumulative portfolio flows in 2018 were far below those in 2016–17 on account of large outflows during the second quarter, with a pickup in nonresident sales of portfolio debt securities as the US dollar started to appreciate. Asian equity indices and exchange rates were negatively affected by trade tensions, while bond yields and spreads generally increased. Some central banks in the region raised policy rates, responding to inflation and exchange rate pressures, while some others directly intervened to support their domestic currencies. The recent volatility of Asian assets has been comparable in some respects to that seen during the taper tantrum, but Asia has been affected much less than other regions, and more tied to developments in China (Figure 2).

Asia's Near-Term Outlook

Notwithstanding the tightening of financial conditions and downside risks discussed below, the near-term outlook for Asia remains positive, supported by steady global momentum and broadly accommodative policies. Asia continues to be the main growth engine of the world and is projected to grow by 5.6 percent in 2018 (unchanged from what was projected in April) and 5.4 percent in 2019, down by 0.2 of a percent from April (Figure 3 and Table 1). Part of the downgrade is attributable to financial market stress and resultant policy tightening in some economies, but recent tariff actions have been another key driver. Indeed, as described below, these actions by themselves would have justified a much sharper growth markdown, but policy stimulus

Table 1. Asia: Real GDP Growth
(Percent change, year over year)

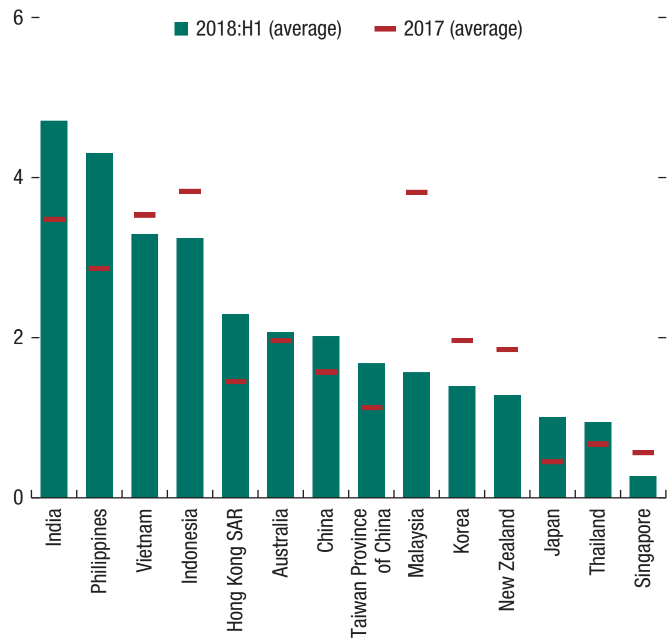
	Estimates and Latest Projections					Difference from April 2018 *World Economic Outlook*		
	2015	2016	2017	2018	2019	2017	2018	2019
Asia	**5.6**	**5.4**	**5.7**	**5.6**	**5.4**	**0.0**	**0.0**	**−0.2**
Advanced economies	**1.8**	**1.7**	**2.4**	**2.1**	**1.8**	**0.1**	**0.1**	**−0.1**
Australia	2.5	2.6	2.2	3.2	2.8	−0.1	0.2	−0.3
New Zealand	4.2	4.1	3.0	3.1	3.0	0.0	0.2	0.1
Japan	1.4	1.0	1.7	1.1	0.9	0.0	−0.1	0.0
Hong Kong SAR	2.4	2.2	3.8	3.8	2.9	0.0	0.2	−0.3
Korea	2.8	2.9	3.1	2.8	2.6	0.0	−0.2	−0.3
Taiwan Province of China	0.8	1.4	2.9	2.7	2.4	0.1	0.8	0.4
Singapore	2.2	2.4	3.6	2.9	2.5	0.0	0.0	−0.2
Emerging markets and developing economies[1]	**6.8**	**6.5**	**6.5**	**6.5**	**6.3**	**0.0**	**0.0**	**−0.3**
Bangladesh	6.8	7.2	7.4	7.3	7.1	0.3	0.3	0.1
Brunei Darussalam	−0.4	−2.5	1.3	2.3	5.1	0.8	1.3	−2.9
Cambodia	7.0	7.0	6.9	6.9	6.8	0.0	0.0	0.0
China	6.9	6.7	6.9	6.6	6.2	0.0	0.0	−0.2
India[2]	8.2	7.1	6.7	7.3	7.4	0.0	−0.1	−0.4
Indonesia	4.9	5.0	5.1	5.1	5.1	0.0	−0.2	−0.4
Lao P.D.R.	7.3	7.0	6.9	6.8	7.0	0.1	0.0	0.0
Malaysia	5.1	4.2	5.9	4.7	4.6	0.0	−0.6	−0.4
Myanmar	7.0	5.9	6.8	6.4	6.8	0.1	−0.5	−0.2
Mongolia	2.4	1.2	5.1	6.2	6.3	0.0	1.2	0.0
Nepal	3.3	0.6	7.9	6.3	5.0	0.4	1.3	1.0
Philippines	6.1	6.9	6.7	6.5	6.6	0.0	−0.2	−0.2
Sri Lanka	5.0	4.5	3.3	3.7	4.3	0.2	−0.3	−0.2
Thailand	3.0	3.3	3.9	4.6	3.9	0.0	0.7	0.1
Vietnam	6.7	6.2	6.8	6.6	6.5	0.0	0.0	0.0
Pacific island countries and other small states	**4.5**	**3.0**	**2.6**	**1.4**	**4.1**	**−0.4**	**−2.3**	**0.2**
Bhutan	6.2	7.3	7.4	5.8	4.8	1.4	−1.3	−2.8
Fiji	3.8	0.7	3.0	3.2	3.4	−0.8	−0.3	0.0
Kiribati	10.3	1.1	3.1	2.3	2.4	0.0	0.0	0.0
Maldives	2.2	4.5	4.8	4.7	5.0	0.0	−0.3	0.0
Marshall Islands	2.0	3.6	2.5	2.3	2.2	0.6	0.5	0.5
Micronesia	3.9	2.9	2.0	1.4	0.9	0.0	0.0	0.0
Nauru	2.8	10.4	4.0	−2.4	−1.0	0.0	0.6	−1.0
Palau	10.1	0.0	−3.7	0.8	2.2	−2.7	−0.2	−1.8
Papua New Guinea	5.3	1.6	2.5	−1.1	3.8	0.0	−4.0	1.2
Samoa	1.6	7.1	2.5	1.8	3.2	0.1	−0.7	0.4
Solomon Islands	2.5	3.5	3.5	3.4	2.9	0.3	0.4	0.0
Timor-Leste	4.0	5.3	−4.6	0.8	5.0	−4.1	−2.0	−0.7
Tonga	3.5	4.2	2.5	2.9	5.5	−0.6	−0.3	2.6
Tuvalu	9.1	3.0	3.2	4.3	4.1	0.0	0.8	1.0
Vanuatu	0.2	3.5	4.2	3.8	3.5	0.0	0.0	0.0
ASEAN[3]	**4.8**	**4.8**	**5.3**	**5.2**	**5.1**	**0.0**	**−0.1**	**−0.2**
ASEAN–5[4]	**4.5**	**4.6**	**5.1**	**5.0**	**4.8**	**0.0**	**0.0**	**−0.3**
EMDEs excluding China and India	**5.1**	**5.1**	**5.5**	**5.5**	**5.4**	**0.0**	**0.0**	**−0.2**

Sources: IMF, World Economic Outlook database; and IMF staff estimates and projections.
[1]EMDEs excluding Pacific island countries and other small states.
[2]India's data are reported on a fiscal year basis. Its fiscal year starts from April 1 and ends on March 31.
[3]ASEAN comprises Brunei Darussalam, Cambodia, Indonesia, Lao P.D.R., Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.
[4]ASEAN-5 comprises Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

from China (and possibly other economies as well) is likely to offset much of the impact. Projected growth in China remains at 6.6 percent for 2018 but has been marked down from 6.4 to 6.2 percent for 2019, with some increase in medium-term risks reflecting a possibly slower pace of deleveraging. In Japan, growth in 2018 has been marked down from 1.2 to 1.1 percent, reflecting the bumpy pattern of quarterly outturns, and over the medium-term growth is projected to converge toward potential. In India, the economy is projected to grow at 7.3 percent in FY2018/19 and 7.4 percent in FY2019/20, revised down by 0.1 and 0.4 percentage point, respectively, on account of higher oil prices and further monetary policy tightening. And in ASEAN-4 economies, growth projections have been revised down except in Thailand.[2]

Inflation across Asia is projected to increase to 2.7 percent in 2018 and 2.9 percent in 2019, reflecting higher commodity prices; however, inflation is expected to remain below target in several economies (Figure 4). Current account balances are expected to narrow with higher oil prices.

Figure 4. Selected Asia: Headline Inflation
(Percent change; year over year)



Sources: CEIC Data Company Ltd.; and IMF staff calculations.
Note: H1 = first half.

Risks to the Forecast

The balance of risks has shifted to the downside in the near term and remains, as in the April 2018 *Regional Economic Outlook: Asia and Pacific*, tilted to the downside over the medium term. While forecasters, including the IMF, systematically underestimated the strength of the recovery over the past couple of years, this trend now appears less likely given outturns in the first half of 2018 and weakening signals from forward-looking indicators. Sources of near-term downside risks include:

- *Escalating trade tensions.* Following tariff increases in early 2018 on washing machines, solar cells, steel, and aluminum, the United States on June 15 announced a list of products imported from China (worth $50 billion) that would be subject to a 25 percent tariff. China announced retaliation on a similar scale. On September 17, the United States announced a further $200 billion in imports from China that would be subject to a tariff starting at 10 percent and rising to 25 percent from January 2019. China, in turn, announced tariffs on an additional $60 billion of US imports. The United States has also suggested that a further $267 billion of goods—covering nearly all remaining Chinese imports—may be hit with tariffs, and it has separately proposed tariffs on the automotive sector that would affect many other countries. Sustained trade tensions could further undermine confidence, hurt financial markets, disrupt supply chains, and discourage investment and trade. Model simulations discussed below suggest that growth in Asia could drop by up to 0.9 of a percent over the next couple of years. Greater protectionism could also make

[2]IMF (2018a) provides a detailed description of the outlook for a range of other countries in the region.

tradable consumer goods less affordable and boost inflation.

- *Tighter global financial conditions*. Signs of higher-than-expected inflation in the United States could lead the US Federal Reserve and other advanced-economy central banks to tighten monetary policy at a faster pace than currently priced in by markets. A sudden deterioration of risk appetite, rising trade tensions, and political and policy uncertainty could also lead to tighter financial conditions. Turmoil already seen in some emerging market economies could worsen, with negative spillovers to Asia through reduced capital flows and higher funding costs. Simulations from the IMF's Flexible System of Global Models suggest that tighter financial conditions could lower Asia's GDP by as much as three-quarters of a percentage point (IMF 2018a).
- *Homegrown risks.* Macro policies in China have been focused on addressing the economy's significant and longstanding financial vulnerabilities, but the shift toward stabilizing growth may mean slower progress on deleveraging and thus heightened medium-term risks for China and the entire region. Economies also face their own domestic risks, including from high private-sector leverage in some countries such as Korea, inflated real estate markets in Australia and Hong Kong SAR, and slower-than-envisaged implementation of structural reforms in India.

Policies to Build Resilience

Policies and reforms should seek to maintain the current expansion, contain risks, and strengthen resilience to the growing downside risks. Policies should also raise medium-term growth and enhance its inclusiveness. Preserving international and regional collaboration remains an important overarching objective. Given the diversity of cyclical positions, structural constraints, and available policy space, specific policy priorities differ across economies:

- As discussed in IMF (2018a), exchange rates should generally be allowed to move flexibly and act as a shock absorber, with foreign exchange intervention used only to deal with disorderly market conditions.
- Monetary policy will then be able to independently address inflation and domestic objectives—currently, with low inflation and negative output gaps in most advanced economies in the region, monetary policy should generally remain accommodative, though a tighter stance would be warranted where inflation is on the rise, or where capital flows remain volatile and balance sheets show significant currency mismatches.
- Financial stability should be addressed by appropriate micro- and macro-prudential measures.
- Fiscal policy should focus on building buffers, supporting inclusive long-term growth, and reducing excessive external imbalances.
- Finally, structural reforms should be pursued to raise potential output and productivity, boost labor force participation—including that of females—and ensure opportunities for all segments of society. As discussed in the following sections, efforts at trade liberalization, measures to boost firm dynamism, and policies to harness the benefits of digitalization while addressing its financial and labor market disruptions will be particularly important structural reform priorities.

3. The Evolving Role of Trade in Asia: Opening a New Chapter[3]

Asia's heavy reliance on trade in general, and its integration in global value chains in particular, have been critical elements behind the region's

[3]This section is based on IMF (2018b).