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

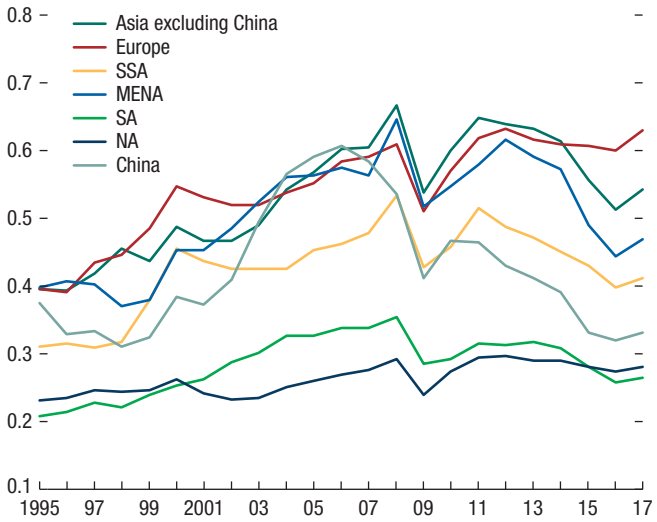
[3]This section is based on IMF (2018b).

stellar growth record. But rising income levels and wages in the region combined with a less buoyant medium-term outlook in advanced economies suggest the need for Asia to reconsider its growth model, currently oriented toward meeting final demand in other regions (IMF 2016, Mano 2016). In addition, China has not exited labor-intensive light manufacturing sectors as quickly as Korea and Japan did in earlier eras, possibly limiting opportunities for the next wave of Asian developing economies and again suggesting the need for a new model (Mathai and others 2016). Finally, the secular decline in manufacturing's share in employment combined with the fast rise in automation (for example, robotics), also points to a needed shift toward tradable services (IMF 2018e).

While Asia confronts this structural transformation, its export-oriented growth model faces an additional threat from increasingly inward-looking policies in advanced economies. Recently enacted tariff and investment-related actions are significant and would weigh on growth—particularly in China—although policy stimulus there is likely to offset some of the impact. Further escalation has been proposed, and this, along with impacts on confidence and financial markets, would have even more substantial economic effects across the region.

On the other hand, a reinvigorated commitment to an open, stable, and rules-based international trade system and negotiations to liberalize trade further at the global level would enhance productivity and raise incomes (IMF, World Bank, and WTO 2017). In Asia, trade restrictiveness and so-called "trade costs" remain high (Cerdeiro and Nam 2018), notwithstanding the progress made in cutting goods tariffs and nontariff barriers in the context of World Trade Organization and regional agreements (ADB 2017). Reinvigorating reforms in areas, such as agriculture, where less progress has been made is important. In addition, opening new areas in services and digital trade could contribute significantly to intraregional and global trade, with Asia being a driver of global demand and economic growth (IMF, World Bank, and WTO 2018).

Figure 5. Trade Openness
(Index)



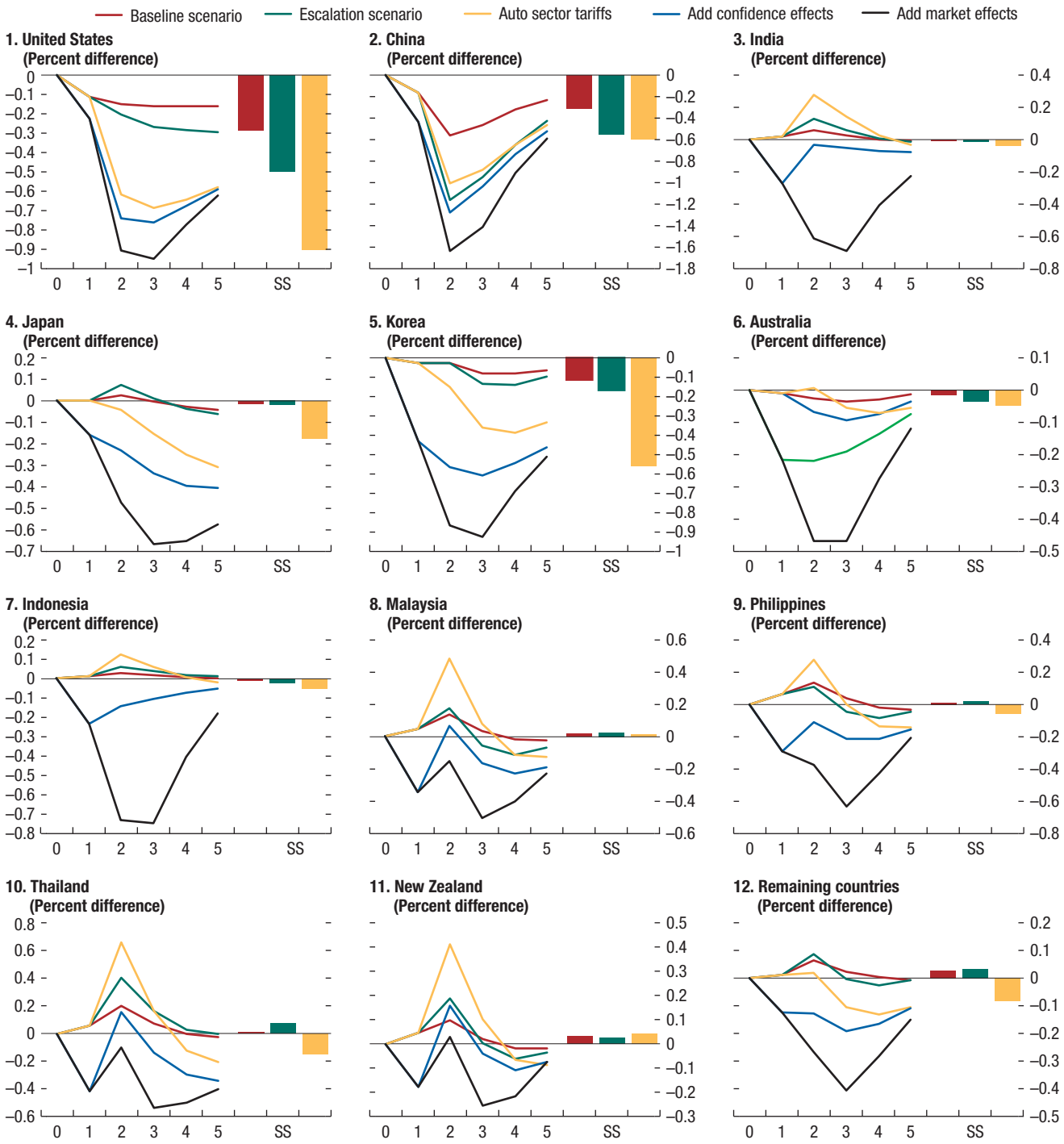
Sources: IMF, *World Economic Outlook*; IMF, Direction of Trade database; and IMF staff calculations.
Note: Europe = Europe and the Commonwealth of Independent States; MENA = Middle East and North Africa; NA = North America; SA = South America, Central America, and the Caribbean; SSA = sub-Saharan Africa.

Key Findings

The second background paper to this report (IMF 2018b) examines how trade has evolved as a driver of growth in Asia and explores the extent to which it can continue to play this role. The paper shows first that trade openness, which rose sharply starting in the late 1990s and early 2000s, has plateaued, and in some cases declined, since the global financial crisis, reflecting both the global trade slowdown and the maturing of global value chains, particularly in China (Figure 5).

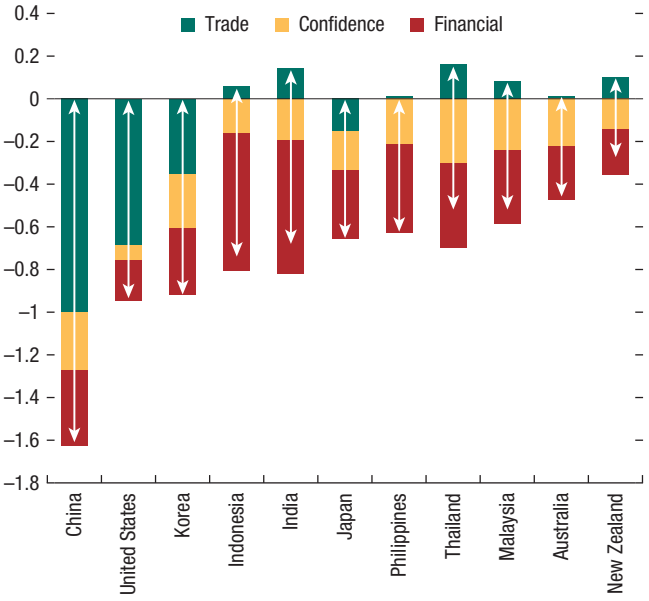
The paper then deploys two complementary models to examine the effects of trade policy changes, consistent with the analysis in the October 2018 *World Economic Outlook*. The effects of recently enacted tariffs and retaliation are small but material, especially for China (red lines in Figure 6). GDP losses would rise substantially should additional tariffs be implemented (green and yellow lines), and particularly so if business

Figure 6. Trade Tension Scenarios—Decomposed by Economy in Asia for Real GDP
(Percent deviation relative to before trade tensions)



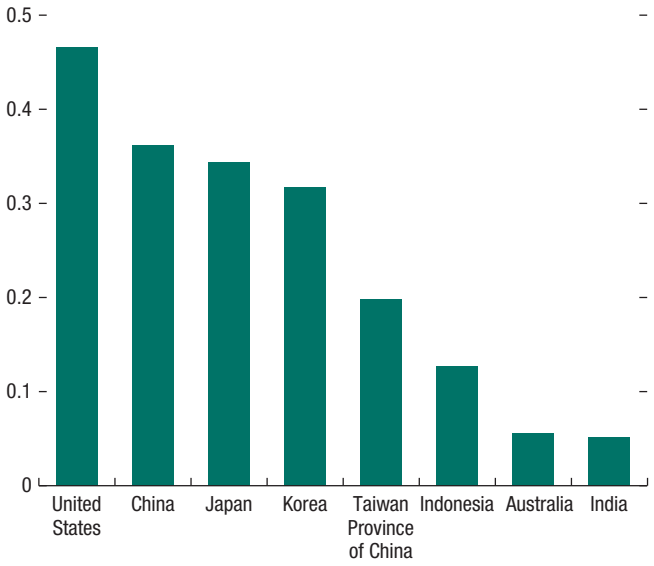
Source: IMF staff calculations.
Note: On the horizontal axes, "SS" is the steady-state outcome. The baseline scenario corresponds to measures that have already been implemented by the United States on steel and aluminum, products imported from China (worth $50 billion) subject to a 25 percent tariff and retaliation from China, and the further $200 billion in imports from China that is subject to a tariff starting at 10 percent and rising to 25 percent by year-end (China, in turn, announced tariffs on an additional $60 billion of US imports) that are included in the World Economic Outlook baseline projections. The escalation scenario estimates the impact of the United States imposing a 25 percent tariff on a further $267 billion of imports from China and China responding by raising both the base that tariffs apply to and the tariff rates such that all goods imports from the United States also face a 25 percent tariff (roughly $130 billion in imports from the United States). The auto sector tariff scenario estimates the impact of the United States following through on the proposal to impose a 25 percent tariff on all imported cars and car parts (worth about $350 billion) and retaliation. The fourth layer estimates the potential impact that rising trade tensions could have on confidence and thus firms' investment plans. The final layer adds the impact of a potential tightening in financial conditions for corporates.

Figure 7. Trade Tension Scenarios: Peak Impacts on Real GDP
(Percent deviation relative to before trade tensions)



Source: IMF staff calculations.
Note: Trade includes baseline, escalation, and auto sector tariffs with confidence and financial market effects as separate layers. Peak responses are generally from 2020.

Figure 8. Total Labor Reallocation in Trade Tension Scenarios
(Percent of initial employment)



Source: IMF staff estimates.

confidence and financial markets were to be affected (blue and black lines). For most countries, the output effects of tariffs would fade after a few years, but there could be substantial lasting effects in China, Korea, and the United States (bars in Figure 6). If all of the channels were in play, enacted and proposed tariffs and retaliation would cause peak GDP losses of 1.6 percent in China and close to 1 percent in the United States; other economies in Asia, many of which supply to China through global value chains and/or are heavily involved in the automotive trade, would also see their economies slowing substantially, and the peak GDP loss for Asia as a whole would be 0.9 percent (Figure 7).[4] Aggregate short-term job losses would likely be limited, but certain sectors—particularly those targeted by specific tariffs—could see sizable impacts (Figures 8 and 9).

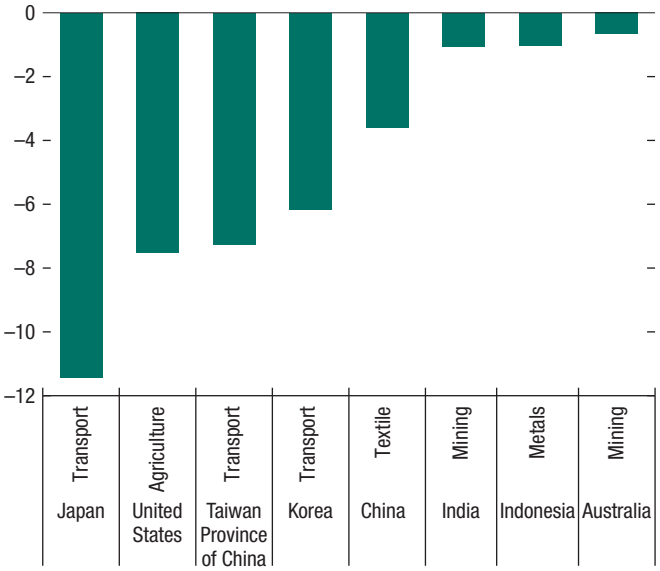
[4]The forecasts in Table 1 above have not been revised down as sharply as this since some of the tariff actions are still just proposals, and also because it is assumed that China implements substantial stimulus to bolster growth.

In the past, tariff reductions by Asian economies helped support growth, but in recent years liberalization efforts have slowed. Asia still suffers from significant trade costs, driven by nontariff barriers. Restrictions on services and foreign investment remain relatively high, and model simulations in IMF (2018b) suggest that there is scope for a new wave of liberalization that could, over time, lift productivity in the region.

IMF (2018b) illustrates three scenarios—one in which China eliminates goods tariffs and reduces nontariff barriers on services for all of its trading partners; another in which all Asian economies open up in this manner to each other; and a third in which all Asia opens up to the whole world (and possibly liberalizes FDI restrictions as well). In all of these scenarios, Asia's trade, productivity, and output increase, as do global trade and output. In the last, most ambitious, scenario, Asia's GDP would rise on average by nearly 12 percent, and some economies could see output increases approaching 20 percent (Figure 10).

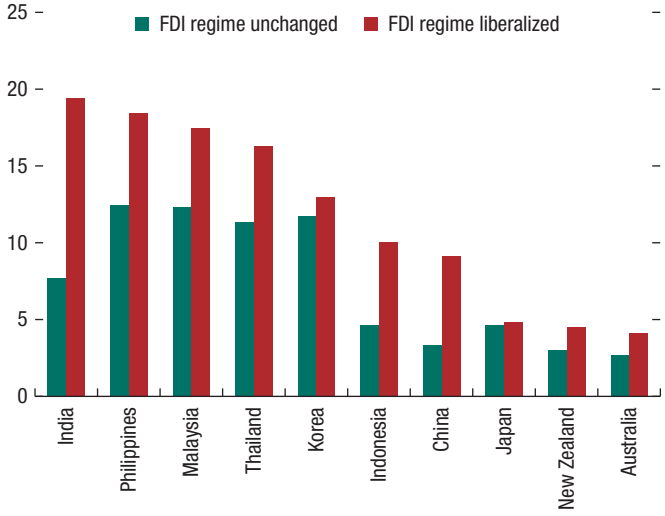
Thus, while today's trade tensions will clearly have a negative impact on the region and the world,

Figure 9. Major Sectors with Large Labor Shedding in Trade Tension Scenarios
(Percent of sector's initial employment)



Source: IMF staff estimates.

Figure 10. Effects of Trade Liberalization and Easing FDI Restrictions
(Percent deviation relative to baseline)



Source: IMF staff calculations.
Note: FDI = foreign direct investment.

Asian policymakers have it within their power to ensure that trade remains important, and in fact becomes more important, as a driver of growth. Multilateral liberalization would be ideal, but plurilateral liberalization within Asia can be a useful second-best solution. The priority should be to reduce nontariff barriers to services trade and liberalize investment regimes, thus promoting intraregional integration as well as global trade. Trade flows within Asia should increasingly cater to final demand within the region, consistent with the rebalancing agenda, with the region thus relying less on manufacturing exports to the rest of the world. And with eased investment restrictions, Asian economies will be better able to diversify their trade structures and move up value chains, playing a greater role in intermediate-goods trade.

All of this may be easier said than done. Negotiating such reforms would in all likelihood take many years to accomplish, especially since liberalization could create both winners and losers (as also shown in IMF 2018d). And even after reforms were implemented, it would take additional time for their full benefits to be realized. In addition, some nontariff barriers may derive from domestic distortions, which may not be easy to correct. Domestic policies to address trade-related adjustments and ensure that all members of society share in the gains unleashed by liberalization will be critically important. Investment in infrastructure, active labor market policies (such as job search assistance and training programs), and social safety nets could aid structural transformation, augment worker skills, and facilitate re-employment. Efforts to boost productivity growth—including measures to promote greater dynamism at the firm level, as discussed in the next section—would also naturally help to cushion the impact of trade reforms.

4. Productivity Growth in Asia: Boosting Firm Dynamism and Weeding out the Zombies[5]

The April 2017 *Regional Economic Outlook: Asia and Pacific* documented that productivity growth

[5]This section is based on IMF (2018c).