External Economic Environment and Regional Outlook

The external recovery has been tentative this year after G3 economic growth slipped during the first half—the better US growth outlook has yet to benefit Asia, there is some uncertainty over Japan's prospects , and the eurozone economy continues to struggle.

In the United States (US), growth in gross domestic product (GDP) rebounded in the second quarter (based on quarter-on-quarter seasonaly adjusted annualize rate [q-o-q, saar]) after an unusually severe winter led to a contraction in the first quarter; while first estimate for third quarter growth came in well above market expectations. The strong growth is expected to continue as industrial production, manufacturing, and consumer confidence indexes continue to rise along with a pickup in housing starts. In Japan, GDP shrank in the second quarter (q-o-q, saar)—wiping out the first quarter's gain—following the implementation of April's value-added tax rate hike. Recent indicators point to weaker-than-expected economic growth, which prompted the Bank of Japan to expand its quantitative easing program. Growth in business investment could support 2015 growth, but private consumption—pending the second sales tax hike—will continue to be constrained. In the eurozone, on the other hand, declining investment and a drop in inventories kept GDP growth unexpectedly flat in the second quarter (q-o-q, saar). Monetary authorities responded by cutting policy interest rates and buying private sector securities. Despite the loose monetary policy, recent economic data suggest a limited recovery as growth in industrial production and retail sales remains sluggish.

Developing Asia's resilient growth is partly due to strong domestic and regional demand, although it varies across subregions.

In aggregate, GDP growth in developing Asia, after 6.1% growth in 2013, will increase marginally to 6.2% in 2014 and 6.4% in 2015 **(Table 2)**. The rising GDP growth in South Asia is offset by a slowdown in

Table 2: Regional GDP Growth[1] (y-o-y, %)

	2011	2012	2013[8]	Forecast[9] 2014	Forecast[9] 2015
Developing Asia[2]	7.4	6.1	6.1	6.2	6.4
Central Asia[3]	6.8	5.6	6.5	5.6	5.9
East Asia[4]	8.2	6.6	6.7	6.7	6.7
People's Republic of China	9.3	7.7	7.7	7.5	7.4
South Asia[5]	6.4	4.6	4.7	5.4	6.1
India	6.7	4.5	4.7	5.5	6.3
Southeast Asia[6]	4.8	5.7	5.0	4.6	5.3
The Pacific[7]	9.4	6.1	5.0	5.3	13.2
Major Industrialized Economies					
eurozone	1.6	-0.7	-0.4	0.8	1.0
Japan	-0.5	1.5	1.5	1.0	1.4
United States	1.8	2.3	2.2	2.1	3.0

[1]Aggregates weighted by gross national income levels (Atlas method, current $) from *World Development Indicators*, World Bank.
[2]Refers to the 45 developing members of the Asian Development Bank.
[3]Includes Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
[4]Includes the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China.
[5]Includes Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. Data for Bangladesh, India, and Pakistan are fiscal-year. For India, fiscal year is from April of the specified year through the following March. For Bangladesh and Pakistan, fiscal year is from July the previous year through June of the specified year.
[6]Includes Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. Excludes Myanmar as weights unavailable.
[7]Includes the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu. Excludes Nauru as weights unavailable.
[8]ADB estimates except for the People's Republic of China, India, eurozone, Japan, and the United States which are actual values.
[9]ADB forecasts from *Asian Development Outlook Update September 2014*.
Source: ADB calculations using data from various issues of the *Asian Development Outlook*, Asian Development Bank; and CEIC.

Southeast Asia and Central Asia, while growth is flat in East Asia. South Asian economies are performing better than expected, led by India—where a popular government has committed to begin implementing long-delayed reforms. On the other hand, Southeast Asian economic expansion moderated on slower investment and consumption growth; while the slowdown in demand from the Russian Federation is dragging down growth in Central Asia. In East Asia, growth in the People's Republic of China (PRC) and Hong Kong, China is gradually easing, offset somewhat by expected upswings in the Republic of Korea and Taipei,China.

Economic growth in the PRC will continue to moderate gradually, in line with government rebalancing efforts; growth prospects across the rest of East Asia remain mixed.

In the PRC, GDP growth moderated to 7.3% in the third quarter on sluggish property market and weaker consumer demand and industrial production. Targeted measures to sustain investment are expected to help the PRC attain its official growth target of 7.5% in 2014, before easing somewhat to 7.4% in 2015. For the rest of East Asia, the outlook is mixed. In the Republic of Korea, consumer and investor sentiment dampened second quarter GDP growth following the tragic ferry disaster. But strong global demand for manufactures is expected to boost growth through 2015. Taipei,China's GDP growth rose in the second quarter on robust domestic demand and higher exports. Yet growth in Hong Kong, China slowed—mainly due to a contraction in fixed investments.

Better-than-expected growth across most of South Asia boosts the growth outlook, supported by stronger exports, rising remittances, and easing inflation.

In India, economic outlook improved as reforms initiated this year boosted the business environment. Sri Lanka's economy is showing robust growth, benefitting from a favorable monsoon, industrial expansion, and benign inflation. Elsewhere in the region, a substantial uptick in public investments, export receipts and overseas worker remittances should bolster economic prospects in Bhutan, Nepal, and Pakistan.

Most Southeast Asian economies will ease this year, though mainly due to temporary domestic factors; but is expected to bounce back in 2015 on recovery of exports and investments.

Indonesia's interest rate hikes last year continued to drag domestic demand, while restrictive mining policies and lower commodity prices led to weaker exports. GDP growth decelerated to a fresh 5-year low of 5.0% in the third quarter. In Singapore, the benign economic outlook is expected to continue with a tight labor market and ongoing domestic restructuring. In the Philippines, after 2 years of strong growth, the expansion is moderating on lower government spending; however, recent data on exports and remittances indicate growth could surprise on the upside. Thailand's GDP growth is also forecast to slow this year due to political events; but latest data show it avoided a technical recession—the change in government boosted economic sentiment. Meanwhile, Malaysia's growth outlook has improved on stronger domestic demand, which buoyed GDP growth in the first half.

Growth in Central Asian economies is declining as the spillover from slower growth in the Russian Federation hurts their trade and remittances; along with a sharp industrial slowdown in Kazakhstan.

The economic slowdown in the Russian Federation—due to political tensions—is dragging down export demand in most Central Asian economies—most notably Turkmenistan and Armenia. Remittances from the Russian Federation also fell sharply, hurting Uzbekistan and Tajikistan most. Kazakhstan's 3.8% first quarter growth was its slowest quarterly growth since the 2008/09 global financial crisis, prompting the government to launch a $5.5 billion stimulus program for 2014 and 2015.

Economic growth in the Pacific will increase somewhat, led by its largest economy, Papua New Guinea.

Papua New Guinea will drive the subregion's growth in 2015 as it starts its first full year of liquefied natural gas exports. Some economies are expected to grow stronger in 2014 on fiscal stimulus tied to large infrastructure projects. Reconstruction and rehabilitation should fuel growth in Nauru, Tonga, and Samoa; while getting delayed infrastructure projects off the ground in Kiribati, the Marshall Islands, Tuvalu, and Vanuatu should raise 2014 growth in these economies. However, the overall growth forecast for 2014 for the subregion was dragged down by the damage caused by torrential rains in the Solomon Islands in early 2014, disappointing business activity in Timor-Leste, and a downturn in construction and tourism in Palau.

Risks to the Outlook and Policy Issues

There are five downside risks to the outlook: (i) delays in planned reforms; (ii) the impact on developing Asia of a faster PRC slowdown; (iii) increasing corporate sector external debt; (iv) weaker recovery in advanced economies, particularly Europe; and (v) capital outflows or financial volatility from early US monetary tightening.

Any delay in planned domestic structural reforms could leave economies more exposed to potential shocks—both external and internal. As governments in developing Asia adjust policies to reduce structural bottlenecks, boost productivity, promote private investment, and lift consumer spending, they could be hindered by lackluster external demand, a slowdown in remittances, or capital flow reversals, for example. Thus, continuing the domestic reform agenda is critical, particularly given the expected tightening of global liquidity and geopolitical uncertainty tensions.

A faster-than-expected slowdown in the PRC economy could hurt prospects for the rest of developing Asia, especially those with strong trade links to the PRC, such as Hong Kong, China; Indonesia; the Republic of Korea; Myanmar; Thailand; and Viet Nam. There could also be direct or indirect effects through financial channels. The region's equity markets and currencies could weaken should investor confidence fall alongside slower PRC growth.

Asia's corporate sector external debt is rising, increasing vulnerability to external shocks. International debt securities issued by non-financial corporations increased from $271.4 billion in December 2012 to $311.9 billion in March 2014.[11] During the same period, net external assets of Asian banks held by corporations increased 10% to $1.9 trillion, with over 80% denominated in foreign currency.[12] Continued US dollar appreciation due to the US recovery would increase this vulnerability.

Advanced economies are also showing differentiated growth prospects. The US recovery is back on track after a poor first quarter performance, although the impact on Asia is yet to happen. But sluggish external demand and domestic weakness—particularly in the labor market—could pose risks to the recovery in Japan. A key risk, however, comes from Europe, where the feeble recovery in the eurozone stalled further in the second quarter with limited options for a rebound in the coming quarters.

Finally, while pace of US monetary tightening may still surprise markets, they would likely have a modest impact on Asia. The US Federal Reserve could tighten monetary policy sooner than anticipated, but it would come from a sustained jump in US growth, which would benefit the region's exports. A US interest rate shock may prompt developing Asia's policymakers to raise interest rates to forestall large capital and exchange

[11] Based on data from the Bank for International Settlements. Includes issuers by nationality from Australia; the People's Republic of China; Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; Malaysia; the Philippines; New Zealand; Singapore; Taipei,China; and Thailand.

[12] Includes Australia; Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; Malaysia; Singapore; and Taipei,China.

rate movements, though this would increase the domestic cost of capital and limit the scope for growth.[13] However, model simulations suggest that policy response in the region remains adequate to avoid these disruptions and should not derail growth.

Taken together, the risks underscore the reasons why Asia's policymakers must continue with their national agendas for structural reform, while keeping macroeconomic fundamentals strong.

Asia's experience with the Asian and global financial crises and contagion makes the case for using macroprudential policy in support of sound macroeconomic policy—including effective financial regulation and supervision. Macroprudential policy should help safeguard financial stability—in particular when dealing with the credit and asset price cycles driven by global capital flows. Regional cooperation on macroprudential policy could also address possible policy spillovers—for example, the side effects these policies can have on capital flows that might increase vulnerability of other economies in the region.

[13]See ADB. 2014. *Asian Development Outlook Update*. Manila.