01

Regional Outlook, Linkages, and Vulnerabilities

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Regional Outlook, Integration, and Challenges

Developing Asia's economic output is expected to grow 5.9% in 2017 from 5.8% in 2016—0.2 percentage point above the projection in the *Asian Economic Integration Report 2016*.

A rebound in global trade, recovery in major industrial economies, and stronger-than-expected growth in the People's Republic of China (PRC) are expected to support the better growth outlook. Gross domestic product (GDP) in the PRC is now expected to grow 6.7% in 2017—0.3 percentage point above the *Asian Economic Integration Report 2016* forecast—led by expansionary fiscal policy and an unanticipated rise in external demand.

More than 70% of the region's economies should see faster growth compared with 2016, with higher rates in all subregions except East Asia and South Asia, where growth this year is stable (Table 1.1). A better external environment and strong domestic demand generally support the forecast. After 2 years of lower export receipts, the value of the region's exports surged 10.1% year-on-year in the first 7 months of 2017. Moderately rising oil prices are giving some fiscal relief to oil and gas exporters without destabilizing oil importers. Excluding the PRC, Asia's eight largest developing economies also saw real manufacturing exports rebound—particularly electronics, where foreign direct investment has been increasing (ADB 2017).

Table 1.1: Regional GDP Growth[a] (%, year-on-year)

	2014	2015	2016	Forecast[c]	
				2017	2018
Developing Asia[b]	6.4	6.0	5.8	5.9	5.8
Central Asia	5.2	3.1	2.2	3.3	3.9
East Asia	6.6	6.1	6.0	6.0	5.8
People's Republic of China	7.3	6.9	6.7	6.7	6.4
South Asia	6.9	7.3	6.7	6.7	7.0
India	7.5	8.0	7.1	7.0	7.4
Southeast Asia	4.6	4.6	4.6	5.0	5.1
The Pacific	9.4	8.4	2.4	2.9	3.2
Major industrialized economies					
euro area	1.2	1.9	1.7	2.0	1.8
Japan	0.2	1.1	1.0	1.5	1.1
United States	2.4	2.9	1.5	2.2	2.4

GDP = gross domestic product.
[a] Aggregates weighted by gross national income levels (Atlas method, current $) from World Development Indicators, World Bank.
[b] Refers to the 45 ADB developing member economies.
[c] Forecasts based on ADB's *Asian Development Outlook Update 2017*.
Sources: ADB calculations using data from ADB (2017); and CEIC (accessed September 2017).

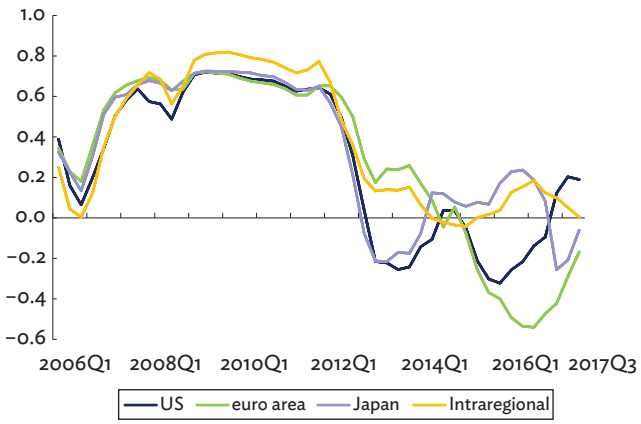
Risks to the outlook have become more balanced, both positive and negative.

There are three main risks to the outlook: (i) lower-than-expected oil prices; (ii) United States (US) monetary policy surprises; and (iii) uncertain US fiscal policy reform. While softening oil prices would benefit importers, it would also hit oil exporters. A sharper-than-expected tightening of the US Federal Funds rate could still induce large capital outflows from developing Asia, although better communication of US Federal Reserve intentions has so far averted market overreaction. And while US tax reform and spending on public works could have positive global spillover effects, intense debate and possible political stalemate over budget details could unsettle currently buoyant business expectations of a boost in domestic demand, thereby increasing market uncertainty.

Recently, developing Asia's growth cycle has moved more synchronous with the US than intraregionally.

Developing Asia's growth cycle has recently become more correlated with the US than internally. This is evident from business cycle correlation analysis that shows the degree of co-movement between business cycle fluctuations in the US, the euro area, Japan, and across developing Asia (Figure 1.1). The region's business cycle correlation with the US has turned positive since first quarter of 2017. The increased business cycle synchronicity could arise from a common global factor—such as resurging trade growth—or a demand spillover from advanced economies to the region. By contrast, intraregional business cycle correlation has weakened—still but remain in positive territory—since the third quarter of 2016, partly reflecting the limited spillover effect of the PRC slowdown.

Figure 1.1: Developing Asia's Business Cycle Correlations

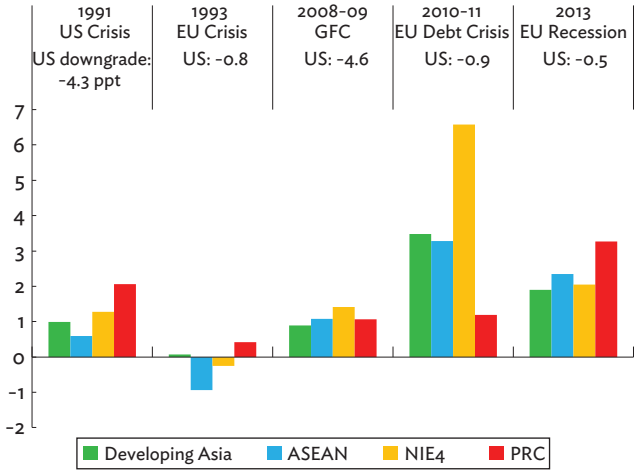


US = United States.
Notes: Developing Asia includes ASEAN4 (Indonesia, Malaysia, the Philippines, and Thailand), NIE4 (Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China), India, and the People's Republic of China. Three-year moving correlations based on cyclical Hodrick-Prescott filtered seasonally-adjusted gross domestic product at constant prices.
Source: ADB calculations using data from Oxford Economics. Global Economic Databank. http://www.oxfordeconomics.com/ (accessed September 2017).

Slowdown in global demand and the PRC growth moderation continue to affect the region's business cycle.

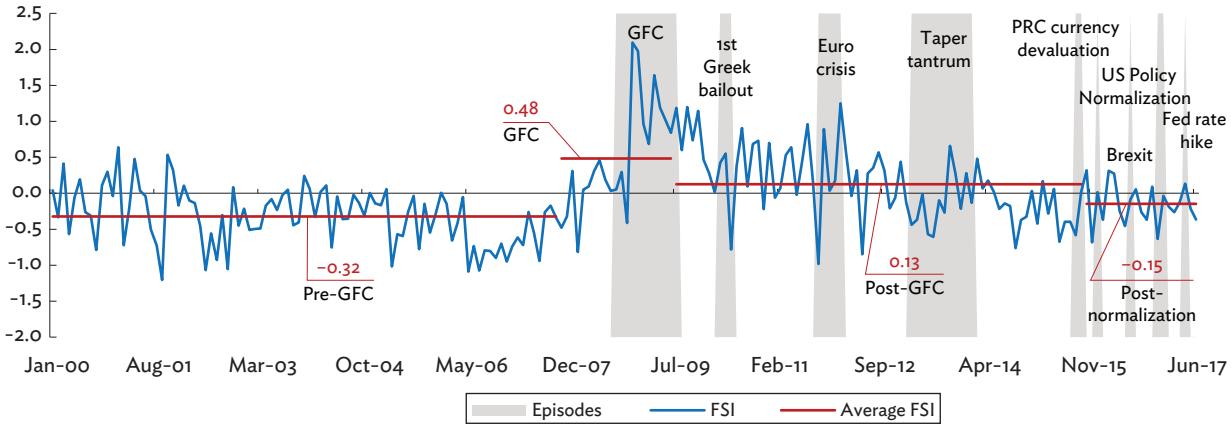
Examining changes in GDP growth during previous recessions in the US and euro area show that global shocks are having an increasing impact on developing Asia (Figure 1.2). For example, the ratio of change between GDP contractions in the US with those in developing Asia—for the same period—has increased over time. It is more closely aligned for export-oriented newly industrialized economies than for middle-income Association of Southeast Asian Nations (ASEAN)

Figure 1.2: Change in GDP Growth During US and EU Recessions—Developing Asia (percentage point change relative to the US)



ASEAN = Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam); EU = European Union; GDP = gross domestic product; GFC = global financial crisis; NIE4 = newly industrialized economies (Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China); PRC = People's Republic of China; ppt = percentage point; and US = United States.
Notes: Change in GDP growth is computed as the difference between peak and trough before and during the US and EU recessions. Aggregates are weighted using gross national income (Atlas method, current $). Developing Asia includes ASEAN, NIE4, India, and the PRC.
Sources: ADB calculations using data from CEIC; and World Bank. World Development Indicators. http://databank.worldbank.org/ (both accessed August 2017).

Figure 1.3: Financial Stress Index—Developing Asia



FSI = Financial Stress Index, GFC = global financial crisis, PRC = People's Republic of China, US = United States.
Pre-GFC = January 2000–September 2007, GFC = October 2007–June 2009, Post-GFC = July 2009–September 2015, Post-normalization = October 2015–June 2017.
Notes: Based on principal components analysis. Includes the PRC; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.
Sources: ADB staff calculations using data from Bloomberg, CEIC, and Haver Analytics (all accessed September 2017).

economies. Similarly, as its exports grew, the PRC economy became more sensitive to the US and euro area recessions. Its growth moderation also continues to affect the region's growth cycle and prospects.

While Asia has endured several economic and financial crises—strengthening its financial resilience in response—global shocks can still affect the region's financial markets and economies.

The current Financial Stress Index (FSI) for developing Asia is quite benign (Figure 1.3). The stress level for the region has subsided since the spikes during the 2008/09 global financial crisis (GFC), reflecting improved resilience in the region's financial systems. Nonetheless, the FSI shows financial systems remain prone to increased volatility from potential global shocks—as seen from the spikes during the taper tantrum, the PRC currency devaluation, and Brexit.

Transmission Mechanism

The GFC severely affected the region's credit, equity, and currency markets—as risk aversion triggered capital outflows from the region. In turn, tighter credit conditions and weak external demand affected the real sector, as seen from the large declines in trade volume and GDP growth. However, adequately capitalized banks and appropriate monetary and fiscal responses from policy makers provided an effective firewall that allowed the region to recover quickly and rekindle robust growth. Nonetheless, it is important to revisit how external shocks from the rest of the world could transmitted to the region.

Given Asia's strong trade orientation and openness, trade remains a key transmission channel for global shocks to affect the region.

Over time, the region has strengthened its capacity to cope with cyclical downturns in external demand by expanding domestic and regional demand. This can be seen from the higher share of intraregional trade, which increased from 53.9% in 2008 to about 57.3% in 2016. At the same time, Asia's trade share with the EU and the US (G2) declined from 25.1% to 24.2% over the same period. Still, a large portion of Asia's intraregional trade appears to be linked to external demand. For instance, a decomposition of Asia's value-added exports show that its own final demand accounts only for 36.8% of its total value-added exports, while 63.2% accrues to external final demand, of which 26.9% is accounted for by final demand from G2 markets. Once the cascading effect of "intermediate goods exports" are accounted for, the region's dependence on external demand grows—particularly with the US. This is consistent with an ADB study that finds the US economy remains an important source of external demand shock for the region although

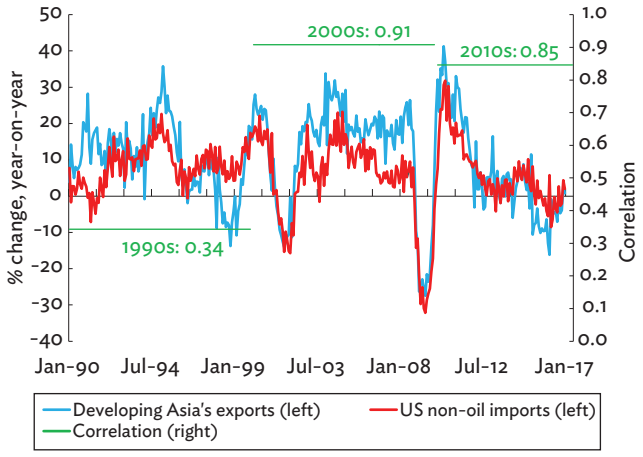
the impact of the PRC has also increased sharply, more recently (Park 2017).

Furthermore, the relationship between the region's exports and growth in US non-oil imports continues to be tight, although loosening somewhat in recent years—from 0.91% in 2000–2010 to 0.84% in 2010–2016 (Figure 1.4). Due in part to improving US domestic demand, most export-oriented economies in the region have seen consistent recovery in export growth since the last quarter of 2016 (see *Trade and the Global Value Chain,* page 14). This recovery is expected to continue as global demand improves in the near future (Box 1.1).

External shocks could also affect Asia through the financial channel via capital outflows and liquidation of foreign asset holdings.

As the region's financial markets deepen and continue to open up, foreign holdings of portfolio assets have grown, making emerging Asia more susceptible to sudden

Figure 1.4: Correlation between US Non-oil Imports and Developing Asia's Exports



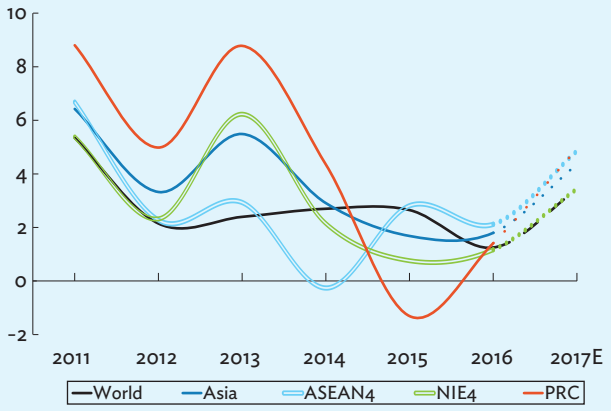
US = United States.
Notes: Non-oil imports is computed by subtracting crude oil imports from total goods imports. Developing Asia includes ASEAN4 (Indonesia, Malaysia, the Philippines, and Thailand), NIE4 (Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China), India, and the People's Republic of China.
Sources: ADB calculations using data from CEIC; International Monetary Fund. International Financial Statistics. https://www.imf.org/en/Data; and United States Census Bureau. https://www.census.gov/ (all accessed August 2017).

Box 1.1: Trade Volume Outlook for Asia

The strengthening global economy is expected to give a boost to the near-term outlook for global trade; trade volume is expected to grow 3.4% in 2017. In turn, steady growth in advanced economies—especially in the United States and euro area—will buoy external demand across Asia; trade volume growth will likely accelerate from 1.8% in 2016 to 4.4% in 2017, 1 percentage point above forecast global trade growth.

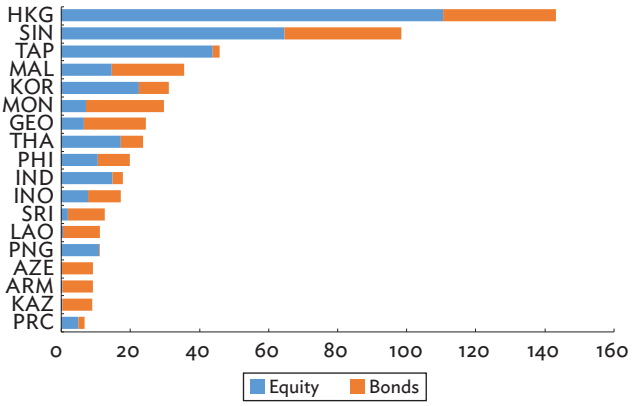
The People's Republic of China and middle-income ASEAN (Indonesia, Malaysia, the Philippines, and Thailand) will continue to drive the region's trade, while Asia's more export-reliant emerging economies (Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China) will also receive a needed boost. In these economies, export will benefit from weakening local currencies and a mild rebound in commodity prices. Buoyant domestic demand—especially from resilient private consumption and sustained public and private investment—will also support import growth.

Trade Volume Growth (%, year-on-year)



ASEAN = Association of Southeast Asian Nations, E = estimate, NIE4 = newly industrialized economies, PRC = People's Republic of China.
Notes: ASEAN4 includes Indonesia, Malaysia, the Philippines, and Thailand. The NIE4 include Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China. Asia covers ADB's 45 developing member economies plus Australia, Japan, and New Zealand. Trade volume growth estimates are calculated using estimated trade volume growth of all Asian economies, which were generated using each economy's elasticities-to-real gross domestic product (GDP) (for imports) and elasticities-to-real GDP of top trading partners (for exports).
Sources: ADB calculations using data from International Monetary Fund. World Economic Outlook April 2017 database. https://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx (accessed October 2017); International Monetary Fund. Direction of Trade Database. https://www.imf.org/en/Data (accessed July 2017); and World Trade Organization Statistics database. http://stat.wto.org (accessed May 2017).

Figure 1.5: Foreign Holdings of Equity and Bonds, as of end 2016—Developing Asia (% of GDP)



ARM = Armenia; AZE = Azerbaijan; GEO = Georgia; GDP = gross domestic product; HKG = Hong Kong, China; IND = India; INO = Indonesia; KAZ = Kazakhstan; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; MAL = Malaysia; MON = Mongolia; PHI = Philippines; PNG = Papua New Guinea; PRC = People's Republic of China; SIN = Singapore; SRI = Sri Lanka; THA = Thailand; VIE = Viet Nam; TAP = Taipei,China.
Source: ADB calculations using data from International Monetary Fund. Coordinated Portfolio Investment Survey. http://cpis.imf.org (accessed September 2017).

capital outflows (Figure 1.5). Many economies in the region continue to rely on foreign borrowing and foreign investment in their financial assets. This reflects the increasing integration of regional financial markets with global markets—increasing the impact and influence of global investor sentiment and asset price movements on the region's financial markets.

There are also other transmission channels, such as commodity prices—which could transmit terms-of-trade shocks to Asia's resource-dependent economies. Similarly, changes in the US monetary policy and exchange rate movements could also transmit some second-round price and wealth effects on trade and global financial asset positions.

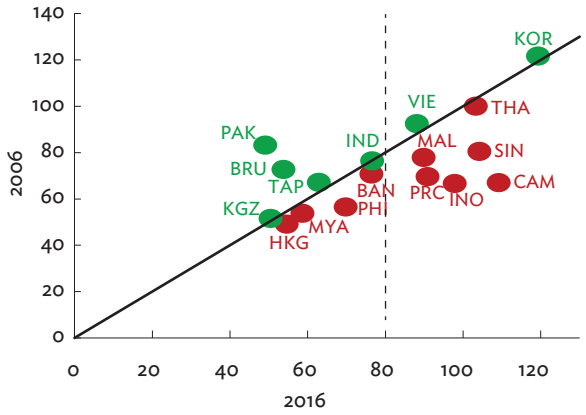
Emerging Vulnerabilities

Despite strong resilience against a weak external environment, vulnerabilities in Asia's financial systems should not be underestimated. Generally, the region's policy makers have remained prudent in managing their economies—as seen in much-improved financial and external vulnerability indicators since 2006. However, some financial vulnerabilities linger and policy space could contract further should external conditions worsen.

While banking systems in the region remain healthy, high leverage and credit growth could increase some economies' vulnerability to tightening global financial conditions.

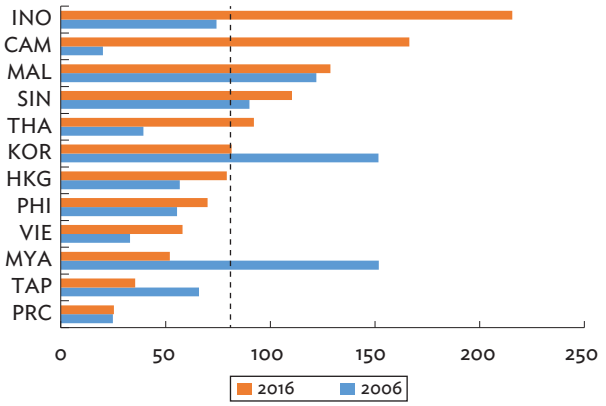
Certain financial vulnerability indicators suggest that loose global monetary policy has fueled excessive credit growth in Asia over the past 10 years. This is evident from high and rising bank loan-to-deposit ratios and foreign liabilities-to-foreign assets ratios in several Asian economies (Figures 1.6 and 1.7). In particular, loan-to-deposit ratios in Cambodia, the Republic of Korea, Indonesia, the PRC, Malaysia, Singapore, Thailand, and Viet Nam remain above 80% with loan-to-deposit ratios rising for most economies (colored red) since 2006. Similarly, foreign liabilities-to-foreign assets ratios in Cambodia, Indonesia, the Republic of Korea, Malaysia, Singapore, and Thailand are also above 80%. The loan-to-deposit ratio is a measure of liquidity, and the concern is that a high ratio could imply that a country could run out of liquidity to cover unforeseen funding requirements. On the other hand, Asia's experience tends to suggest that financial crises are often preceded by a buildup of foreign liabilities in the banking sector—used to fund domestic lending—thereby contributing to currency and maturity mismatches.

Figure 1.6: Loan-to-Deposit Ratio—Developing Asia (%)



BAN = Bangladesh; BRU = Brunei Darussalam; CAM = Cambodia; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Republic of Korea; KGZ = Kyrgyz Republic; MAL = Malaysia; MYA = Myanmar; PAK = Pakistan; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; TAP = Taipei,China; THA = Thailand; VIE = Viet Nam.
Sources: ADB calculations using data from CEIC; and International Monetary Fund. International Financial Statistics. http://www.imf.org/en/Data (both accessed August 2017).

Figure 1.7: Foreign Liabilities-to-Foreign Assets Ratio —Developing Asia (%)



CAM = Cambodia; HKG = Hong Kong, China; INO = Indonesia; KOR = Republic of Korea; MAL = Malaysia; MYA = Myanmar; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; TAP = Taipei,China; THA = Thailand; VIE = Viet Nam.
Source: ADB calculations using data from CEIC; and International Monetary Fund. International Financial Statistics. http://www.imf.org/en/Data (both accessed August 2017).

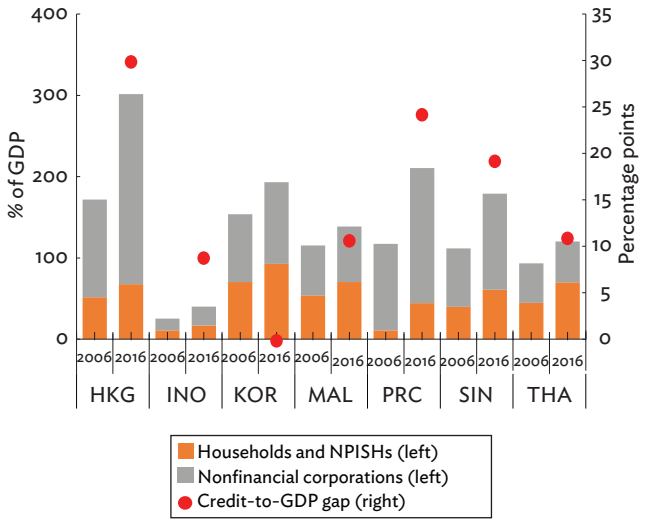
The growing share of credit to private nonfinancial institutions and the proliferation of new risk instruments are potential risks.

In many economies, lending to private nonfinancial institutions has been increasing (Figure 1.8). Lending to private nonfinancial institutions have increased since the GFC, particularly in the PRC; Hong Kong, China; the Republic of Korea; Singapore; and the ASEAN4. More so, comparing credit extended to private nonfinancial institutions with historical trends, shows that recent credit-to-GDP ratios exceeded their long-term trend by about 10–30 percentage points, with credit to the private nonfinancial sector at 300% of GDP in Hong Kong, China; more than 200% in the PRC; and close to 190% in the Republic of Korea and Singapore.

Dependence on external funding is also a concern for the region.

External funding conditions remain broadly stable. However, with the expected increase in the US Federal Funds rate, external funding costs will likely increase and lead to heightened financial volatility. Depending on the pace of the hikes, this could affect domestic credit conditions and ultimately slow economic growth if domestic borrowing costs rise, bank lending volumes fall and asset prices drop.

Figure 1.8: Credit to Private Nonfinancial Sector—Selected Developing Asian Economies



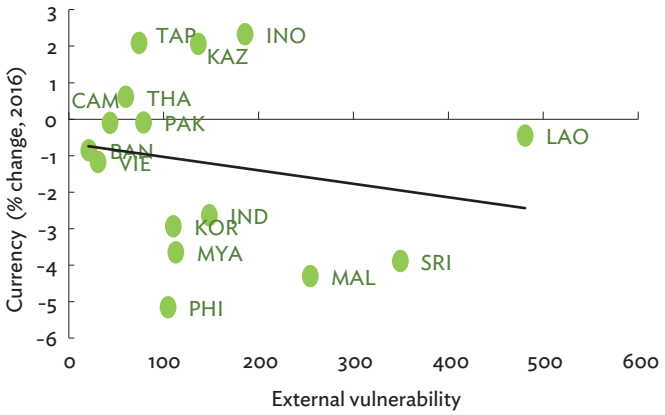
HKG = Hong Kong, China; GDP = gross domestic product; INO = Indonesia; KOR = Republic of Korea; MAL = Malaysia; NPISHs = nonprofit institutions serving households; PRC = People's Republic of China; SIN = Singapore; THA = Thailand.
Notes: Data is based on market values and refer to the total outstanding credit provided by domestic banks, other economic sectors, and nonresidents. The credit-to-GDP gap is defined as the difference between the credit-to-GDP ratio and its long-run trend.
Source: Bank for International Settlements. https://www.bis.org/ (accessed September 2017).

The concern is over the degree of an economy's dependence on short-term flows of external funds placed through stocks, bonds, overseas borrowing, and its current account deficit. Generally, an economy's exposure to short-term external funding could affect its ability to meet external obligations—through either liquidity or solvency problems—in turn affecting its exchange rates and introducing further uncertainty and financial volatility. This can be seen by plotting a country's external vulnerability—measured by the sum of its current account deficit, short-term external debt, and foreign holdings of equity and bond securities as a percent of gross international reserves—against 2016 currency movements (Figure 1.9). It is clear that economies with higher dependence on short-term external funds tend to experience larger currency depreciations. However, other idiosyncratic country-specific factors can also contribute to a country's currency fluctuations.

Another concern involves capital flows, which have started to reverse as the US begins to normalize its monetary policy stance.

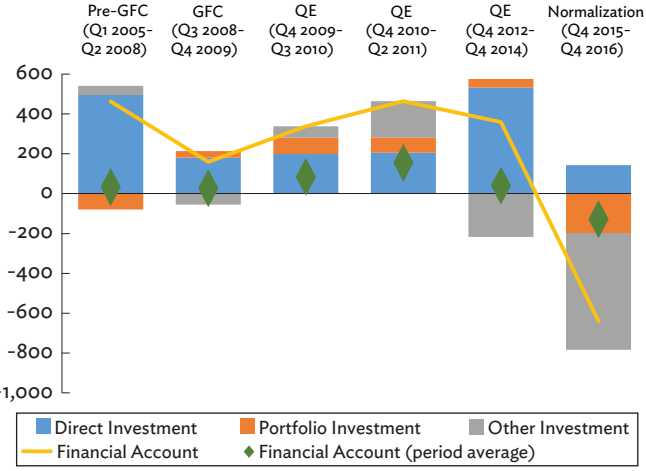
Studies have shown that monetary policy in advanced economies influence financial flows to Asia. For instance,

Figure 1.9: External Vulnerability versus Currency Movement, 2016—Selected Developing Asian Economies



BAN = Bangladesh; CAM = Cambodia; IND = India; INO = Indonesia; KAZ = Kazakhstan; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; MAL = Malaysia; MYA = Myanmar; PAK = Pakistan; PHI = Philippines; SRI = Sri Lanka; TAP = Taipei,China; THA = Thailand; VIE = Viet Nam.
Notes: External vulnerability ratio is derived by dividing the sum of current account deficit, short-term debt, and foreign holdings of stocks and bonds by gross international reserves (excluding gold). Currency movement is the percentage change in the $ value of local currency. Negative values indicate depreciation of local currency, and positive values indicate appreciation.
Sources: ADB calculations using data from Bloomberg; International Monetary Fund. Coordinated Portfolio Investment Survey. http//cpis.imf.org; and World Bank. World Development Indicators. http://databank.worldbank.org/ (all accessed July 2017).

Figure 1.10: Net Financial Flows—Developing Asia ($ billion)



GFC = global financial crisis, QE = quantitative easing, Q = quarter.
Notes:
(i) There was a break in data comparability for the Philippines (2005), India (2009), Brunei Darussalam (2010), and Malaysia (2010). For Malaysia, "other investment" was discounted in the assets and liabilities breakdown.
(ii) For consistency, net of "other investment" corresponds to resident inflows for Malaysia starting 2010.
(iii) In the Lao People's Democratic Republic, net of direct, portfolio, and other investments correspond to "nonresident inflows" direct, portfolio, and other investments starting 2014.
(iv) Developing Asia includes ASEAN (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam), NIE4 (Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China), India, and the People's Republic of China. Excludes Cambodia starting Q1 2015; Brunei Darussalam, Myanmar, and Viet Nam for Q1 2016.
Source: ADB calculations using data from International Monetary Fund. Balance of Payments Statistics. http://www.imf.org/external/datamapper/datasets/BOP (accessed July 2017).

an ADB study by Park et al. (2014) observed that the US quantitative easing (QE) had a significant impact on capital flows to Asian developing economies. Examining flows before and after periods of QE in the US found that while total flows were comparable, their composition changed—direct financing through capital markets partly replaced bank financing. When the individual impact of the three rounds of QE were examined, only the impact of the first was significant. Global risk variables and emerging stock market returns were also significant drivers (Cho and Rhee 2013, Koepke 2016, Morgan 2011, Park et al. 2014, and Sarno et al. 2016).

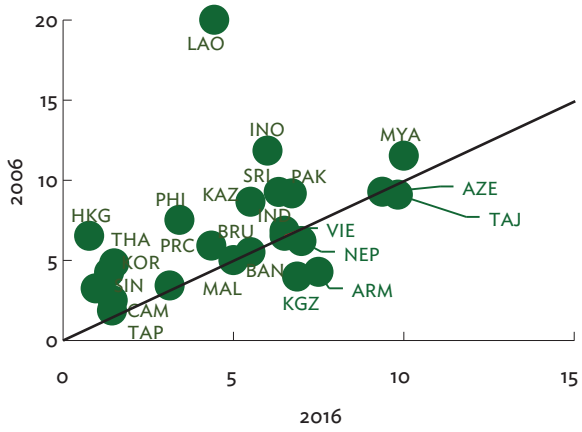
In step with these findings, the region's cumulative and average net financial flows were compared pre-GFC, post-GFC, and during the normalization period (Figure 1.10). There are indications that changes in global monetary policy—as captured by expected movement in the US Federal Funds rate—affect financial inflows in the region. While developing Asia received average net financial inflows of $33 billion per quarter during the pre-GFC period, they fell to $27 billion per quarter during the GFC, suggesting only modest GFC impact on the region. However, net financial inflows to the region increased significantly during QE—peaking at $155 billion per quarter during the second QE period. As expected, net financial flows reversed, averaging $128 billion in outflows per quarter during normalization. It is also notable that the primary source of financial outflows in the region was from other investment, which includes bank lending.

Coping Mechanisms

Countercyclical macroeconomic policies can help support domestic demand in times of economic crisis.

At the height of the GFC, many governments in the region used countercyclical policy measures—such as expansionary monetary policy and fiscal stimulus—to support domestic demand and counter weakening external demand from advanced economies. These fiscal and monetary interventions helped the region weather

Figure 1.11: Policy Rate, 2016 versus 2006—Developing Asia (% per annum)



ARM = Armenia; AZE = Azerbaijan; BAN = Bangladesh; BRU = Brunei Darussalam; CAM = Cambodia; HKG = Hong Kong, China; IND = India; INO = Indonesia; KAZ = Kazakhstan; KOR = Republic of Korea; KGZ = Kyrgyz Republic; LAO = Lao People's Democratic Republic; MAL = Malaysia; MYA = Myanmar; NEP = Nepal; PAK = Pakistan; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; SRI = Sri Lanka; TAJ = Tajikistan; TAP = Taipei,China; THA = Thailand; VIE = Viet Nam.
Sources: Bloomberg and CEIC (both accessed July 2017).

the GFC largely unscathed. Therefore, it is important to have adequate policy space in preparing for future crises.

Easy monetary policy provided important support to domestic demand and economic growth during the post-GFC recovery. However, against rising US interest rates, is not easy to maintain low interest rates—as widening interest rate differentials between the US and domestic markets would set off further capital outflows. Higher US interest rates could also transmit across the region, thereby increasing capital costs, raising debt servicing, and weakening investment and growth prospects. Trend analysis suggests that—except for Cambodia; Hong Kong, China; the Republic of Korea; Singapore; Taipei,China; and Thailand (where rates are already very low)—Asia's economies have ample room to maintain accommodative monetary policy and/or cut rates if global shocks affect domestic demand (Figure 1.11). However, economies in the region should also weigh the benefit of domestic policy rate adjustments—based on the US Federal Fund rate movements—to support their growth prospects.

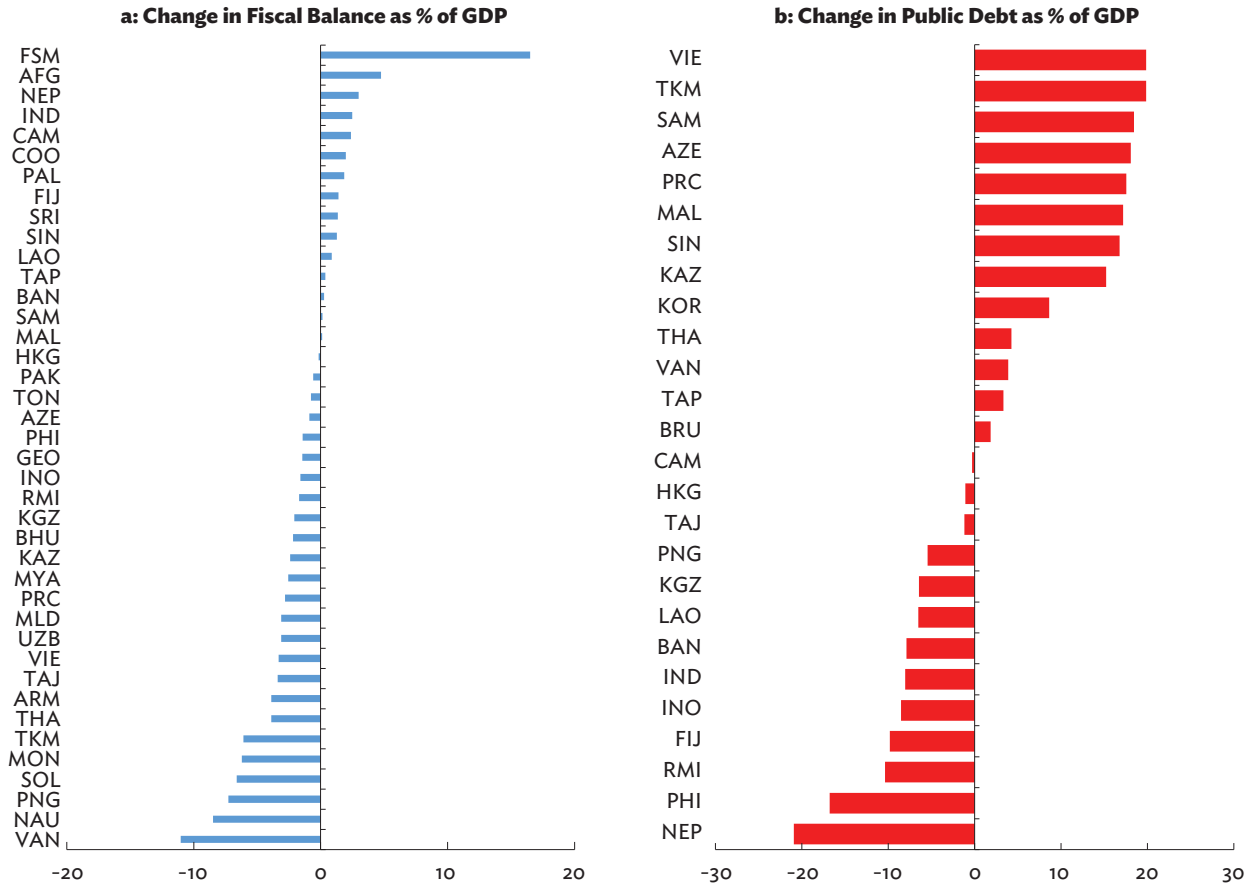
Building sufficient fiscal space is central to maintaining macroeconomic stability and coping with potential external shocks.

Maintaining fiscal soundness and intensifying fiscal consolidation efforts could help create fiscal buffers against future shocks. However, fiscal balances in 25 out of 40 developing Asian economies—mostly coming from the Pacific and Central Asia—have deteriorated compared with pre-crisis levels (Figure 1.12a). Some Central Asian economies, Malaysia, the PRC, Singapore, and Viet Nam have also accumulated additional public debt (ranging from 15%-20% of GDP) over the past decade to 2016 (Figure 1.12b). This means that the region has more limited fiscal space to maneuver should another demand shock emerge in the future.

Adequate reserves can also provide an economy a much-needed cushion in case of sharp swings in external demand and financial conditions.

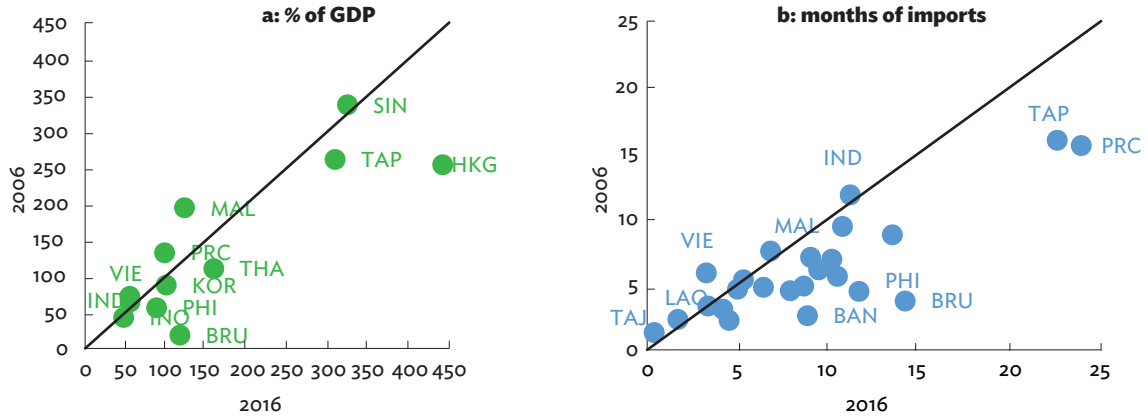
The region's large holdings of international reserves provided effective cushion against the financial turmoil during the GFC. Ample international reserves raise confidence that an economy can cover imports and debt service even during periods of dollar illiquidity. Reserves are also useful when financial volatility triggers regional contagion through sharp currency devaluations. Asian economies have accumulated foreign exchange reserves well beyond the levels required for precautionary or self-protection reasons since the Asian financial crisis. The trend continues and the region has secured adequate levels of reserves relative to GDP and imports requirements (Figures 1.13a and 1.13b).

Figure 1.12: Change in Fiscal Indicators, 2016 versus 2006—Developing Asia (percentage point)



AFG = Afghanistan; ARM = Armenia; AZE = Azerbaijan; BAN = Bangladesh; BHU = Bhutan; BRU = Brunei Darussalam; CAM = Cambodia; COO = Cook Islands; FIJ = Fiji; FSM = Federated States of Micronesia; GDP = gross domestic product; GEO = Georgia; HKG = Hong Kong, China; IND = India; INO = Indonesia; KAZ = Kazakhstan; KOR = Republic of Korea; KGZ = Kyrgyz Republic; LAO = Lao People's Democratic Republic; MAL = Malaysia; MLD = Maldives; MON = Mongolia; MYA = Myanmar; NAU = Nauru; NEP = Nepal; PAK = Pakistan; PAL = Palau, PHI = Philippines; PNG = Papua New Guinea; PRC = People's Republic of China; RMI = Marshall Islands; SAM = Samoa; SIN = Singapore; SOL = Solomon Islands; SRI = Sri Lanka; TAJ = Tajikistan; TAP = Taipei,China; THA = Thailand; TKM = Turkmenistan; UZB = Uzbekistan; VAN = Vanuatu; VIE = Viet Nam.
Sources: ADB calculations using data from CEIC; and International Monetary Fund. International Financial Statistics. www.imf.org/en/Data (both accessed August 2017).

Figure 1.13: Gross International Reserves—Developing Asia



BAN =Bangladesh; BRU = Brunei Darussalam; GDP = gross domestic product; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; MAL = Malaysia; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; TAJ = Tajikistan; TAP = Taipei,China; THA = Thailand; VIE = Viet Nam.
Sources: ADB calculations using data from CEIC; and International Monetary Fund. International Financial Statistics. www.imf.org/en/Data (both accessed August 2017).

Concluding Remarks

While the economic outlook for developing Asia has improved and risks have become more balanced, policy makers must still address some important and lingering concerns.

The region remains vulnerable to global economic shocks as its business cycles have become increasingly synchronized with cycles in advanced economies. The regional economy has also become more sensitive to output shocks in the US, reflecting the significant role that final demand from this economy still plays in regional trade. High leverage and credit growth—particularly to private nonfinancial institutions—with a dependence on external funding, and potential capital flow reversals related to widening interest rate differentials are among the most pressing concerns.

Since the GFC, developing Asia has accumulated additional external borrowing equivalent to $3.4 trillion.[1] The fiscal space—measured as the sum of combined fiscal surpluses and deficits in the region—has also shrunk by $0.5 trillion. And while many regional economies still have ample room to follow accommodative monetary policies, ongoing US monetary policy normalization will make it more challenging for them to keep interest rates low without further undermining foreign capital inflows.

Asia's policy makers should continue to strengthen macroeconomic fundamentals and prepare for a prolonged weak recovery.

Against the backdrop of monetary policy normalization in advanced economies, maintaining sufficient international reserves and policy space should help cushion against potential shocks. Monetary policy must remain flexible to allow timely responses, while keeping inflationary expectations firmly anchored.

Macroeconomic policy support may need to be maintained and only gradually unwound in the face of the prolonged weak post-crisis recovery. In particular, and wherever possible, fiscal buffers could be built up and stand ready for use to mitigate the impact of external shocks. While extreme financial volatility requires careful monitoring of capital flows, excessive exchange rate intervention could lead to drawdowns in foreign reserves, which would further weaken investor confidence.

The region must also monitor any buildup of economic imbalances, while pursuing necessary long-term reforms.

Short-term responses can help stabilize financial volatility and lift market confidence. But the region's policy makers need to deepen reforms to strengthen economic and financial resilience and upgrade regulatory and supervisory frameworks to ensure vulnerabilities are addressed.

Broader and deeper structural reforms will be needed to raise productivity, competitiveness, and economic growth. Asian economies can also explore ways to spur new growth drivers by improving policies that support trade, such as the promotion of foreign direct investment and innovation. An ADB study has noted the importance of policies that offer competitive labor costs, an efficient and reliable business environment, and strong linkages of global value chain with the domestic market through foreign direct investment. Linkages with domestic markets in particular can be better served by helping small and medium enterprises gain greater access to finance, and through supportive institutional mechanisms (ADB 2016).

[1] Based on available data for developing Asian economies: Bangladesh; Fiji; Hong Kong, China; India; Indonesia; Kazakhstan; Malaysia; Pakistan; Papua New Guinea; the Philippines; the PRC; the Republic of Korea; Singapore; Sri Lanka; Taipei,China; and Thailand.

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