PACIFIC ALLIANCES

Asian Economic Outlook Q3

This economic outlook for the third quarter of 2015 focuses on the economic conditions of Asia and also addresses economic issues in China and India to fully reflect economic developments in the region.

It also provides an update on regional economic trends and policy issues, the medium-term economic outlook and macroeconomic matters.

Our overall findings are that the economic outlook for the Asia and Pacific region is secure, stable and vigorous, with growth expected to hold at 5.6 per cent for the rest of the year, tilting slightly downwards to 5.5 per cent in 2016.

Asia still remains the world's leader in global growth, there are certain exposures that need to be addressed, such as increased domestic and foreign debt, which are rising, causing growth to slightly slow.

There is also the issue of diminished productivity gains, together with the effects of an ageing populations and infrastructure blockages that could continue to affect certain countries in the region, according to the OECD and the World Bank.

This report finds that monetary and fiscal policy are largely apposite, but boosting growth remain high-level priorities, with structural reforms continuing to play an important role.

We have found that the economic outlook for Asia still remains favourable. While the rate of expansion has moderated since the global financial crisis, strong consumption has helped to cushion the blow from weaker external demand.

As a region of oil importers and supply chain participants, Asia is set to benefit from the decline in world oil prices and the ongoing recovery in advanced economies.

However, real and financial instabilities could possibly disrupt these favourable conditions if government overlooks structural volatilities. Delays in implementing these structural reforms could hold back growth.

Policies and procedures should therefore remain concentrated on building resilience and developing productive capacity.

Domestic demand is forecast to continue to drive growth, supported by the windfall boost to real incomes from lower world oil prices and strong labour market conditions.

These factors are expected to offset the effect of tighter financial conditions from capital flow reversals prompted by the prospect of monetary tightening by the Federal Reserve.

Net exports are expected to add only slightly to growth across the region, with lower oil prices temporarily pushing down headline inflation; current account balances should increase.

China is slowing to a more sustainable level; Japan is expected to see growth pick up following a year of stagnation; exporters of non-oil commodities will likely be adversely affected. But growth is expected to stabilise or increase.

Some regional currencies, mainly Japan, have remained more closely tied to the US dollar, while others have allowed more flexibility. This regional diversity could lead to volatilities in the markets.

While the overall economic outlook of Asia remains strong, the balance of downside risk is tilted towards the slightly diminished. First, significantly slower-than-expected growth in China would impact the rest of the region.

Countries with strong supply chain linkages as well as commodity exporters to large economies would be especially impacted.

Also, persistent US dollar strength against the euro and the yen would likely exert an autonomous tightening of domestic financial conditions in the region and impose higher debt service costs.

Tighter financial conditions in the United States would raise domestic borrowing costs, while lower global inflation—if imported into Asia—would increase the level of debt. The resulting increase in the cost of debt could interrupt domestic spending.

Conversely, lower world oil prices present an important upside risk for Asia's growth. We predict that over the longer term oil prices are expected to remain significantly below the average of recent years.

Additional support to growth could be realised if the supply contribution to the price decline is larger or more tenacious than currently thought, or if spending increases from the oil price windfall is larger than anticipated.

Financial sector risks have been contained by sustained income growth. However, bubbles are appearing in the real estate sector, and although bank credit-to-GDP ratios have been increasing more slowly in most economies, previous rapid credit growth has generated sizeable positive credit gaps in several of the region's larger economies.

These developments, banks' balance sheets have generally strengthened across Asia and its pace of growth is likely to remain below pre-crisis levels. Mirroring developments in growth, potential growth has slowed across much of the region.

Over the medium term, the region would also benefit from deeper regional financial integration, which has lagged trade integration with the promise of more efficient allocation of regional savings.

Policymakers will also need to contend with several other forces, including the fall and increase in the price of oil, potential capital flow volatility and the possibility of rising asset prices.

Macroprudential policies and foreign currency intervention can assist to contain financial stability risks and address disorderly conditions in the foreign exchange market by permitting exchange rate flexibility to absorb shocks.

Further fiscal consolidation would be appropriate in countries where public debt remains high. Structural reforms are critical to boosting productivity growth across the region, including state-owned enterprises and financial sector reforms, especially in China, initiatives to raise services productivity and labour force participation.

ASEAN should sustain growth in Southeast Asia's momentum in the medium term. Stable economic prospects are also foreseen, with more rapid growth exceeding 7 per cent over the next five years.

China and India face weighty challenges: China's growth is slowing (6.8% in 2015–19, compared with 8.2% over 2011–13) as it seeks to adjust to an ageing population, switches its growth focus from investment to consumption, and copes with agricultural, environmental and educational issues.

India's growth should be stable over 2015–19 (6.7% compared with 5.5% over 2011–13), but this could change as the new government carries out ambitious plans for investment and reform.

Potential external risks include changes to US monetary policy, the Chinese economic slowdown, structural policy changes in Japan, and growth prospects in the eurozone. However, these factors will have only a moderate impact on the region.

Jonathan Brooks is a senior analyst responsible for research on emerging market economies in Asia. He has 30 years of extensive experience, with special emphasis on Japan and China.