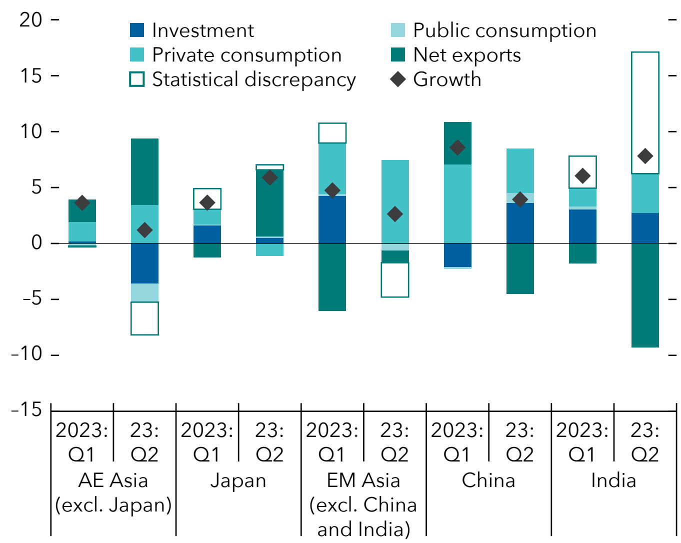
1. Outlook for Asia and the Pacific: Challenges to Sustaining Growth and Disinflation[1]

1.1. Recent Economic Developments

The global economic backdrop has remained challenging for economies in the Asia and Pacific region. Central banks further tightened monetary policy across the globe, although the fall in global commodity prices from their 2022 peak supported disinflation. Forceful policy action limited contagion from bank failures in the United States and Switzerland in the spring. As Asia's economic reopening from COVID health restrictions took place later than elsewhere, the region benefited from the associated domestic demand bounce later. External demand has been slowing noticeably, however, reflecting the global demand rotation from goods to services and a stronger-than-expected technology cycle downturn.

In the first quarter of the year, growth in the region generally surprised to the upside, while second-quarter surprises were to both sides. Robust private consumption supported growth (Figure 1.1), as households in Asia drew down some excess savings accumulated during the pandemic (Figure 1.2, panels 1 and 2). The boost from China's reopening in the first half of the year was above expectations. Strong private demand yielded positive growth surprises in India. Growth in Japan also exceeded expectations, driven first by strong domestic demand and then by a rebound in automobile exports as a result of supply chain normalization. For open economies in the region specializing in merchandise exports—mostly Association of Southeast Asian Nations economies, Korea, and Taiwan Province of China—weak global demand for goods has been a drag, while service-orientated economies have performed better.

Figure 1.1. Growth Outturns in the First Half of 2023
(Percentage points, quarter-over-quarter)



Sources: Haver Analytics; and IMF staff calculations.
Note: AE Asia (excl. Japan) includes Australia, Hong Kong SAR, Korea, New Zealand, and Singapore. EM Asia (excl. China and India) includes Indonesia, Malaysia, Philippines, and Thailand. India numbers are calculated on a year-over-year basis. AE = advanced economy; EM = emerging market.

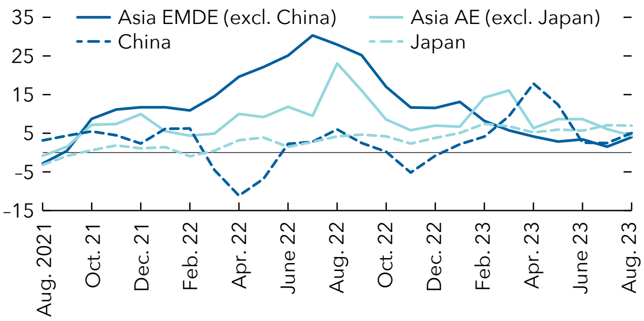
However, more recent data suggest slowing growth momentum across the region. In China, the recovery is losing steam, with manufacturing purchasing managers' indexes entering contracting territory from April to August and conditions in the real estate sector weakening further (Figure 1.2, panels 3 and 4). While some economies in the region have benefited from an increase in arrivals of Chinese tourists, China's outbound tourism is still far from a full recovery. Fixed investment has weakened, likely reflecting external demand weakness and the technology cycle. There are now clear signs of economic scarring in investment, with marked deviations from prepandemic trends (Figure 1.2, panels 5 and 6).

[1] The authors of this chapter are Tristan Hennig and Yizhi Xu (lead), with contributions from Melih Firat, Julia Estefania Flores, Pablo Gonzalez Dominguez, Daniel Jiménez, Paulo Medas, and Chris Redl.

Figure 1.2. Developments in Economic Activity in 2023

Private consumption held up ...

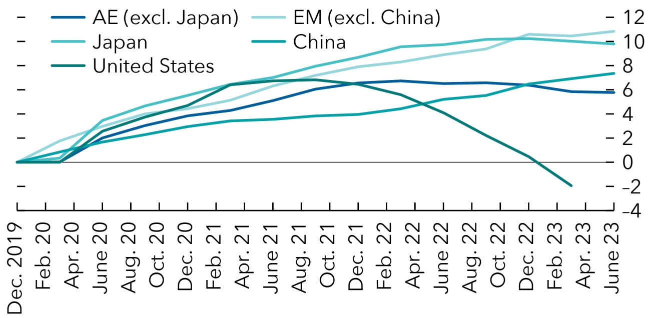
1. Retail Sales
(Percent, year-over-year change)



Source: Haver Analytics.
Note: Asia AE includes Australia, Hong Kong SAR, Japan, Korea, New Zealand, Singapore, and Taiwan Province of China. Asia EMDE includes China, Indonesia, and Vietnam. AE = advanced economies; EMDE = emerging market and developing economies.

... supported by households' excess savings.

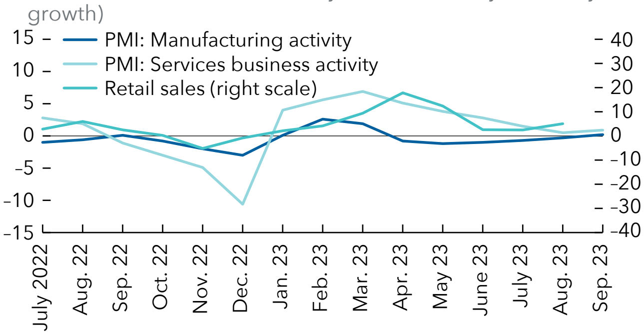
2. Cumulative Excess Saving
(Percent of GDP; cumulative change since end of 2019)



Sources: Haver Analytics; and IMF staff calculations.
Note: Excess saving is defined as the difference between actual household saving and prepandemic projected household saving. AE (excl. Japan) includes Australia, Hong Kong SAR, Korea, New Zealand, and Singapore. EM (excl. China) includes India, Indonesia, Philippines, and Thailand. AE = advanced economies; EMDE = emerging market and developing economies.

China's reopening provided a boost to services and retail sales, but manufacturing activity contracted from April to August ...

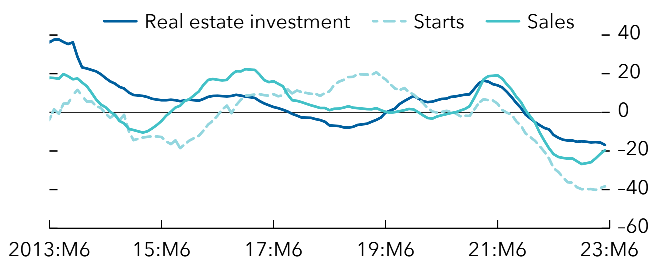
3. China: Manufacturing and Services Indexes
(PMI Indexes are substracted by 50; retail sales year-over-year growth)



Source: Haver Analytics.
Note: PMI = purchasing managers' index.

... and the property sector is showing renewed weakness.

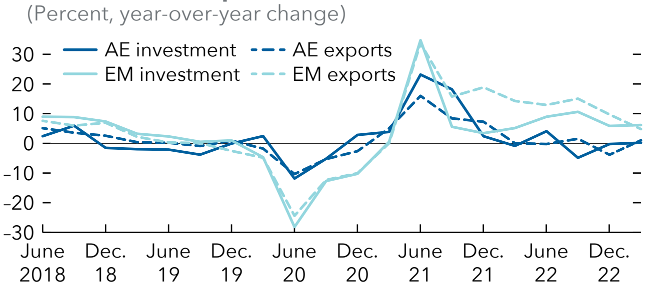
4. Real Estate Sector Indicators
(Percent; 12-month moving average, year-over-year change)



Sources: NBS; and IMF staff calculations.

Weak external demand over the past year has dragged down domestic investment ...

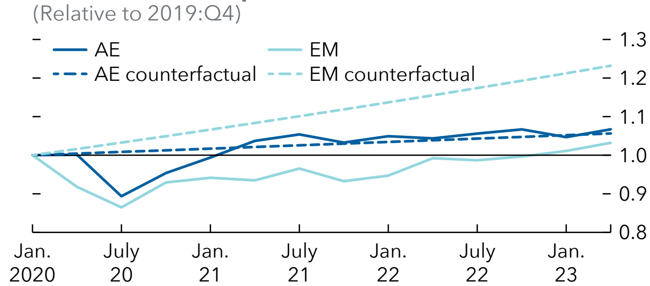
5. Investment and Export Growth
(Percent, year-over-year change)



Sources: Haver Analytics; and IMF staff calculations.
Note: AE = advanced economies; EM = emerging markets.

... providing another setback to the investment recovery in Asia's emerging markets.

6. Real Gross Fixed Capital Formation
(Relative to 2019:Q4)

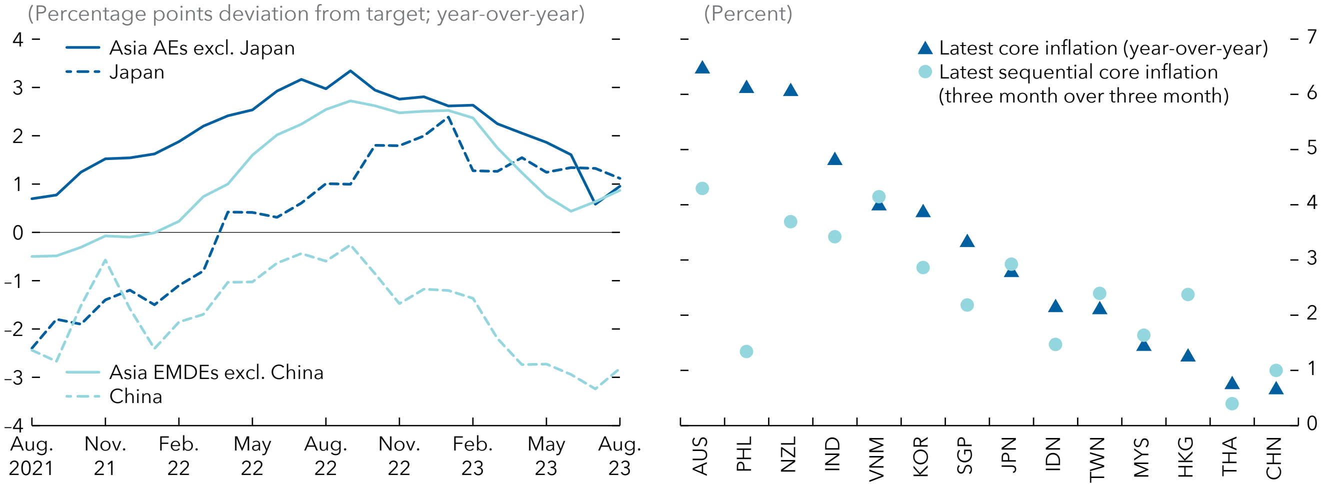


Sources: Haver Analytics; and IMF staff calculations.
Note: Counterfactual assumes average 2014–19 growth rate. AEs include Australia, Japan, Korea, New Zealand, and Singapore. EMs include China, India, Malaysia, the Philippines, Thailand, and Vietnam. AE = advanced economies; EM = emerging markets.

Figure 1.3. Inflation

1. Headline Inflation
(Percentage points deviation from target; year-over-year)

2. Core Inflation
(Percent)



Sources: Haver Analytics; and IMF staff calculations.
Note: Asia AE includes Australia, Hong Kong SAR, Japan, Korea, Macao SAR, New Zealand, Singapore, and Taiwan Province of China. Asia EMDE includes Bangladesh, China, India, Indonesia, Malaysia, Philippines, Thailand, and Vietnam. AEs = advanced economies; EMDE = emerging market and developing economies.

Sources: Consensus Forecasts; and IMF staff calculations.
Note: Data as of September 7, 2023. Country abbreviations are International Organization for Standardization (ISO) country codes.

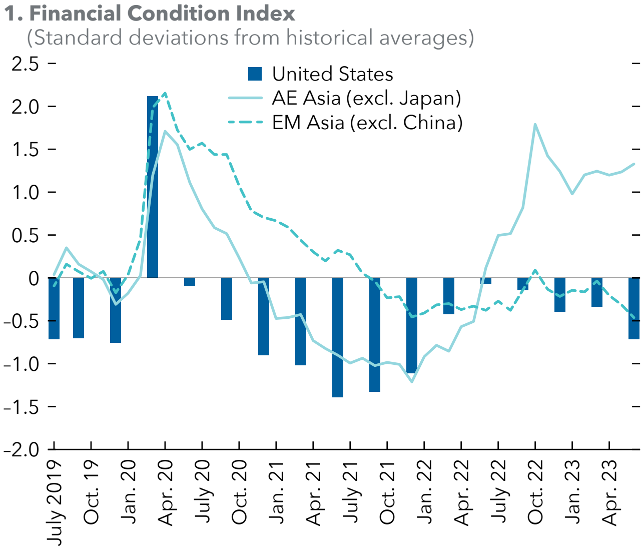
With falling food and energy prices and restrictive monetary stances, headline inflation in Asia and the Pacific has generally been declining, albeit with renewed price pressures emerging recently (Figure 1.3, panel 1). Core inflation has been easing more gradually, as in the rest of the world (Figure 1.3, panel 2). In Japan, inflation has risen to levels not seen in decades on pent-up domestic demand, still-accommodative policies, and rising tourist arrivals. China's inflation remains low and well-below target, reflecting falling food and fuel prices and still sizable economic slack. Headline inflation in India rose in the third quarter due to a weather-related vegetable price shock. In Australia and New Zealand, core inflation pressures are moderating slowly, with still tight labor markets and positive output gaps.

The impact of monetary policy tightening has differed between advanced and emerging Asia. Financial conditions in advanced economies in the region except for Japan have tightened substantially (Figure 1.4, panel 1), as in most other advanced economies (October 2023 *Global Financial Stability Report*, Chapter 1; Borraccia and others 2023). However, in Asia's emerging markets, financial conditions remain relatively accommodative, as sovereign yields have not increased much since the tightening cycle began (Figure 1.4, panel 2; Online Box 1.1). Reasons include strong demand from the domestic investor base (both financial sector and central banks) and a compression in term premiums. Additionally, Asian currencies have regained value against the US dollar and the Chinese yuan this year, while bank lending conditions have remained favorable.

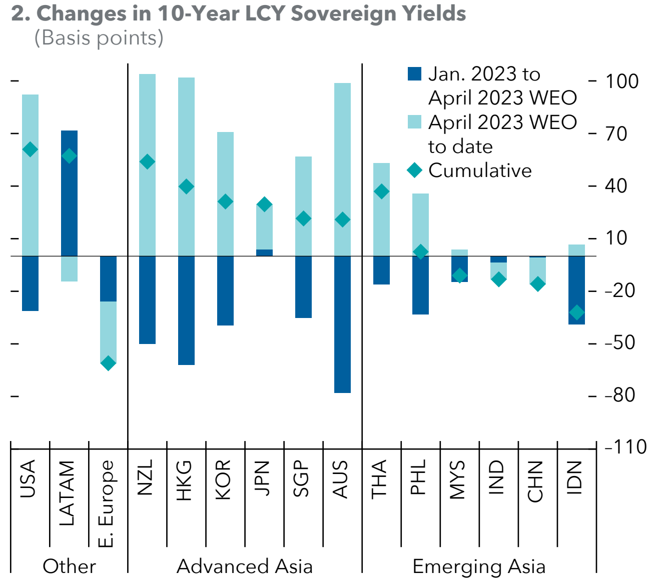
1.2. Factors Shaping the Outlook

Asia and Pacific will remain the most dynamic region this year, with growth expected to rise from 3.9 percent in 2022 to 4.6 percent in 2023. China and India are projected to contribute jointly about half of world growth in both 2023 and 2024. IMF staff estimate that Asia's growth will slow to 4.2 percent in 2024 and to 3.9 percent in the medium term—the lowest in the past two decades except for 2020. In Asia's advanced economies, tight financial conditions will hold back demand, while the outlook for exports will depend on price movements of global

Figure 1.4. Financial Conditions



Sources: Bank for International Settlements; Bloomberg Finance L.P.; Haver Analytics; Thomson Reuters Datastream; and IMF staff calculations.
Note: AE = advanced economy; EM = emerging market.



Sources: Bloomberg Finance L.P.; Haver Analytics; and IMF staff calculations.
Note: LATAM includes Brazil, Chile, Colombia, Mexico, and Peru. Eastern Europe includes Croatia, Czech Republic, Hungary, Poland, and Slovakia. April WEO defined as date of WEO press release (April 11, 2023). Country abbreviations are International Organization for Standardization (ISO) country codes. LCY = local currency; WEO = *World Economic Outlook*.

commodities (Australia, New Zealand) and the technology cycle (Korea, Singapore, Taiwan Province of China). In Asia's emerging markets, relatively accommodative financial conditions will support domestic demand despite monetary policy tightening, but external demand and lackluster investment will be headwinds to growth.

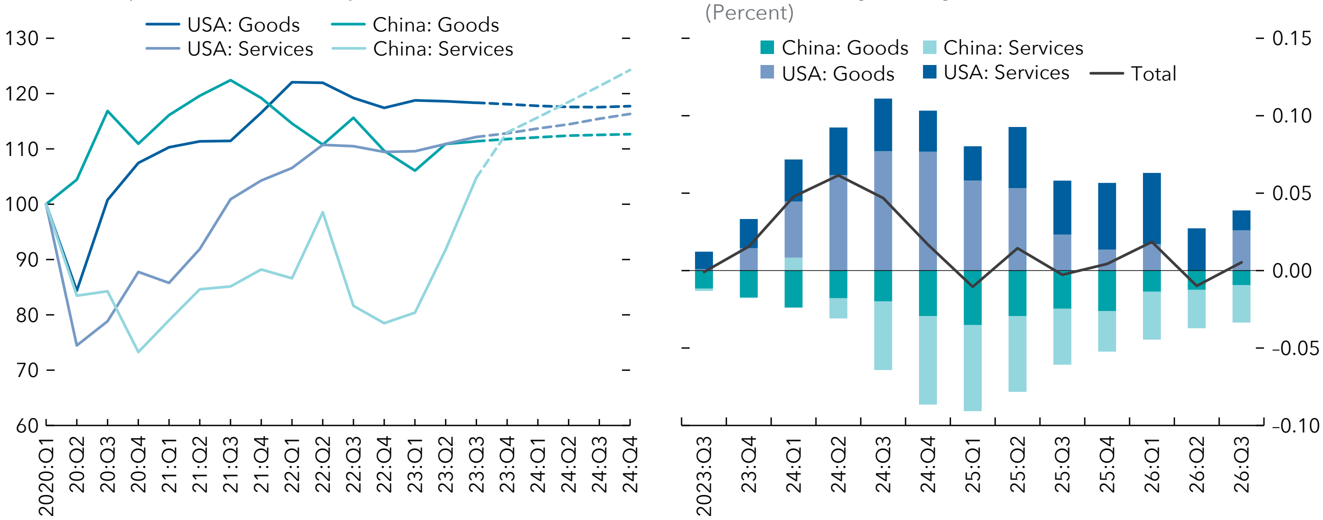
China's weaker near-term growth outlook will weigh on regional growth. The Chinese economy is expected to expand by 5 percent in 2023 and by 4.2 percent in 2024. Compared to the April 2023 *World Economic Outlook*, this is a downward revision of 0.2 and 0.3 percentage points, respectively. It reflects mainly renewed weakness in the property sector, as discussed earlier, despite more policy support than previously assumed.

The global demand rotation toward services will be a headwind for the region for some time, despite a stronger US growth outlook. Owing to strong business investment and resilient consumption growth, US growth for 2023 and 2024 was upgraded in the October 2023 *World Economic Outlook* by 0.5 and 0.4 percentage points, respectively, compared to April. While the large upgrade to US growth compared to a smaller downgrade for China would normally be a net positive for the region, the composition of US demand may mean that Asia will benefit less this time, for three reasons: first, the rotation in demand from goods to services has been reflected in lackluster global goods imports but rising global services imports (Figure 1.5, panel 1). Second, the demand for electronic goods has also moderated—a still-low book-to-bill ratio suggests a delayed turning of the technology cycle. Third, de-risking policies by major economies are reorienting demand for goods toward domestic instead of import supplies. Empirical analysis that accounts for these contrasting changes in the demand for goods and services in the United States and China shows that the net effect is still positive for the rest of Asia, but with a relatively small and short-lived impact (Figure 1.5, panel 2).

Figure 1.5. Regional Impact Due to Changing US and China Growth Outlook

1. US and China: Goods and Services Imports
(Constant price; national currency; 2020:Q1 = 100)

2. Net Spillovers with Calibrated US and China Growth Shocks Decomposed by Goods and Services
(Percent)



Sources: IMF, July 2023 *World Economic Outlook Update*; and IMF staff calculations.

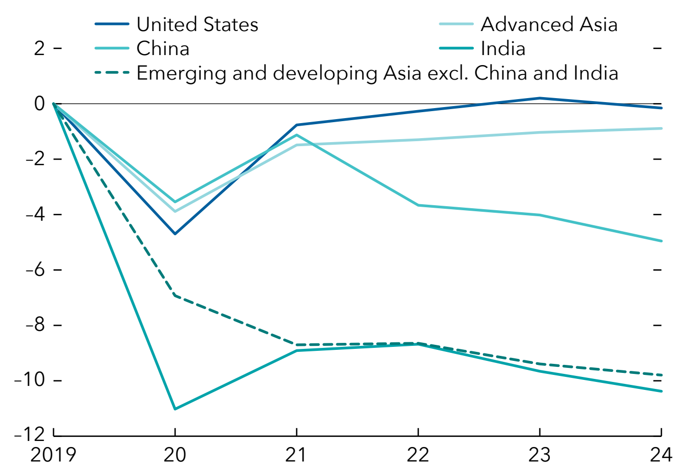
Sources: Copestake and others (2023); and IMF staff calculations.
Note: GDP growth spillovers from a 0.5 percentage point upgrade in the United States and a 0.2 percentage point downgrade in China.

The latest medium-term growth paths projected for emerging Asia are below prepandemic growth trajectories (Figure 1.6). One reason is lower medium-term growth in China, which is expected to weigh on the outlook for the rest of Asia. Strong global value chain links to China have translated into strong growth spillovers for the past two decades, which, absent wide-ranging reforms in China, are expected to be weaker, as outlined in Chapter 3.

Advanced Economies

Growth in Asia's advanced economies (excluding Japan) is slowing, as tight monetary conditions negatively affect interest-sensitive demand and as external demand remains subdued. In Australia and New Zealand, where higher mortgage payments have lowered real disposable household income, domestic demand growth is expected to slow further. In Korea, growth is projected to slow to 1.4 percent in 2023, reflecting a drag from the semiconductor cycle and a weaker boost from China's recovery. Growth in Japan and Singapore has been revised on account of developments in the first half of 2023: up in Japan, to 2.0 percent from 1.4 percent, and down for Singapore, to 1 percent from 1.5 percent previously.

Figure 1.6. Output Losses in Asia
(Percent deviation from January 2020 projections)

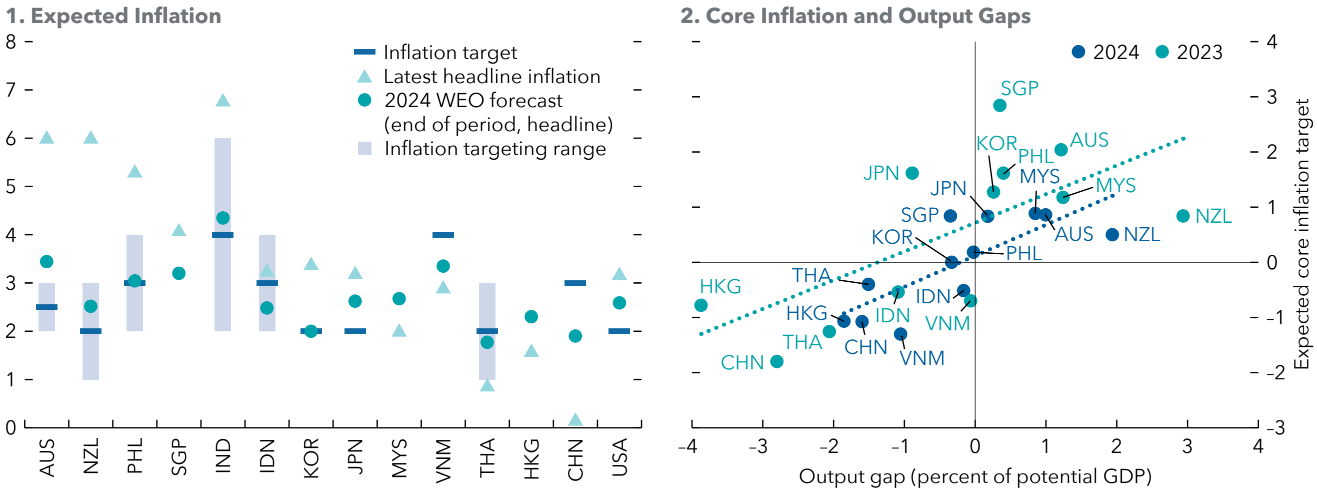


Source: IMF, World Economic Outlook database.

Emerging Markets

The emerging market economies of the Association of Southeast Asian Nations are expected to see growth of 4.2 percent in 2023 and 4.6 percent in 2024—a 0.3 percentage point downward revision relative to April. The downgrade reflects not only weaker

Figure 1.7. Inflation Outlook
(Percent)



Sources: Consensus Forecasts; and IMF staff calculations.
Note: Data as of August 7, 2023. Latest inflation and consensus forecasts are for headline inflation. Some countries do not have explicit inflation targeting regimes or target, while target ranges apply to core inflation in some countries. Country abbreviations are International Organization for Standardization (ISO) country codes. WEO = *World Economic Outlook*.

Source: IMF, World Economic Outlook database.
Note: 2024 (2023) bubbles: expected core inflation 2024 (2023) and output gap 2023 (2022). Country abbreviations are International Organization for Standardization (ISO) country codes.

external demand, but also lackluster domestic demand as a result of monetary policy tightening. In India, however, growth has been revised up to 6.3 percent in 2023, due to resilient domestic demand and strong investment inflows.

Frontier Markets and Small States

The near-term outlook remains favorable for many of Asia's frontier markets and small states, supported by lower commodity price pressure and increased tourist inflows. In Sri Lanka, the economy is bouncing back from the economic crisis, on the back of reduced inflationary pressure and easing foreign exchange pressures. Growth momentum remains robust in other South Asian frontier market economies (Bangladesh, Bhutan, Maldives, Nepal), with near-term growth exceeding 5 percent in this region. The growth outlook varies across Southeast Asia (Cambodia, Lao P.D.R., Myanmar), reflecting a diverse set of economic conditions and challenges. In Mongolia, the government's efforts and favorable external conditions helped lift economic activity. GDP in Pacific Island countries with high dependence on tourism is still more than 10 percent below prepandemic levels, with challenges from higher fiscal deficits, elevated debt, and shrinking fiscal policy space.

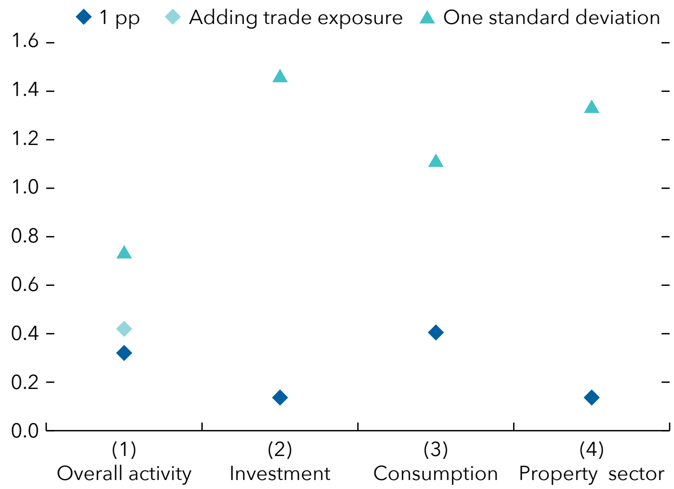
Inflation

Inflation is projected to continue the decline toward central bank targets. Except for Japan, inflation is expected to return to within target ranges by the end of 2024 (Figure 1.7, panel 1). This puts Asia ahead of the rest of the world, which, in general, will not see inflation returning to target until at least 2025 (October 2023 *World Economic Outlook*, Chapter 1). Even in economies where output is still above potential (Australia, Malaysia, New Zealand), gaps will narrow until 2024, and core inflation is expected to moderate (Figure 1.7, panel 2). In China, where food and fuel prices are expected to increase, the baseline outlook is for a gradual increase in inflation as output gaps close. In Japan, core inflation has reached a historically high level due to strong domestic demand and rising wages, and it is expected to stay above 2 percent until early 2025.

1.3. Risks to the Outlook Are Still Tilted to the Downside, albeit More Balanced

While still tilted to the downside, risks to the near-term outlook are now more balanced. Key downside risks include more persistent global inflationary pressures and the need to tighten monetary policy further, a deeper downturn in the property sector in China (Figure 1.8), and an abrupt tightening of financial conditions. However, upside risks have also emerged. A soft-landing scenario after the monetary policy tightening cycle is now more plausible, featuring both a stronger recovery in domestic demand and accelerated global disinflation. This would support a rebound in Asia's exports and provide scope for monetary easing in 2024 (October 2023 *World Economic Outlook*, Box 1.2). In the medium term, a stronger slowdown in productivity and investment in China or greater geoeconomic fragmentation would reduce growth in Asia and the Pacific.

Figure 1.8. Spillovers from China's Growth, by Drivers
(Percent, peak cumulative decline in GDP)



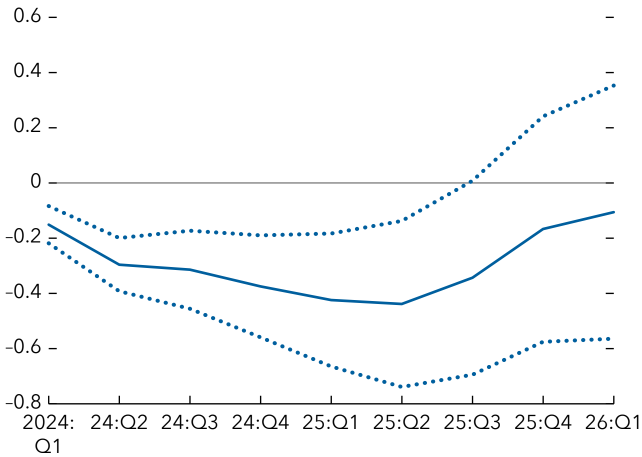
Sources: Copestake and others (2023); and IMF staff calculations.
Note: Peak responses of a shock to (1) overall activity measure from Fernald and others (2021), (2) private investment, (2) private final consumption, (3) and value added in the property sector. Triangles represent mean response in a panel of 50 countries (excluding China); lines are 68 percent confidence intervals. pp = percentage point.

Near-Term Risks

- A deeper or more prolonged housing market correction in China would trigger greater financial stress among property developers and larger asset quality deterioration. Both banks and nonbanks would be affected through balance sheet losses and lower profitability, causing tighter financial conditions. In addition, spillovers to and from highly leveraged local government financing vehicles could result in unintended fiscal tightening. In a downside scenario, China's GDP would decline by as much as 1.6 percent relative to the baseline by 2025, while world GDP would decline by 0.6 percent relative to the baseline (October 2023 *World Economic Outlook*, Chapter 1). Spillovers would be larger for countries whose exports are linked strongly to investment or commodity demand in China. Such a downside scenario would also entail less outbound tourism from China, affecting service sectors across Asia (including in Cambodia, Maldives, and Thailand).
- Upside risks to inflation could be triggered by further commodity price spikes and tighter labor markets. Inflation in Asia's emerging market and low-income economies is particularly exposed to global rice prices, which have recently experienced a bout of volatility, and other essential food prices. Core inflation in emerging Asia is particularly susceptible to global commodity shocks (Carrière-Swallow and others 2023). In advanced economies, core inflation could be more persistent than currently expected, as tight labor market conditions have yet to ease.
- The relatively accommodative financial conditions in both the United States and emerging market Asia come with the risk of a sharp reversal. In the United States, tighter conditions could materialize if markets reprice risks when expectations about the monetary tightening path or monetary transmission lags shift, or if term premiums increase (Figure 1.9, panel 1). Tighter domestic financial conditions could stress sectors whose balance sheets are vulnerable to interest rate risks (May 2023 *Regional Economic Outlook: Asia and Pacific*, Box 2), putting growth at risk, particularly in Asia's emerging markets (Figure 1.9, panel 2). An abrupt adjustment of the Bank of Japan's yield curve control operations could cause cross-border financial spillovers across Asia, especially in countries with close financial and trade links with Japan (Online Box 1.2).

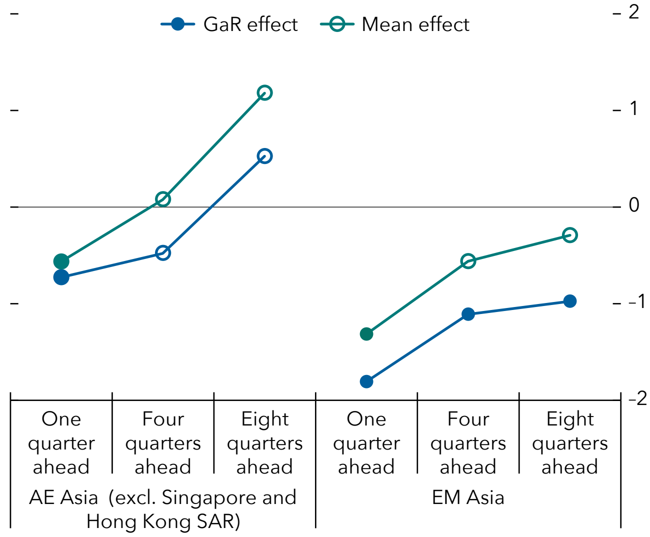
Figure 1.9. Impact of Financial Tightening

1. Growth Spillovers from Tighter US Financial Conditions
(Percent)



Sources: Copestake and others (2023); and IMF staff calculations.
Note: GDP growth spillovers from a one standard deviation increase in US Financial Conditions in 2023:Q4, similar to an increase between 2021:Q3 and 2022:Q3. Dotted lines are 90 percent confidence intervals.

2. Asia: Mean and Growth-at-Risk Impact of Tightening Financial Conditions
(Percent; due to one standard deviation increase in FCI)



Sources: Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: Solid bubbles indicate significant at 90 percent confidence interval. GDP growth spillovers from one standard deviation increase in Asia's domestic financial conditions. AE = advanced economy; EM = emerging market; FCI = financial conditions index; GaR = growth-at-risk.

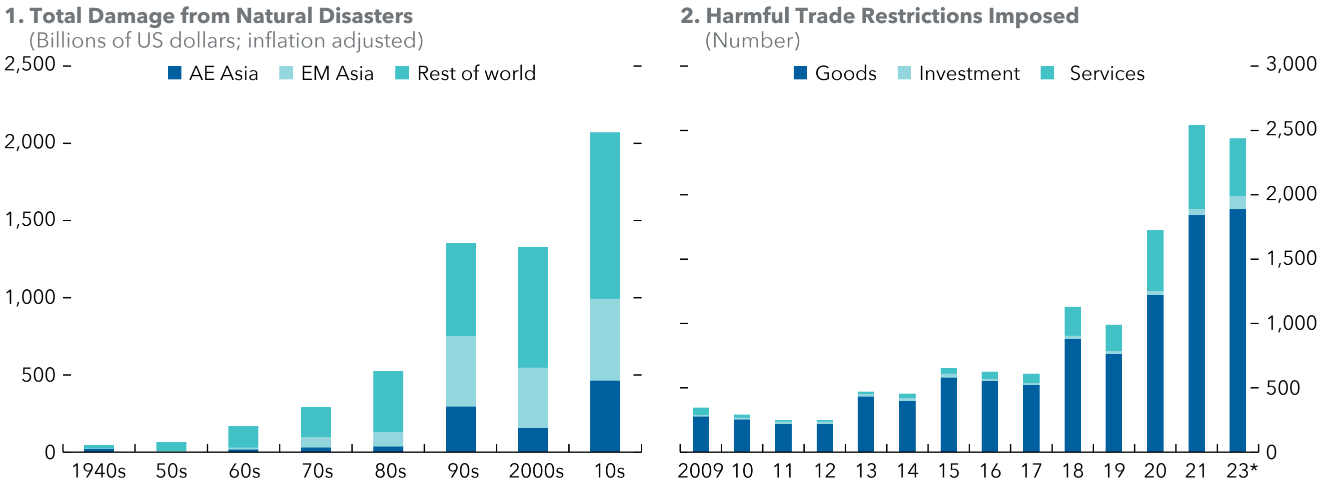
Medium-Term Risks

Medium-term potential growth in China is projected to slow amid uncertainty about the underlying moderation in productivity and labor force growth. Productivity-enhancing reforms in China could moderate the slowdown and lift growth in the region. Geoeconomic fragmentation pressures are clouding medium-term regional growth prospects (see Chapter 3), given the increase in restrictions on trade (Figure 1.10, panel 1), the impact on cross-border portfolio and foreign direct investment flows, and concentrated availability of critical minerals (October 2023 *World Economic Outlook*, Chapter 3). While friend-shoring may bring trade-diversion benefits to some countries, these are more than offset by the contraction in China and other major economies that such policies would cause—and this would only be exacerbated by "re-shoring" policies (see Chapter 3). Although Asia's emerging market and developing economies are benefiting from the fact that sovereign spreads are lower than one year ago (October 2023 *World Economic Outlook*, Chapter 1), several vulnerable low- and middle-income economies in Asia could be at risk of debt distress without measures to improve debt sustainability. Increasing threats from natural disasters and the resulting rising economic losses could affect the most vulnerable populations in Asia and pose a risk to food security (Figure 1.10, panel 2).

1.4. Policies

The task of bringing inflation back to target appears increasingly achievable with current policies, given recent monetary policy tightening in most of the region and the unwinding of some recent supply shocks. However, with challenges from headwinds to the outlook and limited policy space, continued fiscal and financial policy normalization is essential to support disinflation, preserve financial stability, and rebuild fiscal buffers. In addition, structural reforms to mitigate the negative impact from pandemic scarring, global climate change, and geoeconomic fragmentation are urgently needed.

Figure 1.10. Medium-Term Risks



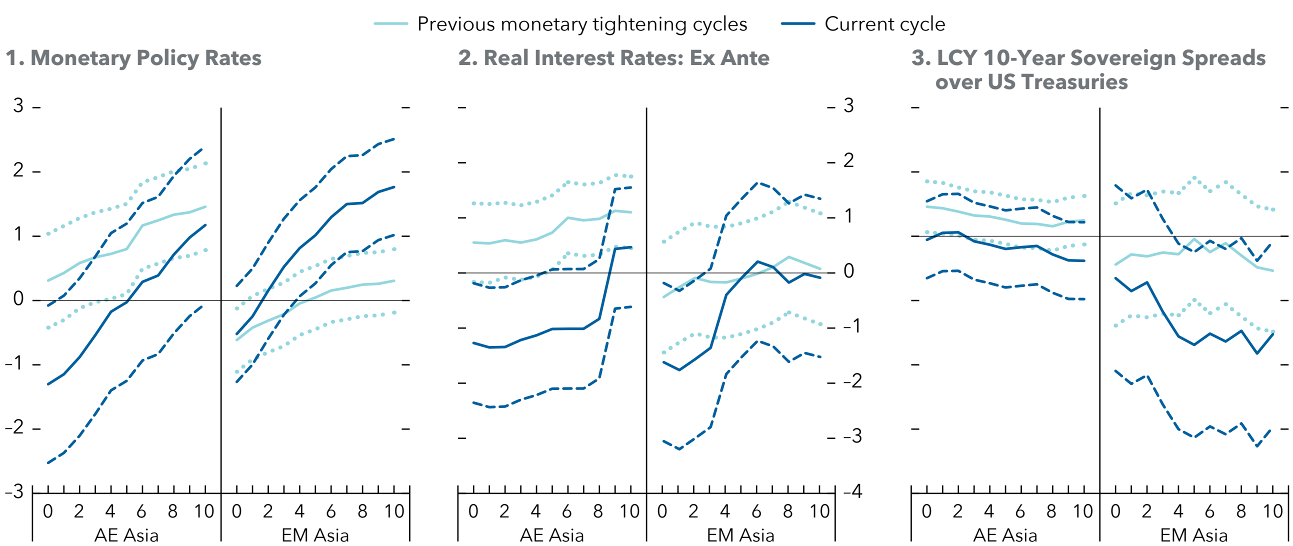
Sources: Emergency Events Database; and IMF staff calculations.
Note: Emergency Events Database does not report the actual economic impact of an event but only provides estimates. AE = advanced economy; EM = emerging market.

Sources: Global Trade Alert; and IMF staff calculations.
Note: * 2023 interpolated values to the end of the year.

Monetary Policy

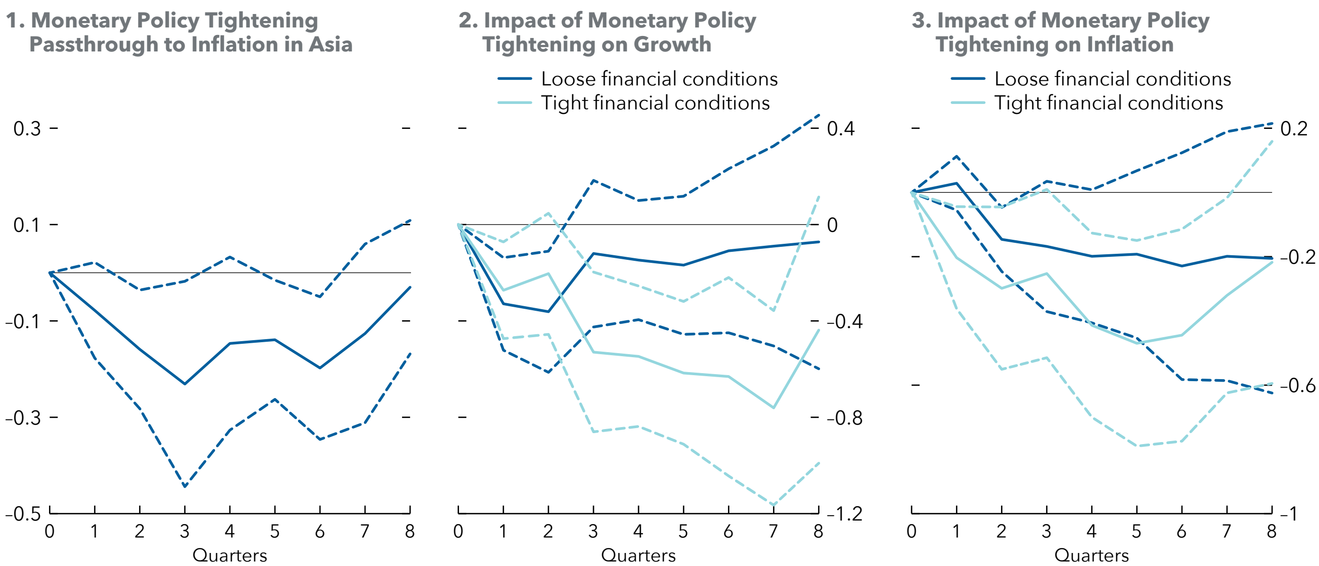
Faced with rising inflation in the last two years, central banks in Asia and Pacific (except for the Bank of Japan and the People's Bank of China) have tightened their monetary policy stances, in line with their price stability mandates. Compared with previous monetary tightening cycles in the new millennium, the pace of nominal policy rate increases has been faster in both advanced and emerging market economies (Figure 1.11, panel 1). Historical pass-through estimates suggest that this tightening has contributed to recent disinflation (Figure 1.12, panel 1).

Figure 1.11. Monetary Tightening Cycles and Financial Conditions from a Historical Perspective
(Percent; T = 0 on the horizontal axis representes the first month of a monetary tightening cycle)



Sources: Bloomberg Finance L.P.; Haver Analytics; and IMF staff calculations.
Note: Dashed lines are 90 percent confidence intervals. AE = advanced economy; EM = emerging market; LCY = local currency.

Figure 1.12. Monetary Transmission amid Eased Financial Conditions
(Percent)



Sources: Deb and others (2023); and IMF staff calculations.
Note: Dotted lines show 90 percent confidence intervals. Results are derived from a sample of nine Asian economies—AUS, IDN, IND, JPN, KOR, MYS, NZL, PHL, and THA—following the methodology in Deb and others (2023). Country abbreviations are International Organization for Standardization (ISO) country codes.

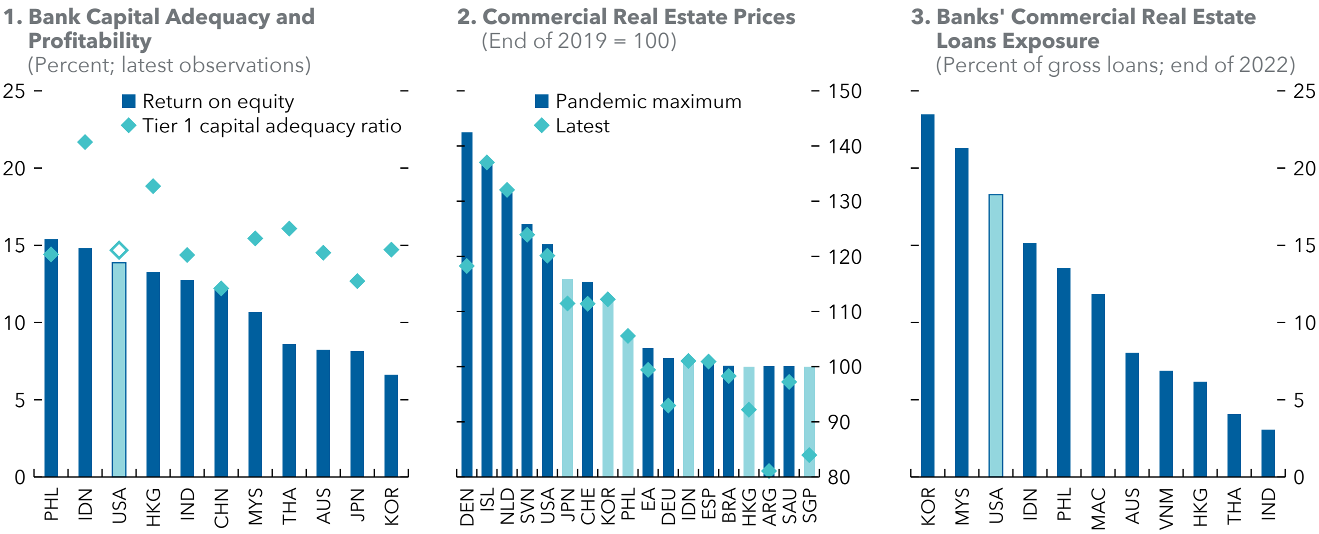
Going forward, central banks in the region should guard against easing monetary policy prematurely:

- Despite the tightening cycle, ex ante real policy interest rates are only at about zero (Figure 1.11, panel 2), which is close to or still somewhat below neutral levels. Financial conditions, especially in emerging market economies, also remain more accommodative than in earlier monetary tightening cycles (Figure 1.11, panel 3). This possible disconnect between financial conditions and policy rates could reduce both the disinflationary impact of hikes (Figure 1.12, panel 2) and their negative impact on growth and employment (Figure 1.12, panel 3).
- Core inflation in a few advanced economies of the region—including Australia, Japan (see Online Box 1.2), and New Zealand—is still substantially above target. The greater persistence mirrors labor markets that continue to be tight (as seen in high vacancy-to-unemployment ratios and rising wages) and output that remains above potential. In these circumstances, central banks should stay the course in their monetary policy response or be ready to tighten until inflation is expected to decline firmly to the target range.
- There are uncertainties about inflation paths. Risks to inflation from food (particularly rice) and fuel prices remain tilted to the upside; core inflation itself is susceptible to food, fuel, and shipping cost shocks, especially in emerging market and developing economies (Chapter 2 and October 2023 *World Economic Outlook*, Chapter 2). There is also considerable uncertainty around lags of policy transmissions and the relative size of supply and demand shocks.

Financial Stability

Asia's banking sector has remained resilient, underpinned by strong capital buffers and rising profitability (Figure 1.13, panel 1). However, as interest rates remain higher for longer, associated asset quality risk could increase and lead to financial sector stresses in Asia. Policymakers should respond by strengthening supervision, including through implementation of Basel III standards, phasing out forbearance measures, and closely monitoring systemic risks.

Figure 1.13. Financial Stability in Asia



Sources: IMF Financial Soundness Indicators database; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

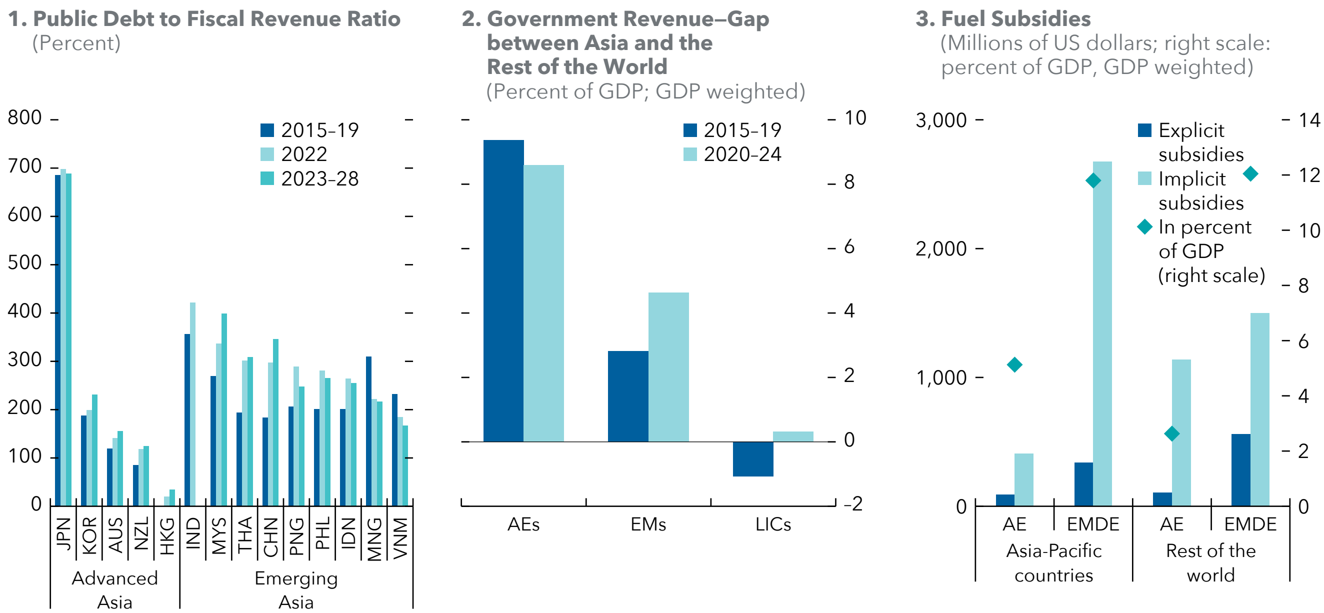
Real estate sectors in Asia could also become a source of financial stability risks in a tighter-for-longer environment. In China, continued stress in the property sector may lead to material losses for smaller banks. Regulators should facilitate the restructuring or bankruptcy proceedings of insolvent developers while protecting buyers' interests and restoring market confidence. Outside of China, high-leverage property sector segments could face challenging funding conditions and liquidity shortfalls (April 2023 *Regional Economic Outlook: Asia and Pacific*). While the commercial real estate sector in Asia is relatively small (April 2021 *Global Financial Stability Report*) and price increases since the pandemic have generally been modest (Figure 1.13, panel 2), regional financial centers such as the Hong Kong Special Administrative Region and Singapore have experienced substantial commercial property price declines recently. Banking sector lending to commercial real estate is high in a few Asian economies (Figure 1.13, panel 3), but vulnerabilities remain contained.

Macroprudential measures should be used preemptively to address emerging risks in banks and nonbanks, including those linked to highly indebted corporate borrowers (April 2023 *Regional Economic Outlook: Asia and Pacific*) and increasingly vulnerable real estate sectors (for example, limits on loan-to-value ratios and debt-service-to-income ratios). For economies where financial conditions remain accommodative, increasing banks' countercyclical buffers and provisions for sectors with pockets of vulnerabilities could mitigate excessive risk taking. If financial sector stress were to emerge, deploying liquidity support promptly while mitigating the risk of moral hazard would limit contagion.

Fiscal Policy

Fiscal consolidation in Asia continues to support disinflation, although the pace is expected to slow in 2024. Debt service burdens are higher than before the pandemic due to higher debt levels and interest rates (Figure 1.14, panel 1)—hence stronger primary balances are needed to ensure debt sustainability. This is a particular concern for countries with limited fiscal space for priority spending or increased risks of debt distress. Market-oriented structural reforms could ease the trade-off by promoting economic growth and strengthening public finances. Gains from structural reforms would materialize through higher tax revenues and narrower sovereign debt spreads, and translate eventually into sizable and long-lasting reductions in the debt-to-GDP ratios (Aligishiev and others 2023).

Figure 1.14. Fiscal Policies in Asia



Source: IMF, World Economic Outlook database.
Note: Public debt burden is defined as the ratio of general government gross debt to fiscal revenue. Country abbreviations are International Organization for Standardization (ISO) country codes.

Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Gap between Asia and the rest of the world is defined as Asia's government revenue-to-GDP ratio minus rest-of-world government revenue-to-GDP ratio. AEs = advanced economies; EMs = emerging markets; LIC = low-income countries.

Sources: Fossil Fuels Subsidies Database 2023; and IMF staff.
Note: AE = advanced economies; EMDE = emerging market and developing economies.

Government revenue in the region remains low compared to international peers. The gap is increasing, among both emerging markets and low-income countries (Figure 1.14, panel 2). Revenue-enhancing reforms, including expanding the tax base and strengthening revenue administration, will be critical to fund development needs and manage high debt levels. In countries with limited fiscal space, public spending should focus on measures that protect the most vulnerable households and boost future productivity. This could be achieved by prioritizing subsidy reforms, strengthening weak social safety nets, and augmenting public investment to boost productivity growth. Reducing the region's large energy subsidies (Figure 1.14, panel 3) would also help tackle climate change by creating incentives for greater energy efficiency and generating fiscal space to invest in renewable energy.

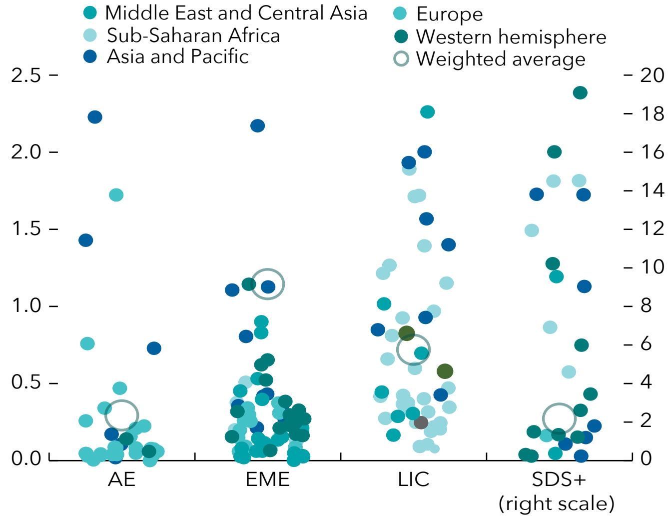
A few frontier market economies (for example, Maldives, Mongolia, and Papua New Guinea) and low-income countries (such as Lao P.D.R.) face high short-term external financing needs or debt servicing costs. Stronger fiscal adjustment may be required in some cases to achieve debt stabilization at a sustainable level. Communication and implementation of credible medium-term fiscal frameworks would facilitate such adjustments.

Structural Policies

To boost productivity and mitigate scarring from the pandemic and fragmentation, countries should implement targeted and carefully sequenced structural reforms. Prioritizing reforms that alleviate the most critical constraints to activity can help front-load output gains and ensure public buy-in. Reforms such as expanding health care coverage, increasing access to early childhood and higher education, supporting start-ups, and deepening digitalization would boost medium-term output. Mitigating potentially adverse distributional effects of structural reforms across economic groups (including gender and age) might require complementary policies, including targeted support to ensure that the reforms' benefits are shared.

Speeding up the green transition would help mitigate the effects of climate change. Temperatures across Asia have risen in recent decades, accompanied by an increasing frequency of natural disasters. Investment in climate change adaptation needs to be scaled up from both public and private sources, including green financing mechanisms (Figure 1.15)—especially in regions most vulnerable to climate shocks. Reductions in global emissions are needed to mitigate climate change. Asia has a large role to play, as 5 of the 10 largest emitters are in Asia (Lim and others, forthcoming). Carbon pricing can benefit Asian economies by discouraging fossil fuel use, promoting the development of renewable energy, and incentivizing technological development. Green industrial policies (currently pursued in China, the European Union, and the United States) can complement carbon pricing to speed up the transition. However, they should be designed to avoid distortions to international trade (such as domestic content provisions) and investment, in line with World Trade Organization rules. Enhancing climate risk monitoring systems and risk management frameworks, and building stronger safety nets and insurance, are also needed to enhance climate resilience (October 2023 *Fiscal Monitor*).

Figure 1.15. Climate Adaptation Needs
(Percent of GDP)



Sources: Aligishiev, Bellon, and Massetti (2022); and IMF staff calculations.
Note: Hollow circles as weighted averages of country groups.
AE = advanced economy; EME = emerging market economy; LIC = low-income economy; SDS+ = small developments states and countries with investment needs in adaptation greater than 2.5 percent of GDP.

Finally, Asian countries should step up reforms that would mitigate the impact of China's medium-term growth slowdown and of global de-risking. As Asia is highly integrated into global supply chains, strengthening multilateral and regional cooperation and mitigating the effects of fragmentation would help maintain the gains from trade and economic integration. This requires efforts to lower inter- and intraregional nontariff trade barriers, improve connectivity, and strengthen regional integration through agreements such as the Association of Southeast Asian Nations plus China, Japan, and Korea forum; the Comprehensive and Progressive Agreement for Trans-Pacific Partnership; and Regional Comprehensive Economic Partnership. Nontariff trade barriers remain high in Asia, and historical experience suggests that their removal could benefit growth (October 2021 *Regional Economic Outlook: Asia and Pacific*). Furthermore, reform measures to improve business environments and regulatory frameworks are essential for attracting more foreign and domestic investment. To enhance innovation and productivity, more investment in research and development, education, and skills development is critical (Dabla-Norris and others 2023).

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