

**FOR RELEASE:**

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**Asia: Bolstering Resilience amid the Slowdown**

*While Asia's growth has recently disappointed, the region is expected to grow at a steady 5.4 percent in 2015–16, remaining the global growth leader. Asia's growth should benefit from relatively strong labor markets and disposable income growth along with the ongoing gradual recovery in major advanced economies. Across most major Asian economies, lower commodity prices should help consumption. Negative risks to growth dominate, especially the possibility of a sharper slowdown in China or larger spillovers from the changing composition of China's demand. In addition, further U.S. dollar strength accompanied by a sudden tightening of global financial conditions, weaker growth in Japan, and weaker regional potential growth could also dim Asia's growth prospects. High leverage could amplify shocks, and lower commodity prices will also hurt corporate investment in key commodity-producing sectors. All in all, despite its resilient outlook, Asia is facing a challenging economic environment. This calls for carefully calibrated macroeconomic policies and a renewed impetus on structural reforms to facilitate investment and improve economic efficiency, bolstering economic resilience, and potential growth.*

***The global and regional backdrop has become more challenging, particularly in China and other major emerging markets.***

**Global growth is expected to pick up modestly in the near term, but the economic environment will remain challenging.** Growth in advanced economies is projected to rise somewhat this year and next, with output gaps narrowing and monetary policy remaining accommodative. Medium-term prospects, however, remain weak, reflecting subdued productivity growth and investment,

Note: Prepared by Roberto Guimarães-Filho and Dulani Seneviratne under the guidance of Ranil Salgado. Socorro Santayana assisted with the production.

unfavorable demographic trends, and, in some countries, crisis legacies (such as high public and private debt and financial sector weaknesses). Emerging economies' prospects have continued to deteriorate, reflecting a number of factors, including spillovers from China's rebalancing and slowdown, lower commodity prices, supply bottlenecks, tightening financial conditions, decelerating credit cycles, and policy uncertainty.

**Global financial market volatility remains high.** Global risk aversion spiked in August, triggered by concerns about China's growth outlook, the sharp decline in the Chinese stock market, and uncertainty about the new exchange rate regime.

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Other emerging economies have also experienced sharp drops in stock prices and weakening currencies. Despite still relatively easy financial conditions in advanced economies, financial conditions for emerging market economies have tightened considerably in recent months, as capital outflows have accelerated and corporate and sovereign spreads have risen. With the policy rate liftoff in the United States approaching, emerging economies' financial volatility is expected to remain relatively high.

**Several revisions to medium-term growth forecasts across major economies (advanced and emerging) also suggest that long-term factors are at play.**

Advanced economies are facing weaker labor productivity growth, partly driven by the lower investment (including in human capital) since the global financial crisis (October 2015 World Economic Outlook (WEO), Chapter 1). In the case of emerging markets, the slowdown in recent years has been much more pronounced, with GDP growth declining, on average, by nearly 2 percentage points between 2011 and 2014. This drop in growth masks significant heterogeneity across economies and in many cases (including some of the large emerging market countries) reflects country-specific factors, including the failure to address supply bottlenecks owing to changes in structural policies and policy uncertainty. But as in the case of advanced economies, there are common factors, including lower growth in trading partners, lower commodity prices, and more recently capital outflows and greater financial market volatility. China's ongoing slowdown and rebalancing toward consumption and services has contributed to slowing global

goods trade (Box 1) and lower commodity prices.

**Economic growth in the Asia-Pacific region has continued to moderate.**

Following a weak first quarter, growth outturns across much of the region were broadly in line with WEO forecasts in Q2 2015, with the major exception of advanced Asia (Figure 1). The main culprit was external demand, as export growth weakened rather sharply in 2015 in comparison to quite a moderate slowdown in GDP growth (Box 1). Whereas private consumption also came in weaker than expected in Japan, Singapore, and Taiwan Province of China, domestic demand has held up elsewhere in Asia. For instance, retail sales growth has moderated somewhat but has also been holding up, underpinned by still robust—albeit declining—credit growth and relatively low nominal interest rates. Across the region, labor market conditions remain favorable and overall slack in the economy is estimated to be small. Headline consumer price inflation has moderated, partly reflecting lower oil prices, with core inflation generally stable.

- In China, growth has continued to moderate, particularly in the industrial sector, while the services sector has been more resilient and has become an increasingly important engine of growth. On the demand side, consumption remains strong, with retail sales (adjusted for inflation) still growing above 10 percent despite some recent moderation. Investment growth continues to slow, driven by the needed adjustment in real estate. Despite declining exports, the net exports contribution to growth has been

positive, as the investment slowdown led to a larger contraction in imports.

- In Japan, second quarter growth disappointed, following a strong performance in the previous quarter. Consumption growth has remained sluggish, despite the large windfall from lower commodity prices, as nominal wage growth remained weak. The latter has continued to defy expectations as the labor market has continued to tighten, exemplified by the declining unemployment rate, which currently stands at 3.3 percent, and the high vacancy-to-applicant ratio. After a strong first quarter, momentum in non-residential investment growth (excluding inventories) also faltered, despite firms' rising profitability and large cash holdings. Export growth has also been weak, particularly to China.
- In India, the growth recovery has continued, supported by a pickup in domestic demand, on the back of strengthening industrial production and fixed investment. Lower global oil prices have also boosted economic activity in India and underpinned a further improvement in the current account and fiscal position and a sharp decline in inflation. As well, forward-looking indicators such as the manufacturing and services Purchasing Managers' Indices (PMIs) indicate improving activity. However, export growth dropped sharply in the first half of 2015, partly reflecting subdued global demand.
- Lower exports have been the main culprit behind the slowdown across most of the Association of Southeast

Asian Nations (ASEAN) and other emerging and developing Asian countries, but there is considerable heterogeneity, as commodity exporters have been hit particularly hard by the decline in commodity prices and the global and regional trade slowdown.

**Regional financial market volatility has risen in tandem with global risk aversion.**

Asia's foreign exchange and equity markets were buffeted in recent months, and several factors were the proximate causes, chief among them the sharp declines in Chinese equity markets and the change in China's exchange rate regime. After a big rally fuelled by margin financing and perceived policy support, the stock market corrected sharply since mid-June by over 30 percent in three weeks, followed by some rebound after a broad set of policy measures to support valuations was implemented. More recently, concerns about a sharper slowdown in China and expectations of the impending U.S. interest rate liftoff led to renewed bouts of financial volatility in August.

**Asia has also experienced large capital outflows and regional currencies have generally depreciated.** The portfolio outflows during July–August 2015 were mostly in the form of equity flows, and cumulatively have surpassed the levels reached during the “taper tantrum” episode in May–June 2013. Commodity exporters such as Malaysia and Indonesia and their currencies have been particularly hard hit, and China announced that market forces would be allowed to play a bigger role in the determination of the exchange rate, which led to a depreciation of the renminbi, as capital outflows from China accelerated in

recent months. At the other end of the spectrum, reflecting its safe-haven status, the Japanese yen has strengthened. Other financial markets have also reflected the overall sense of retrenchment vis-à-vis emerging markets more generally, with sovereign Credit Default Swaps (CDS) spreads widening by 50–70 basis points for Indonesia, Malaysia, and Thailand since mid-July. Some country authorities have responded by selling reserves to ensure orderly market conditions and smooth exchange rate volatility, and as a result foreign reserves have declined in a number of countries, particularly in China and Malaysia.

*Asia will continue to outperform the rest of the global economy, but growth is moderating and major downside risks are looming.*

**While Asia's outlook is expected to remain robust, regional growth is being revised down modestly, in line with global developments.** Asia's gross domestic product (GDP) growth is forecast to reach 5.4 percent in both 2015 and 2016, down by 0.2 and 0.1 percentage points compared to the April 2015 WEO forecasts (Table 1). This markdown is broadly in line with the revisions in forecasts for the global economy. Global growth, particularly the recovery in the United States and euro area, coupled with weaker Asian currencies, is expected to lift Asia's export growth, while relatively low domestic interest rates, strong job markets, and still generally robust income and credit growth should continue to support domestic demand across most of the region.

- China continues to rebalance its economy toward domestic consumption and services and away from credit-led investment. GDP growth in the second half of 2015 should remain at around 6.5 percent (year-on-year), helped by monetary easing and targeted fiscal stimulus measures (boost to transportation spending and social housing). Overall, the economy is expected to grow by 6.8 percent and 6.3 percent in 2015 and 2016, respectively (no revision relative to the April 2015 WEO, though downside risks have increased). The recent equity market turmoil and the change in the exchange rate regime are not likely to have a significant impact on growth, but could pose more downside risks to the economy. Further efforts to address vulnerabilities (related to the credit-investment growth model) should continue to exert a drag on headline growth numbers, particularly in the manufacturing sector, while at the same time making growth more sustainable over the medium term.
- In Japan, growth is projected to recover from last year's contraction, but only moderately. For 2015 GDP is expected to expand at 0.6 percent (a 0.5 percentage point markdown from the April 2015 WEO), driven largely by a recovery in consumption on the back of rising real wages as well as a modest improvement in investment and exports. Growth will rise to 1 percent in 2016 (compared with 1.2 percent in the April 2015 WEO), partly as a result of favorable base effects and accelerating wage pressures as the labor market continues to tighten further. Domestic

demand should also benefit from lower oil and commodity prices and very accommodative financial conditions in light of the Bank of Japan's quantitative and qualitative easing. Headline inflation will continue to remain low this year, but is projected to average about 0.5 percent next year owing to favorable wage-price dynamics and a recovery of oil prices from its lows. Due to a continuation of these trends and the closing of the output gap, over the medium term inflation is expected to rise to 1.5 percent—closer to the official target.

- In India, the ongoing economic recovery is underpinned by robust domestic demand. With the revival of consumer and business sentiment, the incipient recovery of investment is expected to contribute more to growth going forward. In addition, higher public infrastructure investment and government initiatives to unplug raw material linkages and support the lending capacity of Indian banks should help crowd-in private investment. Although lower oil prices are supportive of domestic demand, weakened exports as well as headwinds from weaknesses in India's corporate and bank balance sheets will weigh on the economy. GDP is expected to grow at 7.3 percent in 2015 (0.2 percentage points lower than in the 2015 April WEO), rising to 7.5 percent in 2016 (unchanged from the 2015 April WEO).
- Growth in Australia and New Zealand is projected to be less robust because of lower commodity prices, while Korea's growth continues to be impacted by lackluster business and consumer confidence. In Australia, GDP growth is expected to moderate to 2.5 percent in 2015 as lower commodity prices dent exports and disposable income. Growth is expected to recover in 2016 owing to policy accommodation and stronger global growth, which should boost export volumes. New Zealand's activity is set to continue to benefit from earthquake reconstruction efforts, and growth should average close to 2.5 percent in 2015–16. In Korea, despite the boost from lower commodity prices and policy accommodation, growth is expected to moderate to 2.7 percent in 2015 before recovering to 3.2 percent in 2016, helped by the aforementioned factors.
- Growth in major ASEAN economies is projected to moderate in 2015, owing to lower commodity prices (Indonesia and Malaysia), political uncertainty (Malaysia), and weaker growth in China. Lower trade growth should also dent growth prospects in Singapore and the Philippines, though in the latter the underlying growth momentum is expected to be quite strong, owing in part to lower commodity prices and strong remittance inflows. Thailand is expected to see a rebound as public and private domestic demand recover on the back of reduced policy uncertainty.
- The recovery in advanced economies, strong foreign exchange inflows from remittances and tourism, and country-idiosyncratic factors will propel growth in other emerging and developing Asia as well as small states and Pacific island countries. Growth is projected to pick

up in 2015–16 in Vietnam, Bangladesh, and the Pacific island countries and other small states. As in recent years, vulnerabilities stemming from high fiscal and current account deficits and lower commodity prices would adversely affect growth prospects in some countries, including Mongolia and Lao P.D.R.

### *Downside risks continue to dominate.*

Negative risks to growth dominate, notably the possibility of a sharper slowdown in China. A sudden tightening of global financial conditions, weaker growth in Japan, and weaker potential growth could also adversely affect the Asia's growth outlook. High leverage could amplify shocks (particularly as the credit cycle turns), and lower commodity prices, while generally a tailwind for the region, could also hurt corporate investment in commodity-producing sectors.

- *A sharper slowdown in China.* Given the sheer size of the Chinese economy, a negative growth shock there would hit the rest of Asia-Pacific region hard. Such a shock could come from failure to fully implement reforms (owing to reform fatigue, for instance) or from financial shocks and stronger-than-envisaged financial linkages, which could make policy measures less effective in containing domestic financial contagion. Ongoing efforts to rebalance the Chinese economy could also prove less effective than anticipated, leading to a sharp drop in demand. A sharp slowdown in China would pose regional growth risks through strong trade linkages and increasingly through

impacts on financial market sentiment. Econometric estimates accounting for trade and financial linkages between China and the rest of Asia indicate that spillovers could be sizable, with a 1 percentage point drop in China's GDP growth lowering Asia's GDP growth by about 0.3 percentage points (see Asia-Pacific April 2014 Regional Economic Outlook). The effects could be potentially greater today given the growing linkages within the region. Weaker commodity prices would also impact growth in commodity exporters (Australia, Indonesia, Malaysia, and New Zealand).

- *Weaker growth in Japan.* Greater policy uncertainty from weak fiscal and structural reform momentum in Japan would represent a shock to external demand in the rest of the region. Slow progress on fiscal and structural reforms could lead to overburdening of monetary policy in Japan and further weaken the yen, hurting trade-oriented economies such as Korea and Taiwan Province of China.
- *Rapid tightening of global financial conditions and turning of the credit cycle.* A sharper-than-expected rise in long-term U.S. rates following the liftoff of the policy rate could lead to a spike in global risk aversion and trigger further capital outflows from Asia. This would lead to higher domestic borrowing costs and another bout of weakening of Asian currencies, posing potential balance sheet risks for corporates and households with significant foreign exchange exposure, especially were the U.S. dollar to appreciate significantly.

Higher borrowing costs would also interact with the turning of the credit cycle in most of emerging Asia (including China), further impacting domestic demand. Financial stability could be compromised as asset quality deteriorates, triggering a financial accelerator effect as credit contractions could further depress activity and creditworthiness. A spike in interest rates could lead to drops in other asset prices, such as house prices, further hurting households' balance sheets and impacting domestic demand.

- *Lower-than-estimated potential growth* caused by, among other things, protracted weaker growth in major trading partners (e.g., with potential for hysteresis effects) and a compositional shift in growth toward the services sector where productivity growth is relatively weaker. These could also hinder private investment in the near term (because of lower expected demand growth) and lead to a sustained shortfall in aggregate demand and lower rates of technological adoption, further impacting potential growth over the medium and long term.
- *Lower oil and commodity prices.* Lower oil and commodity prices have so far provided generally limited impetus to growth in Asia as windfalls are estimated to have been mostly saved, either by the public sector (through reformed subsidy regimes in some countries) or the private sector (uncertainty affecting consumer and business sentiment). But as the declines prove to be persistent, consumers may start saving less and some businesses investing more, providing a boost to aggregate demand

in commodity importing economies and a larger upside spur to growth than currently envisaged. On the other hand, commodity producers are adversely affected, and in addition lower oil prices could hurt investment in the broader oil and gas sector (Box 2), which accounts for around 12 percent of corporate investment in Asia (even in oil importing economies).

***Policy accommodation should be considered where there is policy space, but trade-offs will come to the fore.***

**Given the ongoing slowdown across most of the region and the challenging global economic environment, policies should aim at supporting demand and lowering vulnerabilities.** In light of this, accommodative policies should be considered, particularly where there is policy space and where the decline in growth has a clear cyclical or temporary component. But policy recalibration should also focus on boosting potential growth and should not lead to further vulnerabilities.

- *Structural reforms* should remain a priority to bolster medium-term growth by facilitating investment and job creation, which would also help lower vulnerabilities in the near term. Not surprisingly, the reform agenda differs considerably across economies.
  - In China's case, reforms should continue to aid efforts to rebalance the economy away from debt-led investment. This would include, among other things, leveling the playing field between state-owned enterprises (SOEs) and the private sector,

- and improving the management of local government finances. Financial sector reforms should continue apace to improve the allocation of capital and move financial institutions to a more market-based financial system. Steady progress with implementation will help reduce policy uncertainty and allow the growth-enhancing benefits of the reforms to materialize.
- In Japan, while monetary easing needs to continue, fiscal and structural reforms should be accelerated to help reduce vulnerabilities and reduce the overreliance on monetary policy. Specifically, reform measures should continue to aim at boosting female labor market participation, enhancing positive wage-price dynamics through labor contract reform, and lowering fiscal risks through the implementation of a credible and concrete medium-term fiscal plan. Progress on other structural reforms (the third arrow of Abenomics), such as further deregulation of product markets to improve labor productivity in the services sector, is also needed.
  - In frontier economies such as Vietnam and Mongolia, banking sector and SOE reforms to improve efficiency and the allocation of capital remain priorities.
  - In India, while several policy actions have been taken recently, further steps in relaxing long-standing supply bottlenecks, especially in the energy, mining, and power sectors, as well as labor and product market reforms, and improving the business climate are crucial to achieving faster and more inclusive growth.
  - Across ASEAN and other emerging and developing Asia reforms to address the infrastructure gap are needed.
  - *Fiscal policy* frameworks should let automatic stabilizers operate, except where fiscal consolidation needs are more evident. In economies in which contingent fiscal liabilities are significant, ensuring fiscal consolidation remains at a greater premium. In economies with fiscal space, such as low debt and cyclically adjusted fiscal surpluses, targeted fiscal stimulus to counter temporary shortfalls in demand could be considered. Elsewhere, gradual fiscal consolidation should continue, especially in commodity exporters, as fiscal stimulus could increase fiscal vulnerabilities, triggering spikes in risk premiums and capital flow reversals.
  - *Monetary policy* could also be used to support demand where inflation and inflation expectations are low, particularly if fiscal space is limited. Inflation pressures are generally low and real rates have increased as inflation has trended down this year across most of the region. In addition, policy rates are broadly in line with levels implied by

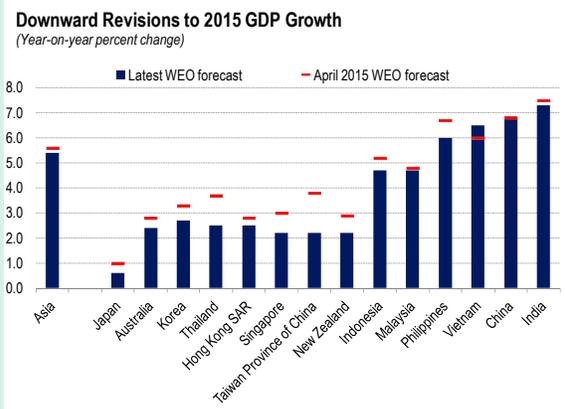
estimated Taylor rules in a number of major Asian economies. All of these factors suggest that policy interest rates could be lowered should growth disappoint and negative output gaps emerge or increase. But weaker exchange rates might limit the scope for monetary easing, especially in commodity exporters or those economies with pre-existing vulnerabilities such as current account deficits (Indonesia) or less credible policy frameworks. The risk that monetary easing could further weaken exchange rates and trigger spikes in financing costs (via higher risk premiums) should also be taken into account, particularly where financial stability risks arising from foreign exchange debt are relevant (India and Indonesia).

- *Exchange rate policy* should remain focused on ensuring that exchange rates remain a key shock absorber. In light of the anticipated tightening of global financial conditions, foreign exchange reserves should be used judiciously and should not hinder exchange rate adjustment, especially where growth prospects and/or terms of trade have deteriorated. Exchange rate flexibility notwithstanding, foreign exchange intervention should remain in the toolkit to ensure orderly market conditions and, where reserve levels are relatively high, smooth excessive exchange rate volatility.

*Macroprudential policies* should be calibrated to ensure financial stability and limit systemic risks. As asset price volatility is expected to remain elevated and exchange rates could adjust further, stronger macroprudential frameworks may be needed. In this light, strengthening supervisory and regulatory frameworks should remain high on the agenda of policymakers in the region. In particular, to deal with the turning of the credit cycle, the authorities should further improve provisioning standards and asset quality reviews, as well as review insolvency frameworks for private debt resolution.

Figure 1  
2015 Fall REO Update: Real and Financial Developments

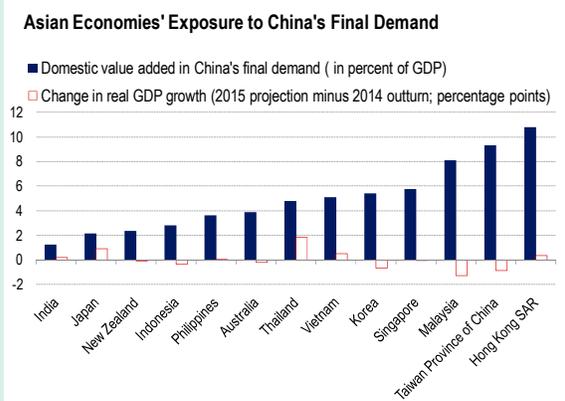
Asia's growth momentum is moderating...



... partly because of weak export growth...



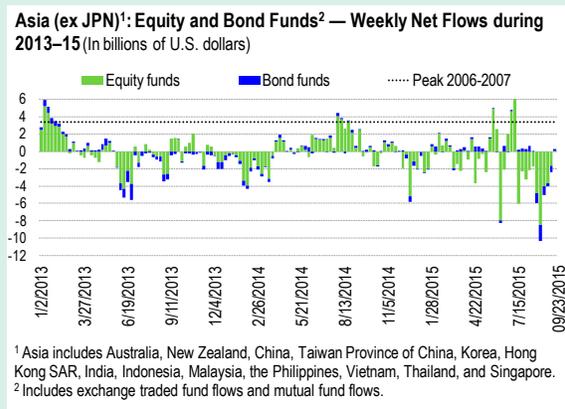
...and significant exposure to a weaker Chinese economy.



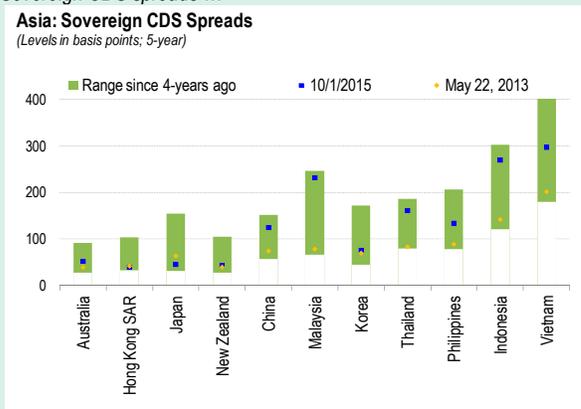
On the bright side, consumer demand seems to be holding up.



But pressures are increasing, as capital outflows have picked up...



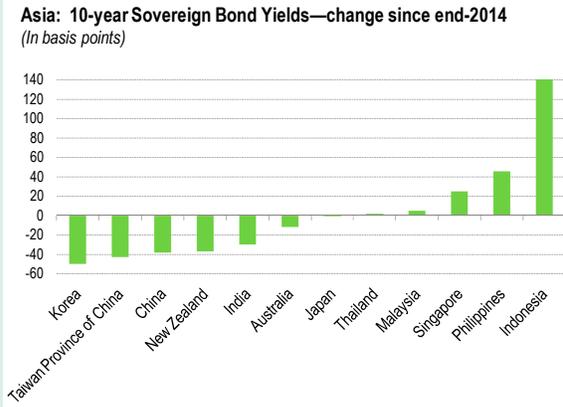
...leading to a tightening in financial conditions, seen here by the rise in Sovereign CDS spreads ...



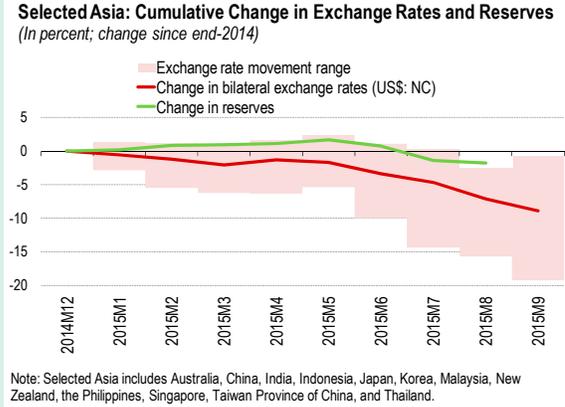
Sources: Bank for International Settlements; Bloomberg L.P.; CEIC Data Company Ltd.; Consensus Economics; EPFR Global; Haver Analytics; OECD-WTO Trade in Value Added (TiVA) database; IMF, International Financial Statistics database; IMF, World Economic Outlook database; and IMF staff calculations.

Figure 1  
2015 Fall REO Update: Real and Financial Developments (concluded)

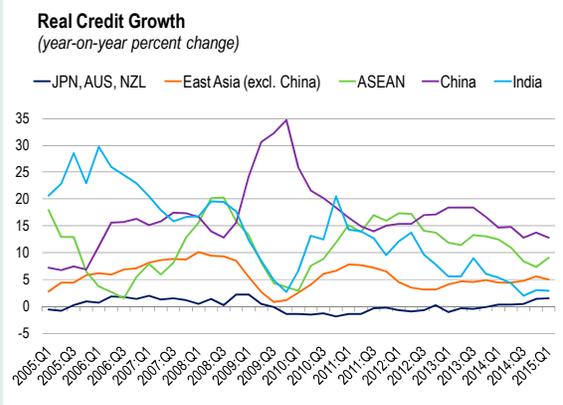
...and sovereign bond yields have increased in some emerging Asian economies...



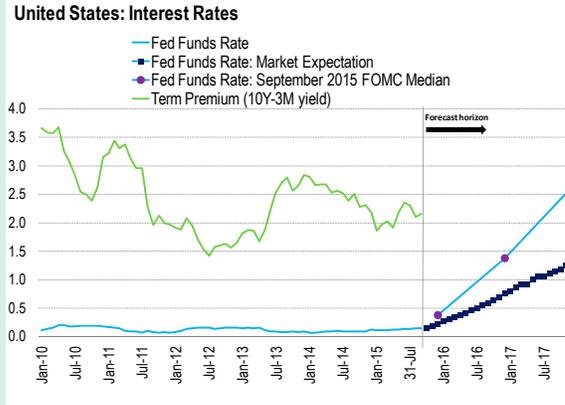
...and Asian policy makers have started to drawdown on reserves in some cases.



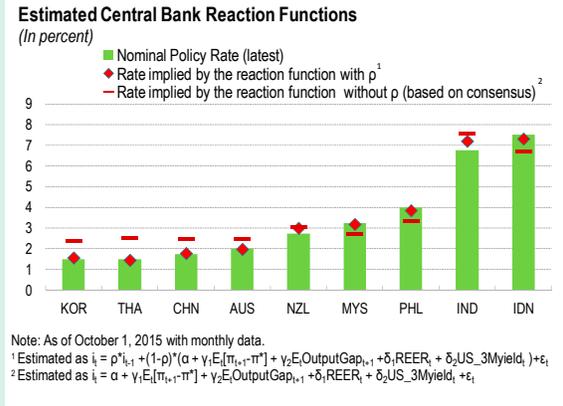
While credit growth remains robust across most of the region, the credit cycle appears to be turning as credit growth moderates.



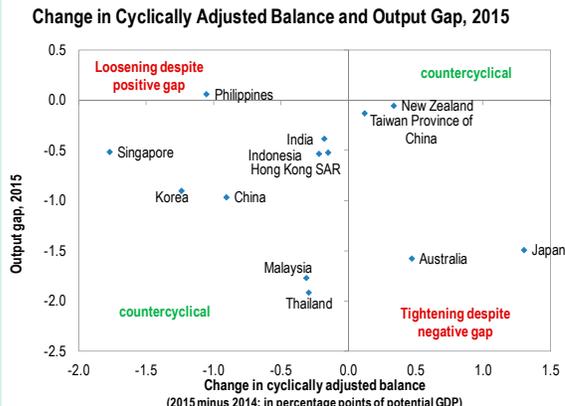
The reaction to the Fed liftoff in the United States could lead to a sharp tightening of financial conditions in Asia.



Monetary policy remains generally accommodative in the region...



...and fiscal policy has been largely countercyclical.



Sources: Bank for International Settlements; Bloomberg L.P.; CEIC Data Company Ltd.; Consensus Economics; EPFR Global; Haver Analytics; OECD-WTO Trade in Value Added (TiVA) database; IMF, International Financial Statistics database; IMF, World Economic Outlook database; and IMF staff calculations.

Table 1

**Asia: Real GDP***(Year-on-year percent change)*

|  | Actual Data and Latest Projections |      |      |      |      | Difference from April 2015 WEO |      |      |
|--|------------------------------------|------|------|------|------|--------------------------------|------|------|
|  | 2012                               | 2013 | 2014 | 2015 | 2016 | 2014                           | 2015 | 2016 |
| <b>Asia</b>  | 5.7                                | 5.8  | 5.6  | 5.4  | 5.4  | 0.0                            | -0.2 | -0.1 |
| <b>Emerging Asia<sup>1</sup></b>                                   | 6.8                                | 7.0  | 6.8  | 6.5  | 6.3  | 0.0                            | -0.1 | -0.1 |
| Australia  | 3.6                                | 2.1  | 2.7  | 2.4  | 2.9  | 0.0                            | -0.4 | -0.3 |
| Japan  | 1.7                                | 1.6  | -0.1 | 0.6  | 1.0  | 0.0                            | -0.4 | -0.2 |
| New Zealand  | 2.9                                | 2.5  | 3.3  | 2.2  | 2.4  | 0.1                            | -0.7 | -0.3 |
| <b>East Asia</b>   | 6.8                                | 6.9  | 6.7  | 6.2  | 5.8  | 0.0                            | -0.1 | -0.1 |
| China  | 7.7                                | 7.7  | 7.3  | 6.8  | 6.3  | -0.1                           | 0.0  | 0.0  |
| Hong Kong SAR  | 1.7                                | 3.1  | 2.5  | 2.5  | 2.7  | 0.2                            | -0.3 | -0.4 |
| Korea  | 2.3                                | 2.9  | 3.3  | 2.7  | 3.2  | 0.0                            | -0.6 | -0.3 |
| Taiwan Province of China   | 2.1                                | 2.2  | 3.8  | 2.2  | 2.6  | 0.1                            | -1.6 | -1.5 |
| <b>South Asia</b>  | 5.2                                | 6.8  | 7.2  | 7.2  | 7.4  | 0.1                            | -0.1 | 0.0  |
| Bangladesh   | 6.3                                | 6.0  | 6.3  | 6.5  | 6.8  | 0.2                            | 0.2  | 0.0  |
| India  | 5.1                                | 6.9  | 7.3  | 7.3  | 7.5  | 0.1                            | -0.2 | 0.0  |
| Sri Lanka  | 6.3                                | 7.3  | 7.4  | 6.5  | 6.5  | 0.0                            | 0.0  | 0.0  |
| Nepal  | 4.8                                | 4.1  | 5.4  | 3.4  | 4.4  | -0.1                           | -1.6 | -0.6 |
| <b>ASEAN</b>   | 6.0                                | 5.2  | 4.6  | 4.6  | 5.0  | 0.0                            | -0.5 | -0.3 |
| Brunei Darussalam  | 0.9                                | -2.1 | -2.3 | -1.2 | 3.2  | -1.6                           | -0.7 | 0.4  |
| Cambodia   | 7.3                                | 7.4  | 7.0  | 7.0  | 7.2  | 0.0                            | -0.2 | 0.0  |
| Indonesia  | 6.0                                | 5.6  | 5.0  | 4.7  | 5.1  | 0.0                            | -0.5 | -0.4 |
| Lao P.D.R.   | 7.9                                | 8.0  | 7.4  | 7.5  | 8.0  | 0.0                            | 0.2  | 0.2  |
| Malaysia   | 5.5                                | 4.7  | 6.0  | 4.7  | 4.5  | 0.0                            | -0.1 | -0.4 |
| Myanmar  | 7.3                                | 8.4  | 8.5  | 8.5  | 8.4  | 0.8                            | 0.2  | -0.1 |
| Philippines  | 6.7                                | 7.1  | 6.1  | 6.0  | 6.3  | 0.0                            | -0.7 | 0.0  |
| Singapore  | 3.4                                | 4.4  | 2.9  | 2.2  | 2.9  | 0.0                            | -0.8 | -0.1 |
| Thailand   | 7.3                                | 2.8  | 0.9  | 2.5  | 3.2  | 0.2                            | -1.2 | -0.8 |
| Vietnam  | 5.2                                | 5.4  | 6.0  | 6.5  | 6.4  | 0.0                            | 0.5  | 0.6  |
| <b>Pacific island countries and other small states<sup>2</sup></b> | 3.0                                | 1.3  | 3.5  | 3.6  | 3.4  | -0.1                           | -0.4 | 0.0  |
| <b>Memorandum items:</b>   |                                    |      |      |      |      |                                |      |      |
| <i>World</i>   | 3.4                                | 3.3  | 3.4  | 3.1  | 3.6  | 0.0                            | -0.4 | -0.2 |
| <i>Advanced economies</i>  | 1.2                                | 1.1  | 1.8  | 2.0  | 2.2  | 0.0                            | -0.4 | -0.2 |
| <i>United States</i>   | 2.2                                | 1.5  | 2.4  | 2.6  | 2.8  | 0.0                            | -0.5 | -0.3 |
| <i>Euro area</i>   | -0.7                               | -0.2 | 0.9  | 1.5  | 1.7  | 0.0                            | 0.0  | 0.0  |
| <i>Emerging and developing economies</i>                           | 5.2                                | 5.0  | 4.6  | 4.0  | 4.5  | 0.0                            | -0.3 | -0.2 |

Sources: IMF, World Economic Outlook database; and IMF staff projections.

<sup>1</sup> Emerging Asia includes China, India, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam. India's data are reported on a fiscal year basis.<sup>2</sup> Simple average of Pacific island countries and other small states which include Bhutan, Fiji, Kiribati, Maldives, the Marshall Islands, Micronesia, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

**Box 1****China and the Global Trade Slowdown<sup>1</sup>**

Global goods trade growth has slowed sharply so far in 2015, turning negative in value terms. In the first half of 2015, global imports growth fell to -12 percent (year-on-year) in U.S. dollar value terms and to 1 percent in volume terms, distinctly below the average trend since 2001 (Table 1.1). Over the same period, global export growth fell to 2 percent in volume terms. The large difference between value and volume measures primarily reflects the collapse in global commodity prices.

Moreover, global goods trade growth—in volume terms—has been much weaker than GDP growth in 2015, with the ratio of trade to GDP growth (elasticity) below the average trend since 2001 and even the weaker trend since 2012. We confirm a consistent pattern in the exports of Asian countries. Our analysis indicates that the export income elasticity, after controlling for the exchange rate effect, has been declining since 2012 or so for a broad range of Asian countries. The decline in income elasticity has been puzzlingly steep so far in 2015, while the pre-2014 result has a common thread with the evidence of a gradual decline in export income elasticity reported in the April 2015 Asia and Pacific Regional Economic Outlook (Box 1.1). If long-lasting, the lower income elasticity could limit the boost to exports coming from the recovery in global economy.

**Table 1.1. Growth in Global Goods Trade and GDP Growth**

|               | 2001-07                              | 2008 | 2009  | 2010 | 2011 | 2012 | 2013 | 2014 | 2015H1 |
|---------------|--------------------------------------|------|-------|------|------|------|------|------|--------|
|               | <i>(year-on-year percent change)</i> |      |       |      |      |      |      |      |        |
| Export value  | 12.2                                 | 16.7 | -21.8 | 21.4 | 19.7 | 0.5  | 2.1  | 0.9  | -11.7  |
| Export volume | 5.8                                  | 2.4  | -12.0 | 15.4 | 6.0  | 2.1  | 2.8  | 3.4  | 2.2    |
| Import value  | 12.1                                 | 16.8 | -22.0 | 21.0 | 19.5 | 0.7  | 1.4  | 1.0  | -11.9  |
| Import volume | 6.1                                  | 2.2  | -12.2 | 13.8 | 6.1  | 1.9  | 2.3  | 3.3  | 0.9    |
| GDP           | 4.4                                  | 3.1  | 0.0   | 5.4  | 4.2  | 3.4  | 3.3  | 3.4  | 3.2    |

Sources: CPB Netherlands Bureau for Economic Policy Analysis (CPB); IMF, Direction of Trade and World Economic Outlook databases.

From the global perspective, the 2015 slowdown in trade volume growth relative to GDP growth turns out to be mostly an emerging market economy phenomenon.<sup>2</sup> Bottom-row panels of Figure 1.1 show the difference between growth rates of goods export (import) volume and GDP, which we call “trade-growth wedge.” If exports (imports) grow slower than GDP, the trade-growth wedge for exports (imports) will be negative. The trade-growth wedge for exports declined and turned to a sizable negative value for Asian emerging market economies in 2015H1, while the wedge for imports declined sharply and turned negative for most emerging market economies in 2015H1.<sup>3</sup>

In value terms, the decline in goods trade growth is distributed quite broadly across different country groups (Figure 1.2, top row). Europe accounts for about one-half of the decline in export and import growth between 2014 and 2015H1. For exports, the Middle East and Asia each account for about a fourth of the decline, with lower oil prices explaining the large contribution of the Middle East. For imports, China and the rest of Asia each account for about a fourth of the decline, with China making a larger contribution than its share in global trade (13 percent of global imports over 2014-15H1).

<sup>1</sup> Prepared by Jaewoo Lee, Wei Carol Liao, and Dulani Seneviratne.

<sup>2</sup> Monthly volume data are not available for individual countries especially for 2015, but is available for selected countries and regional groupings from CPB World trade monitor.

<sup>3</sup> Note that we have no further country breakdown from the publicly available CPB data.

**Box 1** (continued)

The conspicuous role played by China in the recent fall in import values resonates with the market concern over the pace of China's GDP growth slowdown. In particular, the rapid pace of import value decline may be a harbinger of a sharper slowdown in the GDP growth.<sup>4</sup> However, this is just one of four possible causes of slowdown in China's import growth: two related to the level of demand and the other two related to the composition of demand. It also goes without saying that low commodity prices are a large part of the decline in import value growth in China.

- *China's Demand Slowdown* Weak domestic demand in China suppresses its imports, increasing the risk of sharper-than-expected slowdown in its economy with global ripple effects.
- *Global Demand Slowdown* Weak demand in China's export destinations, including core advanced economies, reduces China's exports and also imports with it, given the role China has played as the key downstream leg in global value chains.
- *China's Rebalancing* Transition of China's aggregate demand away from the import and investment-intensive manufacturing sector toward a more domestic demand-oriented service sector lowers import growth.
- *China's Onshoring* Progress in China's technological sophistication increases the share of domestically produced capital and intermediate goods, lowering import growth.

A successful rebalancing of China toward domestic demand-oriented and more sustainable growth would be an important positive development for both the global and Chinese economies over the long term. And onshoring toward a more domestically based production structure will be a natural outcome of ongoing economic development in China, also a positive development for the global economy.

Although we cannot yet—including owing to data lags—offer unequivocal answers on which of the four causes drove the sharp trade slowdown so far in 2015, we provide suggestive evidence that tempers the risk that it is a harbinger of a much sharper slowdown in China's growth than is currently expected. The overall weakness in global demand, probably more in emerging markets which now account for nearly a half of the global trade, may be playing an important role in the trade slowdown in 2015, contrary to some speculation that China's demand slowdown may have been the main driver.

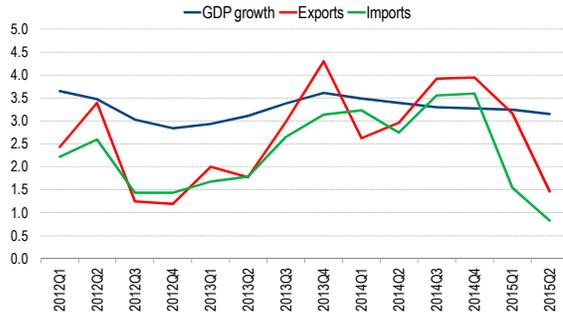
- The slowdown in China's imports since the last quarter in 2014 has been driven by a sharp contraction in China's goods imports, while China's services imports have been going strong. If any, China's services import growth has been gaining speed over previous years. These strong services imports are unlikely to have been inputs for exports, which have been declining. Instead, the recent strength of services imports is suggestive of strong domestic demand, consistent with rebalancing views.
- To look at non-commodity trade by destination and source, the speed and magnitude of import decline are somewhat unevenly distributed, leaving open the possibility of rebalancing or onshoring. China's imports from and exports to Asia, the euro area, and the rest of the world declined sharply. Imports from Asia and the euro area fell more sharply than exports to those destinations, suggesting that China's role in global value chains was at play. It could have been caused by weak global demand, rebalancing, or onshoring in China, mitigating the concern of a sharper-than-expected deceleration in China's GDP growth.

<sup>4</sup> IMF staff estimates suggest that the decline in goods import volume hit bottom several months ago.

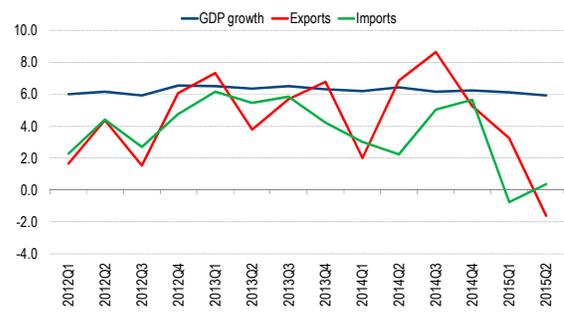
Box 1 (continued)

Figure 1.1  
**Slowdown in Goods Trade (Volume)**

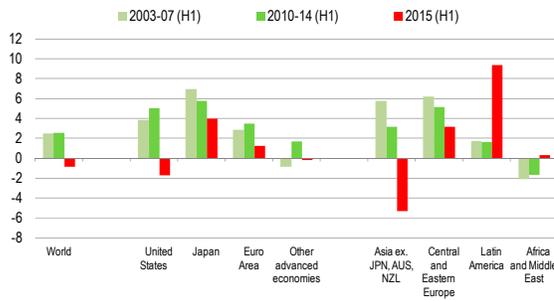
**World: GDP Growth and Trade Performance**  
*(Year-on-year percent change)*



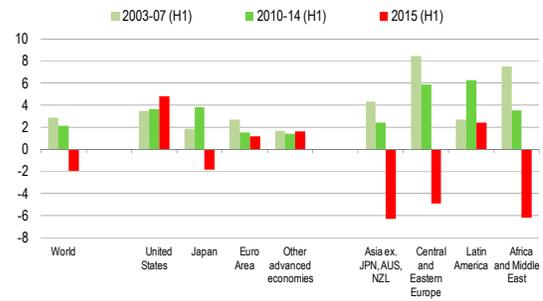
**Asia ex. JPN, AUS, NZL: GDP Growth and Trade Performance**  
*(Year-on-year percent change)*



**Trade-Growth Wedge: Export Volume**  
*(In percentage points; defined as growth in export volume minus real GDP growth)*



**Trade-Growth Wedge: Import Volume**  
*(In percentage points; defined as growth in import volume minus real GDP growth)*

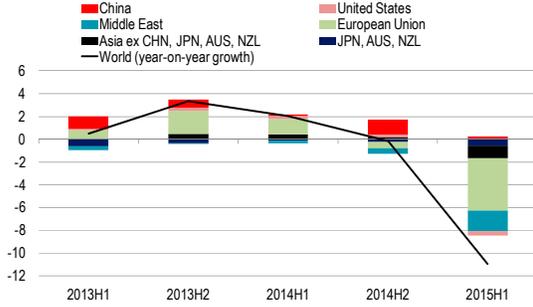


Sources: CPB Netherlands Bureau for Economic Policy Analysis (CPB); IMF, World Economic Outlook database; and IMF staff calculations.

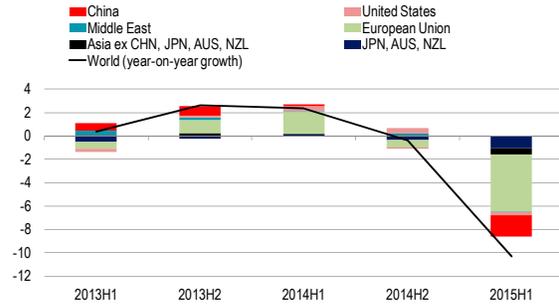
Box 1 (concluded)

Figure 1.2  
**Slowdown in Goods Trade (Value)**

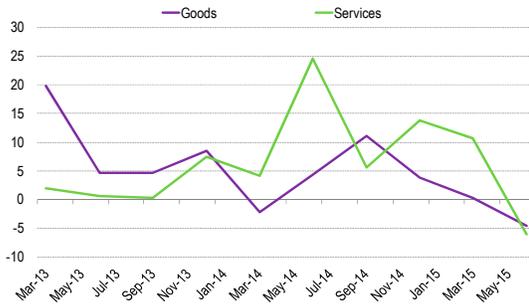
**Contribution to Global Export Value Growth**  
 (In percentage points)



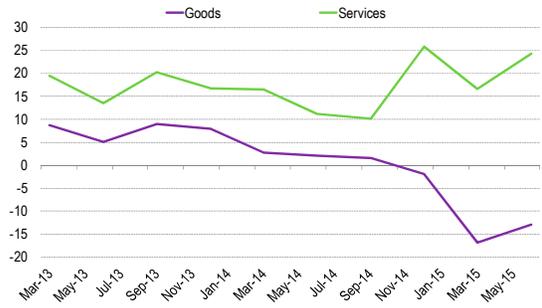
**Contribution to Global Import Value Growth**  
 (In percentage points)



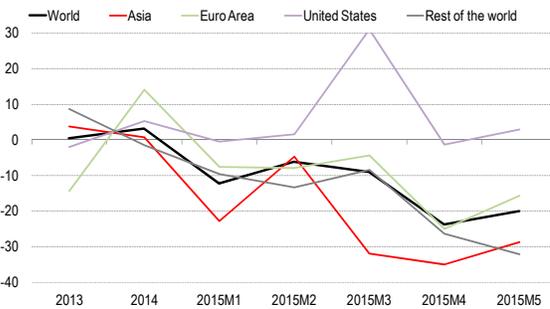
**China: Export Value of Goods and Services**  
 (year-on-year percent change)



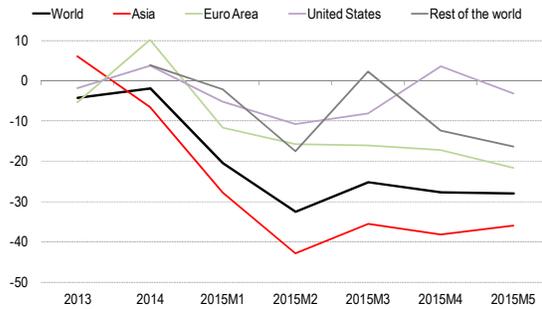
**China: Import Value of Goods and Services**  
 (year-on-year percent change)



**China: Non-Commodity Export Growth by Destination**  
 (Year-on-year growth; in nominal terms)



**China: Non-Commodity Import Growth by Origin**  
 (Year-on-year growth; in nominal terms)



Sources: CEIC Data Company Ltd.; IMF, Direction of Trade database; United Nations, Comtrade Monthly database; and IMF staff calculations.

**Box 2****Corporate Investment and Oil prices: Evidence from Asia<sup>1</sup>**

The decline in global oil prices since mid-2014 has increased risks for firms in the oil and gas sector in Asia and could impact investment going forward. While the number of firms in the oil and gas sector in Asia is relatively small (compared to the universe of listed companies), they capture about 10 percent of Asian listed firms' market capitalization and about 12 percent of investment. Given that some oil and gas companies have announced significant cuts in capital expenditure, the implications of a sustained decline in oil prices for corporate investment could be sizable, particularly if other segments of the corporate sector (and consumers) do not increase spending in response to lower oil prices. As is the case with the rest of the corporate sector in the region, the recent buildup in debt is also likely to impact investment—directly and indirectly by amplifying the effect of fundamentals—of companies in the oil and gas sector. Against this backdrop, this box provides an assessment of Asia's oil and gas sector vulnerabilities amid falling oil prices and a rising U.S. dollar.

***How Vulnerable is the Funding Structure of the Asian Oil and Gas Sector?***

The oil and gas sector has relied heavily on both debt and non-debt financing in the run-up to the oil price slump. Both bond issuance and syndicated loan issuance by the Asian oil and gas firms surged in recent years. In addition, more than half of the debt issued by Asian oil and gas firms after the global financial crisis has been denominated in foreign currencies (mostly in U.S. dollars) (Figure 2.1, panels 1-2). Non-debt financing through equity issuance—mostly through follow-on offerings—also constituted an important source of financing in Asia (Figure 2.1, panel 3). Both sources of financing are closely linked with asset values and profitability expectations, hence driven by the natural hedge of the industry.

The increasing reliance on external financing—combined with common global shocks—could propagate risks through several channels. First, amid declining oil prices, firms in the oil and gas sector may face difficulty in obtaining external debt financing given their leverage and liquidity positions. Second, non-debt funding such as equity issuance, an important source of financing during the oil price boom years, may be less robust due to the loss of the natural hedge. Finally, both debt and non-debt financing may be hurt by higher refinancing costs of foreign currency-denominated debt amid a stronger U.S. dollar and hardened financing terms for the oil and gas sector.

The distribution of debt by *buckets of leverage, profitability, and liquidity* based on firm-level financial statements shows further risks owing to concentration of debt in some cases (Figure 2.1, panels 4-6). For instance, in the case of the oil and gas sector in Korea, about 60 percent of total corporate debt is owed by companies with higher leverage, which here is defined as a debt-to-equity ratio above 2. In the cases of India and the Philippines the corresponding ratios are 25 percent and 100 percent, respectively.<sup>2</sup> There is also concentration of debt in the weakest segments in the oil and gas sector in terms of profitability. In Hong Kong SAR, Malaysia, and Taiwan Province of China, about 20 percent of total debt is held by the companies that have negative net income (return on assets less than zero). Between 10–20 percent of debt is owed by companies with interest coverage ratios below 1 in China, Hong Kong SAR, India, and Taiwan Province of China (in increasing order).

<sup>1</sup> Prepared by Roberto Guimarães-Filho, Shi Piao, and Dulani Seneviratne.

<sup>2</sup> In the latter's case, the number of firms is very small, and so the results should be interpreted with caution.

**Box 2 (continued)**

The high leverage in the corporate sector not only has the short-term risks from a financial stability point of view, but also could impact activity through investment. Against this backdrop, the effect of oil prices on investment in the oil and gas sector in Asia is examined empirically.

***Could Lower Oil Prices Reduce Investment in the Oil and Gas Sector in Asia?***

Firm-level panel data from Worldscope are used to assess the impact of oil price on investment.<sup>3</sup> The main findings are as follows:

- Higher oil prices induce greater investment in firms in the oil and gas sector in Asia, while firm-level investment in other sectors does not react significantly to an increase in oil prices (both statistically and economically). The oil and gas sector investment not only has a strong response to oil prices, but this response is also stronger than the response to other important firm-level fundamentals such as profitability expectations (augmented by Tobin's Q) and cash flow (Figure 2.1, panel 7).
- Apart from the direct impact of oil prices on investment, oil prices also have an indirect impact through firms' fundamentals estimated using three-term interaction terms. In particular, in firms in the oil and gas sector in Asia, higher oil prices not only induce a direct impact on investment, but they also amplify the impact through cash flow and profitability (Figure 2.1, panel 8).
- Firms in the oil and gas sector also increase their investment by building up leverage when oil prices rise; this is contrary to the negative impact of leverage on investment one would typically see (Figure 2.1, panel 8).

Overall, the empirical analysis suggests that the recent decline in global oil prices could be a drag on investment by oil and gas companies in Asia going forward. Lower oil prices have also increased balance sheet risks for the companies in the oil and gas sector.

<sup>3</sup> The dataset includes an unbalanced panel with nearly 20,000 companies in 14 economies covering the periods 1995–2013, of which 500 companies are in the oil and gas sector. The baseline specification is estimated as:

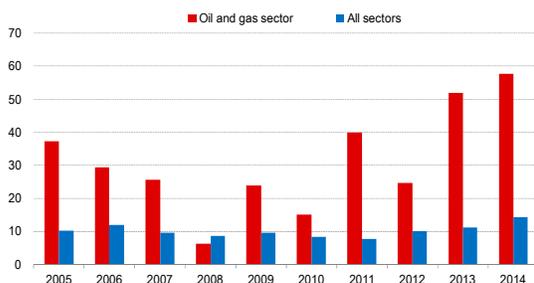
$$(I/K)_{i,t} = a_i + a_t + \beta(I/K)_{i,t-1} + \gamma Q_{i,t} + \delta CF/K_{i,t} + \theta L_{i,t} + \zeta P_t + \varepsilon_{i,t}$$

where  $I/K$  is the investment to fixed asset ratio,  $Q$  is Tobin's Q,  $CF$  is cash flow,  $L$  is leverage, and  $P$  is the change in real global oil prices based on the simple average of Dated Brent, WTI, and Dubai Fateh oil prices. The impact on the oil and gas sector is captured through interaction terms based on the oil and gas sector dummy and oil prices/other fundamentals. The estimation is done with GMM with instrumental variables and the model passes the Hansen-J test of over-identifying restrictions and the residual serial correlation tests. As a robustness check and to assess the appropriateness of treating oil and gas exporters similarly to oil and gas importers, the same regressions were ran excluding major oil exporters, and the results remain broadly unchanged though the size of the coefficient of oil prices on investment is slightly smaller when oil exporters are excluded from the sample. The difference between the two estimates is not statistically significant, though. Moreover, as noted by Fitch (Fitch Asia Pacific Corporate Sector Outlook for 2015), lower oil prices have been found to be detrimental for investment for both upstream and mid-stream oil and gas firms. Clustering standard errors of coefficient estimates at the sub-sector level also lends support to the findings reported here.

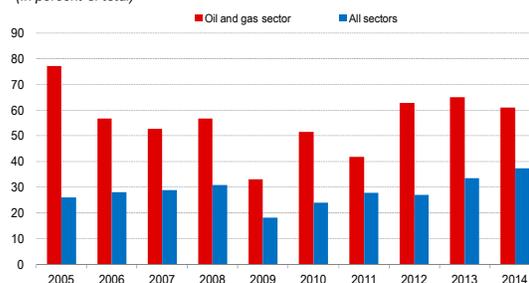
Box 2 (concluded)

Figure 2.1  
Asian Oil and Gas Sector Developments

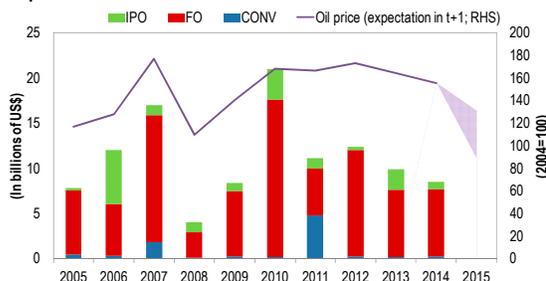
**Selected Asia: Bond Issuance—Foreign Currency Composition**  
(In percent of total)



**Selected Asia: Syndicated Loan Issuance—Foreign Currency Composition**  
(In percent of total)

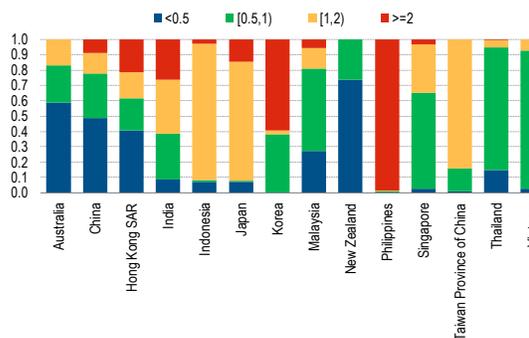


**Selected Asia: Oil and Gas Firms' Equity Issuance vs. Oil Price Expectations**

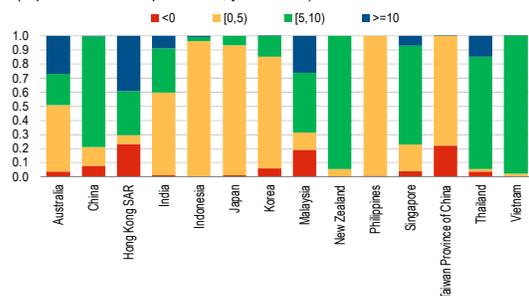


Note: The oil price expectation is based on oil price index (2004=100). The oil price expectation in 2014 is from consensus economics forecast for 2015 as of mid-2014, while the oil price expectation in 2015 is based on the upper and the lower bounds of oil price consensus forecast for 2016 as of August 2015. IPO stands for Initial Public Offering; FO stands for follow-on offering; CONV stands for convertible new issues.

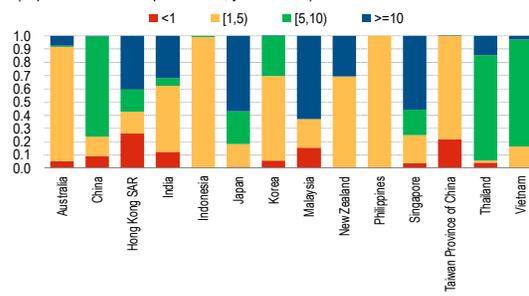
**Corporate Debt by Leverage Ratio - Oil & Gas Sector**  
(In percent of total corporate debt; year of 2012)



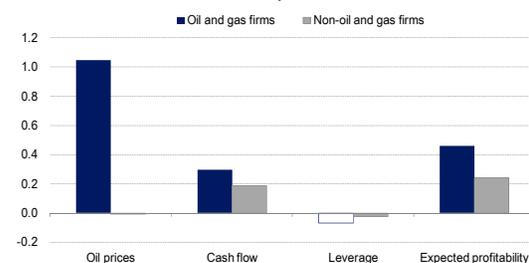
**Corporate Debt by Return on Assets - Oil & Gas Sector**  
(In percent of total corporate debt; year of 2012)



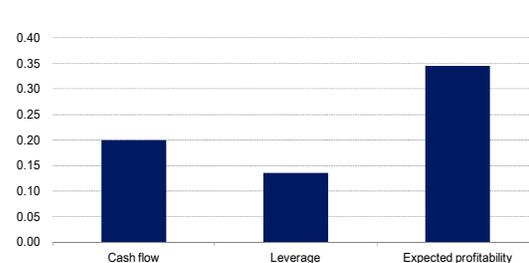
**Corporate Debt by Interest Coverage Ratio - Oil & Gas Sector**  
(In percent of total corporate debt; year of 2012)



**Estimated Impact of a 1 Percent Increase in Oil Prices and Firm-level Fundamentals on Investment-to-Capital ratio**



**Estimated Impact of Oil Prices on Investment-to-Capital Ratio through Firm-level Fundamentals: Oil and Gas Sector Firms**



Sources: Dealogic; Thomson Reuters Worldscope database; IMF staff estimates.