Macroeconomic Prospects and Challenges

The global economic outlook has improved across advanced and emerging economies, with inflation firming. In the U.S., robust growth has seen some firming of price pressures, with additional fiscal stimulus from tax cuts and fiscal spending expected this year and in future. In the Eurozone, the cyclical recovery has been stronger than anticipated, supported by strengthening private sector demand. In contrast to the Eurozone, the U.K. economy has slowed on Brexit uncertainty.

Global trade has expanded robustly with global demand, with added impetus from the global semiconductor upcycle, and growing capital expenditures. Technology sector indicators such as global semiconductor sales continue to signal strong momentum for global trade. Commodity prices in energy and industrial metals have also recovered, supporting exports.

Given that the U.S. Fed has already started with its monetary policy normalization and interest rate hikes, and with the ECB set on an exit strategy, global financial conditions would tighten. Inflation has re-emerged as a concern in the U.S. that may trigger faster-than-expected monetary policy tightening. Despite some selloffs in global equities in early February 2018, emerging markets in ASEAN+3 have continued to receive net capital inflows into bond markets. As the region has received large inflows into bond markets over the last five years, the risk and impact of outflows that may be triggered by tightening of global financial conditions or confidence shocks should be closely monitored.

Boosted by favorable global conditions, regional economic growth has been underpinned by resilient domestic demand and export growth, with stable inflation. Most regional economies are at mid-business cycle, with a small output gap around trend growth. With improving external demand, growth in the region is expected to be sustained at mid-5 percent level, with AMRO’s GDP growth forecast for the ASEAN+3 region at 5.4 percent for 2018 and 5.2 percent for 2019. GDP growth is forecast at 6.6 percent for China in 2018 and 1.3 percent for Japan in FY2018.

The two main near-term risks facing the ASEAN+3 region are externally driven, as summarized in AMRO’s Global Risk Map:

- Faster-than-expected tightening in global financial conditions led by the U.S. Fed’s interest rate hikes in response to rising domestic inflation could cause sharp market reactions if policy actions are not well communicated. The spillovers to the region would be via capital outflows, higher sovereign yields, higher borrowing costs and debt refinancing risk; and

- Escalation of global trade tensions from imposition of tariffs by the U.S. on more imports and on major trading partners including those in the ASEAN+3 region could derail the region’s robust export growth. The impact of trade tensions would be amplified through the global value chains (GVCs) in the region. Furthermore, escalation of trade tensions would increase uncertainties and generate spillovers onto the global economy as well as on financial markets.

Tail risks in the near term include escalation of geopolitical risks in the region, weaker than expected growth in G3 economies in conjunction with other risks of trade protectionism. The risk of a sharper-than-expected slowdown in China’s economic growth is assessed as unlikely in the near-term. Finally, there are perennial non-economic risks of climate change and natural disasters, and cyber-attacks.

The improving external demand has allowed the region to build up buffers against potential external shocks. Considering the significant degree of foreign participation in regional domestic financial markets, the sudden unwinding of foreign holdings of local currency assets and capital outflows in a “risk-off” scenario would put downward pressure on exchange rates and foreign exchange reserves. However, regional exchange rates have become more flexible in recent years, and have played a greater role as a shock absorber. With judicious intervention by the authorities, the pace of adjustment to external shocks and the impact on the real economy can be managed.

Policymakers should continue to build policy space, particularly in monetary policy, for tighter global financial conditions ahead. The policy mix of fiscal, monetary and macroprudential policies would depend on where each economy is currently, in its business and its credit cycle.

- For economies in the mid-business cycle, there would be no strong impetus for policymakers to pursue additional monetary or fiscal stimulus. In contrast, for economies in the late-business cycle where there are signs of inflation pressures or external imbalance building up, policymakers may consider adjusting the degree of monetary accommodation and reducing fiscal stimulus.
The thematic chapter studies how the region can maintain its resilience and growth in view of fundamental and global changes in trade and production networks and technology as well as demographic challenges. ASEAN+3 economies have pursued a “manufacturing for exports” strategy over the past few decades – starting with Japan and Korea, then the major ASEAN economies and now the developing ASEAN economies – creating strong and self-reinforcing dynamics to boost economic growth, employment, productivity and wages. The formation of GVCs, centered on China as a production base in the past decade, has enabled economies in our region to boost exports and benefit from export-oriented FDI to build up manufacturing capacity.

This “manufacturing for exports” strategy is now being put to the test by structural changes in the evolution of GVCs, which show signs of plateauing with enhanced domestic productive capacity that allows countries to produce instead of importing intermediate inputs. GVCs, while making the ASEAN+3 region as a whole more competitive in attracting FDI and as a regional production base, also amplify the impact of near-term challenges such as protectionism on the whole supply chain. Balanced against these forces is • Even though most regional economies are in an early- to mid-business cycle, given the build-up of credit over the past years, policymakers should prioritize financial stability in the near future over economic growth, with monetary policy on a tightening bias.

• Where pockets of vulnerability have built up in sectors such as the property market, tightening macroprudential policy can help safeguard financial stability, and most regional economies have already tightened macroprudential policy proactively.

• With monetary policy constrained by global conditions, fiscal policy may have to play a greater role in supporting growth so that the overall macroeconomic policy is not tightened too much. However, this is subject to available fiscal space and to fiscal rules.

• Policy will have to be calibrated taking into account constraints from domestic and external vulnerabilities such as leverage, and degree of reliance on external financing. The policy momentum for structural reform should continue, to build productive capacity.

Theme: Resilience and Growth in a Changing World
the region’s growing intra-regional final demand, which is absorbing more regional exports and can help cushion the external shock of protectionism.

Technology has proven to be a double-edged sword in the “manufacturing for exports” growth dynamics. On the one hand, technology and automation in the manufacturing sector have meant that manufacturing will no longer generate employment opportunities as strongly as in the past. The case studies of the automobile sector and the textile, clothing and footwear (TCF) sector in the region are illuminating. They suggest that economies that lag in terms of developing skilled workforces and ramping up capacity to absorb and apply new technology will lose out the most in maintaining economic resilience and growth.

On the other hand, technology has facilitated the emergence of the services sector as a potential new engine of economic growth and employment. While the services sector is commonly regarded as low-productivity and creating low-wage jobs, this does not have to be the case with the right enabling technologies. Technology transforms services by making them tradable across borders and creating skilled employment opportunities, as seen in the case study on business process outsourcing. Technology also “commoditizes” and “uberizes” services, facilitating market-driven identification of services in demand, then use of technology to deliver these more efficiently and cheaply to consumers. Similar to trade in goods, growing intra-regional demand for services such as tourism can also create another engine of growth.

To harness the benefits of intra-regional demand, technology and the services sector, and to build resilience in an economy and in the region requires policy commitment and action. For an individual economy in ASEAN+3, given the challenges of changes in trade and production and technology, the key recommendation is to build resilience through multiple engines of growth, including through the growing services sector. For the ASEAN+3 region as a whole, the key recommendation is to strengthen intra-regional connectivity and integration to meet growing intra-regional final demand. While the region remains open to global trade and investment, leveraging on intra-regional demand will improve the resilience of the region as a whole against external shocks such as protectionism. The ample resources and diversity in development within the ASEAN+3 region are a source of strength.

- Improving connectivity through investment in domestic and intra-regional infrastructure, coupled with trade facilitation policies, can maximize the efficiency of current GVCs in the region, and through continued cost advantages, make the region still more competitive in the “manufacturing for exports” strategy. For GVC integration, reducing costs of imported inputs is as important as promoting exports, and establishing Special Economic Zones (SEZs) in the region could facilitate imported inputs for processing into exports.

- Developing a vibrant services sector would require a set of dedicated policies, starting with reviewing policies that may have disadvantaged the services sector relative to promotion of the manufacturing sector. Liberalizing the services sector to international competition would improve productivity, and technology is likely to force this liberalization against vested interests.

- As human capital and skilled labor are closely linked to the highest value-added segments of the services sector, leveraging on the availability of human capital across the ASEAN+3 region through supportive workforce and immigration policies may be appropriate. The challenge posed by technology and automation to unskilled employment has to be dealt with through a comprehensive policy mix, including labor force upskilling, immigration to leverage on mobility of skilled labor across ASEAN+3, and education policies.