

Highlights



Macroeconomic Prospects and Challenges

While the economies in the ASEAN+3 region have weathered external shocks well in 2016, global policy uncertainty has risen significantly, in particular for the global trade outlook with rising protectionist sentiment. Global financial markets remain volatile, with spillovers on emerging markets in our region.

- While the underlying growth momentum is gradually improving across major global economies, the recovery is vulnerable to policy uncertainty. In the U.S., the pro-growth agenda of the Trump administration presents some upside potential to the U.S. economy, although more restrictive trade and immigration policies may dampen growth. In the E.U., growth momentum in the Euro area and the U.K. has been stronger than anticipated, but we are cautious over the economic outlook ahead of elections in major Eurozone countries and Brexit negotiations.
- The spillovers of global policy uncertainty to the ASEAN+3 region are through both trade and financial channels. In trade, while signs of recovery in global trade and commodity prices are encouraging, the recovery is threatened by protectionist signals from the Trump administration, especially where these signals target economies in the ASEAN+3 region with large bilateral trade surpluses with the U.S. In the financial markets, global financial conditions are tightening with U.S. Fed interest rate hikes under way, with policy uncertainty threatening to accentuate financial market volatility and capital outflow risks from emerging markets as a whole.

Growth in China and Japan is expected to remain stable in 2017,

with downside risks from rising U.S. trade protectionism. Their growth will anchor growth in the ASEAN+3 region, which is expected to slow slightly to around 5.2 and 5.1 percent in 2017 and 2018 respectively.

- China's economic growth in the short term has shown signs of stabilization amid ongoing structural adjustments, while producer prices have picked up sharply recently. China's stable growth will continue to anchor economic growth in the ASEAN+3 region and absorb imports from the region. Going forward, speeding up the pace of state-owned enterprise (SOE) reform, continuing industrial overcapacity reduction, curbing corporate debt and containing financial stability risks will remain key challenges.
- In Japan, growth is expected to remain strong in 2017, higher than the potential growth rate, supported by macroeconomic policies and external demand. With monetary policy divergence as U.S. Treasury yields rise relative to JGB yields, and also structural factors, Japan's outward portfolio flows to the ASEAN+3 region are expected to continue.
- AMRO's empirical work comparing the impact of spillovers from the U.S., China and Japan using a Global Vector Autoregressive (GVAR) model suggests that the real economy shocks from the U.S. and China have a more significant impact on exports from the region than a similar shock from Japan, with the impact from a shock from China being more persistent than from the U.S. Stresses to the corporate sector originating from the U.S., China and Japan are also found to

be important channels of stress transmission to financial and corporate sectors in emerging markets in our region.

With an uncertain trade outlook, economic growth in the region will continue to be driven primarily by domestic demand, with support from monetary and fiscal policy. Foreign exchange (FX) reserve buffers in the regional economies remain substantial. Compared to 2016, however, policy room in monetary and fiscal policy has generally narrowed.

- While FX reserve buffers are high by conventional metrics of import and short term external debt cover, these buffers should be maintained in the face of potential capital outflow pressures. Sudden unwinding of foreign holdings of local currency assets and capital outflows in a “risk-off” scenario may put additional pressure on the exchange rate and on FX reserves. Exchange rate flexibility combined with judicious intervention to moderate the pace of adjustment would continue to be the appropriate response to risks of external shocks.
- In monetary policy, compared to 2016, rising inflation and tightening global monetary conditions in 2017 will reduce the room for regional economies to ease monetary policy to support growth. Economies in which financial

vulnerabilities have built up with high credit growth or external debt will face the sharpest trade-off in maintaining an accommodative monetary policy to support growth and maintain financial stability.

- Fiscal policy may have to play a greater role to cushion downside risks to the real economy, although fiscal policy space has generally narrowed, and in some economies, is constrained by fiscal rules. Regional economies with lower public debt and stronger external positions can consider maintaining a moderate pace of fiscal expansion. Economies already relying on external financing for both the current account and the fiscal balance (“twin deficits”) would face tighter financing constraints when trying to expand fiscal policy.
- In the current uncertain global environment, in the balance between growth and stability, it would be prudent for policymakers to prioritize financial stability. With constraints on monetary policy, regional policymakers may consider recalibrating targeted macroprudential policy measures to safeguard financial stability and support growth. Given the limitations of short-term demand management policies, there is an urgent need for policymakers to accelerate the structural reform agenda.

Theme: ASEAN+3 Region 20 Years after the Asian Financial Crisis

2017 marks 20 years after the Asian Financial Crisis (AFC), a landmark event in the ASEAN+3 region that has shaped the subsequent foundations and trajectory of economic growth and regional integration, as well as policymakers’ perspectives on crisis management and resolution. In particular, the AFC highlighted the urgent need for regional financial cooperation in crisis management and resolution, which resulted in the Chiang Mai Initiative under the ASEAN+3 Finance process, its subsequent expansion into the Chiang Mai Initiative Multilateralisation (CMIM) Agreement, and the creation of AMRO as an independent macroeconomic surveillance unit supporting the CMIM.

- The first decade after the AFC (1997-2006) was a period of economic consolidation after a sharp negative shock, and of rebuilding foundations for economic growth. The recovery path necessitated fundamental and painful policy adjustments in exchange rate regimes, corporate and financial sector reforms, fiscal consolidation, and reforms in prudential regulation. These policy adjustments enabled the affected economies to rebuild the foundations for economic growth, with exports leading the recovery.
- The region’s continued openness to trade, FDI and capital flows after the AFC enabled economies — especially the developing ASEAN economies — to reap the benefits of

growing regional integration and the emergence of China in regional trade and FDI in the decade following the Global Financial Crisis (GFC), even when the tailwinds provided by global external demand came to an abrupt halt in the advanced economies of the U.S. and Eurozone. Regional financial flows also increased, with Japan continuing its role as a major lender and investor in the ASEAN+3 region.

- Increased intra-regional financial flows have occurred in the context of massive monetary policy stimulus by the U.S. and the Eurozone, which eased the ASEAN+3 region’s rebalancing from export-led to domestic-led demand. However, large and sustained inflows created financial vulnerabilities in the recipient economies, amplified financial market volatility, and complicated monetary policy management. To manage the financial stability risks while reaping the benefits from capital inflows, policymakers in ASEAN+3 have been among the most active in the world in deploying macroprudential measures.
- In the current uncertain global environment, the AFC continues to offer valuable lessons to policymakers. First, the AFC placed policy focus squarely on the risks arising from financial markets and capital outflows. Second, the AFC highlighted the speed and impact of contagion between economies. Third, the AFC highlighted the need for a more

flexible and responsive policy framework domestically, and also greater financial cooperation within the region to deal with external shocks.

- The current global policy uncertainty — which may include uncertainty from non-economic events — requires policymakers to maintain policy discipline and to respond flexibly to the rapidly changing global environment, coordinating between different policy agencies of government, and ensuring policy intentions are well-communicated to the market. Besides these near-term challenges, the ASEAN+3 region also faces structural challenges as bottlenecks to growth, not only in terms of physical infrastructure but also human capital, which are becoming increasingly apparent in a slower-growth environment. Accelerating structural reform to address the inefficiencies directly has become more urgent.
- The role played by global and regional financial safety nets such as the CMIM in augmenting an economy's buffers to deal with external shocks and contagion risks has become even more important in the current global environment. Policymakers' affirmation of their commitment to regional financial cooperation would help anchor market expectations and provide a solid policy basis for the region's continued growth and development.