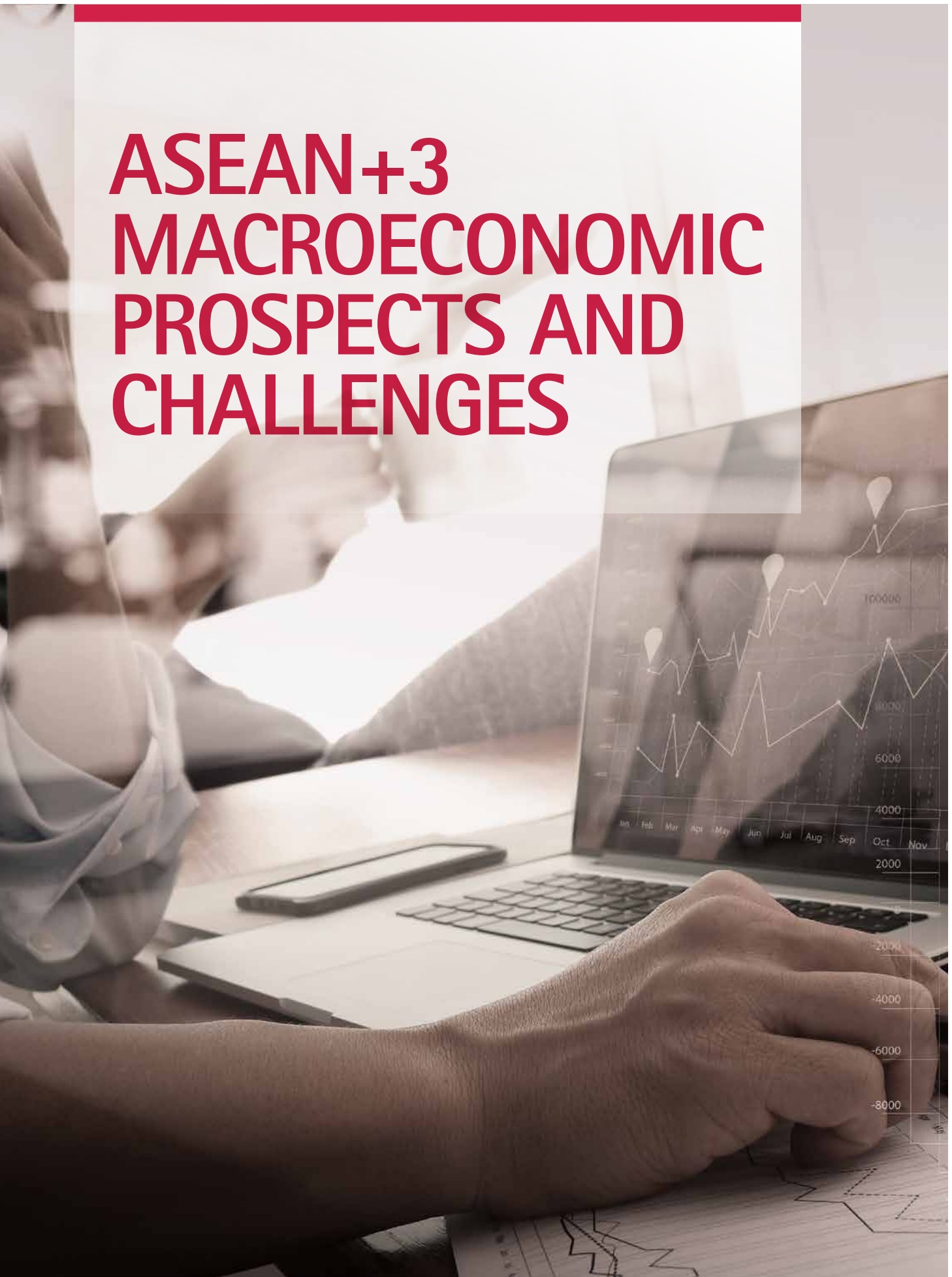


ASEAN+3 MACROECONOMIC PROSPECTS AND CHALLENGES

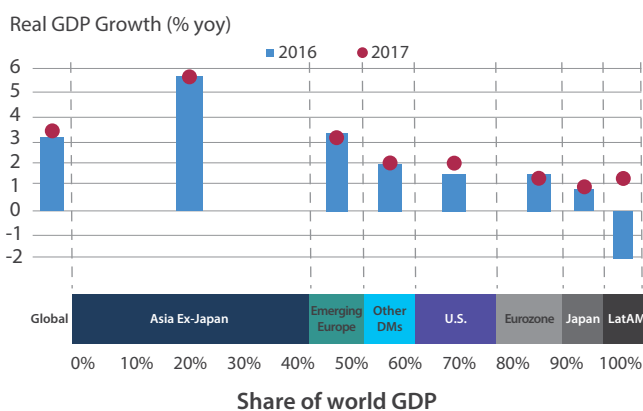


1. Global Settings and Spillovers to Regional Economies

Global growth is expected to pick up moderately in 2017, led by a recovery in the U.S., but policy uncertainty has increased significantly under the Trump administration, especially in the area of global trade. Global financial markets remain volatile, with risks of capital outflows for emerging markets.

1 While the underlying growth momentum is gradually improving across major global economies, the recovery is vulnerable to policy uncertainty. Major advanced economies entered 2017 on a better footing, with Q4 2016 GDP growth trends showing sustained domestic demand, led by steady consumer spending and improving business investment in the U.S. and the Eurozone. In the U.K., despite Brexit-related worries, growth momentum accelerated in Q4 2016 on strong consumer spending, beating market consensus. In the EM sphere, particularly in commodity-exporting economies, real economic activities are generally improving, supported by higher commodity prices, although the outlook remains cautious considering the U.S. interest rate upcycle and the strong USD. Baseline global growth for 2017 is expected to be slightly better than last year (consensus forecast²: +3.2 percent), led by the U.S. and an improvement in some major commodity-exporting EMs (Figure 1.1). Accordingly, global growth estimates

Figure 1.1 Global growth in 2017 is anticipated to be slightly better as compared to 2016



Source: Consensus Mean Forecast from Bloomberg (as of 31 March 2017)

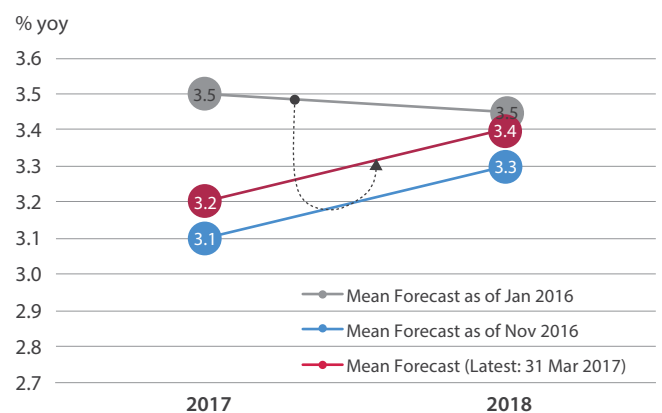
for 2017-18 have been revised slightly upwards as compared to end-2016 (Figure 1.2). However, general discontent around global integration and trade liberalization and potential geopolitical tensions could contribute to a step down in global growth.

2 In the U.S., the pro-growth agenda and financial deregulation plans by the Trump administration present some upside growth potential to the economy, although more restrictive trade and immigration policies may dampen growth. The underlying U.S. fundamentals have progressively

strengthened, with job creation consistently averaging close to 200,000 a month since January 2016, while the unemployment rate has trended down. Looking ahead, Trump's plans for fiscal expansion and tax cuts may stimulate U.S. economic recovery with anticipated higher business spending driving growth and inflation. However, potential reviews of existing trade deals such as NAFTA and other trade pacts by the U.S., could lead to a more restrictive trade environment. These, together with relatively tighter immigration policies, could have some spillback effects, dampening the growth outlook for the U.S. Consequently, the net effects on the trajectory of the U.S. economic recovery remain unclear.

3 In Europe, growth momentum in the Euro area and the U.K. has been stronger than anticipated, though we are cautious about the outlook, potentially weighed down by policy uncertainties ahead, and the continuing slow resolution of non-performing loans (NPLs) in some major Eurozone banks. Recent composite PMI readings showed strong growth in the Eurozone (led mainly by Germany and to some extent, France), which supported the cyclical recovery (Figure 1.3). Headline inflation has also started to trend upwards on higher oil prices. However, the outlook is clouded by policy uncertainties ahead

Figure 1.2 Global growth estimates have been revised slightly upwards for 2017-18



Source: Consensus Mean Forecast from Bloomberg

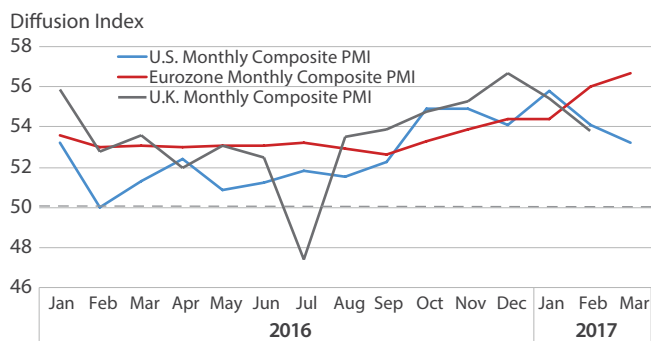
of the upcoming national elections in the Netherlands, Italy and France in H1 2017, and Germany in H2 2017. Similarly, in the U.K., despite a relatively resilient outturn, the outlook is expected to be more moderate in 2017, weighed down by the possibility of a "Hard-Brexit" and its implications for U.K. exports. At the same time, in the banking sector, given the slow resolution of NPLs, concerns continue to build up over the health of some Eurozone banks.³ In Italy in particular, markets are jittery over the country's troubled banking sector, which could weigh on sentiments across the Eurozone.

² Consensus mean forecast from Bloomberg (as of 31 March 2017).

³ The ECB's high level group on NPLs is expected to publish the final guidance to banks in spring 2017. This follows the initial publication of the draft guidance last year and an extensive public consultation process and public hearing. See Interview with Sharon Donnery, Deputy Governor of the Central Bank of Ireland and Chair of the ECB's High Level Group on NPLs, published in Supervision Newsletter (Winter 2017) on 15 February 2017.

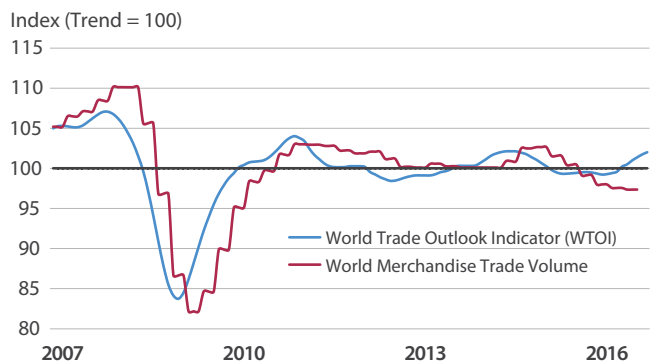
4 Notwithstanding the improving global demand, the outlook for global trade remains lackluster despite recent upturns, weighed down by growing protectionist threats in the period ahead. The WTO's World Trade Outlook leading indicator, a composite of trade indicators such as export orders, air freight and container throughput, showed continued subdued growth in global trade volume going in 2016 (Figure 1.4). While the recent pick-up in global trade activity is encouraging, it is uncertain whether this recovery is sustainable, given signs of the shift in the commitment of the

Figure 1.3 Composite PMI readings in major advanced economies, notably in the Euro area, have trended higher going into 2017



Source: Markit

Figure 1.4 While the global trade picked up recently, it is uncertain whether this recovery is sustainable



Notes: Readings of 100 indicate growth in line with medium-term trends; readings greater than 100 suggest above trend growth, while those below 100 indicate the reverse. The direction of change reflects momentum compared the previous month. The chart compares historical values of the WTOI to actual merchandise trade data. Trade volume growth tends to accelerate when the WTOI (blue line) is above the index for merchandise trade (red line), and decelerate when the WTOI is below the trade index. Source: WTO

U.S. away from multilateral trade deals towards a more bilateral trade approach. The border adjustment tax proposal⁴ currently under consideration in the U.S. may also fundamentally change the organization of global value chains. Global trade volume elasticity with respect to changes in global output has also declined after the GFC, suggesting structural factors may limit the recovery in global trade even if global economic growth recovers (Figure 1.5).⁵

5 Rising commodity prices may pass through to renewed inflation pressures in commodity importers, but do offer some relief to EM commodity exporters. Both energy and non-energy commodity prices have recovered since the trough in January 2016 (Figure 1.6). Considering the projected large stock of global oil inventories going into 2017-18 (Figure 1.7), increases in oil prices are likely to be gradual as suggested by the recent oil futures contracts. OPEC's agreement to cut crude oil production to 32.5 million barrels per day may be partially offset by production from non-OPEC producers including the U.S.

6 Expectations of a fiscal stimulus by the Trump administration have renewed concerns over inflation that may prompt a faster pace of interest rate hikes by the U.S. Fed. Core PCE inflation, the Fed's preferred measure of underlying price trends, has been gradually edging higher towards the Fed's 2.0 percent target, while market-based inflation expectations have jumped on Trump's election victory (Figure 1.8). Expectations

Figure 1.5 Global trade (volume) elasticity with respect to changes in global output has declined

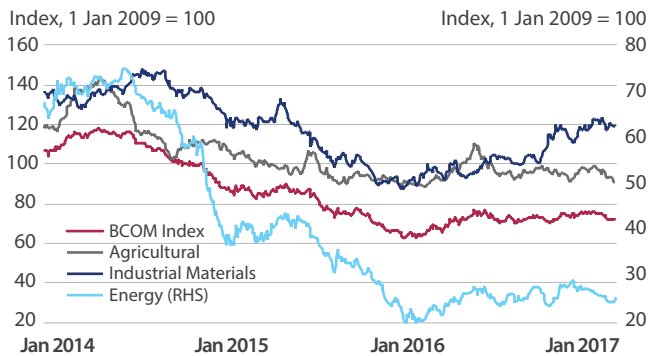


Sources: IMF, CPB

⁴ The proposed border adjustment tax by the U.S. is essentially a subsidy on U.S. exports and tariff on U.S. imports. It is a proposed destination-based, border adjustable international corporate consumption tax system in which a tax is "applied to all domestic consumption and excludes any goods or services that are produced domestically, but consumed elsewhere." (Pomerleau, K. and Entin, S-J., (2016), "The House GOP's Destination-Based Cash Flow Tax, Explained", Tax Foundation.)

⁵ The economic literature suggests several possible factors for the secular decline in trade growth. On the demand side, the first is the decline in fixed asset investment with the global cyclical slowdown. Such investment in capital goods, which entails vertical specialization via the global value chain (GVC) and typically generates higher global trade intensity, remains sluggish. On the supply side, there could be structural shifts as supply chains shorten, with domestic firms becoming more cost-effective in supplying the intermediate goods and parts needed for downstream production activities. There are other factors such as the rise of e-commerce and services trade in recent years.

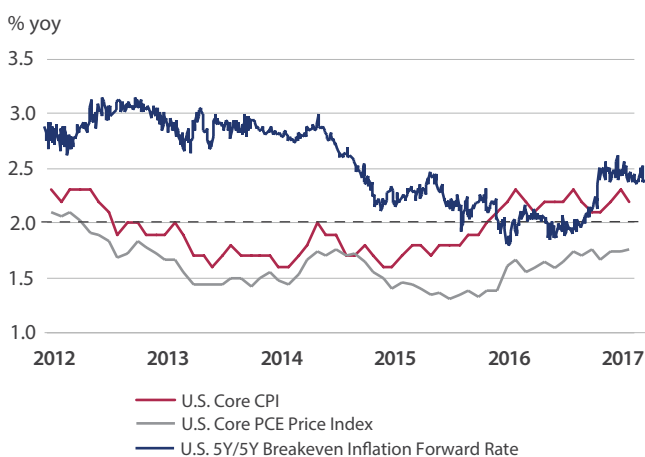
Figure 1.6 Major commodity prices have recovered, although they are still below 2014



Notes: The Bloomberg Commodity Index (BCOM) is made up of 22 exchange-traded futures on 20 physical commodities which are weighted to account for economic significance and market liquidity. Among the commodities are Brent crude oil, corn, gold, natural gas, soybeans and WTI crude oil. Data as of 31 March 2017.
Source: Bloomberg

of a fiscal stimulus by the Trump administration could stoke inflationary pressures given the relatively tight labor market in the U.S. economy. After the 25 bps rate hike in December 2016, the U.S. Fed raised the target range for the federal funds rate by another 25 bps in March 2017 to 0.75 – 1.0 percent, citing steady economic growth, strong job gains and confidence that inflation is rising to the central bank’s target. Looking ahead, the future pace of rate hikes would depend on how the outlook for the U.S. economy develops.⁶ EM portfolio flows are sensitive to market expectations of U.S. Fed rate hikes, and if such rate hikes by the Fed are not well-telegraphed, there is

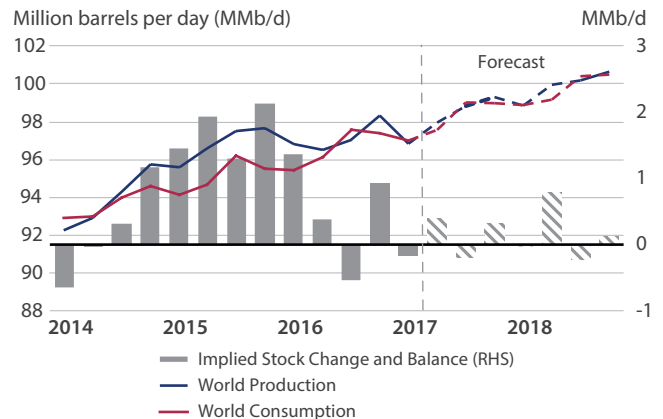
Figure 1.8 U.S. inflation expectations have jumped on Trump’s election victory



Note: The 5Y/5Y inflation swap rate is a common measure which is used by central banks and dealers to look at the market’s future inflation expectations.
Source: Bloomberg

⁶ In the March 2017 FOMC meeting, Fed officials maintained their outlook for two additional rate increases this year and three more in 2018.
⁷ While the fiscal stimulus plans are still unclear, Trump promised during his campaign to lower individual income and corporate taxes while borrowing more. Based on estimates by the Tax Policy Center, his federal budget proposal will cause an estimated fall in federal revenue for the first decade of USD6.2 trillion and an estimated rise in federal debt of USD7.2 trillion. In the area of infrastructure, Trump has promised increased expenditure of USD550 billion (or 3.0 percent of GDP).

Figure 1.7 Projected global oil inventories going into 2017-18 may limit any spike in oil prices

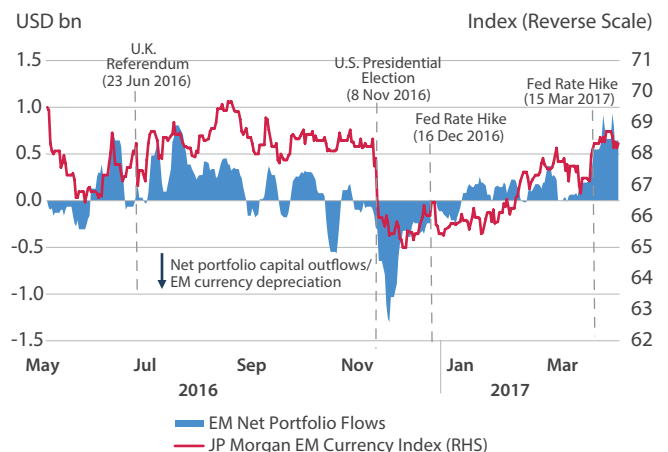


Source: IEA

potential for large and volatile capital outflows and exchange rate depreciation in EMs (Figure 1.9).

7 Global financial markets are likely to remain volatile, with risks of capital outflows, and overshooting in currency depreciation in EMs stemming from global monetary policy divergence, risk aversion and asset rebalancing. U.S. Treasury yields have trended higher, alongside investors’ portfolio reallocation from EM assets into U.S. equities. The pro-growth agenda of the Trump administration has stoked concerns over the rising U.S. government debt level⁷ leading to a re-pricing of

Figure 1.9 EM net portfolio flows are sensitive to market expectations of U.S. Fed rate hikes

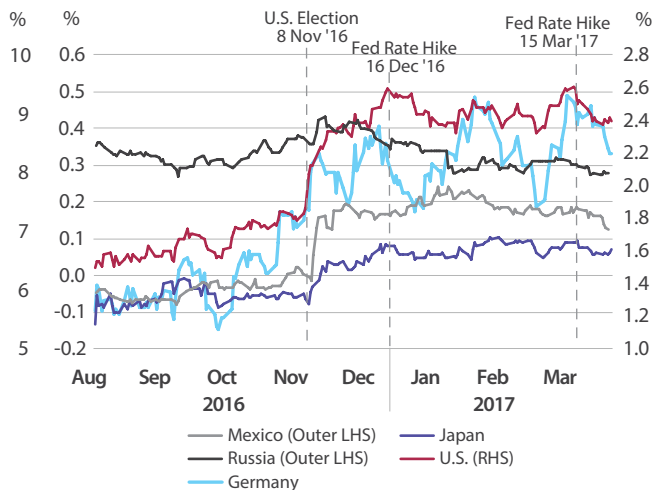


Sources: IIF, JPM

U.S. sovereign debt risks. This has, in turn, pulled up borrowing costs across key sovereign fixed income markets. Figure 1.10 shows that 10-year German Bund yields have edged higher post-U.S. election, while in Japan, 10-year JGB yields have also edged higher, while remaining close to zero, reflecting the BOJ's policy (under its QQE with Yield Curve Control) of targeting 10-year JGB yields at around zero percent. In view of the more upbeat U.S. macroeconomic outlook and higher US interest rates, there has been a shift from EM assets into USD assets, particularly into U.S. equities. Concurrently, EM currencies and the JPY weakened after the Trump victory in November 2016, but have strengthened since the beginning of 2017 as risk aversion waned and capital flows into EMs resumed (Figure 1.11).

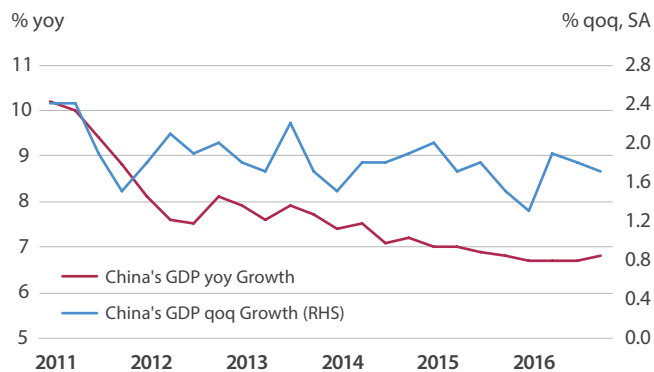
Growth in China and Japan are expected to remain stable in 2017, with downside risks from rising U.S. trade protectionism.

Figure 1.10 Selected AE and EM 10-Year sovereign bond yields jumped post-Trump's victory...



Source: Datastream

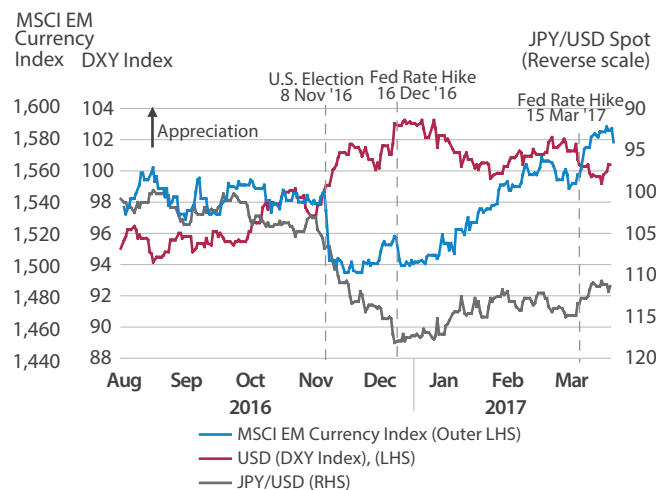
Figure 1.12 A rebound in China's property sector and public spending helped support growth in 2016



Source: China National Bureau of Statistics

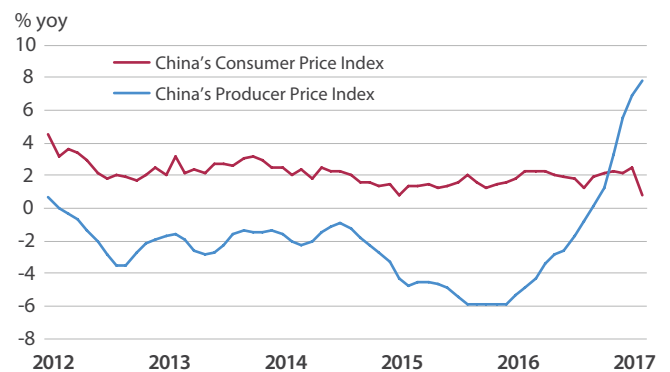
8 China's growth in the short term has shown signs of stabilization amid ongoing structural adjustments, while producer prices have picked up sharply recently. GDP grew by 6.8 percent yoy in Q4 2016, slightly higher than in the previous three quarters (Figure 1.12), leading to a 6.7 percent annual growth for the whole year. On the demand side, growth was mainly driven by expanding consumption and infrastructure investment but weighed down by moderating private investment and slowing exports. On the supply side, the growth drivers included expanding activity in the property and auto sectors. Looking ahead, the reduction of industrial overcapacity will continue to have a moderating impact on growth. Headline inflation remains moderate while producer price inflation (PPI) has reversed to positive territory since September 2016 due to rising commodity prices amid ongoing overcapacity reduction as well as speculation.⁸

Figure 1.11 ...while EM currencies and JPY depreciated against the USD



Source: Bloomberg

Figure 1.13 The yoy growth of China's PPI has reversed to positive territory since September 2016

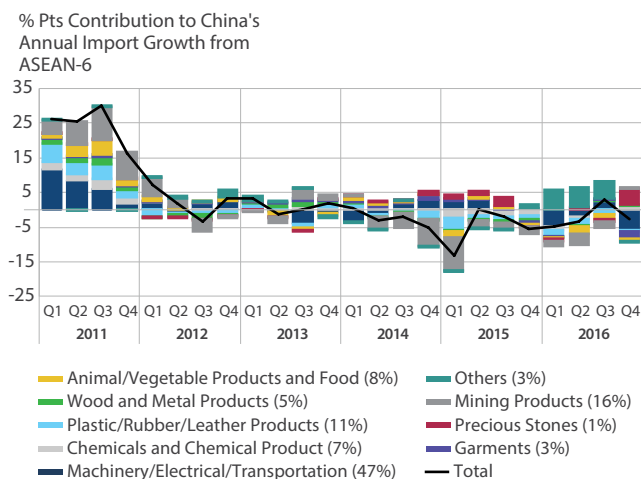


Source: China National Bureau of Statistics

⁸ The low-base effect also helped the PPI to rebound. Further improvements in the PPI and profits are still uncertain as industrial overcapacity remains a challenge and slowing overall investment could weigh on the demand for commodities.

9 China's commodity imports in value terms from the region are likely to increase boosted by rising prices. China's imports of mining, chemicals and plastic and rubber products from ASEAN-6 have largely contracted in USD terms since 2014,⁹ mainly reflecting the collapse of global commodity and oil prices in H2 2014 (Figure 1.14). As prices recover and contribute positively to producer prices, China's commodity imports from the region are likely to increase, thereby supporting regional commodity exporters. However, it is noted that with changing domestic policy priorities, there have been changes in the composition of China's commodity imports. For example, greater emphasis on environment protection and improved fuel-saving technology in China may have contributed to a general decline in the import volume of some energy products, such as coal since January 2015¹⁰ (Figure 1.15).

Figure 1.14 China's imports of mining, chemicals and plastic/rubber products from ASEAN-6 have contracted since 2014



Notes: Percentage contribution is calculated from import values in USD terms. Figures in parentheses refer to the shares in China's total imports from ASEAN-6.

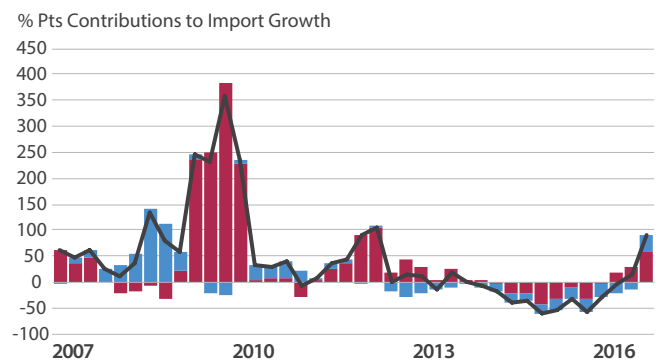
Source: China General Administration of Customs

10 The reduction of industrial overcapacity would have a negative short-term impact on growth, but the medium-term gains from more efficient resource allocation can be expected to be large, especially when it is accompanied by SOE reforms. The legacy of investment-led growth has led to overcapacity, particularly in the metal product and coal mining sectors, which is weighing on near term growth and job creation. As SOEs are present in many industries, the resolution of overcapacity, especially when it is accompanied by SOE reforms, can be expected to result in more efficient resource allocation and gains in productivity. While SOE reforms have made some progress,

they have been slower than market expectations, reflecting the complexity of the task.

11 As overcapacity is progressively reduced in industrial sectors in China, the spillovers to the region in terms of competing imports may also taper off. In the past few years, domestic overcapacity in China's steel sector has led to a surge in steel exports from China to the region and exacerbated the decline in global steel prices.¹¹ With steel prices at historical lows, some regional economies have chosen to import more, rather than expand production. However, such a trend in the region's steel imports from China is not new. Since the GFC, some regional economies have increasingly relied on Chinese steel imports, such as for infrastructure needs, although imports have slowed recently. There could be some substitution effects for local

Figure 1.15 China's import demand for coal has softened with domestic rebalancing and the shift to cleaner energy policy



Source: China General Administration of Customs

production in some regional economies, as local steel producers are facing competition from Chinese steel exporters.¹² That said, the spillovers to the region in terms of competing imports may taper off (Figure 1.16) as overcapacity is progressively reduced in China's steel sectors.

12 On the financial side, heightened global policy uncertainty has not resulted in large movements in China's RMB, which is a key EM currency in the region. After depreciating towards end-2016 reflecting the U.S. Fed rate hike, the RMB and other EM currencies in the region appreciated at the beginning of

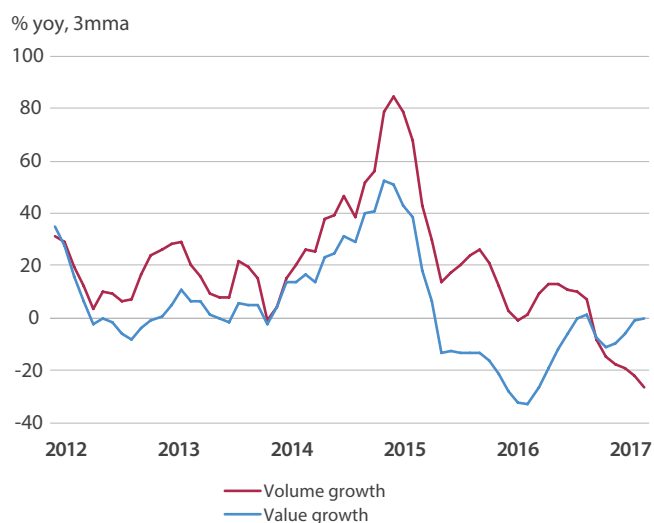
⁹ Although the figures are in USD terms and are affected by price changes including exchange rate movements, China's import volume data showed that the demand from China for these products has actually declined.

¹⁰ Starting January 2015, China has imposed stricter rules to limit low quality coal imports.

¹¹ The 2016 increase in steel prices was due to the temporary spike in demand from the Chinese property market, speculation and rising iron ore prices.

¹² In March, Vietnam imposed temporary anti-dumping tariffs ranging from 14.0 percent to 23.0 percent on steel imports from China and elsewhere. It imposed additional import duties of up to 25.0 percent on more Chinese steel products that will remain in place until October 2019. Thailand's Commerce Ministry has approved anti-dumping measures related to steel imports from China in November 2016.

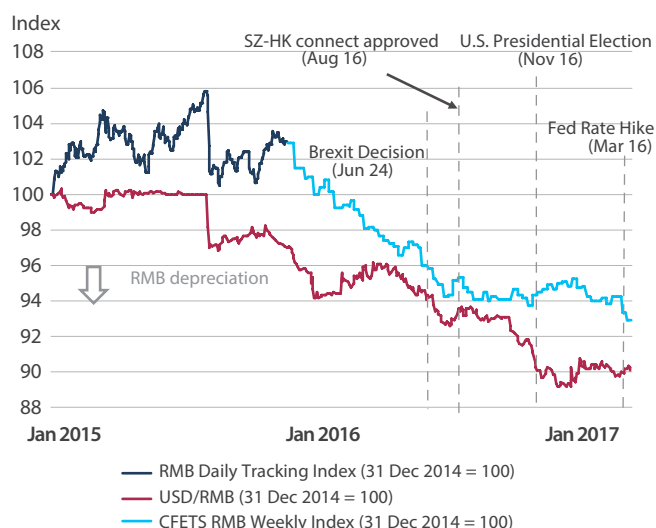
Figure 1.16 China's steel exports have tapered off since 2015



Source: China General Administration of Customs

this year. Despite increased global policy uncertainty, RMB movements have been relatively moderate. The RMB trade-weighted exchange rate, the RMB CFETS, has declined slightly (Figure 1.17). Improvement in communication by policymakers with market participants and tightening of capital flow management measures have also helped in containing RMB volatility. Currencies and financial markets in the region are more sensitive to movements in the RMB and China's financial markets than direct financial linkages with China would suggest, underscoring the importance of confidence in the transmission

Figure 1.17 While the RMB/USD strengthened since early-2017, the RMB CFETS index has remained largely stable

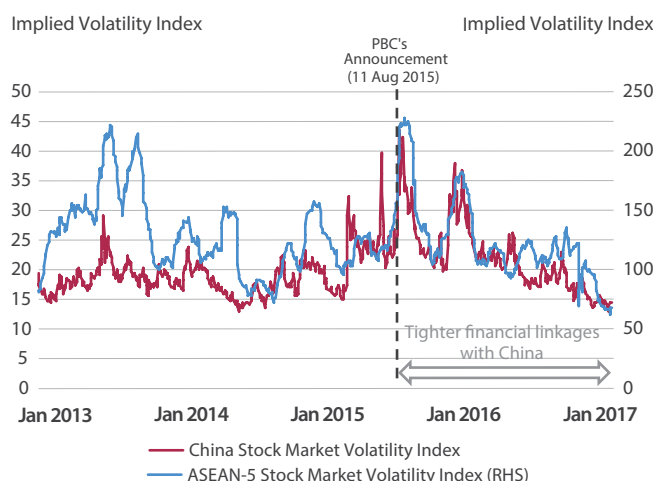


Source: People's Bank of China

of stress in China (Figure 1.18). Global equities markets, and to a lesser extent currencies, have shown significant co-movement with China post-GFC. (Figures 1.19).¹³ With policy uncertainty rising globally, especially after Trump's election win, continued clear policy communication by major economies, including China, are essential to avoid triggering unwarranted concerns in financial markets.

13 In view of the continuing domestic structural adjustment, and rising external headwinds, Chinese economic growth is expected to moderate slightly in 2017. Vulnerabilities have continued due to high corporate debt, persistent industrial overcapacity, and slow SOE reforms which are three major and inter-related challenges to sustainable growth. On the external front, export growth remains largely sluggish, which can be exacerbated by potentially rising trade tensions with the U.S. Capital outflows have eased recently due to further signs of growth stabilization, moderating USD as well as strengthened capital flow management. However, capital outflows continue to be an important risk (Figure 1.20), as market confidence is susceptible to signs of slowing growth and reform uncertainties, as well as external shocks. On the other hand, further expansion in private consumption, the services sector (including the internet economy) and infrastructure investment will sustain growth. GDP is expected to grow by 6.5 percent in 2017 (2016: +6.7 percent).¹⁴ Ensuring adequate policy support to keep the economy on a steady path, while pursuing the needed supply-side reforms for sustainable medium-term growth is essential for macroeconomic stability.

Figure 1.18 Regional equities showed co-movements with China

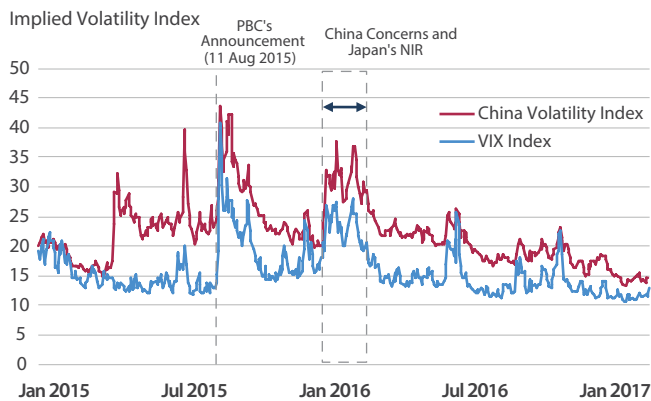


Source: Bloomberg

¹³ As a major EM, China's financial spillovers are large enough to affect global markets, as proxied by the VIX indicator. Recent BIS survey data found that the RMB has become the world's eighth most actively traded currency and the most actively traded EM currency, overtaking the Mexican peso (BIS Triennial Central Bank Survey, "Foreign exchange turnover in April 2016).

¹⁴ China's authorities recently set the growth target at about 6.5 percent for 2017, or slightly higher if possible.

Figure 1.19 Global VIX is increasingly affected by market developments in China



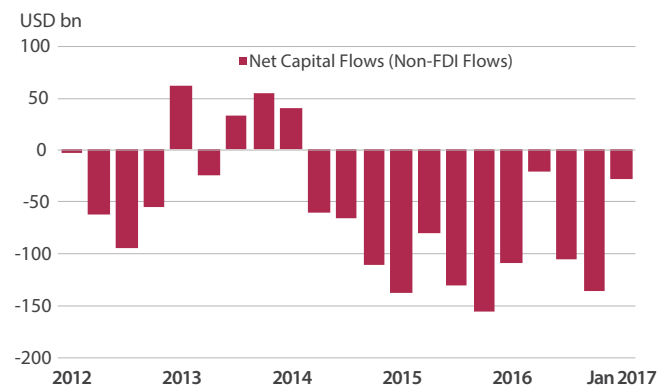
Notes: The AlphaShares Chinese Volatility Index measures the implied volatility of options on the FTSE Xinhua China 25 and Hang Seng (HSI) indices. It will serve as a measure of the market's expectations of near-term volatility conveyed by the options of these two benchmark indexes. VIX represents Chicago Board Options Exchange Volatility index. Data as of 31 March 2017.

Source: Bloomberg

14 In Japan, growth is expected to remain strong in 2017, higher than the potential growth rate, supported by macroeconomic policies and external demand. AMRO staff project GDP growth of 1.3 percent in the fiscal year 2017, supported by major policy stimulus, with headline inflation averaging around 0.6 percent. The sizable fiscal stimulus package announced in August 2016, to be implemented through FY2017, is expected to contribute to some pick-up in economic activities going into 2017.¹⁵ Inflationary pressures have been fairly muted with the consumer price inflation (CPI, all items excluding fresh food) being near zero for some time, reflecting amongst others, weak private consumption and still soft global oil prices (Figure 1.21). However, the oil price recovery, albeit gradual, as well as continual tightening in the labor market are expected to put some upward pressures on inflation in the near term. On the other hand, the still lackluster domestic demand continues to weigh on inflation.

15 With rising U.S. Treasury yields relative to JGB yields, and also rising regional yields, Japan's outward portfolio flows to the region may continue. With a less steep JGB yield curve and negative yields, Japanese investors continue to rebalance their portfolios towards foreign assets, mainly U.S. stocks and Treasuries, as well as alternative investment assets such as J-REIT. In particular, institutional investors such as Japan's Government Pension Investment Fund have almost completed rebalancing their new policy asset mix from 23.0 percent foreign securities to 40.0 percent. Some insurance companies and banks have also re-allocated their investments away from domestic bonds to foreign bonds and other riskier assets in a search for yield. So

Figure 1.20 Capital outflows from China remain a risk



Sources: China State Administration of Foreign Exchange, AMRO staff estimates

far, the reallocation is mainly in favor of advanced economies' assets including U.S. Treasuries.

16 Tightening global financial conditions may also have second-order effects through funding costs on Japanese banks' lending to the region. Japanese banks fund their USD lending to the region through the wholesale market, a part of this through cross-currency basis swaps. There could be spikes in their funding costs should global USD liquidity conditions tighten significantly. Figure 1.22 shows the sudden, though short-lived spikes in JPY/USD cross-currency basis swaps that occur during times of global market volatility, such as during the Lehman collapse. It is also notable that financial regulatory reforms adopted globally after the Lehman collapse partly contributed to the widening trend of the USD funding cost after the GFC. Looking ahead, a confluence of factors is likely to exert some stress on Japanese financial institutions' FX hedging and funding activities, including the continuation of the ultra-low yield environment in Japan, market expectations of higher yields in the U.S. along with the strengthening USD and the continuing trend of global tightening of capital regulations. Notwithstanding these developments, the funding liquidity risk in USD for Japan's banks is a risk that Japan's authorities are aware of and are monitoring closely.¹⁶

Emerging markets' economic outlook, hurt by prolonged subpar global economic and trade growth, faces risks from rising trade protectionism and volatile global financial markets in 2017.

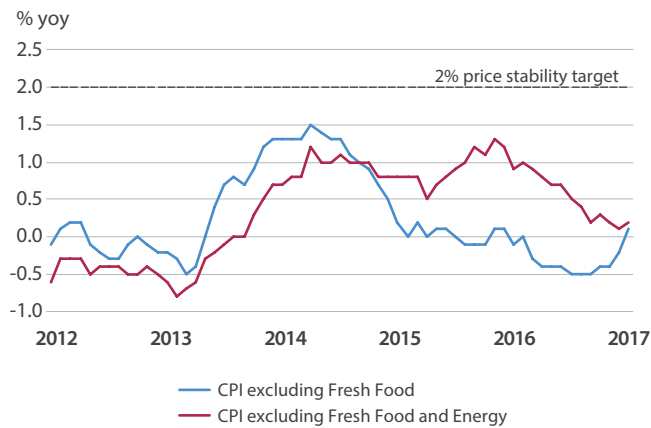
¹⁵ Of the total JPY28.1 trillion economic stimulus package, fiscal components are JPY13.5 trillion which comprises JPY7.5 trillion of budgetary support and JPY6.0 trillion of non-budgetary fiscal measures (fiscal investment and loan program).

¹⁶ Stress in the FX funding costs, while having eased recently, could increase again when Japanese investors resume their portfolio investments abroad.

17 In terms of trade, final demand in the U.S. and E.U. remains important and rising trade protectionist sentiment in the U.S. and uncertainties over the U.K.-E.U. trade negotiations can weigh on the already sluggish export outlook for EMs. Trade tensions, particularly between the U.S. and China — a tail risk event — could propagate through the China-centric Asian supply chain, and have far-reaching effects on the real economy.

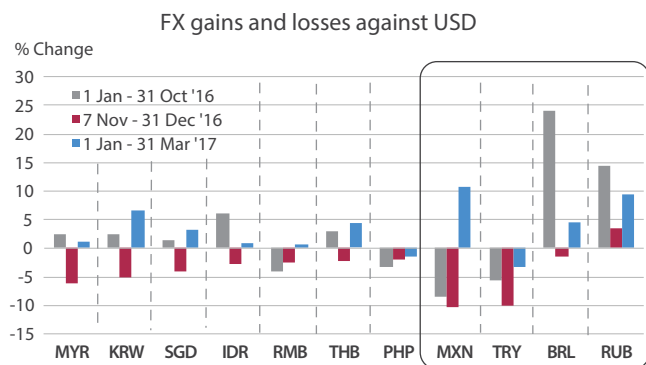
18 On the financial side, while the initial reaction of Asian EM currencies and equities markets to the Trump election was severe, it was comparatively less severe than that of other EMs. Among Asian EMs, the Korean won (KRW) and the Malaysian ringgit (MYR) saw the sharpest falls in the immediate aftermath of the U.S. election result (from 7 November to 31 December

Figure 1.21 Achieving the price stability target of 2.0 percent remains challenging



Note: Figures are adjusted to exclude effects of changes in the consumption tax rate in FY2014.
Source: National Authorities

Figure 1.23 The region’s EM currencies depreciated against the USD but the magnitude were less severe compared to Mexico and Turkey

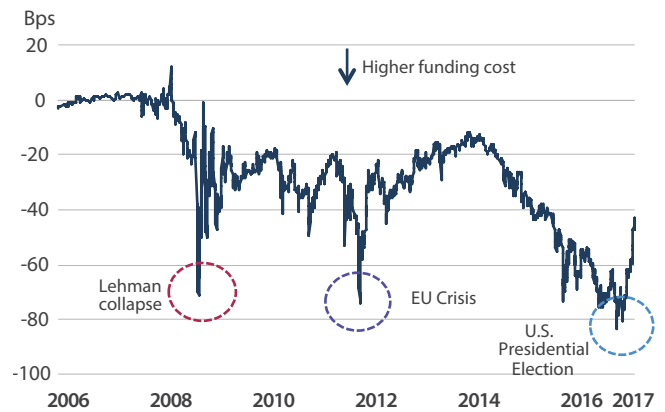


Source: Bloomberg

2016), but still less than the falls in non-Asian EMs (Figure 1.23). The Mexican peso, has been hit particularly hard on fears of more restrictive trade and immigration policies, plunging against the USD since the eve of the U.S. presidential election. Currencies in Brazil and Turkey also fell against the USD. In equities, while Asian EM equities market indices have also fallen, the fall has been less severe than in Latin America. Figure 1.24 shows that on a year-to-date basis (1 Jan to 6 Feb 2017), the MSCI Global EM Index has managed to recoup its post-election losses.

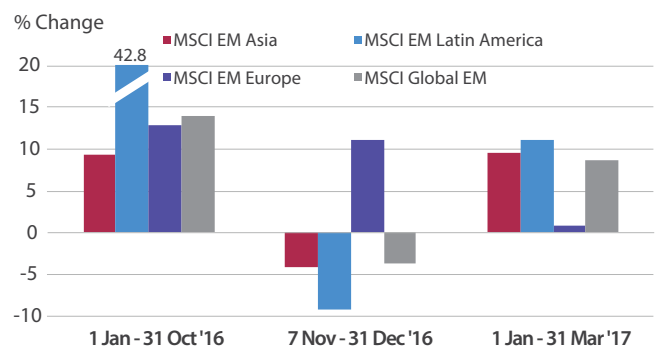
19 Notwithstanding the resumption of net foreign capital inflows into EMs in recent weeks, the external environment is expected to remain challenging in the period ahead, stemming from USD strength, asset price volatility and bouts of capital outflows. The period immediately after the U.S. election result

Figure 1.22 The recent spike of JPY/USD cross currency basis swap spread has been more persistent than during past episodes of uncertainty



Notes: The cross currency basis swap is a calculation that shows how much premiums (-) / discount (+) that needs to be paid / received to convert lump-sum borrowings in local currency into US dollar. Data as of 31 March 2017.
Source: Bloomberg

Figure 1.24 Equities markets in Asian EMs declined less as compared to their peers in Latin America



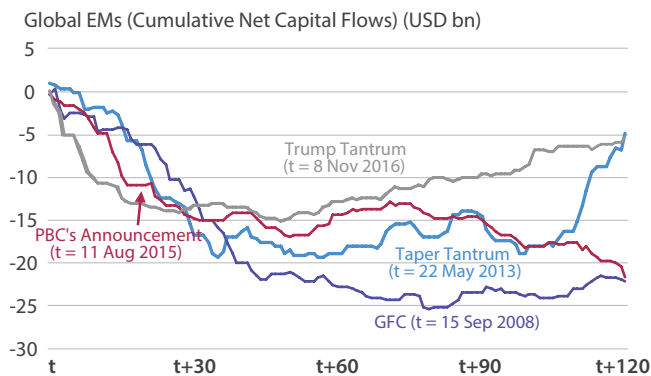
Source: Thomson Reuter Datastream

saw a cumulative net portfolio capital outflow from global EMs amounting to about USD15.0 billion from 8 November until the end of 2016. This magnitude is relatively smaller compared to previous stress periods (Figure 1.25). In the first six weeks of 2017 however, net portfolio capital flows into EMs resumed, partly due to global fund managers increasing their EMs asset allocations, while cutting back on their exposure to U.S. equities (Figure 1.26). The USD has also weakened after President Trump and the Treasury Secretary raised concerns over its recent strength. More hawkish signals from FOMC members at upcoming meetings can fuel a return of USD strength and related asset price volatility. The external environment for global EMs is expected to remain challenging given the more frequent shifts in investor risk appetite. Global investors will also be scrutinizing EMs’ macro-fundamentals more closely, such as current account balances and fiscal positions (Figure 1.27). Figure 1.28 shows that except during periods of heightened global risk aversion, there is some degree of differentiation in

investor risk perception amongst EMs.

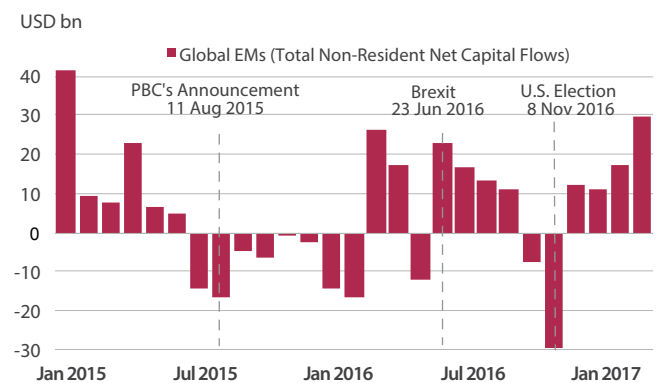
20 Given the high degree openness of some EMs, including in the ASEAN+3 region, EMs are susceptible to negative spillovers from adverse external developments, both in terms of trade and financial linkages. First, in terms of real sector propagation of shocks through trade linkages, spillover analysis using Global Vector Autoregressive (GVAR) model suggests that real economic shocks, such as from a contraction in real GDP growth in the U.S. and China have a significant impact on global EMs mainly through the negative effects on these EMs’ export performance (the impulse response functions (IRFs) of exports to a sustained 1.0 percent drop in U.S./ China’s industrial production — a proxy for real GDP, are significantly negative at a 12-month horizon). Export-dependent and commodity-exporting economies such as Malaysia, Singapore, Brunei and Thailand (regional economies), as well as India, South Africa, Saudi Arabia and Australia (economies outside the region)

Figure 1.25 As compared to previous stress periods, global EMs saw relatively “milder” cumulative net portfolio capital outflows during the Trump Tantrum



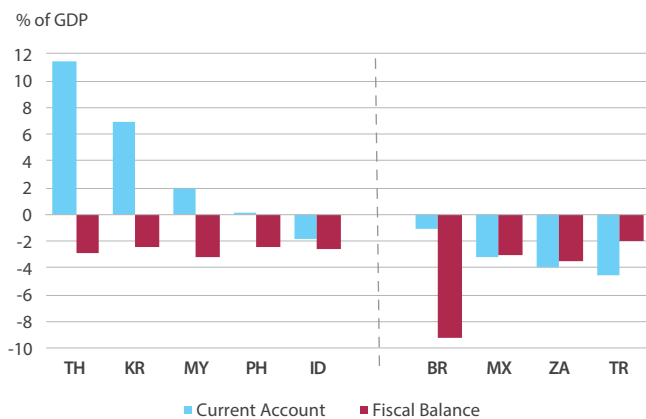
Sources: National Authorities, IIF

Figure 1.26 In the first six weeks of 2017, net portfolio capital flows into EMs resumed



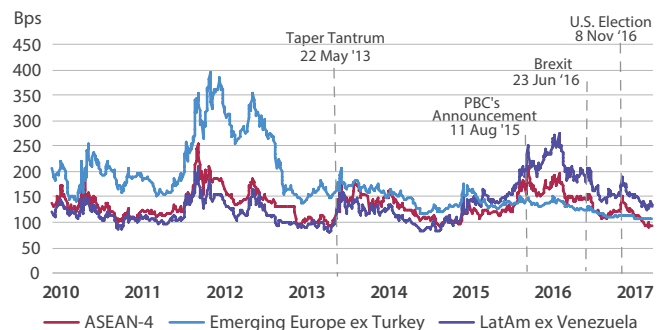
Sources: National Authorities, Bloomberg, IIF.

Figure 1.27 Comparison of EMs’ current account and fiscal balances in 2016



Note: Korea's fiscal balance refers to the adjusted balance, which exclude Social security funds (SSF)
Sources: Bloomberg, AMRO staff estimates

Figure 1.28 Sovereign CDS premiums showed some variations across the EM sphere



Notes: Data is derived from using simple average of economies’ cds spreads of the respective regions. LatAm consists of Brazil, Chile, Colombia, Mexico, Panama and Peru. Emerging Europe consists of Bulgaria, Croatia, Czech Rep, Estonia, Hungary, Latvia, Poland, Romania, Russia, Slovakia and Slovenia. ASEAN-4 consists of Indonesia, Malaysia, Philippines and Thailand. Data as of 31 March 2017.
Source: Bloomberg

were found to be negatively affected by a growth shock in the U.S. and China. In contrast, in the case of real economic shocks in Japan, the response of exports was found to be fairly muted. Given the centrality of China's trade activities globally, the capacity for China to transmit real economy shocks is also rising. Spillovers from a major disruption in China's imports have far-reaching effects given the role of China in the global value chain. Analysis using GVAR suggests that any shock in China's imports is found to have significant impact, the effects of which appear to be more persistent and broad-based, affecting even large systemic economies such as the U.K., France and Germany. The large effects of a China import shock reflect the importance of its final demand. Box A describes the comparative study on the impact of spillovers from the U.S., China and Japan on regional economies.

21 In terms of financial spillovers, the impact of increases in banking sector default risks in the U.S., U.K. and China (financial shocks) on EMs' financial sector are significant, alongside rising corporate distress, given that the shocks originate in systemic economies. Following the approach by Chen et. al. (2010)¹⁷ of using the Expected Default Frequency (EDF) as a measure of stress,¹⁸ analysis using GVAR suggests that the negative spillovers from financial shocks in the U.S. are transmitted rapidly across global EMs' financial and corporate sectors.¹⁹ EMs' corporate sectors in particular, saw a fairly persistent rise in corporate default probabilities (within a 36-month horizon). In contrast, financial shocks originating in China, while significant, appear to be less persistent, as the stress on regional EMs' financial and corporate sectors diminishes within half a year. In the case of financial shocks in Japan, the GVAR analysis showed generally insignificant results for both the financial and corporate sectors. When it comes to the U.K., financial shocks are generally transmitted across the EMs' financial sector, although the spillovers to EM corporates, while positive, are inconclusive.²⁰

22 Should the corporate sector in the U.S., China and Japan face increased default risks, estimates of spillovers using GVAR show

that the banking sectors across both advanced and developing economies are affected as well. Empirical analysis suggests that banking sector EDFs in the U.S., U.K., major Eurozone economies, Australia, Brazil, Turkey and regional EMs (ASEAN-4, Singapore and Korea) spiked in the first six months following a shock in U.S. corporate EDFs, i.e. rising corporate distress. This is intuitive as U.S. corporate earnings are seen to be a key barometer of global corporate health, and hence drive global asset prices, which in turn has a bearing on financial institutions' asset quality (e.g. loans and portfolio assets). A shock in China's corporate EDFs has a significant effect on the financial sector of major commodity producing economies (notably Brazil, Australia, Indonesia and Malaysia), while also affecting countries such as Thailand, Korea, Singapore and Turkey, possibly through the confidence channel. Interestingly, the effect on U.S.' and Japan's financial sectors is not statistically significant, while the effect on the U.K.'s and major Eurozone economies' financial sector, while negative, is relatively small in magnitude. A shock originating in Japan's corporate sector is found to have significant spillover effects on the financial sectors in the U.K. and major Eurozone economies, Australia, China, Korea, Singapore, Malaysia, Turkey and Brazil. In contrast, a shock in U.K.'s corporate EDFs does not appear to have statistically significant effects on the financial sector across major global economies. In the case of the U.S., China and Japan, the shocks to the financial sectors are found to be persistent (within a 36-month horizon).

23 In terms of real equity price shocks in the U.S., Japan and China, the spillovers tend to have a strong positive impact on regional equity markets. An equity rally in the U.S. is often associated with a rally in global equity prices, reflecting generally positive optimism in the global economy. GVAR analysis suggests that the impact, while positive, diminishes within a short period of time, within a year. In the case of China, considering the close trade and financial linkages with regional economies, the spillovers from a positive equity price shock in China is also shown to be positive and non-persistent (see Box A for further details).

¹⁷ Chen, Q., Gray, D., N'Diaye, P., O, Hiroko, and Tamirisa, N., (2010), "International Transmission of Bank and Corporate Distress", IMF Working Paper.

¹⁸ Expected Default Frequency (EDF) is a measure of the probability that a firm will default over a specified period of time (typically one year). "Default" is defined as failure to make scheduled principal or interest payments. According to the Moody's EDF model, a firm defaults when the market value of its assets (the value of the ongoing business) falls below its liabilities payable (the default point). The firm level EDFs are aggregated to form EDFs at the sectoral and country levels.

¹⁹ This could be due to the choice of estimation period, where the study does not cover the years immediately after the AFC, where Japanese banks' pull-back from the region occurred.

²⁰ Nevertheless, the negative spillovers on other major Euro area corporates are found to be statistically significant, underscoring the close inter-connectedness between U.K. banks and Eurozone corporates.

Box A. Comparative Impact of Spillovers from the U.S., China and Japan: Preliminary Results from GVAR Analysis²¹

Given the openness of EMs in ASEAN+3 to global and regional shocks, it is useful to investigate empirically the impact of real economic and exchange rate shocks from the U.S., China and Japan on the region. AMRO employed a Global Vector Autoregressive (GVAR) model to investigate the spillover impacts of real and financial shocks on regional economies, as well as other economies outside the region. For the real economy GVAR model, the specification uses economy-specific variables such as industrial production, consumer prices, trade, nominal effective exchange rates (NEERs) and interest rates as well as other global variables such as oil and food prices. For the financial GVAR model, the specification uses the Expected Default Frequency (EDF)²² of the banking sector, EDF of the corporate sector, real short term interest rates, industrial production, real equity prices and real effective exchange rates (REERs). All ASEAN+3 economies are included in the study (excluding Brunei, Lao PDR and Myanmar for the financial GVAR), along with others such as Brazil, South Africa, the U.K., France, Germany, Spain, Mexico, Saudi Arabia, the U.S., India, Australia, Turkey, and New Zealand from outside the region. Monthly data were used for a dataset of 33 countries from 2001 through to 2015. For more details including methodology and other related technical specifications, please refer to the Annex A.

Real Economy GVAR

- Results from the Real Economy GVAR analysis suggest that growth shocks (proxied by industrial production (IP)) in the U.S. and China have a more significant impact on regional industrial production as compared to a growth shock in Japan. Figures A1 and A2 show the negative impact on the regional economies' IP from shocks of a sustained 1.0 percent drop in the U.S. and China IP, respectively, at a 12-month horizon, as compared to a Japan shock (Figure A3). Accumulated over a 36-month horizon, the response of regional IP tends to be negative (-0.1 percentage points (ppts) from a U.S. IP shock, and -0.9 ppts from a China IP shock, on average). The response of regional IP to a Japan IP shock is statistically not significant.
- In terms of nominal export performance (in local currency terms), a sustained 1.0 percent drop in China's IP has negative spillovers not only to regional EMs' exports, but also affected the exports of other EMs outside the region, and major advanced economies. Moreover, the negative impact is

found to be persistent over a 36-month horizon (-1.35 ppts) (Figure A4). Export-dependent and commodity-exporting economies in the region such as Japan, Malaysia, Singapore, Brunei and Thailand were negatively affected. Reflecting China's importance as an absorber of global demand, the negative impact of a shock from China's IP was also found for European countries such as the U.K., France, Germany. Several large EMs outside the region such as India, South Africa and Saudi Arabia saw a cumulative negative response of -3.2 ppts over a 36-month horizon. The shock was also large for commodity-dependent economies outside of this region such as Australia (-3.5 ppts).

- In terms of exchange rate shocks, a RMB depreciation in China (on a NEER basis) did not have a significant impact on NEERs in the region after 12 months²³, except for Thailand and Japan (in Japan, the NEER appreciated) (Figure A5). Exchange rate appreciation in Japan (on a NEER basis) also did not yield a significant impact on regional NEERs (Figure A6). This could be due to the timeframe used in the GVAR, as exchange rate shocks may have had a more short-lived impact.

Financial GVAR

- Financial shocks (proxied by the financial sector's EDF that originates in the U.S., the U.K. and China are significant, spillovers of which propagates rapidly to regional economies (both the financial and the corporate sectors)). Using the EDFs as a measure of stress,²⁴ a shock in U.S., U.K.'s and China's financial sector EDFs has significant impact on the financial sector EDFs of EMs, the stress of which is then subsequently transmitted to EM corporate sectors, which saw a fairly persistent rise in corporate default probabilities (within a 36-month horizon). Similarly, shocks in the U.K.'s financial EDFs are generally transmitted across the EMs' financial and corporate sectors. In contrast, shocks in China's financial EDFs, while significantly positive, appears to be less persistent relative to the U.S. financial stress scenario, as the stress on EMs' financial and corporate sectors diminishes within half a year (Figures A7 — A12). This is observed for regional EMs (Malaysia, Indonesia, Thailand, China and Korea), as well as other EMs outside the region (India, Mexico, Turkey and South Africa). In the case of financial shocks in Japan, the GVAR analysis generally showed insignificant results for both financial and corporate sectors, therefore not shown.

²¹ These preliminary results are from an ongoing study between AMRO and Professor Tomoo Inoue of Seikei University, Japan.

²² See footnote 18.

²³ The study also considered alternative specification of the exchange rate variable as bilateral exchange rates against USD instead of NEERs.

²⁴ EDF is a measure of the probability that a firm will default over a specified period of time (typically one year). "Default" is defined as failure to make scheduled principal or interest payments. According to the Moody's EDF model, a firm defaults when the market value of its assets (the value of the ongoing business) falls below its liabilities payable (the default point). There are three key values that determine a firm's EDF credit measure: the current market value of the firm (market value of assets), the level of the firm's obligations (default point), and the vulnerability of the market value to large changes (asset volatility).

- Stresses in the corporate sector (proxied by corporate sector EDFs) that originate in the U.S., China and Japan are found to be an important channel of stress transmission to EMs' financial and corporate sectors.
 - Rising corporate default probabilities in the U.S. in particular, have far-reaching negative spillovers to the global economy, as the U.S. corporate financial health is often regarded as a key barometer to gauge the health of the global economy. Stresses in the U.S. corporate sector are associated with falling asset prices, and this in turn affects both financial and corporate sectors' asset quality and soundness in EMs given the centrality of the U.S. economy (Figures A13 and A14).
 - A rise in corporate default probabilities in China also has important systemic ramifications, particularly on the financial sector soundness of commodity producing economies (notably Brazil, Australia, Malaysia and to some extent, Indonesia), while also affecting other regional EMs such as Korea and Thailand. Considering the rising systemic importance of China, financial stress in China is found to also propagate to major advanced economies (Japan, U.K. and major Eurozone economies) possibly through

the confidence channel. Similarly, the transmission of risks in China's corporate sector is also found to be impacting EMs' and major advanced economies' corporate sector soundness (Figures A15 and A16).

- Similarly, in Japan, rising corporate EDFs are found to have significant negative spillover effects on both the financial and corporate sectors in China, Singapore, Malaysia and Thailand (regional EMs), Brazil and Turkey (other EMs), as well as in major advanced economies except the U.S., notably the U.K., major Eurozone economies and Australia. In all cases, the effects are persistent (within a 36-month horizon) (Figures A17 and A18).
- In terms of real equity price shocks, a positive shock in U.S., Japan's and China's equity markets have strong positive impact on regional equity markets, the spillover effects of which diminish after about one year. The result is consistent with the observations that an equity rally in the U.S. is often associated with a rally in global equity prices. In the case of China, the result underscores the notion that regional equity prices have showed large co-movements with China in recent years (Figures A19 to A21).

Generalized Impulse Response Functions: Real Sector GVAR

Figure A1.

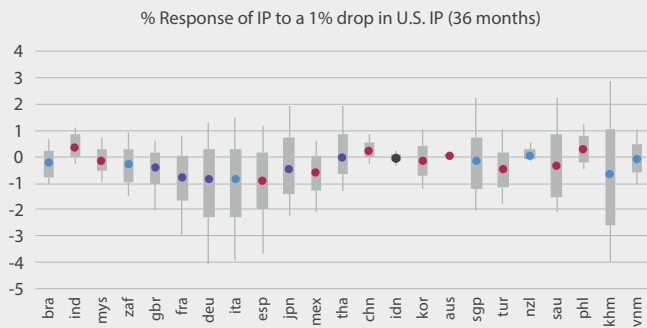


Figure A2.

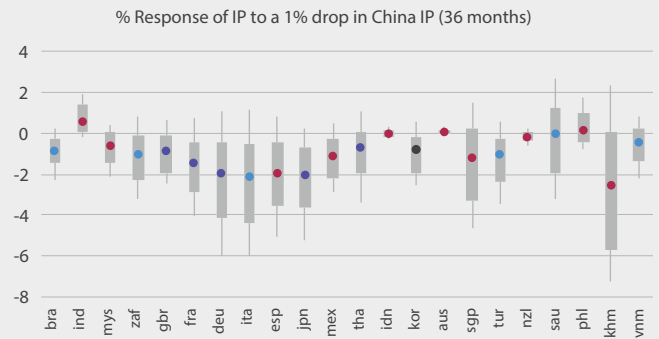


Figure A3.

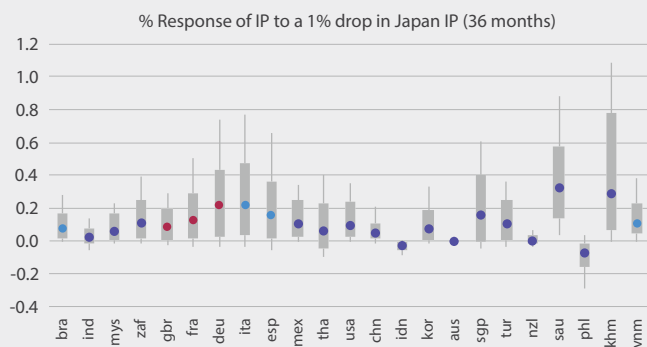


Figure A4.

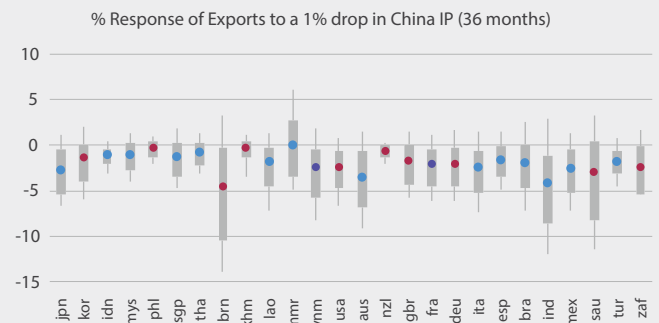


Figure A5.

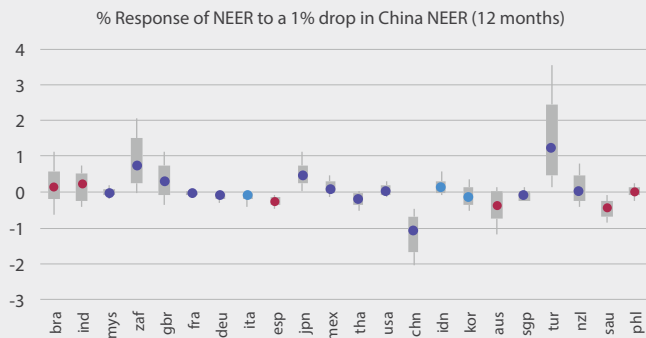
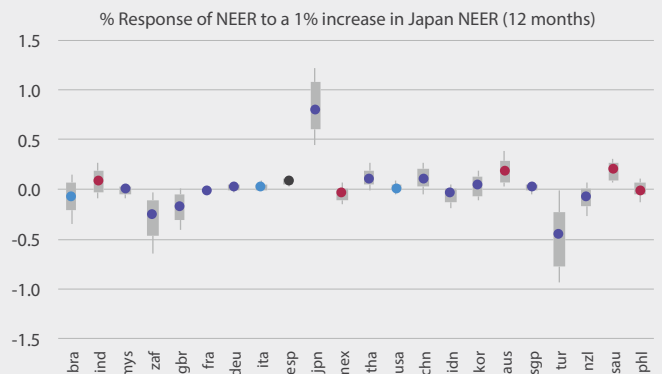


Figure A6.



Generalized Impulse Response Functions: Financial Sector GVAR

A. Spillovers from Financial Sector Shocks in the U.S., the U.K. and China on Sample Countries' Financial and Corporate Sectors

Figure A7.

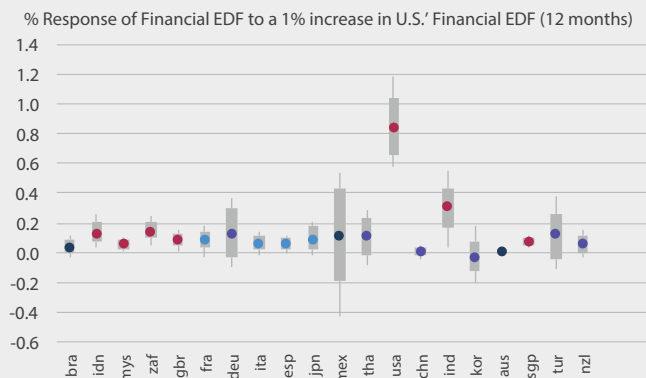


Figure A8.

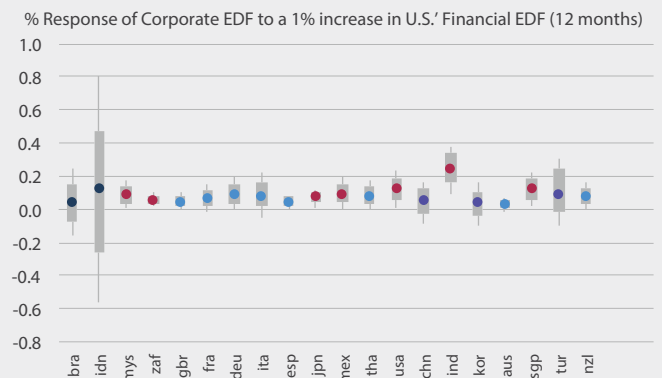


Figure A9.

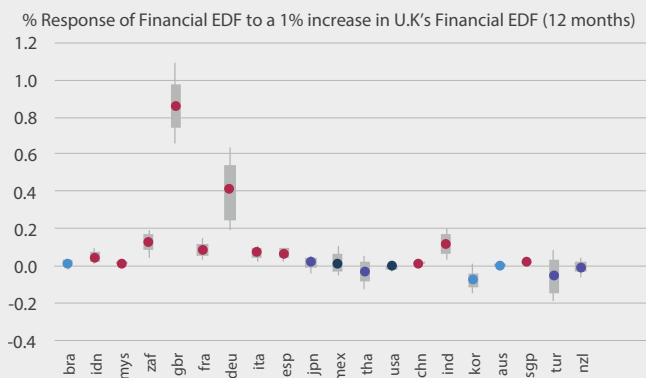


Figure A10.

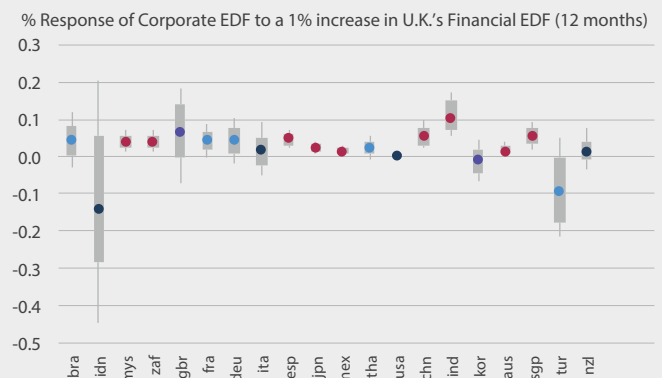


Figure A11.

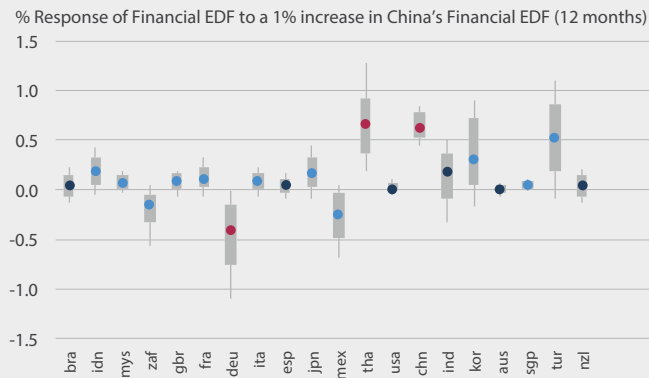
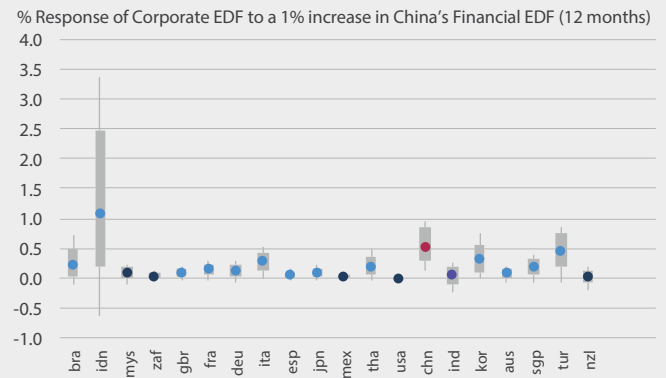


Figure A12.



Generalized Impulse Response Functions: Financial Sector GVAR

B. Spillovers from Corporate Sector Shocks in the U.S., China and Japan on Sample Countries' Financial and Corporate Sectors

Figure A13.

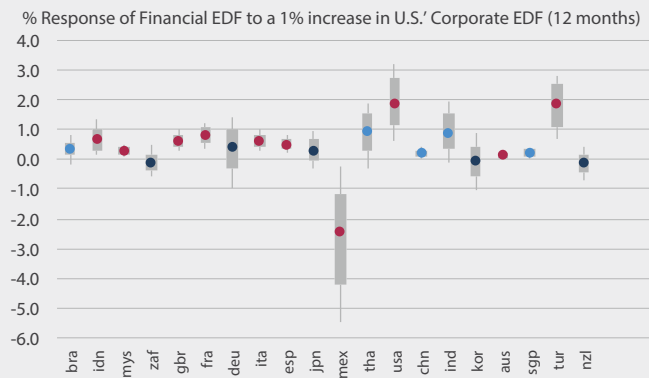


Figure A14.

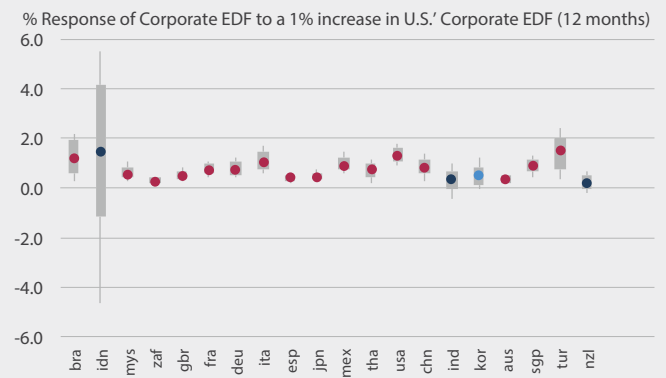


Figure A15.

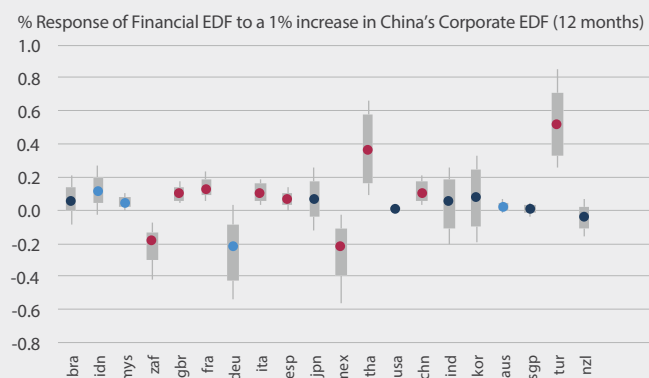


Figure A16.

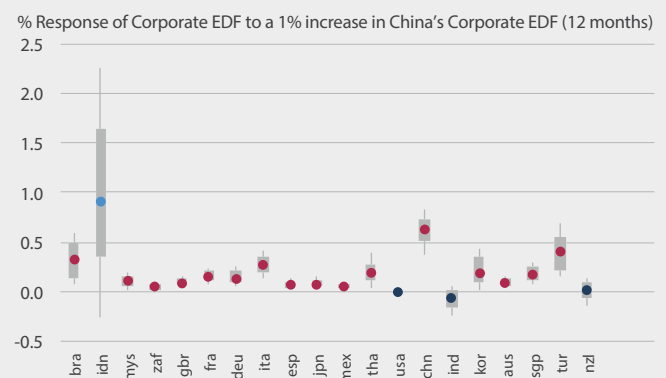


Figure A17.

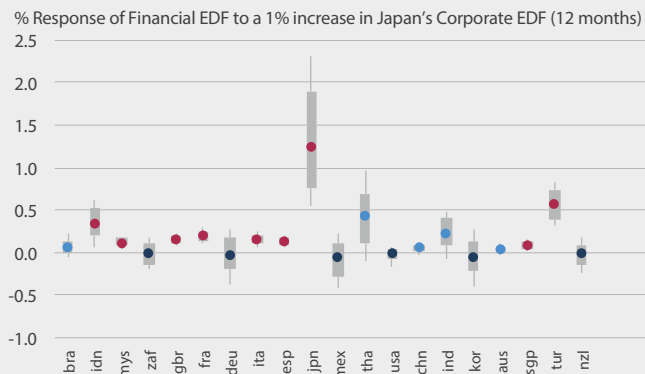


Figure A18.

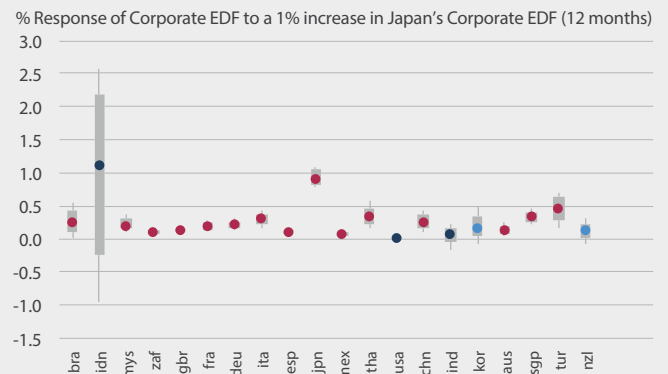


Figure A19.

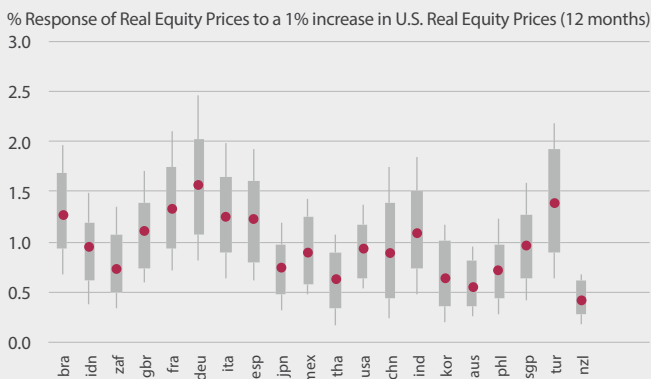


Figure A20.

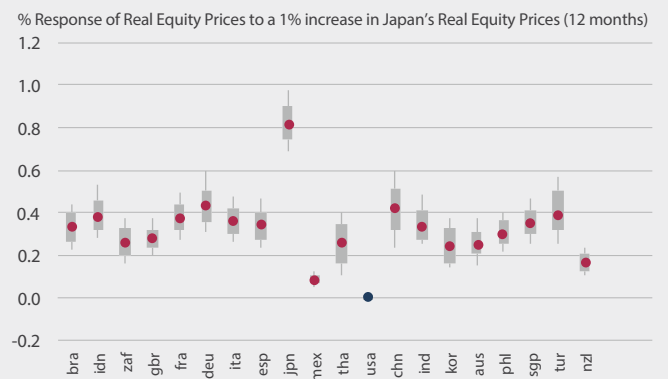
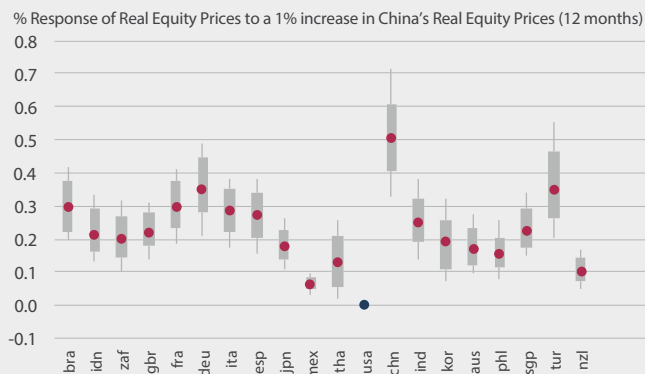


Figure A21.



Legend: Median dots: Red: Statistically significant (95%), Blue: Statistically significant (84%), Purple: Not statistically significant

Notes: The figures presented in this Box are the Generalized Impulse Response Functions of the GVAR, which are calculated by bootstrapping. The number of iterations is 100. The top of the box corresponds to the upper 16 percentile of the distribution; the bottom of the box corresponds to the lower 16 percentile of the distribution. Similarly, the top edge of the whisker corresponds to the upper 5 percentile, and the bottom edge of the whisker corresponds to the lower 5 percentile. The dot is the median value.

2. Regional Economic Outlook and Challenges

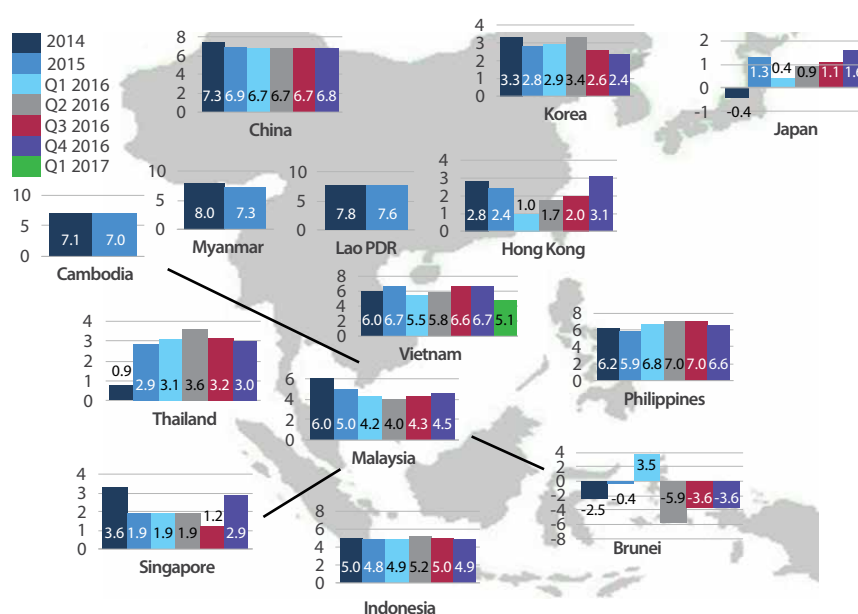
Overall regional growth is expected to slow slightly in 2017-2018, with regional headline inflation expected to pick up after trending downwards since 2011. With sluggish global demand and trade, growth in the region has been predominantly driven by domestic demand with some support from monetary and fiscal policy.

24 Regional economies in 2016 remained resilient despite a less benign external environment, with growth expected to moderate slightly from 2016 to around 5.2 percent in 2017, and 5.1 percent in 2018 (Figure 2.1, Table 2.1). Domestic demand has supported growth, aided by expansionary macroeconomic policies in most regional economies. The ASEAN+3 region remains in a position of strength and has shown resilience so

far to external shocks caused by global policy uncertainty, such as the “taper tantrum” in May 2013, the Brexit referendum, and the unexpected outcome of the U.S. Presidential election in November 2016.

25 Barring tail-risk events such as an escalation of U.S.-China trade tension, an outbreak of a geopolitical conflict or severe climate change events, the baseline scenario is for moderate growth to continue in 2017-18. Trade-dependent economies such as Korea, Singapore and Hong Kong will continue to see moderate growth in 2017 with macroeconomic policies playing a critical role in supporting the economies. Among emerging ASEAN economies, growth has either bottomed out or is picking up gradually supported by accommodative macroeconomic

Figure 2.1 Regional economies remained resilient



Note: On % yoy basis. Data for Japan, Lao PDR and Myanmar refer to the respective fiscal years. Source: National Authorities

Table 2.1 AMRO’s Projections for GDP Growth and Inflation (2017 and 2018)

	Real GDP Growth			Headline Inflation (Period Average)		
	2016 e/	2017 p/	2018 p/	2016 e/	2017 p/	2018 p/
ASEAN+3 Region	5.3	5.2	5.1	1.7	2.5	2.4
Brunei Darussalam	-2.5	1.6	2.9	-0.7	0.2	0.6
Cambodia	6.9	6.8	6.8	3.0	4.0	4.2
China	6.7	6.5	6.3	2.0	2.8	2.5
Hong Kong	1.9	2.3	2.4	2.4	1.8	2.0
Indonesia	5.0	5.1	5.2	3.5	3.8	4.0
Japan	1.4	1.3	1.1	-0.1	0.6	0.9
Korea	2.8	2.5	2.6	1.0	1.8	1.9
Lao PDR	6.9	7.0	7.0	1.6	3.0	3.8
Malaysia	4.2	4.5	4.6	2.1	2.7	2.9
Myanmar	6.0	7.0	7.2	6.8	7.1	6.8
The Philippines	6.8	6.8	7.0	1.8	3.1	3.2
Singapore	2.0	2.0	2.2	-0.5	0.8	1.0
Thailand	3.2	3.4	3.5	0.2	1.2	1.7
Vietnam	6.2	6.4	6.4	2.7	4.0	3.0

e/ Estimates p/ Projections

Notes: Real GDP data refers to fiscal year ending March 2017, 2018 and 2019, respectively for Japan and Myanmar. For Lao PDR, real GDP data for 2016 refers to fiscal year ending September 2016. Thereafter, the data refers to calendar years. For headline inflation, data for Myanmar refers to the respective fiscal years.

Sources: National Authorities, AMRO staff estimates

policies although the growth outlook has become shrouded by uncertainty over impact of the Trump policies on trade, immigration and finance. Growth in the lower-income ASEAN economies (Cambodia, Lao PDR and Myanmar) is expected to be sustained at a moderately high level, supported by capital inflows from multilateral and bilateral development agencies, although they remain vulnerable to external shocks. Other key macroeconomic indicators are set out in the Appendix.

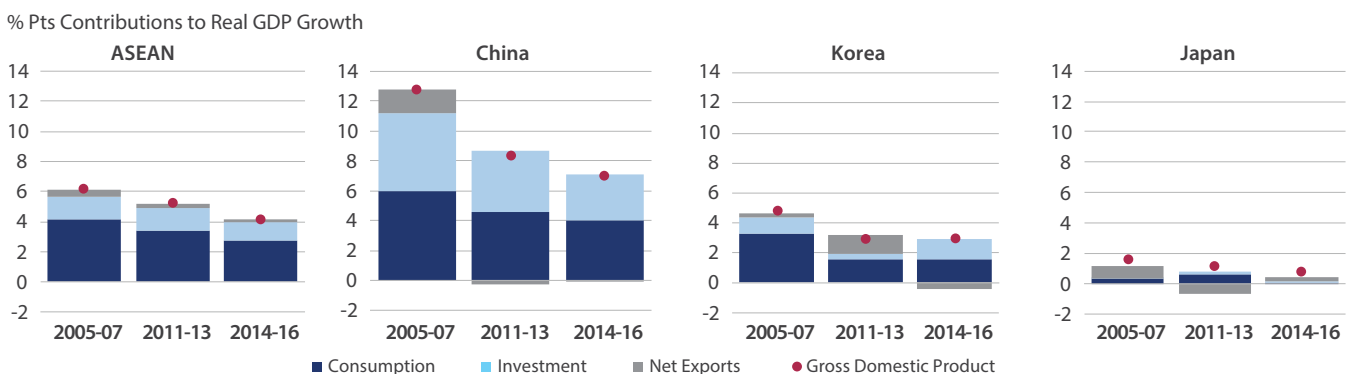
26 Domestic demand will continue to drive growth in 2017, while support from exports is expected to remain tepid, weighed down by potential protectionist measures. Figure 2.2 shows that as compared to the period before the GFC, the drag on growth from net exports has been apparent post-GFC. Compensating for this drag from net exports, private consumption has been the key growth driver, underpinned by stable labor market conditions, continued wage growth and borrowing. The outlook for private consumption is expected to be steady, supported partly by macroeconomic policies. In some ASEAN economies such as Malaysia and Thailand, household spending has been partly bolstered by policy measures to

raise disposable income or to stimulate consumption in an environment of soft commodity prices. Fiscal stimuli in several regional economies, such as Japan, Korea and Thailand, have provided impetus to growth. In view of the rising protectionist sentiment in the U.S. and Europe, external support from exports is expected to be tepid. Potential pull-back in U.S. outward FDI flows to bring manufacturing jobs back to the U.S. could also weigh on longer-term growth potential in trade-dependent regional economies.

Unlike in 2016, the shifting global landscape in 2017 has accentuated the transmission of risks to regional economies via trade, financial and confidence channels.

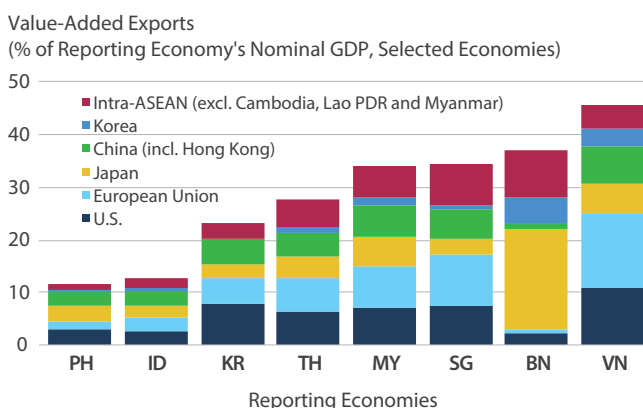
27 Growing U.S. trade protectionism can be partially cushioned by intra-regional trade in final goods within the ASEAN+3 region, which has been rising noticeably (Figure 2.3). Intra-ASEAN trade accounts for around 24.0 percent of ASEAN's total trade, while ASEAN's trade with China, Japan and Korea has increased to 31.2 percent (Figure 2.4). This compares with a decline in ASEAN's trade with North America (mainly the U.S.),

Figure 2.2 Regional growth is mainly driven by domestic demand, with net exports contributing relatively less to headline real GDP growth in recent years



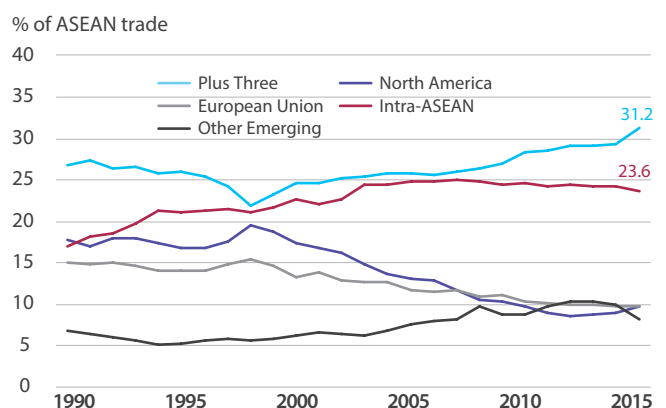
Notes: Changes in inventories and statistical discrepancies are not shown. Data are based on calendar years including Japan. Source: National Authorities

Figure 2.3 The ASEAN+3 region is an important final demand export destination (2015)²⁵



Sources: National Authorities, IMF, OECD-WTO & AMRO staff estimates

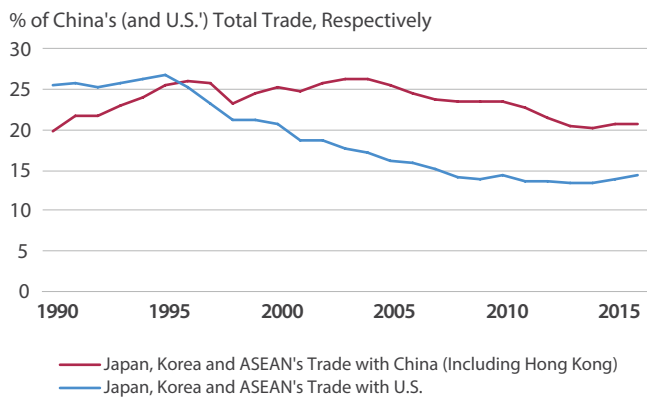
Figure 2.4 Intra-ASEAN trade and ASEAN's trade with the Plus-3 economies have increased



Source: Asia Regional Integration Center (ARIC)

²⁵ Latest data are up to 2011. 2015 estimates are based on unchanged production structure, but allows for changes in market share.

Figure 2.5 Direct trade linkages of ASEAN, Japan and Korea with the U.S. have declined, while their linkages with China have increased

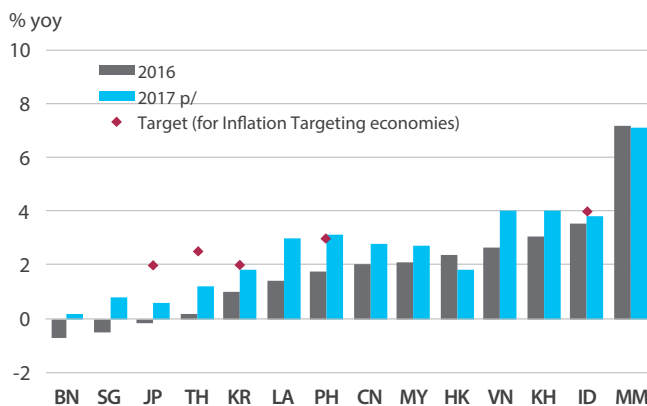


Source: IMF

and to a lesser extent the EU. This is unlike some non-Asian EMs such as Mexico and Brazil that have greater trade linkages with the U.S. (Figures 2.5, 2.6). Nevertheless, with both China and the U.S. absorbing significant shares of the region's exports, an increase in U.S.-China trade tensions will have significant negative spillovers on the region through dampening growth and demand in these major economies.

28 Compared to 2016, rising inflation and tightening global monetary conditions in 2017 have reduced the room for regional economies to ease monetary policy to support growth. For economies in the region that have adopted inflation-targeting monetary policy regimes, inflation remains below the level where policy tightening is warranted (Figure 2.7). Some economies, including Indonesia, Korea and Malaysia, have eased policy interest rates since early 2016, while others have held rates at current levels²⁶ (Figure 2.8). Looking ahead, considering the

Figure 2.7 Headline inflation, while below the level where policy tightening is warranted, is expected to trend upwards in 2017



Source: National Authorities

Figure 2.6 Non-Asian EMs such as Brazil and Mexico also have growing trade linkages with China

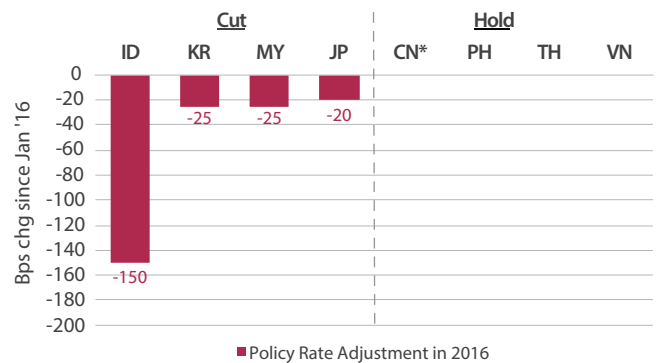


Source: IMF

fading of base effects from low global oil prices, the outlook for inflation is expected to trend upwards, which may constrain monetary policy space to support growth. On the external front, while regional economies' bilateral exchange rates against the USD have generally strengthened, albeit less as compared to the level at the beginning of 2016 until early November 2016, the potential for capital flow reversals from EMs could further reduce the room for accommodative monetary policy support (see Section 3 on Policy Issues).

29 On the fiscal side, despite generally weaker revenue collection, some economies have been able to rebalance their budgets and maintain an expansionary fiscal stance to support growth. Fiscal conditions have tightened, as the commodities downturn has reduced revenue collection, notably in Brunei, Indonesia, Malaysia, Vietnam, Lao PDR and Myanmar. In some oil-exporting regional economies, fiscal authorities have been

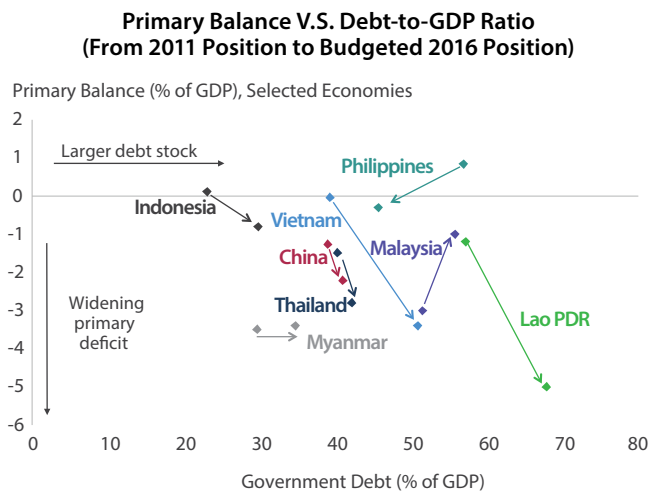
Figure 2.8 Rising inflation and potential capital flow reversals could limit the degree of monetary policy accommodation ahead



Note: * For China, policy rate refers to benchmark 1-year lending rate
Source: National Authorities

²⁶ Several regional central banks such as China (March 2016) and Malaysia have also lowered the reserve requirement ratios of banks in an effort to boost funds in the financial system.

Figure 2.9 Some regional economies have been able to run larger primary deficits, while keeping the debt-to-GDP ratio relatively stable



Notes: 2016 data refers to the budgeted figures. For Myanmar, data refer to 2014 and 2016. For Philippines, Thailand and Vietnam, government debt refers to central government debt only. For Malaysia, the 2016 debt-to-GDP ratio has been adjusted to account for the transfer MYR21.9 billion of debt (1.8 percent of GDP) to the Public Sector Home Financing Board. Sources: National Authorities, AMRO Staff estimates

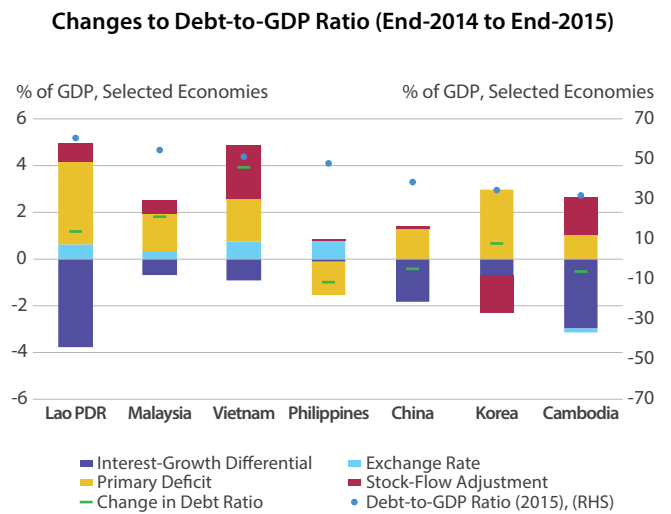
able to mitigate the fall in oil revenue by cutting fuel subsidies (Malaysia and Indonesia), introducing alternative sources of revenue, such as the GST (Malaysia). Most economies (China, Japan, Korea, Singapore and Thailand) ran a larger primary deficit and undertook expansionary fiscal policy in 2016 to support growth (Figure 2.9).

30 In general, fiscal authorities have been able to run a more expansionary fiscal policy without hitting debt ceiling constraints. Although primary deficit has increased, the increase in government debt has been partially offset by low interest rates relative to growth (the interest-growth differential) (Figure 2.10). As global interest rates rise in 2017, fiscal policy will be more constrained in some economies from a debt sustainability perspective. It is imperative to ensure that amidst a narrowing fiscal space, fiscal resources are used efficiently to maximize impact.

Private domestic demand has been sustained partly by borrowing and rising leverage amid an extended period of ultra-low global interest rates, which is a source of vulnerability when monetary conditions tighten.

31 Sustained credit growth at low interest rates has led to a substantial build-up in private sector debt and leverage in several economies. The stock of credit to the private sector, as a percentage of GDP, has increased significantly in most regional economies after the GFC, particularly in China (Figure 2.11). In

Figure 2.10 The debt-to-GDP ratio is mainly driven by larger primary deficits, reflecting expansionary fiscal policy



Source: National Authorities

ASEAN economies such as Thailand, Indonesia, the Philippines and Malaysia, this partly reflects household borrowing that supported private consumption and investment in properties. In smaller ASEAN economies such as Cambodia, Myanmar and Vietnam, this partly reflects financial inclusion as informal lending becomes regulated and is captured in credit statistics, and also partly reflects rapid growth in credit to sectors such as real estate and construction. Using an alternative metric of the credit-to-GDP gap, i.e. the gap between credit trend and GDP trend, the buildup of credit is high in several economies although the gap is narrowing. In comparison, the credit-to-GDP gap is stabilizing in Indonesia and Malaysia, partly reflecting the adoption of macroprudential policy measures to rein in excessive credit growth in the real estate market and in consumer credit (Figure 2.12). In addition, lending by the non-bank sectors in some regional economies is also increasing.

32 Non-financial corporates (NFCs) in the region have borrowed from banks and also issued bonds in foreign currencies, and some NFCs are exposed to FX and rollover risks as global monetary conditions are set to tighten. While most NFC corporate borrowing is in local currencies, a portion is in foreign currencies, notably USD (Figure 2.13). NFCs have also issued USD-denominated debt, with a large share of this debt due to mature in the next three years.²⁷ In 2017, the combination of an appreciating USD, higher global interest rates, and higher term premiums would increase FX and rollover risks

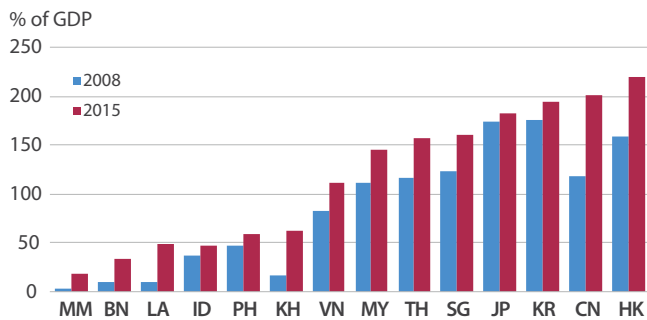
²⁷ China accounts for more than half of the region's foreign-currency debt due in 2016 to 2020. For EMs as a whole (including non-Asian EMs), IIF estimates USD750.0 billion has been issued, with the Asia-Pacific region comprising 51.4 percent of it; Central Asia, Eastern Europe, Middle East and Africa comprising 31.3 percent; and Latin America 17.3 percent.

to these NFCs (Figure 2.14). While some NFCs have natural FX hedges from overseas revenues,²⁸ or have already entered into a financial hedge, those which have not done hedging may find it difficult and costly to hedge in this environment.²⁹

33 While capital buffers in the region’s banking sectors appear adequate (Figure 2.15), they have to be maintained. However, the interest rate upcycle and tightening of global monetary conditions ahead could lead to rising NPLs and bond defaults over the next few years. Across the region, corporates

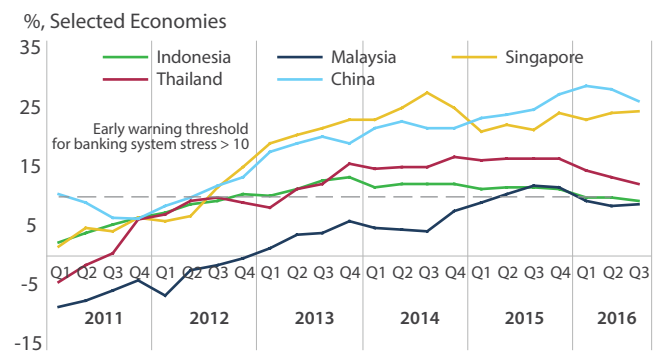
in the commodities and trade sectors have been adversely affected by the sharp fall in commodity prices and downturn in global trade. In terms of debt service capacity, as measured by interest coverage ratio,³¹ the share of debt by NFCs with lower-than-unitary interest coverage ratios (i.e. ICR<1) is rising (Figure 2.16). This decline in debt service capacity among NFCs suggests that NPLs will increase in future. In addition, where NFCs have issued bonds instead of borrowing from the banking system, bond defaults may also increase as economic headwinds increase.

Figure 2.11 The stock of private sector credit to GDP has been rising since 2008



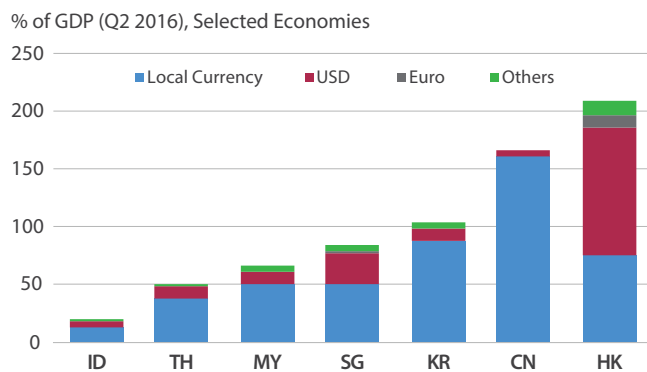
Notes: Private sector credit refers to loans and advances extended by the banking system to financial and non-financial companies, and households. Sources: National Authorities, World Bank

Figure 2.12 The credit-to-GDP gap has increased, though moderated



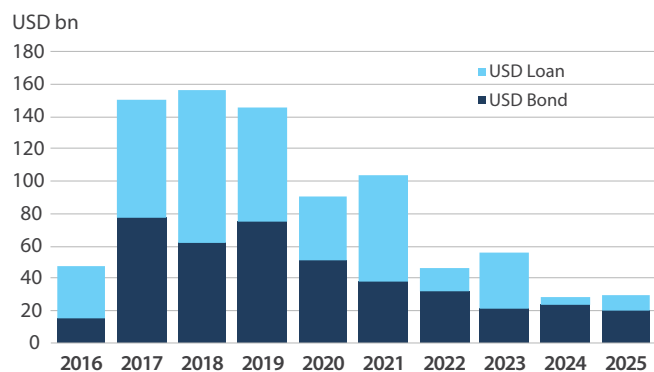
Notes: Data refers to private non-financial sector only. Credit-to-GDP gap is the difference between credit-to-GDP ratio and its long-term trend. Trends are calculated using Hodrick-Prescott filter with a smoothing factor lambda of 400,000, taking account only of information up to each point in time. Readings above 10 percent signal elevated risks of banking strains, according to the BIS. Source: BIS

Figure 2.13 While most NFC borrowing is in local currencies, a portion is in FX



Source: IIF

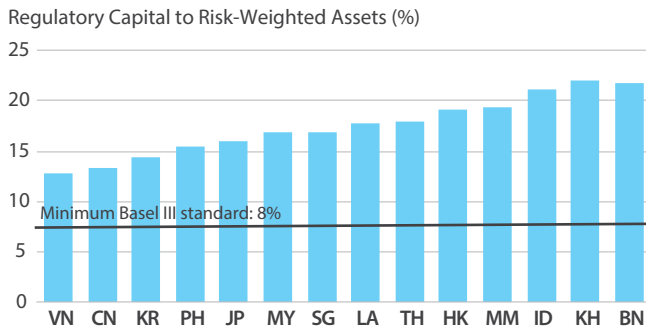
Figure 2.14 A large share of USD-denominated debt in regional EMs is due to mature in 2017-19³⁰



Notes: The data includes non-financial corporations and financial corporations. Regional Asia EM in the sample includes China, Hong Kong, Indonesia, Malaysia, Singapore, Korea, and Thailand. Source: IIF

²⁸ Due to lower external revenue resulting from lower commodity prices and lower export volumes, for example, compared to FX liabilities.
²⁹ As hedging costs are typically high in the region and USD liquidity could become unavailable or very costly during stress periods.
³⁰ At the end of 2015, one-third of the almost USD10.0 trillion of USD-denominated debt outside the U.S. was held by residents in emerging markets. In Brazil, Russia and China, USD-denominated credit to non-bank borrowers has more than doubled since 2007. One-third of this debt is due to mature by the end of 2019.
³¹ Interest coverage ratio (ICR) refers to the earnings before interest, taxes, depreciation and amortization (EBITA) to total interest expense. An ICR less than 1 indicates that a company is not generating sufficient cash to cover its interest payments. An ICR of at least 1.5 is generally a rule of thumb for investors in assessing a company’s financial health.

Figure 2.15 Regional banks' capital buffers appear adequate ³²

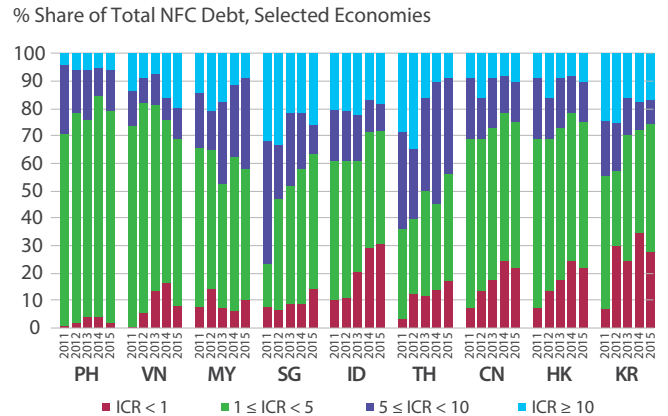


Notes: Data as of Q4 2016, except Japan (Q1 2016), Korea, Malaysia, Indonesia (Q2 2016), and Singapore, Myanmar, Philippines (Q3 2016)
Sources: National Authorities, IMF

Economies relying on bank borrowing or portfolio inflows to finance the current account or the budget would be vulnerable to rising financing costs amid capital outflow risks.

34 Current account positions have been supported by import compression and low commodity prices for commodity importers in 2016, but are projected to weaken slightly in 2017 for most economies. For net oil importers such as China, Japan, Korea, Thailand and Singapore, a faster rate of import compression relative to exports has boosted the current account surplus. In comparison, sustained expansion in domestic demand has contributed to robust import growth which saw the current account surplus shrinking

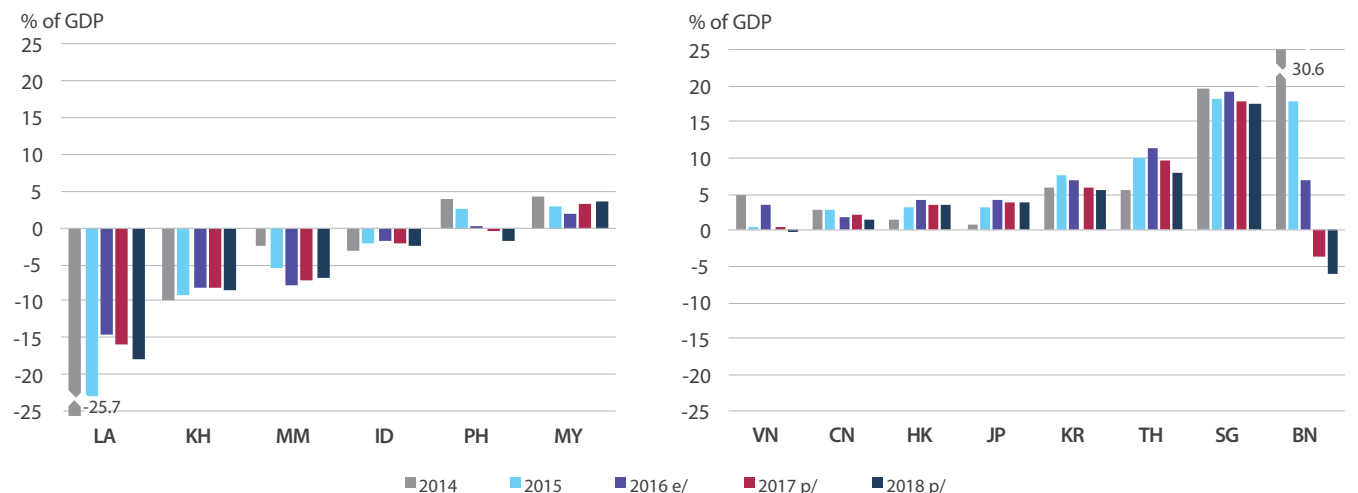
Figure 2.16 NFC debt service capacity has also deteriorated, in line with weakening profitability



Source: Reuters

over the past few years in some economies such as Malaysia and the Philippines (Figure 2.17). Economy-specific factors, such as slowing inward remittances, have also underpinned the moderating current account surplus in the Philippines. Further downside risks could stem from Trump's policies to limit immigration with a negative outlook for remittances considering that the U.S. is the world's largest source country for remittances (Figure 2.18). In smaller ASEAN economies (Cambodia, Lao PDR and Myanmar), current account deficits persist due to sustained large capital imports to support economic development. AMRO staff projects a slight widening of current account deficit for these smaller ASEAN economies for 2017-18.

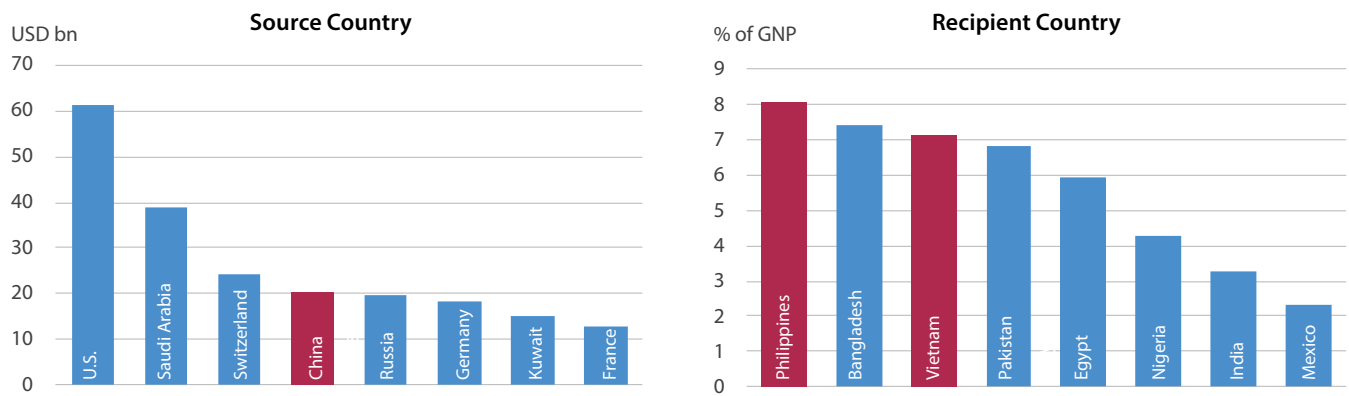
Figure 2.17 Current account surpluses of some emerging ASEAN economies have narrowed



Notes: e/ Estimates p/ Projection
For Myanmar, estimates for 2018 refer to fiscal year ending March 2019.
Sources: National Authorities, AMRO staff estimates

³² For some countries, such as Lao PDR, the figure is based on Basel I standards.

Figure 2.18 The U.S. remains the world's largest source country for remittances

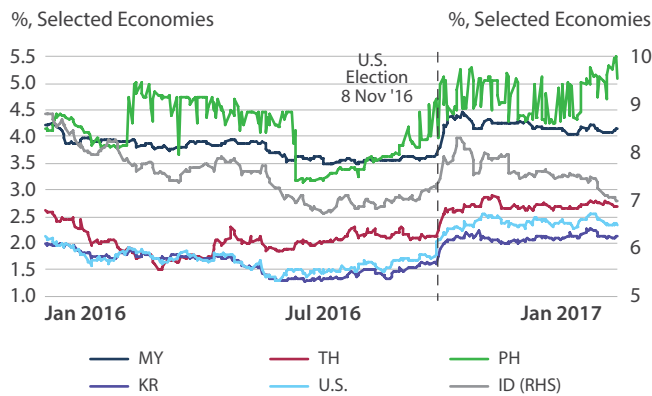


Source: World Bank

35 Where an economy's current account deficits and fiscal deficits rely on external financing through portfolio inflows, tightening global monetary conditions and financial market uncertainty in 2017 are risks that may disrupt financing. The sharp rise in U.S. Treasury yields after Trump's election has pulled sovereign yields higher in EMs, including in regional EMs (Figure 2.19). In addition, foreign investors hold a significant share of local currency sovereign bonds in some regional EMs (Figure 2.20). These holdings are vulnerable to adverse shifts in investor sentiments and retrenchment in foreign

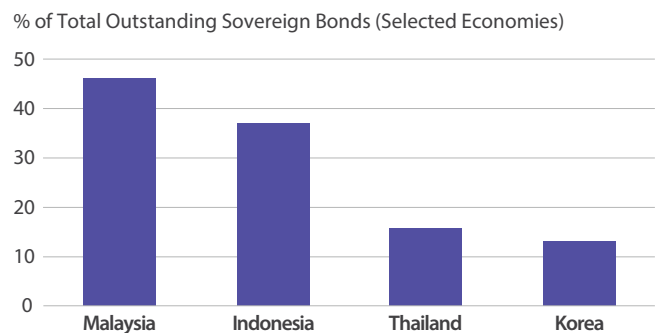
capital. In the weeks after the U.S. election results, regional EMs (Korea, Thailand, Indonesia, Malaysia and the Philippines) saw significant portfolio capital outflows, alongside declining asset prices (currencies, stock and bond markets) (Figure 2.21). In comparison, the smaller ASEAN economies (Cambodia, Lao PDR and Myanmar) are more dependent on FDI and concessional official financing, and less exposed to private portfolio flows. For them, the challenge is to maintain access to official financing and improve their attractiveness to FDI investors to grow their economies.

Figure 2.19 Sovereign bond yields spiked after Trump's election



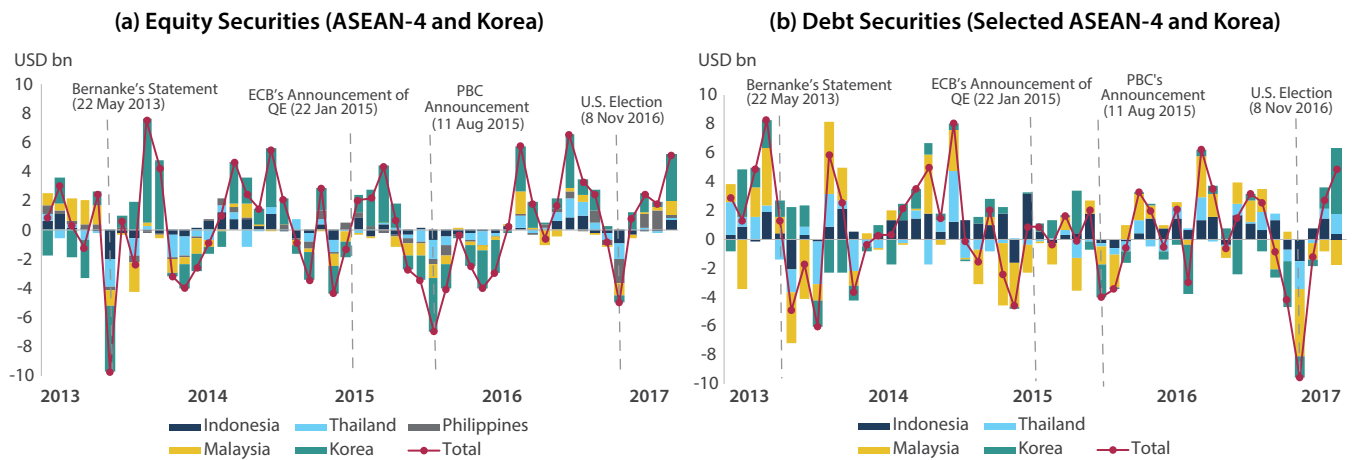
Source: Thomson Reuters Datstream

Figure 2.20 Foreign holdings of local currency sovereign bonds are significant in some regional EMs



Notes: Data refers to foreign participation in local currency sovereign securities only. Data do not include Government Investment Issues and Bank Negara Malaysia Bills/Notes (for Malaysia), State-Owned Enterprises Bonds and Bank of Thailand bonds (for Thailand), Bank Indonesia Certificate (for Indonesia) and Bank of Korea's Monetary Stabilisation Bonds (for Korea). Data as of December 2016
Source: National Authorities

Figure 2.21 Non-resident capital inflows into major ASEAN EMs turned to net outflows during the Trump Tantrum, but have recovered since January 2017

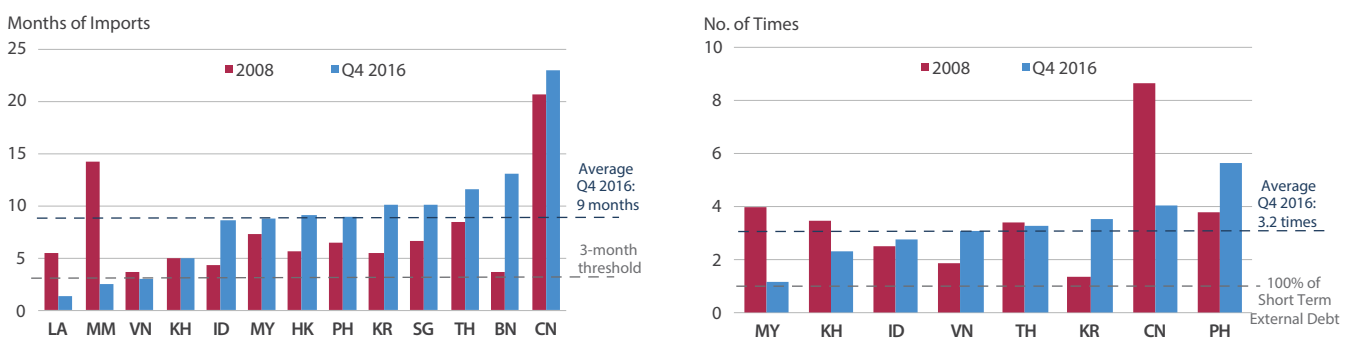


Notes: Equity data are as of end-March 2017, while debt data are as of end-February. Source: National Authorities

36 While FX reserve buffers are high by conventional metrics of import and short-term external debt cover, buffers have to remain adequate in the face of potential capital outflow pressures in a “risk-off” scenario. Regional economies have built up their FX reserves since 2008, with FX reserves covering on average 9.0 months of imports and 3.2 times of short-term external debt (Figure 2.22). As mentioned previously, foreign holdings in domestic asset markets such as local currency sovereign bonds are significant (Figure 2.20). Sudden unwinding of these holdings and capital outflows in a “risk-off” scenario may put additional pressure on the exchange rate and

FX reserves. In recent years, exchange rates have become more flexible, playing a greater role as a buffer against external shocks. 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 2017. This is especially so as markets may overreact to declines in FX reserves, regardless of their absolute levels.³³ This is especially so as markets may overreact to declines in FX reserves, regardless of their absolute levels.³⁴ Box B compares and contrasts the recent developments in portfolio capital flows between ASEAN-4 and Korea, and other EMs outside the region.

Figure 2.22 FX reserves appear adequate, by metrics of import and short-term external debt cover



Notes: Latest data refers to 2012 (for Vietnam), 2014 (for Cambodia), 2015 (for Brunei), Q3 2016 (for Myanmar). For Myanmar and Lao PDR, data reflect imports of both goods and services based on AMRO's calculations. Japan is not included as the JPY is used as one of the reserve currencies.

Notes: Latest data refers to 2012 (for Cambodia), Q3 2016 (for China), and 2014 and 2016, respectively (for Vietnam). Some member economies have adopted the latest BPM6 (such as Malaysia), which includes local currency-denominated debt held by non-residents in their short term external debt data.

Sources: National Authorities, AMRO ERP Matrix

³³ Market expectations of FX reserve adequacy have also changed, with markets interpreting a fall in FX reserves negatively as a sign of vulnerability.

³⁴ In Malaysia, the drop in the FX reserves to short-term external debt cover is due to the re-definition of external debt in line with international standards. It now also includes non-resident holdings of local-currency denominated debt paper and other debt-related non-resident financial flows such as trade credits, currency and deposits, and other loans and liabilities.

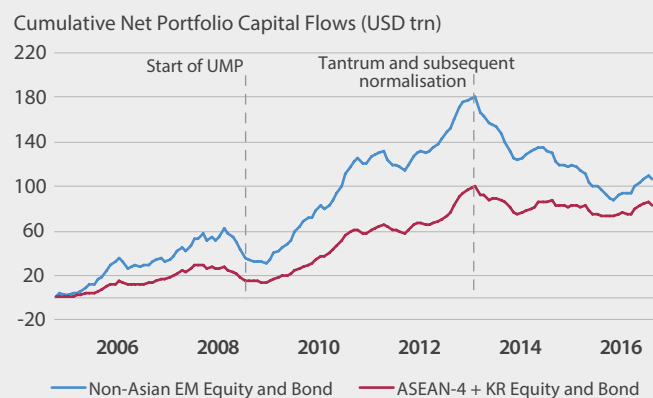
Box B. Recent Developments in Non-Resident Portfolio Capital Flows (Comparison between ASEAN-4 and Korea, and Other Emerging Market Economies)

Capital flows into EMs have been affected by global pull and push factors. Since the “taper tantrum” in mid-May 2013, non-resident portfolio capital flow developments in particular, have become more differentiated amid the re-pricing of risks across asset classes. This box discusses the evolution of the main drivers of portfolio capital flows in the global EMs (Asean-4, Korea and other non-Asian EMs, namely Brazil, Mexico, Russia, South Africa and Turkey), compares the macroeconomic fundamentals and highlights the foundations for financial stability and resilience.

Portfolio capital flows to regional EMs (ASEAN-4 and Korea) have been influenced by the following pull and push factors:³⁵ (Figure B1):

- **Fundamentals:** Economic fundamentals in the region have improved significantly post-AFC. Together with better growth prospects amid the search for yield post-GFC, regional EMs have attracted large inflows.

Figure B1. Portfolio capital flows to EMs were driven by different factors since the AFC



Source: EPFR

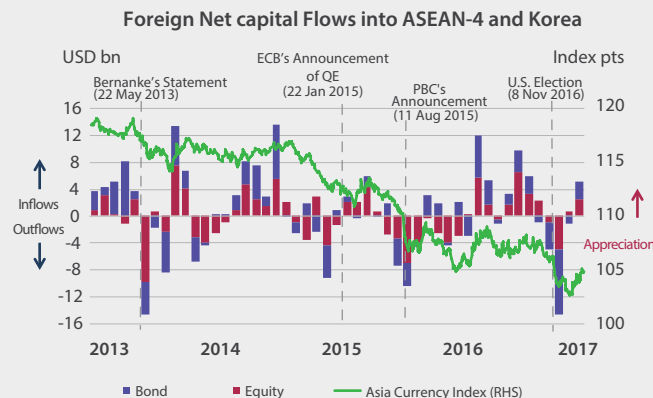
- **Unconventional Monetary Policy (UMP)** in major advanced economies:
 - (1) Easing: AEs commenced QE as domestic interest rates approached zero bound. Differentials in AEs and EMs rates and bond yields, as well as economic fundamentals

played vital roles in the portfolio rebalancing towards EM assets. The risk perception of investors on EM assets gradually reduced.

- (2) Normalization (by U.S. Fed): The Fed’s intention to rollback UMP was not well-signaled, which led to severe financial stress in the EMs especially the “Fragile Five” economies in May 2013 (Taper Tantrum). The region experienced large portfolio capital outflow episodes but they were less severe vis-a-vis other EMs due to relatively better current account balances as well as lesser vulnerabilities from foreign ownership of assets. Strong external positions and adequate buffers have helped mitigate market volatility during the Trump Tantrum in November 2016. (Figure B2)

In terms of resilience, following the AFC, the region has strengthened buffers and risk management in the financial sector with adequate financial buffers/liquidity backstop to withstand adverse developments and shocks. The region has

Figure B2. ...while recently, the region has been able to withstand external shocks better



Notes: All data are as of end-January 2017, and refers to Indonesia, Malaysia, the Philippines, Thailand and Korea. For bonds data refers to Indonesia, Malaysia, Thailand and Korea. The Bloomberg Asia currency index consists of currencies from China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand against USD.

Sources: National Authorities, Bloomberg

built a well-capitalized banking system over the years³⁶ that remains resilient despite recent exposure to the commodity and energy-related sectors. An adequate level of foreign reserves has helped to absorb some shocks (Figure B3) and a sound financial regulatory and supervisory framework is also

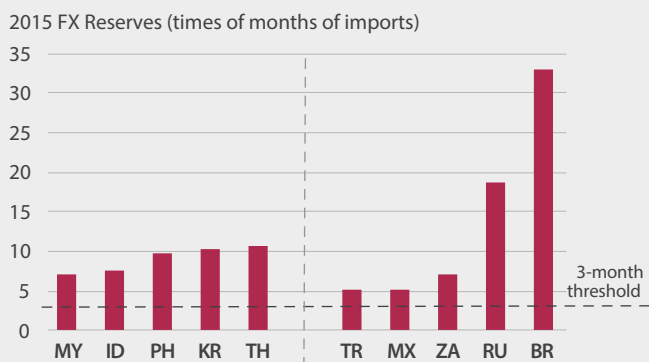
³⁵ Asian Development Bank Institute (Chantapacdepong and Hemvanich): “The pattern of capital flows into Asia in the last decade”, June 2016.

³⁶ Moody's Investor Service Stress-Testing on Emerging Asia: “Banks-Emerging Asia Stress Tests Reveal Resilience Among Most Emerging Asian Banks But Also Some Pockets of Risk”, December 2016.

put in place to safeguard depositors and financial stability.

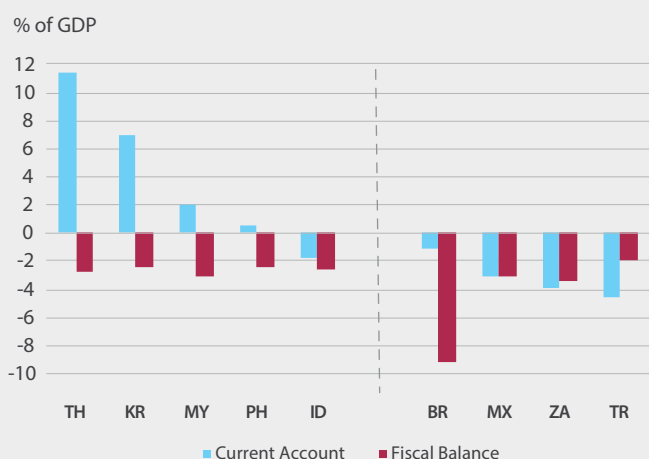
Efforts by the region’s regulatory agencies in developing the domestic capital market have generally helped to mitigate the impact of volatile capital flows. Initiatives like the deepening of local currency bond market has helped reduce reliance on short-term foreign financing and mitigate currency mismatch risk. Figure B4 shows the negative relationship between foreign holdings of sovereign bonds and currency performance during uncertain times. Overall, systemic risks have lessened with

Figure B3. ASEAN-4 and Korea foreign reserves were higher than that of Turkey, Mexico and South Africa



Sources: AMRO ERPD Matrix, National Authorities, AMRO staff calculations

Figure B5. Running better current account and fiscal positions would allow more policy room for the region in times of need



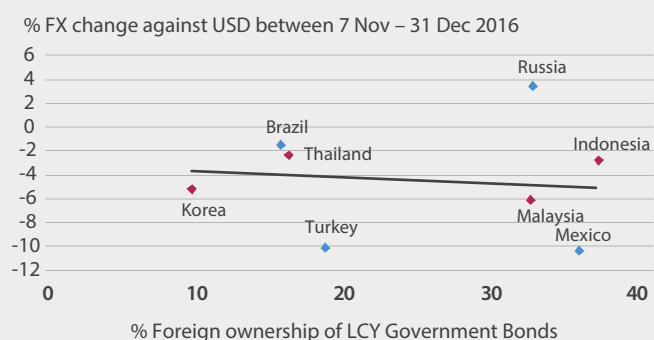
Note: Korea’s fiscal balance refers to the adjusted balance, which exclude Social security funds (SSF)

Sources: AMRO staff estimates, Bloomberg

the development of a stronger asset core denominated by domestic currencies.

Regional EMs have gradually strengthened their macroeconomic policy frameworks and improved their conduct of policy. By doing so, they have attained relatively sound public finance and external positions (Figure B5) in view of the need for policy room in future. Within the region, authorities have also enhanced financial cooperation in the areas of macroeconomic surveillance, crisis prevention and information sharing.³⁷

Figure B4. Currencies of EMs with higher foreign ownerships in bonds fell more after the U.S. election



Sources: AsianBondsOnline, Bloomberg

Going forward, policymakers will need to remain vigilant and be ready to respond as near-term risks may create more turbulence in capital markets. Key risks would include the already-slow global trade growth exacerbated by rising anti-globalization sentiments; the tightening of monetary conditions in AEs; and policy uncertainties in U.S. and Europe where the elections begin to unfold this year. To deal with these risks, policymakers have deployed an expanded policy toolkit, such as macroprudential policies and/or capital flows management measures in order to address potential risks ahead.

³⁷ Asian Development Bank Institute (Kawai and Morgan): “Regional Financial Regulation in Asia”, February 2014.

3. Policy Issues

Despite better fundamentals, diminishing cyclical tailwinds and rising external headwinds in the period ahead suggest that regional policymakers will face a sharper trade-off between growth and financial stability objectives, at a time when policy space is narrowing.

37 Regional economies have been able to weather the external challenges from a position of strength, benefiting from earlier reforms and structural adjustments. The ending of the commodity price uptrend, moderating credit growth, and less robust foreign capital inflows have contributed, however, to a step-down in growth in several regional economies. At the same time, policymakers are confronted with financial stability challenges arising from the increase in household and corporate debt, high property prices, weakening corporate profitability, and rising NPLs. With the turning of the global credit cycle, stronger USD and the associated capital flow reversal risks, the macroeconomic policy setting has become more constrained by external developments, at a time when policy space in some regional economies is narrowing.

Tightening global monetary conditions in 2017 and rising inflation, albeit from a low base, will constrain regional economies' use of monetary policy to support growth, with the constraints most apparent in economies where financial vulnerabilities have built up. Targeted macroprudential policy measures can help to complement monetary policy to safeguard financial stability.

38 As global monetary conditions tighten, domestic monetary conditions will also tighten at a time when risks to economic growth are growing. The period after Trump's election has already tested EMs with a sharp rise in U.S. Treasury yields, expectations of a faster pace of U.S. Fed rate hikes, and a sharper USD appreciation. The risks going into 2017 are of a disorderly portfolio reallocation, leading to large capital outflows, and excessive exchange rate depreciation or loss of reserves. This scenario may be worsened by confidence channels in the transmission of stress and feedback loops within ASEAN+3.

39 The pick-up in global inflation, mainly reflecting the recent increases in commodity prices, could also be a policy concern moving forward, depending on the extent of pass-through of import prices to domestic prices. In some regional economies, energy prices have started making a positive contribution to headline inflation since the end of 2016. Along with the recovery in producer prices, regional economies that

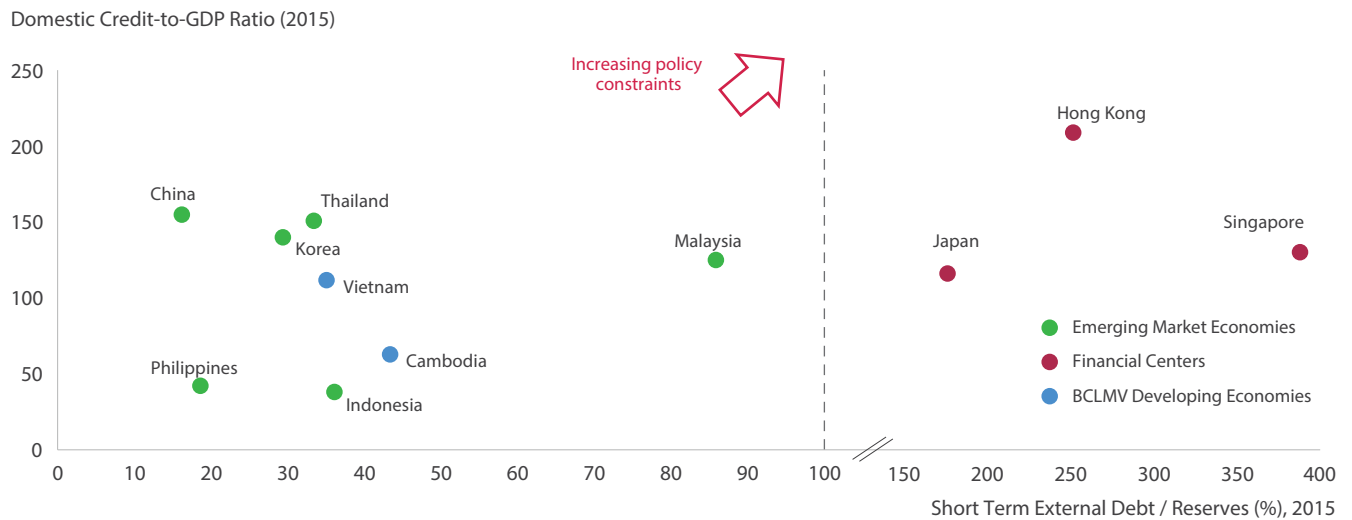
are net commodity importers could see near term inflation gradually firming. As a pre-emptive measure to stem the buildup of cost pressures, regional central banks may have to adjust their degree of monetary policy accommodation in the period ahead.

40 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. With interest rates rising, economies with a larger stock of private domestic credit to GDP would be more exposed to a sharper than expected rise in debt servicing burdens. In addition, economies with a larger stock of short-term external debt to GDP are more vulnerable to higher cost of borrowing in foreign currency and rollover risks.

41 Figure 3.1 plots ASEAN+3 economies along two dimensions: domestic credit to GDP ratio on the vertical axis, and short-term external debt as a percentage of FX reserves on the horizontal axis. The constraints on monetary policy would increase for economies as they move towards the upper top right, that is, high stock of credit and high short-term external debt. There are, however, several caveats to this framework. First, short-term external debt for financial centers such as Hong Kong, and Singapore can be expected to be higher, and does not necessarily indicate higher vulnerability compared to non-financial centers. Second, for several of the ASEAN CLMV economies and ASEAN-4 EMs, such as Cambodia, Lao PDR, Myanmar, Vietnam, the Philippines, and Indonesia, part of the build-up in domestic credit can be attributed to financial deepening.

42 With these caveats, credit-to-GDP ratios in some economies have remained elevated since 2011. While credit growth has slowed recently in major ASEAN economies, the stock of private sector debt remains relatively high. Looking at the magnitude of short-term external debt to FX reserves, the current levels of debt seem generally manageable in regional EMs. The policy priority for these regional EM central banks will be to shift to a slightly tighter monetary policy stance to safeguard financial stability, while allowing a more flexible exchange rate to cushion some of the adjustments. For economies with high foreign participation in their local domestic financial markets, and/or high gross external financing needs, policymakers would need to keep a tighter monetary policy stance and ensure that the bond yields are market-determined, although there would be some moderating impact on near-term growth.

Figure 3.1 Constraints are more binding for economies with higher financial vulnerabilities



Notes: Domestic credit refers to private domestic credit provided by financial sector. Short term external debt refers to outstanding short-term debt (original maturity) and the outstanding long-term debt (original maturity) due for payment in one year or less. There are no short term external debt data available for Brunei, Lao PDR and Myanmar. Total reserves includes gold. For Singapore, Singapore Government borrowings are not for spending. Singapore Government Securities (SGS) are issued to develop the domestic debt market and Special Singapore Government Securities (SSGS) are issued specifically to meet the investment needs of the Central Provident Fund (CPF) Board.

Source: National Authorities

43 With constraints on monetary policy, regional policymakers should recalibrate targeted macroprudential policy measures to safeguard financial stability and support growth. Where monetary policy may not be available as a policy tool, for example in dollarized economies such as Cambodia, greater reliance has to be placed on appropriate macroprudential policies. Macroprudential policies have been a useful complement to, but not a substitute for broader macroeconomic policy adjustments. Macroprudential measures such as loan-to-value (LTV) limits, debt servicing ratios (DSR) and single borrower limits (SBL) have helped to rein in excessive build-up of debt and contain potential systemic risks to the financial sector, and can continue to be applied where appropriate. However, with rising interest rates, it may be timely to recalibrate the measures to provide support to the property markets where appropriate.³⁸ Similarly, in the banking sector, countercyclical capital buffers that were introduced in some regional economies, along with prudential supervision of the financial sector, should be reviewed.

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.

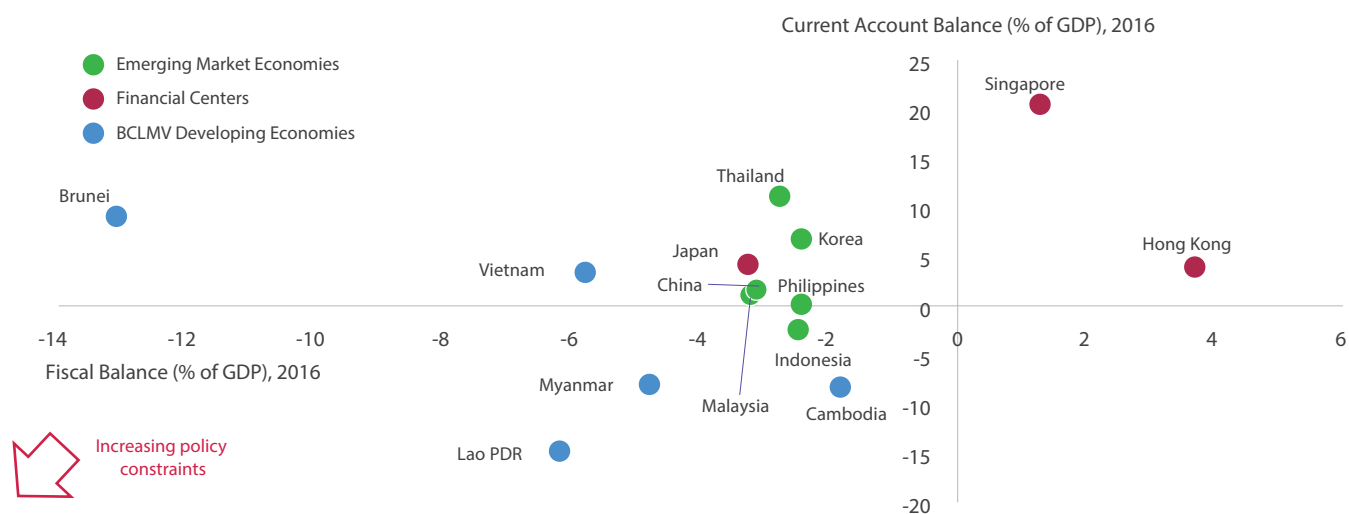
44 As global monetary conditions are likely to tighten, rising U.S. Treasury yields will pull up sovereign bond yields in the region and increase financing costs. In the region, sovereign bond yields have already increased in tandem with the recent sharp increase in U.S. Treasury yields,³⁹ suggesting that policymakers would need to prepare for higher borrowing costs and debt service burdens.

45 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. Figure 3.2 plots ASEAN+3 economies along two dimensions: current account balance as a percentage of GDP on the vertical axis, and fiscal balance as a percentage of GDP on the horizontal axis. The financing constraints would increase for economies as they move towards the lower bottom left, that is, for economies having to finance both a current account and a fiscal account deficit.

³⁸ During the period of unconventional monetary policies by major advanced economies, emerging markets in the region have been actively using targeted macroprudential policy measures in order to safeguard financial stability, which have generally been effective. In an environment of rising global interest rates, regional policymakers are now confronted with a challenge of normalizing/unwinding some of the earlier set of macroprudential policy measures.

³⁹ The U.S. long-term rate affects both the global benchmark yield and global investor risk appetite, which are important determinants of the pricing of bonds issued by emerging economies in local and global markets. With the growing foreign participation in regional economies' (local currency) sovereign bond market, the sensitivity of the longer end of the yield curve to global factors has increased.

Figure 3.2 Economies running “twin deficits” face the most constraints in using fiscal policy



Notes: Data for Cambodia, Lao PDR and Myanmar include grants. Korea's fiscal balance refers to the adjusted balance, which exclude Social security funds (SSF)
Sources: National Authorities, AMRO staff estimates

46 Regional economies with lower public debt and stronger external positions can consider maintaining a moderate pace of fiscal expansion. In China, Korea, Hong Kong, Singapore and Thailand, considering the relatively ample fiscal space; and the stronger external position, authorities can consider maintaining a moderate fiscal expansion to support short-term growth, while being targeted in their expansionary measures to incentivize the acceleration of structural reform agenda. In the event that growth falters, a more expansionary fiscal stimulus could be considered, provided it is framed within a credible medium-term consolidation plan.

47 In some regional economies, expansionary fiscal spending has to be funded by revenue increases, given the constraints posed by their fiscal rules (Indonesia and the Philippines). While some economies have already started to implement revenue-raising reforms or to reprioritize expenditure, these efforts may need to be enhanced. First, fiscal space may be capped by a policy objective not to further increase the debt-to-GDP ratio (such as in Malaysia and Vietnam). Even if there is no change in the fiscal policy stance, exchange rate depreciation can inflate the debt-to-GDP ratio. As a result, authorities may adopt a more cautious attitude about running a large primary deficit. Second, even if the debt-to-GDP ratio is relatively low (such as in Indonesia

and the Philippines), binding fiscal rules—for example where the central government budget deficit is capped at 3 percent of GDP—can limit the fiscal stimulus. Third, in some economies with relatively ample fiscal space, fiscal prudence is considered a national objective, and the authorities tend to be fiscally conservative, by slowing down expenditures in the event of larger than expected revenue shortfalls.

48 In economies where fiscal positions are expected to remain weak, reprioritizing and rebalancing existing expenditure programs should be the first steps pursued. Such a fiscally neutral approach focusing on improving efficiency and effectiveness can support growth without significant additional fiscal resource requirements. Several economies have taken steps towards revenue-neutral or revenue-enhancing reforms. In particular, in the smaller ASEAN economies (Cambodia and Myanmar), where the “twin” deficits reflect the stage of their economic developments, the policy priority would be to continue with fiscal consolidation and expenditure reprioritization/rebalancing, as economic growth remains relatively robust. In these economies, external financing is mostly in the form of long-term concessionary or bilateral loans from multilateral development banks or sovereign governments, which are relatively stable.

On balance, the recommended policy mix would be to hold monetary policy at current settings to preserve room to deal with a tightening in global monetary conditions, while using fiscal policy, where there is space, to support growth.

49 The policy mix for each ASEAN+3 economy would depend on the need for policy stimulus relative to where it is in the growth cycle, as well as available monetary and fiscal policy space. In terms of monetary policy, while the general recommendation is to hold monetary policy at current settings, economies where high credit growth has been a concern (Cambodia, Lao PDR, Myanmar and Vietnam) may need to adopt more targeted policies — for example, macroprudential measures, and tighter monetary policies. Similarly, for fiscal policy, while the general recommendation is to pursue expansionary fiscal policy where there is room, economies that have had challenges in fiscal revenue due to external shocks (Brunei and Malaysia) may need to prioritize implementation of fiscal consolidation plans. In calibrating these macroeconomic policies, effective and clear policy communication by the authorities is key in helping to bolster policy efficacy through influencing market expectations.

50 Given the limitations of short-term demand management policies, there is an urgent need for policymakers to accelerate the structural reform agenda. With global trade slowing down and policy space constrained, accelerating structural reform agenda is critical to maintain and enhance the economy's growth potential. Policy priorities are to enhance productivity and efficiency to maximize output from existing resources, while concurrently removing obstacles that impede growth such as through further deregulation, streamlining of administrative processes, improving soft and hard infrastructure, strengthening public sector management and legal capacity as well as strengthening revenue collection and administration to reduce the cost of doing business. Easing labor market regulations can increase flexibility in the labor market, such as encouraging flexible work hours, further promoting female participation in the workforce, and creating more regular jobs and opportunities for young adults. Policy commitment to these supply-side policies is critical to enhancing growth potential and economic resilience.