Highlights

Macroeconomic Prospects and Challenges

We expect the ASEAN+3 region to remain resilient despite the balance of global risks shifting to the downside with stronger headwinds for emerging economies. The maturation of business cycles in the G3 economies, the cyclical slowdown in tech and capex spending, and the ongoing uncertainties from trade frictions suggest that global growth drivers are likely to moderate over the course of 2019–2020. For the more open and trade-dependent economies, the drag from weaker external demand could become more evident. However, most ASEAN+3 economies have worked hard to strengthen their fundamentals; and most are in the mid-phase of the business cycle, where growth is near their respective long-term trends with output gaps close to zero, and inflation within policy targets or at around their long-run trend. Although policy space has narrowed for most, policymakers should still be able to utilize various levers and accumulated buffers to mitigate headwinds and manage uncertainties brought about by macroeconomic interdependencies.

Markets experienced renewed volatility in the second-half of 2018, largely as a result of global trade uncertainties. The combination of higher borrowing costs and U.S. dollar appreciation contributed to financial stress in emerging markets, especially those with structural vulnerabilities, which intensified risk aversion and their sell-off in emerging markets. The tightening in global financial conditions was felt strongly in Asia, in particular, by Indonesia and the Philippines, which saw their borrowing costs rise sharply. Capital outflows from the region totaled USD 6 billion in September and October as foreign investors liquidated their portfolios.

Recent monetary policy pivots in the major economies should ease the pressure on capital outflows from the region. At the turn of 2019, weakening economic indicators and expectations of a broad-based slowdown in the global economy (including in China) further unsettled markets. The about-face by the U.S. Federal Reserve and the European Central Bank—which had been on a normalization path—also had the unintended effect of confirming fears over a synchronous global economic slowdown, leading to further market volatility. Going forward, however, the easing in global financial conditions should be supportive for growth as long as policy directions are well-signaled and markets are not constantly caught by surprise.

Our baseline is that the ASEAN+3 region will grow at only a slightly slower pace in 2019–2020, compared to 2018, but with higher uncertainty over the growth trajectory. Notwithstanding the softer outlook, the underlying prospects of the region remain solid. Baseline regional growth is projected at 5.1 percent in 2019–2020 (5.3 percent in 2018) taking into account the estimated short-term impact from the trade protectionism measures that have been implemented so far. Headline inflation is expected to be stable at around the 2 percent level relative to 2018. We have revised China's growth forecast upwards, to 6.3 percent (compared to 6.2 percent in January 2019) for 2019, and 6.2 percent for 2020. Japan's growth is forecast to remain at 0.6 percent for the 2019 fiscal year before moderating to 0.5 percent in fiscal year 2020. Our growth forecast for the ASEAN region is maintained at 5.1 percent, picking up slightly to 5.2 percent in 2020.

The region will undoubtedly be tested amid growing headwinds from slowing global trade. Uncertainties surrounding trade remain high, and the risk of further escalation in trade tensions frictions cannot be discounted despite the reported progress made in the Sino-U.S. trade negotiations. The risk transmission from trade protectionism to the region would mainly be through exports and global value chains, which could be amplified by second-order effects as global growth slows. Regional economies with larger direct export exposures to China, as well as indirect ones via global value chains that are oriented towards demand outside the region, would be significantly more affected in the short-term. Highly open and trade-dependent economies such as Hong Kong, Korea, Malaysia, Singapore and, to some extent, Vietnam, are particularly vulnerable.

Our adverse scenario envisions an equal tit-for-tat escalation in trade tensions resulting in a 0.4 percentage point hit to the region's baseline growth. In this extreme situation, both the United States and China would impose tariffs of 25 percent on all imports between the

two countries. In the short-run, the estimated impact on growth for a particular economy in the region would be larger in absolute terms, of up to -1.0 percentage point. Not surprisingly, both the United States and China would stand to lose, and more so if additional non-tariff measures were to be implemented. The absolute impact would be relatively smaller for the United States (-0.3 percentage point) over the over 2019–2020 period, compared to China (-0.6 percentage point), but the relative impact would be larger for the former (13 percent of 2019–2020 average growth) relative to the latter (below 10 percent).

There is little room for complacency on the policy front, given that downside risks have become more pronounced. Some members have adopted pre-emptive or frontloaded policy measures that have helped assuage market concerns. In some economies, monetary policy has been tightened to maintain external and domestic price stability and to stem the build-up of risks to financial stability from a protracted period of low interest rates. Other measures, such as the suspension of import-intensive infrastructure projects, have also been undertaken to ease pressure on the current account. On the fiscal front, sound public finances have allowed fiscal policy to play a limited but crucial countercyclical role. Members have either adopted more expansionary policies or, where fiscal rules are binding, reprioritized expenditures, even as fiscal space has generally narrowed across the region. After coming off a period of above-trend growth, buoyed by easy global financial conditions, several regional economies are now in the slowing phase of the credit cycle and some have eased macroprudential measures to support lending activities.

For the medium- to longer-term, more needs to be done to support the region's growth prospects and foster resilience. In particular, they include building productive capacity and connectivity, and deepening domestic capital markets. The region as a whole has prospered over the past two decades, with the "manufacturing for export" strategy as the main pillar in most countries. However, the transformation to services is inevitable and the issue of investment in the requisite areas to generate and sustain growth will need to be addressed.

Theme: Building Connectivity and Capacity for the New Economy

Building capacity and connectivity will be a priority for the ASEAN+3 region as they embrace the "new economy" and embark on the next phase of their growth trajectory. The region as a whole has prospered in the past two decades, with the "manufacturing for growth" strategy as the main pillar in most countries. While the move up the technological frontier has been and will continue to be uneven, the transformation to services is inevitable, and will require a rethink of what capacity means, and what connectivity is needed. One key theme that is emerging is that underinvestment—if not addressed—will impinge on growth. The 2019 thematic chapter builds on the AREO 2017 narrative of economic consolidation and rebalancing in the region after the Asian Financial Crisis, and the AREO 2018 message of resilience and growth.

Three key drivers will shape capacity and connectivity priorities in the region over the short- to medium-term. First, the technological or Fourth Industrial Revolution (4IR) has led to automation, deindustrialization and the rise of the services sector. Second, maturing populations and a rapidly growing middle-class will underline the shift to more labor-saving, skills- and knowledge-based productive capacity, and spur intra-regional demand for consumer goods and services, including enhanced living spaces and new or reconfigured services, and the need for better connectivity. Third, western protectionism, coupled with growing regional affluence and final demand, will exert both push and pull on regional integration.

Developing economies, especially emerging markets, face complex challenges in investing for the long-term in areas that are not themselves self-financing. They include public infrastructure, human capital, and other intangibles that boost national productivity. Rapid economic growth in the ASEAN+3 region will generate new infrastructure demand and magnify the projected investment shortfall. Consequences of climate change put countries with weak infrastructure at higher risk of lower growth.

Three key gaps to capacity and connectivity are identified, namely, funding, foreign exchange and factors gaps. The "funding gap" is the shortfall between what is required for domestic investment (including public infrastructure) and what is available from domestic savings. The "foreign exchange gap" describes the financing constraint that emerging market and developing economies face because of the need to mitigate the risks of sudden capital outflows by accumulating large foreign exchange reserves. The "factors gap" captures the non-financial constraints. The ability to carry out infrastructure projects (when financing has been secured) hinges on effective project management, availability of requisite manpower, and the expertise and technology employed.

To bridge the gaps, there is a need to leverage on intra-ASEAN+3 investment, and rely on the regional financial safety net, while developing professional expertise, technology and institutions. There is scope for more long-term investments from ASEAN+3 economies to enhance capacity and connectivity across the region. ASEAN+3 emerging markets should also continue to benchmark against the best practices of the advanced countries, which remain the main drivers of investment in technology transfers and transitioning to the "new economy" for the region. The Chiang Mai Initiative Multilateralization is a regional public good that provides a financial safety net for ASEAN+3 economies. The diversity in the levels of development of human capital, expertise and technology in ASEAN+3 economies provides scope for closer cooperation and collaboration to meet the factors gap in the regional economies while optimizing the deployment and returns to the region's scarce resources. In particular, the region should push ahead with the various initiatives for closer regional integration and connectivity.