1 The International Economy

Firmer US Growth will Provide an Uplift to Asia

Global growth picked up in Q2 2014 after a weak start to the year, as a rebound in the US helped lift exports from Asia ex-Japan. However, the Eurozone's fragile recovery stalled in Q2, after sluggish growth in the previous quarter. At the same time, the output contraction in Japan, precipitated by the consumption tax hike, was steeper than initially anticipated. Amid divergences in individual country performances, the G3 as a whole is poised for a modest upswing, while Asia ex-Japan is also on a moderate expansion path as the domestic headwinds that held back growth in H1 2014 begin to fade. Overall, global growth is expected to rise from 4.0% in 2014 to 4.4% in 2015. (Table 1.1)

Beyond the next few quarters, there is concern that some of the advanced economies may be at risk of slipping into a period of sustained sub-par expansion, due to less favourable demographics, lower productivity growth and higher structural unemployment. With monetary policy constrained by interest rates at the zero lower bound, this outcome can still be avoided by appropriate fiscal and supply-side policies, which include tax reforms and measures to increase labour market flexibility.

Slower growth in the advanced economies implies that demand for Asia's exports will not be as robust as before the Global Financial Crisis (GFC). Therefore, the medium-term prospects for this region will hinge on the success of structural reforms to lift productivity growth and rebalance demand towards domestic sources. China and India have taken encouraging steps in this direction. Meanwhile, the outlook for the ASEAN economies remains positive in view of their intrinsic strengths, including a large labour pool, abundant natural resources and integration into global production and trade networks. As the region's wealth and incomes rise, the Asian consumer will increasingly become an important driver of global growth.

Table 1.1
Global GDP Growth

(%)

	Q1 2014	Q2 2014	2014F	2015F
	q-o-q SAAR		y-o-y	
Total*	**2.7**	**3.9**	**4.0**	**4.4**
G3*	**0.6**	**0.4**	**1.5**	**2.0**
US	−2.1	4.6	2.2	3.1
Japan	6.0	−7.1	1.1	1.2
Eurozone	0.9	0.1	0.8	1.2
NEA-3*	**2.2**	**1.3**	**3.0**	**3.3**
Hong Kong	1.1	−0.6	2.3	3.0
Korea	3.8	2.0	3.5	3.7
Taiwan	2.5	3.9	3.6	3.6
	y-o-y			
ASEAN-4*	**4.6**	**4.9**	**4.8**	**5.3**
Indonesia	5.2	5.1	5.2	5.6
Malaysia	6.2	6.4	5.7	5.2
Philippines	5.6	6.4	6.3	6.3
Thailand	−0.5	0.4	1.3	4.3
China	**7.4**	**7.5**	**7.3**	**7.1**
India**	**4.6**	**5.7**	**5.6**	**6.3**

Source: CEIC, Consensus Economics and EPG, MAS estimates
* Weighted by shares in Singapore's NODX.
** Refers to fiscal year ending March.

1.1 G3 Economies

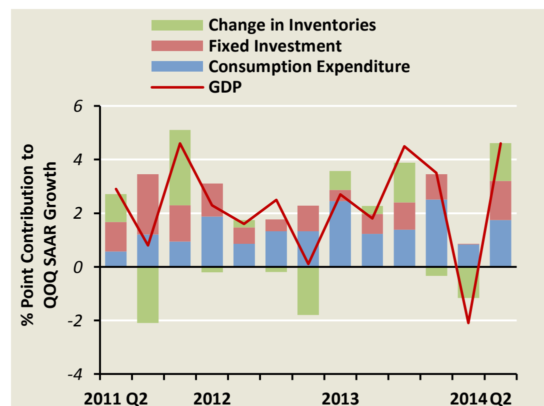
Divergence in Growth and Prospects

Economic activity in the G3 continued to pick up in Q2 2014, largely supported by a rebound in the US economy. In comparison, Europe and Japan posted much weaker performances. This divergence within the G3 will become more apparent in H2 2014. The US has advanced furthest in its recovery from the GFC, as evident from the steady improvement in its labour market and a quickened pace of corporate and residential investment. Eurozone growth has been held back by weak credit expansion and poor business sentiment, even as rising deflationary risks are compelling the ECB to ease monetary policy aggressively. Japan's near-term prospects are also less certain, with private spending yet to show visible signs of recovery in early Q3. Structural reforms in the Eurozone and Japan need to proceed faster in order to unshackle businesses, raise economic efficiency and stimulate investment. On balance, GDP growth in the G3 as a whole is projected to rise from 1.5% in 2014 to 2.0% in 2015.

US growth is expected to rise above trend in the near term.

The US economy expanded by a robust 4.6% q-o-q SAAR in Q2 2014, bearing out the expectation that the contraction of 2.1% in Q1 was transitory. Private domestic demand contributed 4.6% points to overall growth in Q2, as spending on household durables grew at its fastest pace since 2009 and gross investment rebounded after contracting in the previous quarter. (Chart 1.1) Non-residential fixed investment increased by 9.7% q-o-q SAAR, providing firmer signs of an upturn in the capex cycle. Equipment spending rose by 11.2% q-o-q SAAR in Q2, bringing its share of GDP to 6.3%, compared with a pre-GFC average of 5.4%. Residential investment also recovered, following two quarters of decline, suggesting that the housing recovery is proceeding apace. In contrast to preceding quarters, fiscal policy added to growth in Q2, with the increase in government spending accounting for 0.3% point.

Chart 1.1
Contribution of Private Domestic Demand to US GDP Growth



Source: CEIC

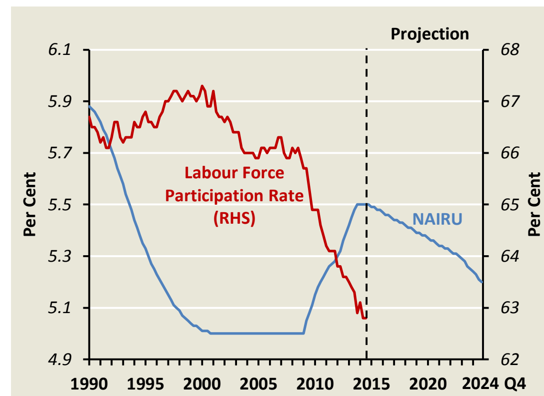
Looking ahead, leading indicators point to above-trend GDP growth in H2 2014. The PMIs for both the manufacturing and services sectors are firmly in expansionary mode, having pushed past multi-year highs in Jul–Aug, although they pulled back slightly in September. Consumer confidence surveys indicate that household demand will be sustained, as firm employment and improving incomes lift sentiment. Following a hiatus in August, when just 180,000 jobs were added to the labour market, non-farm payrolls rose by 248,000 in September, pushing the unemployment rate down to 5.9% from 6.1%. As firms increase hiring, they are also likely to ramp up

investment in machinery and software, especially with capacity utilisation nudging close to pre-crisis levels. Moreover, with increasing take-up in cloud computing, info-communications equipment spending will have further scope to grow. Overall, US GDP growth is projected to come in at 2.2% in 2014, before accelerating to 3.1% in 2015.

Although near-term economic prospects for the US have improved, concerns regarding the longer-term outlook remain. The labour force participation rate (LFPR), which has been on a declining trend since the early 2000s, has fallen at a faster pace after the financial crisis. (Chart 1.2) The US Council of Economic Advisers has estimated that about half of the decline was due to an ageing population, with another one-third due to weak aggregate demand. At the same time, the risk of hysteresis in the labour market has risen, with an elevated number of long-term unemployed workers. Although the LFPR is expected to recover alongside the cyclical pickup in the economy, the non-accelerating inflation rate of unemployment (NAIRU) is expected to stay above the pre-crisis level for some time. (Chart 1.2) Moreover, on the productivity front, future gains may be restrained by a slower rate of technological innovation. These factors would serve to lower the US' potential growth rate, with a number of estimates suggesting that it has fallen to about 2.0% presently, compared to an average of 3.5% from 1950 to 2006. (Chart 1.3)

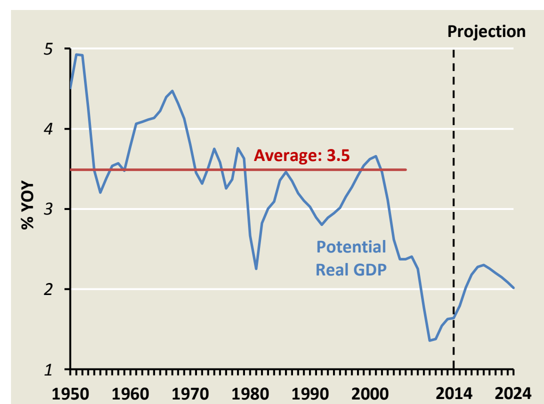
These difficulties could be addressed by policy reforms targeted at raising potential growth. Tax policies could be enhanced to boost the competitiveness of US firms, while increased government spending on infrastructure could crowd-in private investment. At the same time, new education and training programmes are needed to raise workers' skills and employability. Taken together, these measures can help spur a manufacturing revival in the US economy, which is already benefiting from lower energy costs due to the shale gas revolution. Between 2006 and 2010, increased availability of natural gas led to a fall of 11% in average energy prices for manufacturers. (Chart 1.4) Concomitantly, chemical companies that are large users of ethane have ramped up investments. Alongside rising R&D spending—currently averaging 2.8% of GDP—these developments could reverse the recent trend of slowing productivity growth.

Chart 1.2
US Labour Force Participation Rate and NAIRU



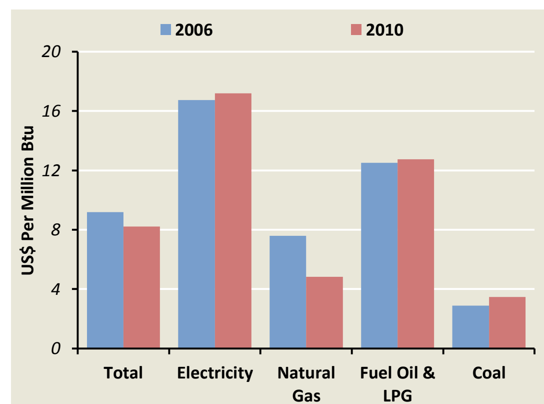
Source: Bureau of Labour Statistics and St Louis Fed FRED

Chart 1.3
US Potential GDP Growth Projections



Source: St Louis Fed FRED

Chart 1.4
Energy Prices for US Manufacturers



Source: US EIA

Eurozone growth faltered in Q2.

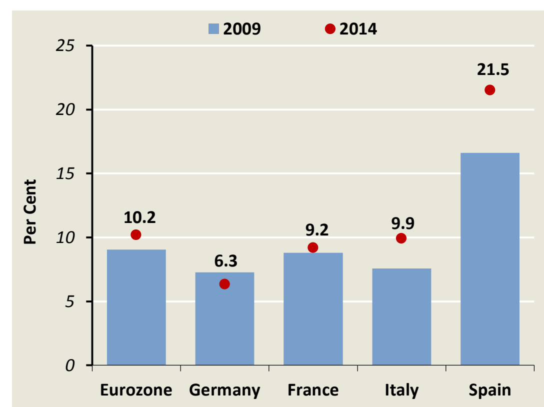
After growing by 0.9% q-o-q SAAR in Q1 2014, the Eurozone economy posted a marginal expansion of 0.1% in Q2. Germany surprised with a contraction of 0.6%, reflecting a loss of cyclical momentum after an exceptionally strong Q1. Growth in France and Italy failed to gain traction, as the patchy implementation of structural reforms kept domestic demand subdued. While the smaller economies of Spain and Portugal grew faster, this was insufficient to offset the weak performance of the larger Eurozone economies.

Weighed down by uncertainties associated with geopolitical tensions over Ukraine, the outlook for the Eurozone is envisaged to improve only gradually. Consumer spending should provide some support, as lower energy and food prices boost real disposable incomes. However, the recent declines in inflation and GDP growth have accentuated fears that the monetary union could be stuck in a prolonged period of sub-par growth and low inflation. Even with nominal interest rates at close to zero, real interest rates have continued to rise as inflation remains extremely low. In turn, high real rates will hinder the return to full employment and the increase in capacity utilisation. Alongside elevated unemployment rates, estimates of structural unemployment in many Eurozone countries have crept up over the past five years, and may result in a lower potential growth rate. (Chart 1.5)

In a bid to rekindle bank lending and boost economic activity, the ECB had recently committed to purchase covered bonds and asset-backed securities, as well as to provide banks with funding at concessionary rates through targeted longer-term refinancing operations. While these measures may be helpful in easing financial conditions at the margin, their effectiveness in kick-starting growth remains to be seen. According to the *ECB Bank Lending Survey*, liquidity constraints are no longer inhibiting bank lending. (Chart 1.6) Instead, bank lending is being held back by subdued credit demand, especially by small- and medium-sized firms. Given these constraints, growth in the Eurozone is forecast to come in at a modest 0.8% this year, before picking up to 1.2% in 2015.

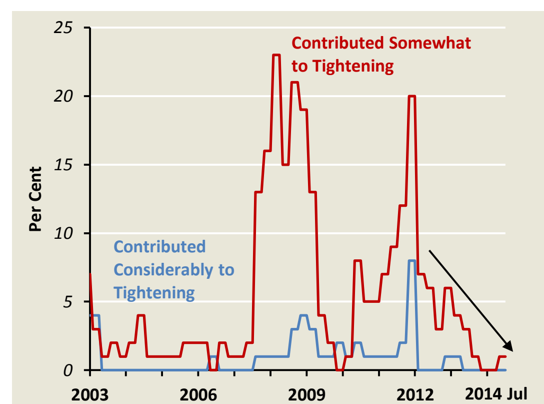
Structural reforms would help revive investment and narrow the output gap, while boosting potential growth and productivity in the medium term. However, progress has been uneven so far. Spain and Portugal have made considerable headway in

Chart 1.5
Structural Unemployment in Selected Eurozone Economies



Source: OECD

Chart 1.6
Share of European Banks Citing Liquidity Constraints



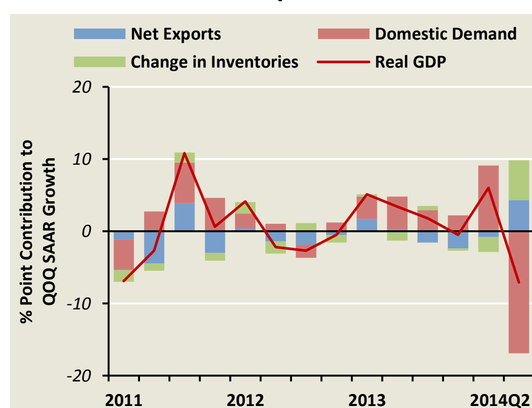
Source: ECB

reforming the labour market, enhancing domestic competition and cutting administrative burdens. These measures have contributed to a stronger rebound in the periphery more recently. Conversely, reforms have been slower to take off in France and Italy, although the recent passage of new labour legislation in the latter should inject much needed flexibility into the job market. In France, the new reform-minded government has promised to roll back the 35-hour work week, cut the top income tax rate of 75% and extend shopping to Sundays.

Japan's economy pulled back more than anticipated in Q2, but a return to growth is envisaged.

Japan's GDP contracted by 7.1% q-o-q SAAR in Q2 2014 following a greater than anticipated retraction in consumption and investment, thus more than offsetting the 6.0% gain in the previous quarter. (Chart 1.7) Net exports supported growth, although this was chiefly due to a cutback in imports. As of Jul–Aug, private spending growth had not reverted to its pre-tax hike pace, while industrial production was hampered by an inventory overhang from Q2. Nonetheless, the continued rise in nominal wages in recent quarters may portend a stronger recovery in household consumption. Meanwhile, business fixed investment is expected to increase, underpinned by healthy corporate profits. On the whole, GDP growth is anticipated to come in at 1.1% in 2014 and 1.2% in 2015.

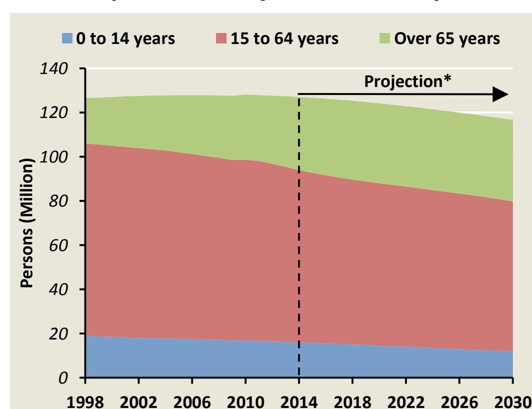
Chart 1.7
Contribution to Japan's GDP Growth



Source: CEIC

Japan's prospects for a sustained increase in GDP growth and an escape from deflation depend greatly on the ability to raise productivity growth, given the continued shrinking of the labour force due to an ageing population. (Chart 1.8) In this regard, the government has released details of its "Japan Revitalisation Strategy" aimed at enhancing economic competitiveness and raising the potential growth rate. Proposed measures include cuts in the corporate tax rate, regulatory reforms, as well as labour market reforms which include measures aimed at boosting the female LFPR. The establishment of the National Strategic Special Zones will help firms to bypass the tight regulatory environment, while the opening up of selected industries will also boost profitability and productivity. Effective implementation of these initiatives will be crucial to entrench the recovery of the economy.

Chart 1.8
Population Projections For Japan



Source: CEIC and National Institute of Population and Social Security Research

* As of January 2012.

1.2 Asia

Growth will Pick Up Modestly in 2015

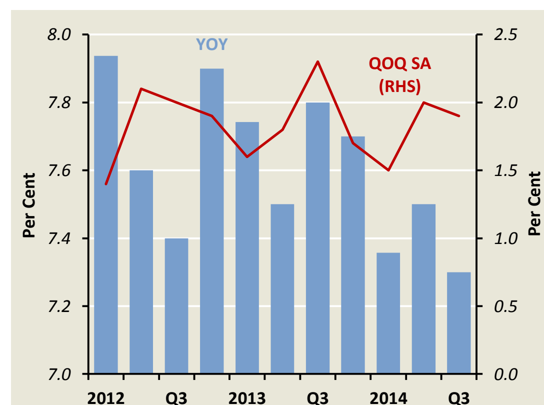
Growth in Asia ex-Japan was resilient in Q2 2014, partly underpinned by stronger US demand. The trade-oriented economies, such as Korea, Taiwan and Malaysia, registered larger increases in exports, and will continue to benefit from the gradual firming of G3 growth. In other countries, notably India and Thailand, domestic demand softened over H1 2014, which indirectly bolstered growth through import compression. However, the idiosyncratic factors that dampened domestic activity in these countries seem to be dissipating. Going into 2015, overall economic activity will strengthen, supported by stable domestic demand, as well as improving exports to the G3 and the region. China is the exception, where slackening domestic spending and a property market downturn are posing downside risks to the region as a whole. In addition, an earlier-than-expected rise in US interest rates could lead to a further tightening of financial conditions in Asia and slower growth than currently anticipated.

China's economy slowed on tepid domestic demand and a property market downturn.

The Chinese economy decelerated in Q3 2014 after gaining momentum in the previous quarter on the back of modest stimulus measures. Earlier in Q2, China's GDP growth had edged up to 7.5% y-o-y, from 7.4% in Q1. This was driven by a rise in exports and a surge in stimulus-driven infrastructure investment, which helped to offset a slowdown in real estate and manufacturing fixed asset investment. However, in Q3, as the effects of earlier fiscal support started to fade, China's GDP growth declined to 7.3% y-o-y. (Chart 1.9) Exports rose faster in Q3, but this was more than offset by muted domestic demand. Amid an intensifying property downturn, residential floor space sold shrank by an average of 14% y-o-y in Q3, which had knock-on effects on China's industrial production, especially in cement and steel. (Chart 1.10) In September, 69 out of the 70 Chinese cities tracked by official data experienced m-o-m declines in new home prices, compared with six cities in January.

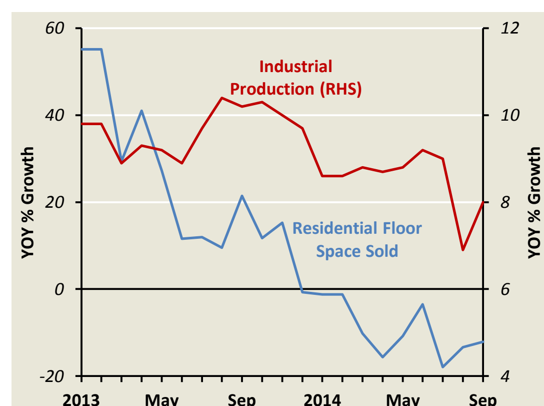
To arrest the growth slowdown, the authorities have recently reversed some property curbs, while providing additional liquidity to the banking system. The official PMI for September was unchanged from the previous month with a reading of 51.1, suggesting muted activity ahead. Given the significant spillovers from the construction sector to heavy industry, and the impact which downstream inventory de-stocking has on upstream sectors, property sales will have to trough before industrial production can recover. Nevertheless, policymakers are expected to continue to support GDP growth in a measured and targeted manner,

Chart 1.9
China's GDP Growth



Source: CEIC

Chart 1.10
China's Industrial Production and Sales of Residential Floor Space



Source: CEIC

while implementing structural reforms. According to consensus forecasts, China's GDP growth is expected to slow to 7.3% this year, before sliding further to 7.1% in 2015.

A decisive election result in India has boosted sentiment in the near term.

In a tentative sign of recovery, the Indian economy grew at its fastest pace in 10 quarters in Q2 2014, by 5.7% y-o-y, up from 4.6% in the previous quarter, boosted by a manufacturing upturn and stronger government spending. (Chart 1.11) Manufacturing output grew by 3.5% y-o-y, following two quarters of contraction. Meanwhile, spending on community, social & personal services rose strongly by 9.1% in Q2, from 3.3% the quarter before, as the new financial year accorded the government greater flexibility to spend. From the expenditure perspective, gross fixed capital formation posted robust growth of 7.0% y-o-y in Q2—the best performance since Q1 2012—in part due to faster project approvals by the authorities.

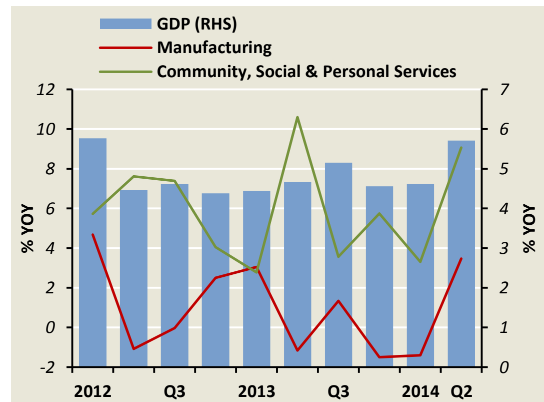
Looking ahead, a gradual economic recovery is expected to take hold in India, as initiatives by the new Modi government have lifted sentiment and reduced policy uncertainty. The administration has focused on securing macroeconomic stability by committing to medium-term fiscal consolidation, while making a concerted push to revive productive investment. Recent indicators have signalled a revival in domestic activity and Indian exports will also benefit from increased final demand in the advanced economies. (Chart 1.12) Taking these into consideration, India's GDP growth is expected to rise to 5.6% in FY2015, before strengthening further to 6.3% in FY2016.

Structural reforms in China and India will lift growth in the medium term.

Beyond the immediate quarters, there are reasons to be cautiously optimistic about the growth outlook for emerging Asia's two largest economies, China and India. Both have embarked on structural reforms under new administrations that, if successful, would bring about stronger productivity gains and hence, higher potential growth in the medium term.

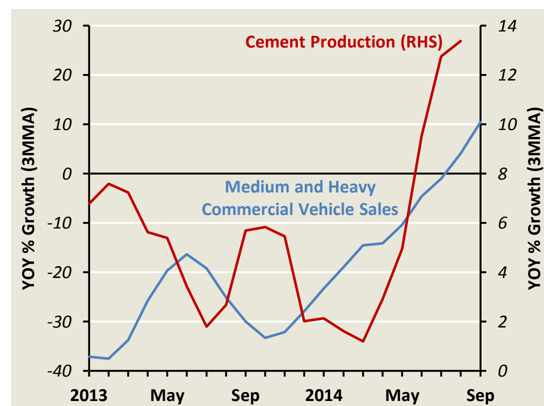
In China, the authorities have set out to reshape the economy by implementing the ambitious reforms unveiled at the Third Plenum meeting in November

Chart 1.11
India's GDP Growth



Source: CEIC

Chart 1.12
India's Vehicle Sales and Cement Production

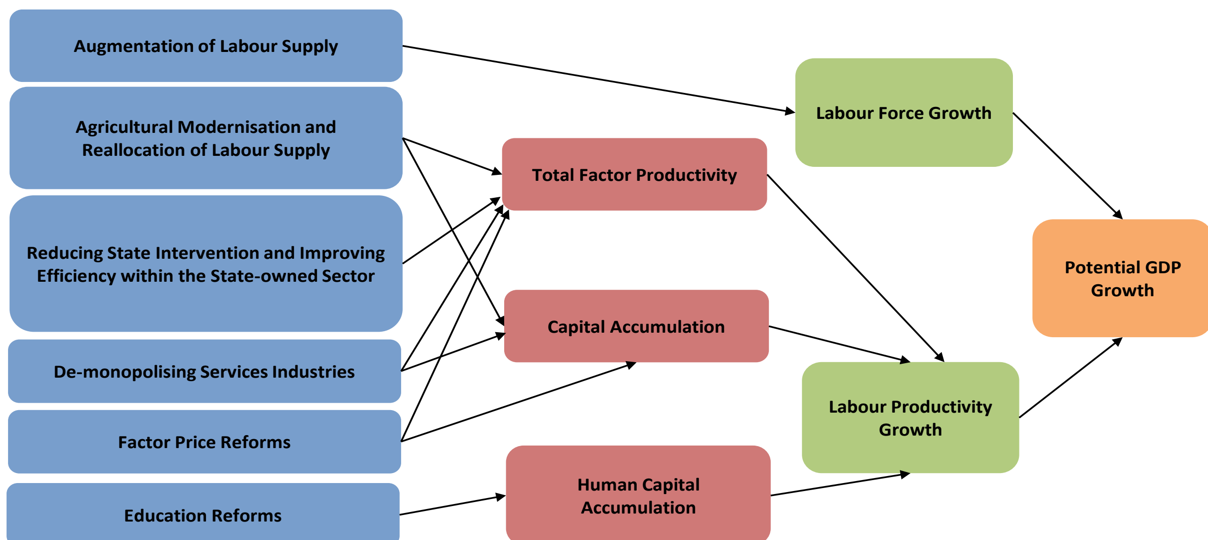


Source: CEIC

last year. The key reforms involved granting market forces a greater role in resource allocation, lowering entry barriers to most industries, increasing the size of the labour force and raising its quality. Reforms to reduce government intervention in the economy and raise efficiency within the state sector will provide a fillip to TFP growth. Measures to open up the services industries to more competition and introduce market-determined factor prices will not only bolster TFP, but spur capital deepening by raising the returns on fixed investments. Coupled with education reforms to boost human capital, the reforms taken as a whole would serve to raise China's potential GDP growth in the medium term. (Figure 1.1)

Thus far, Chinese policymakers have made encouraging progress on a number of fronts. Notably, they have made sweeping changes to the *hukou* (household registration) and fiscal systems, while vigorously cutting administrative procedures and freeing up factor prices. In addition, the authorities announced in March that they will allow the establishment of five privately-owned banks, with plans for more. This development is instrumental to fostering greater competition in the Chinese financial sector and represents a credible start to service sector deregulation.

Figure 1.1
Impact of China's Reforms on Growth

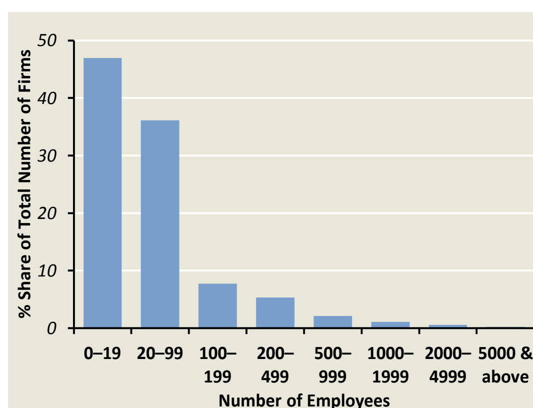


At the same time, the Indian government has announced its intention to increase the share of manufacturing in GDP to 25% by 2022, from 13% at present. Accordingly, Prime Minister Modi launched a "Make in India" campaign in September, with the key thrust being to improve the ease of doing business in

the country. To date, the new administration has taken measures to remove bureaucratic impediments and improve accountability, which should enhance conditions for businessmen looking to invest in India. However, the country's heterogeneity suggests that some states would be more amenable to the development of export-driven manufacturing industries than others. In particular, states with more reliable power supply, better developed infrastructure and proximity to the sea should have an advantage, as well as areas located along the planned Dedicated Railway Freight Corridor stretching from New Delhi to Mumbai.

The success of the manufacturing initiative is also conditional on labour and land reforms, which could encounter resistance at the state level. At present, a host of well-intended labour laws have inadvertently limited the size of Indian firms and hindered the development of the manufacturing industry. (Chart 1.13) Thus far, states have proceeded with labour reforms at a varied pace, but the early movers could be the first to gain from the manufacturing push. If the required changes can be effected, India may be able to realise its comparative advantage of an abundant supply of labour and lift its medium-term growth rate.

Chart 1.13
Size of Firms in India

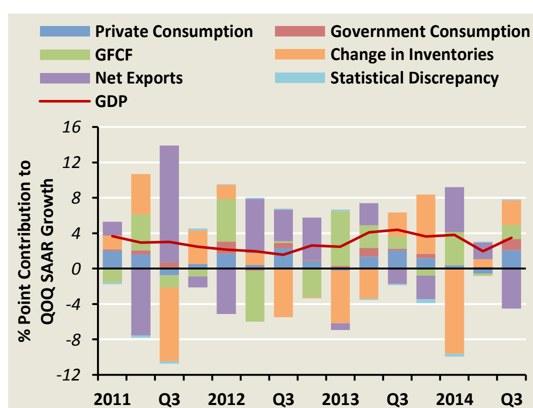


Source: *Annual Survey of Industries 2011–12*, Ministry of Statistics and Programme Implementation, Government of India

Strengthening global demand should lift economic activity in the NEA-3 economies.

Despite an upturn in overseas shipments, growth in the NEA-3 as a whole slowed in Q2 owing to persistent domestic headwinds in Hong Kong and Korea. The Hong Kong economy contracted by 0.6% q-o-q SAAR, as political uncertainty and a cutback in spending by mainland Chinese tourists took a toll on retail sales and the hospitality industry, while Korea's growth weakened alongside a fall in private spending amid downbeat sentiment following the Sewol ferry disaster. Nonetheless, consumption and investments in Korea recovered in Q3 on the back of pump-priming measures and a stabilisation in confidence. (Chart 1.14) Meanwhile, the Taiwanese economy continued to gain traction in Q2, expanding at a faster pace of 3.9% q-o-q SAAR, as the export-led recovery broadened to private consumption and investment.

Chart 1.14
Korea's GDP Growth



Source: CEIC

For the rest of 2014 and into 2015, a modest recovery in the global economy and the launch of new consumer IT products should underpin economic activity in the region. In Korea, domestic demand should be bolstered by further monetary easing, although lower

borrowing costs could exacerbate already high levels of household debt. The outlook for Hong Kong is dependent on the lifting of political uncertainty, but growth for 2014 is likely to be subdued. All in, GDP growth for the NEA-3 is projected to rise to 3.0% this year, and further increase to 3.3% next year.

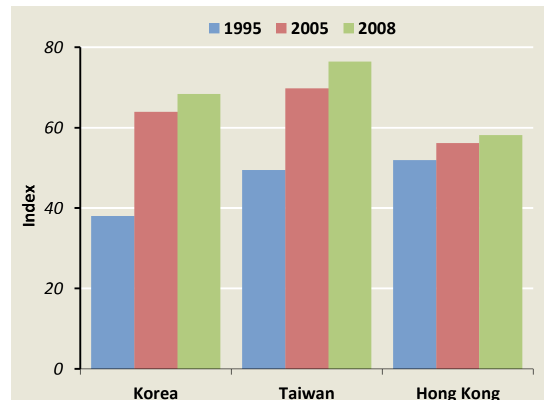
Over the longer term, the NEA-3 will continue to be important players in the global production network, as indicated by the OECD's Global Value Chain participation index, which measures the extent to which an economy is involved in vertically-fragmented production processes. (Chart 1.15) As with Hong Kong, Korea and Taiwan are likely to become even more integrated with the global and Chinese economies, as indicated by a recent expansion of free trade agreements between these economies and their key trading partners. Already, China is Korea's and Taiwan's biggest trading partner in terms of manufactured goods. Their trade in services with China is also poised to expand further with the internationalisation of the renminbi, the relaxation of Chinese tourist restrictions in Taiwan and the increasing popularity of Korea as a travel destination.

Firmer growth in ASEAN-4 will be supported by a moderate pickup in exports and resilient domestic demand.

The ASEAN-4 economies recorded firm growth of 4.9% y-o-y in Q2, reflecting a recovery in exports and severe import compression in some countries. (Chart 1.16) Malaysia and the Philippines both saw solid growth of 6.4% in Q2, as exports, particularly shipments of manufactured goods and oil products, expanded robustly in line with strengthening global demand. GDP growth in Indonesia, however, eased further to 5.1% in Q2, as the effects of past rounds of monetary policy tightening filtered through more strongly, leading to a slowdown in investment. Meanwhile, the Thai economy expanded marginally by 0.4% y-o-y in Q2, following a contraction in Q1. While the improvement was mainly due to a sharp pullback in imports, the stabilisation in private consumption also contributed to the turnaround in GDP growth.

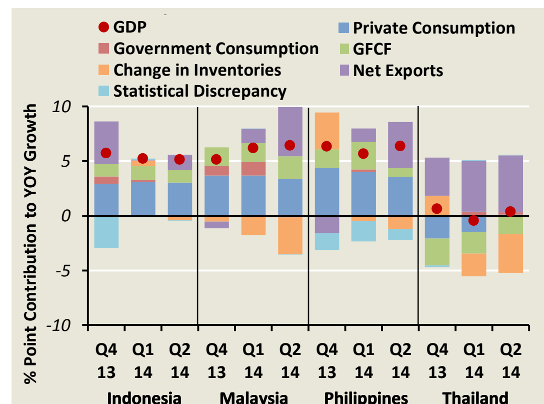
The export upturn in the ASEAN-4 is likely to be sustained over the next few quarters, although the extent of the recovery in countries such as Indonesia and Malaysia will be limited by soft commodity prices, given their relatively large exposure to primary products. (Chart 1.17) The pickup in exports will,

Chart 1.15
NEA-3 Global Value Chain Participation Index



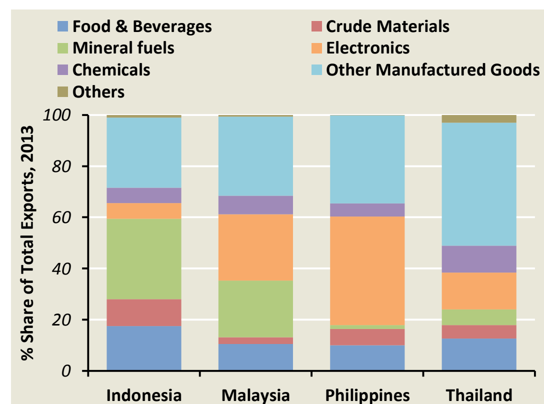
Source: OECD

Chart 1.16
ASEAN-4 GDP Growth by Expenditure



Source: CEIC and EPG, MAS estimates

Chart 1.17
Composition of ASEAN-4 Exports



Source: CEIC and EPG, MAS estimates

in turn, have positive knock-on effects on domestic demand, while investment will also be supported by infrastructure projects in Malaysia and the Philippines.

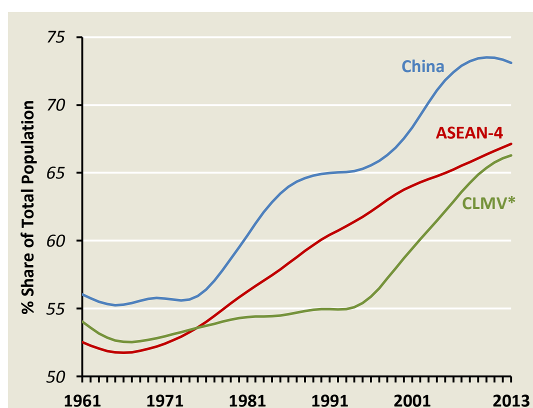
Nevertheless, most central banks in the region have already embarked on a tightening cycle in response to decreasing economic slack and subsidy rationalisation, which will have a further dampening effect on domestic demand. Bank Indonesia has hiked its policy rate by 175 bps since May last year, while the central banks of Malaysia and the Philippines have raised rates by 25 bps and 50 bps, respectively, over the past few months. Meanwhile, the Thai economy should see a strong rebound in domestic demand, as consumer and business confidence strengthens further and the government ramps up construction spending. On balance, GDP growth in the ASEAN-4 economies is expected to remain resilient at 4.8% this year, and rise to 5.3% in 2015, driven principally by the economic recovery in Thailand.

ASEAN's growth potential remains strong, given intrinsic strengths and deepening intra-regional trade and financial linkages.

ASEAN's longer-term prospects remain positive, due to several trends that are currently unfolding. First, the region is enjoying a favourable demographic profile, which has significantly boosted its supply of labour. (Chart 1.18) Second, countries such as Indonesia and Myanmar are richly endowed with natural resources, such as coal and natural gas. As such, there is much scope to both tap on these resources and to manufacture downstream products.

Third, ASEAN has benefited from increasing economic integration within the region and deepening trade linkages with the other Asian economies. Progress is being made towards the realisation of ASEAN Economic Community 2015 (AEC 2015), which aims to create a regional market with free flow of goods, services, investment, and skilled labour. The realisation of AEC 2015 is expected to substantially reduce trade costs and bring about welfare gains. According to a study by Petri *et al.* (2012), ASEAN's GDP as a whole would be 5.3% higher in 2015 with AEC 2015 than without it.[1] (Table 1.2) ASEAN is also well-positioned

Chart 1.18
Share of Working Age Population



Source: United Nations and EPG, MAS estimates

* CLMV countries include Cambodia, Lao PDR, Myanmar and Vietnam.

Table 1.2
Welfare Gains from the ASEAN Economic Community 2015

(%)

	Change in GDP	Change in Exports	Change in Imports
Brunei	7.0	10.4	30.1
Cambodia	6.3	77.6	82.0
Indonesia	6.2	53.6	17.6
Lao PDR	3.6	101.1	73.3
Malaysia	3.0	35.6	40.6
Myanmar	4.4	65.8	45.1
Philippines	3.2	45.4	34.0
Singapore	9.7	43.7	38.1
Thailand	4.9	33.6	34.7
Vietnam	2.8	55.4	47.1
ASEAN	**5.3**	**42.6**	**35.4**

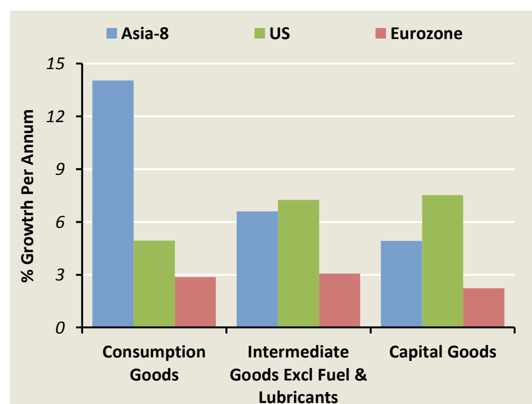
Source: Petri *et al.* (2012), "ASEAN Economic Community: A General Equilibrium Analysis", *Asian Economic Journal*, Vol. 26(2), pp. 93–118.

[1] The results are based on a computable general equilibrium model that incorporates several channels of benefits from integration that have been identified in the literature, such as the elimination/reduction of tariffs and non-tariff measures, trade facilitation and improvements in the investment climate.

to benefit from the ongoing shift of labour-intensive production out of China. Indeed, FDI flows into ASEAN (excluding Singapore) have more than doubled as compared to the period prior to the GFC and averaged US$56 billion over the period 2011–13, equivalent to about half of the inflows into China.

Fourth, the growing pool of people in the working-age group will give rise to a sizeable middle class, which will underpin growth in aggregate demand, despite a more modest growth in exports. ASEAN is also strategically located between China and India, and stands to gain from these Asian giants. The Asian Development Bank estimates that half of the world's middle class consumers, or about 2.6 billion people, will reside in ASEAN, China and India in 2030. There are already signs that Asian final consumption demand is growing at a rapid pace: in 2010–13, Asia-8's imports of consumption goods grew by 14% per annum, or two to four times that of the G3. (Chart 1.19) In line with growing wealth and income levels, Asia's demand for modern services will also increase faster than incomes. Indeed, EPG's estimates show that in Asia, a 1.0% rise in income raises imports of modern services by 2.1%, compared with 1.0% for traditional services, and only 0.8% for goods imports. (Please refer to the October 2011 issue of the *Review*.)

Chart 1.19
Merchandise Imports, 2010–13



Source: United Nations and EPG, MAS estimates

Note: Asia-8 comprises China, India, Indonesia, Korea, Malaysia, Singapore, Thailand, and the Philippines.

Nonetheless, there are several critical challenges that the ASEAN countries need to overcome to attain their full potential. First, they need to rebuild investment levels. The current investment rate of about 26% of GDP on average in the ASEAN-4 is well below the level prevailing prior to the Asian Financial Crisis of 1997–98, and is lower than would be expected for economies at this stage of development. In particular, investments in transport and energy infrastructure are necessary to lower logistics costs and ensure reliable power supply, both of which are pre-requisites for the development of large-scale manufacturing. Even so, cross-border projects, such as the Trans-Asian Rail, will further advance regional integration. Second, ASEAN countries need to raise their stock of human capital, which will enable them to move up the value-added chain, facilitating technological catch-up with the developed economies. Third, ASEAN needs to maintain momentum on economic reforms. Budgetary resources need to be set aside to ensure sustainable financing of investment in physical and human capital, while broader reforms to legal and regulatory frameworks are necessary to enhance competitiveness.

1.3 Global Inflation

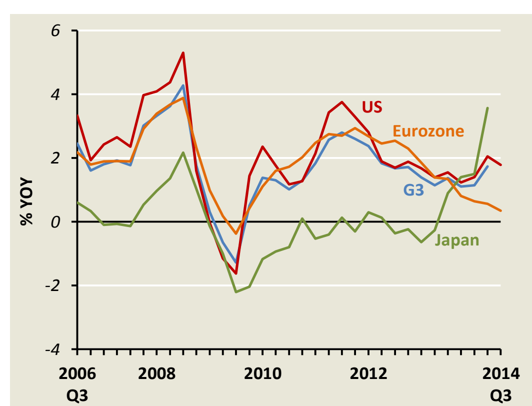
Global Price Pressures Remain Subdued

Prolonged slack in economic activity in the advanced economies and, more recently, a pullback in aggregate demand in many emerging market economies have kept global inflationary pressures subdued. Weak global demand is reflected in the softening in the prices of primary agricultural commodities and industrial inputs. Inflation outcomes have fallen below central banks' targets, particularly in the advanced economies, and are expected to remain so until a more decisive recovery in the real economy takes place. In Asia, slackening domestic demand alongside negative output gaps in several economies will keep price pressures contained, although inflation will stay high in some ASEAN countries due to subsidy rationalisation. Barring price shocks stemming from geopolitical tensions, global inflation is expected to come in at around 2.2% in both 2014 and 2015.

G3 inflation will stay below trend.

Inflation rates in the G3 economies have diverged markedly in recent periods, partly due to differences in growth outcomes. (Chart 1.20) Headline CPI inflation in the US has continued to rise at a moderate pace, but remained mostly below 2.0% in the past year, save for a brief period in Q2 2014. Core private consumption expenditure inflation has also been fairly steady at between 1.2% and 1.5% y-o-y this year. In Japan, headline inflation rose to 3.6% y-o-y in Q2 2014, largely due to the 3.0% point consumption tax hike. In the Eurozone, the gradual but persistent decline in inflation to very low levels—alongside the stagnation in the economy—has raised concerns about deflation. The region's headline inflation averaged only 0.6% y-o-y in H1 2014, and fell further to 0.4% y-o-y in Q3.

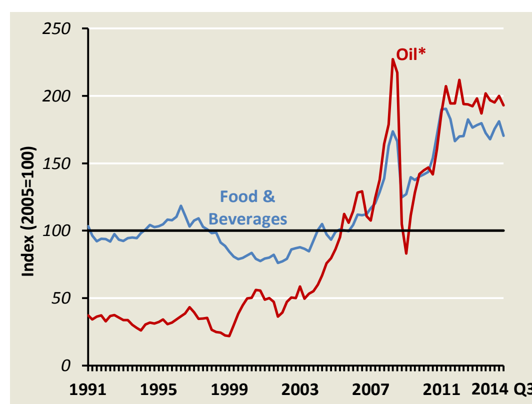
Chart 1.20
G3 Inflation



Source: CEIC

Inflationary pressures in the US should remain contained on account of subdued oil and food prices. (Chart 1.21) Indeed, both headline and core CPI inflation moderated to 1.8% y-o-y in Q3, from a high of 2.1% in Q2. In the Eurozone, a high degree of slack will likely keep inflation at low levels for the next several quarters. Excluding the effects of the tax hike, headline and core inflation in Japan over the Jul–Aug period were 1.4% and 1.2%, respectively—below the BOJ's target of 2.0%. Although inflation has risen markedly from the mild deflation of the past, there remains uncertainty as to its future direction given that growth outcomes have been somewhat disappointing. Given these developments, the G3 average inflation rate will likely remain steady at 1.5% in both 2014 and 2015.

Chart 1.21
Global Oil and Food Price Indices



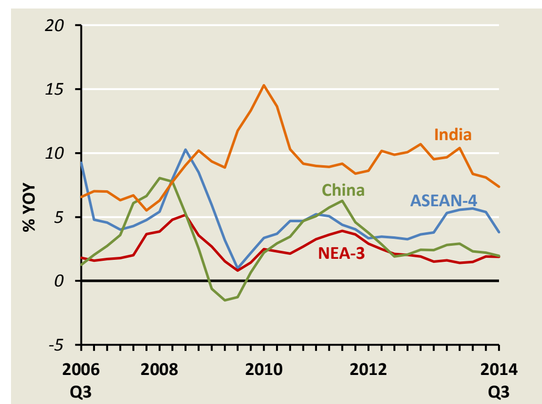
Source: IMF

* Average of UK Brent, Dubai and West Texas Intermediate oil price benchmarks.

Asia ex-Japan inflation is expected to moderate further.

Headline inflation in China has declined from 2.2% in Q2 2014, to 2.0% in Q3, alongside a protracted bout of producer price deflation. (Chart 1.22) As input prices continue to face downward pressures, China's CPI inflation is expected to slip from 2.6% last year to 2.3% this year.

Chart 1.22
Asia ex-Japan inflation



Source: CEIC

In India, CPI inflation eased from 8.1% y-o-y in Q2 2014 to 7.4% in Q3 2014, largely due to lower fuel prices. With a favourable base effect, CPI inflation will continue to moderate until the end of this year. In addition, lower global fuel prices will reduce imported inflation while higher than expected rainfall should mitigate the risk of resurgence in food inflation. Nonetheless, the pass-through of administered price increases and continued supply constraints from strengthening growth present some upside risks.

Within the NEA-3, the average inflation rate remained firm at 1.9% y-o-y in Q3 2014. While consumer price gains moderated in Korea and Taiwan, headline CPI inflation picked up in Hong Kong alongside a surge in housing inflation in September due to the removal of public housing rental subsidies. On balance, inflation is envisaged to remain mild in the region, on account of stable commodity prices and persistent negative output gaps, before rising somewhat next year.

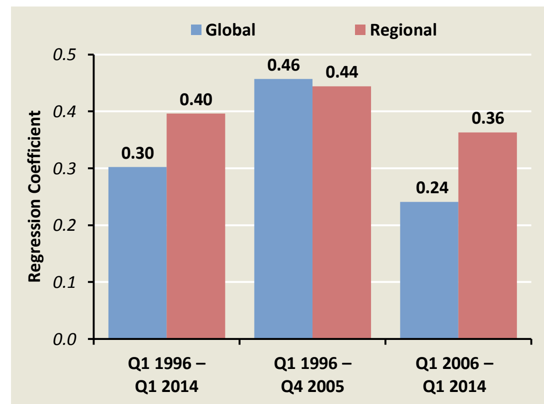
After trending up over the past five quarters, ASEAN-4 inflation fell in Q3 2014 to 3.8% due to the fading impact of past subsidy adjustments in Indonesia and Malaysia, and muted inflationary pressures in Thailand, given the substantial negative output gap in the economy. Meanwhile, inflation in the Philippines notched up due to tighter supply constraints. Price pressures in the ASEAN-4 economies are projected to remain relatively strong next year, with some countries likely to hike subsidised fuel and electricity prices. Malaysia will also see a one-off shock to inflation with the introduction of a goods and services tax in April 2015. Consequently, ASEAN-4 inflation is expected to persist at a high rate of around 4.5–5.0% in 2015, for the third year in a row.

Overall, inflation in Asia ex-Japan is expected to come in at 3.4% in 2014 and pick up slightly to 3.7% in 2015.

With greater integration, regional drivers of inflation may have become more important.

In addition to idiosyncratic shocks and subsidy adjustments, inflation in Asia ex-Japan will increasingly be driven by regional influences. First, rising trade and financial linkages have resulted in greater synchronisation of business cycles within the region, as well as stronger co-movements in national inflation rates. Second, the presence of extensive intra-regional production networks will lead to stronger transmission of inflationary impulses through the impact of imported intermediate input costs on domestic producer prices. Empirical estimates by EPG, using principal component analysis, show that while global and regional influences played equally important roles in driving inflation in the Asia Pacific in the mid-1990s to the mid-2000s, the impact of the regional component has since risen relative to the global component in the past decade.[2] (Chart 1.23)

Chart 1.23
Underlying Drivers of Asia Pacific* Inflation



Source: EPG, MAS estimates

Note: The coefficient for the global component over the Q1 2006 – Q1 2014 period was found to be statistically insignificant at the 10% level.

* The economies included in the study are Australia, China, Hong Kong, Indonesia, Japan, Malaysia, New Zealand, Singapore, South Korea, Thailand and the Philippines.

[2] A regression of EMEAP inflation rates against these components was carried out and the relative roles of the global and regional components in influencing inflation outcomes in the EMEAP countries was assessed through the magnitude of the regression coefficients. The sample period was from Q1 1996 to Q1 2014.