

SUMMARY

Real GDP growth in East Asia has been moderating after a sharp rebound from the global crisis. The slowdown in growth since mid-2010, even though smaller than earlier projected, has occurred despite a stronger-than-expected recovery in high-income economies and only gradual withdrawal of the monetary and fiscal stimulus across the region. We project real GDP growth will settle to about 8 percent in 2011 and 2012 from about 9.6 percent in 2010.

Inflation has become the key short-run challenge for the authorities in the region, complicated by a surge in portfolio capital inflows and rapidly increasing food and commodity prices that hit low-income households disproportionately. Price shocks are affecting core inflation that could trigger a wage-price spiral. Central banks across developing East Asia have tightened monetary policy only cautiously because of earlier concerns about the durability of the global expansion, expectations that the surge in food and fuel prices may turn out to be temporary, and worries that higher interest rates may boost interest-sensitive inflows.

For many middle-income countries in East Asia, lowering inflation presents difficult policy choices. Most have eschewed the use of capital controls, and allowing exchange rates to appreciate may protect against importing inflation but jeopardizes international competitiveness. And the independence of monetary policy is partially constrained by open capital accounts. This places the bulk of the adjustment burden on fiscal policy where the challenge lies in lowering deficits more rapidly while creating the fiscal space to finance infrastructure to drive future growth and assuring necessary social investments and cash transfers to the poor.

The sharp increase in commodity prices portends increased volatility for the foreseeable future. All commodity prices are on an upswing, some either at all-time highs or at levels exceeding those reached only two years ago. These latest price developments continue the trend that began earlier this decade of a steady climb in real commodity prices, interrupting a decade-long downward trend in the 1990s. Policies to provide incentives and ensure the investment needed to help develop new and greener energy sources, notably with low-carbon emissions and much improved energy efficiency should be a priority for governments in the region.

Over the medium-term, East Asia has the potential to sustain rapid increases in living standards even as the global economy enters a more challenging phase. Unlike the framework of stable exchange rates and closed capital accounts that characterized the background for the rise of Western Europe, Japan, and the NIEs after World War II, the future will likely be dominated by sharply increased volatility in commodity prices, capital flows, and exchange rates. If history is any guide, periods of sustained monetary expansion in high-income economies tend to be followed by a surge in global inflation, high nominal interest rates, and economic instability. If such a scenario unfolds, as is likely, it will test the resolve of governments in East Asia and circumscribe the policy options available to maintain rapid but steady growth.

China, today the world's second largest economy and its leading exporter and manufacturer, will remain a powerful source of external demand for East Asian producers in the foreseeable future. The trend toward increasing intra-regional trade, with China a larger final consumer of regional product, is likely to continue. And favorable prospects for China augur well for the global and regional production networks into which countries of the region are increasingly tightly integrated. Rising wages in coastal China are forcing companies located there to either move up the value chain or relocate further inland or to neighboring low-income countries (and occasionally to lower-cost regions in neighboring middle-income countries). And with China deploying its large foreign exchange reserves, capital flows to the region could rise substantially. Tighter regional integration will ensure that these trends further

boost the international competitiveness of Developing East Asia while also providing an engine of growth that is relatively less dependent on the slow-growing high-income countries.

But even as developing East Asia continues to grow rapidly, rising inequality is a matter for concern and could pose a challenge to future social stability. One factor underpinning rising inequality is rapid globalization which raises skill premiums—a phenomenon observed worldwide. Another is rapid urbanization that contributes to high growth rates but at the same time leaves behind lagging regions. Ensuring equal access to education, improving connectivity between leading and lagging regions, and expanding targeted social services are some of the policy responses necessary to ensure inequality does not rise to levels that breed social exclusion and cut growth potential.

As much as one-third of per-capita growth in East Asia over the last half a century was due to the favorable demographic dividend. In the future, however, a rapidly ageing population will slow growth rates in the economies of East Asia unless its effects are offset by faster growth in productivity, larger fixed investment, increased participation in the work force of women, longer work lives, and policy adjustments that encourage productivity and help contain ageing-related fiscal costs.

No country has grown to middle income without industrializing and urbanizing. East Asia's cities have helped support economic growth, but their full potential as the source of innovation and productivity is yet to be realized. Cities will need to become the true crucibles of innovation by exploiting the proximity of companies and workers, acting as knowledge exchanges, and providing capital for innovative but risky projects.

The risks of climate change and natural disasters complicate East Asia's quest for continuous rapid growth. On the one hand, the carbon footprint of the region must be contained: this is the essence of the mitigation agenda. On the other, countries need to learn to live with the consequences of a changing climate—the adaptation agenda. And nowhere is the adoption and implementation of an adaptation agenda more important than in East Asia's urban centers, the concentration of increasingly larger share of output and population. These agglomerations are under the grave threat of extreme weather events, rising sea levels and other natural hazards—some of which, such as earthquakes, are not climate-related. However every natural hazard does not automatically lead to catastrophic loss of life and property. The recent tragic earthquake in Japan with a magnitude 8.9—the most powerful in the country's recorded history—and the subsequent tsunami are a stark reminder of the dangers from natural hazards and the key role of careful and thorough investments the authorities have made in seismic safety and emergency preparedness. The extent to which countries in the region will be affected economically will vary and depend on factors that will become clearer in the coming weeks.