

## SUMMARY

Growth in developing East Asia in the first half of 2011 remained strong, but continued to moderate, mainly due to weakening external demand. Global growth was also affected by supply shocks from geopolitical disturbances in the Middle East, supply chain disruptions following the earthquake and tsunami in Japan, and a slower-than-expected recovery of private demand in crisis-affected countries. More recently, uncertainties over fiscal sustainability in the U.S. and sovereign debt in the Eurozone fed financial volatility and affected investor and consumer sentiment. Domestic demand in East Asian economies has also been softening, driven by the normalization of fiscal and monetary policy, although it remained robust and the largest contributor to growth. We project that real GDP in developing East Asia will increase by 8.2 percent in 2011 (4.7 percent excluding China), while growth will slow to 7.8 percent in 2012. Risks are on the downside, however.

Based on the still robust current growth projections, the proportion of people living on less than US\$2 a day in developing East Asia is expected to decrease to about 24 percent in 2011, down two percentage points from 2010, and an estimated 38 million people are projected to move out of poverty. However, poverty reduction efforts would be hampered in the event of another sudden increase in food prices against a backdrop of slowing income growth.

The growth slowdown was particularly pronounced in industrial production. Exports of major regional industrial supply chains, especially electronics, have started to decline. Demand for commodities and raw materials remained strong, helping resource-rich economies maintain high levels of export and GDP growth. East Asia, and China in particular, is gaining importance as a source of global demand, while rising consumer goods imports in China are benefiting the region's manufacturing exporters.

In the short- to medium-term, East Asia's growth prospects are constrained by global uncertainty and by the impact of natural disasters. The slow progress towards resolution of debt problems in the Eurozone intensified investors' concerns over global growth and stability. As capital flowed out of emerging markets into relatively safer havens, portfolio investments reversed and stock markets lost value in East Asia. Markets remain jittery, even after the Eurozone countries agreed on a solution for the sovereign debt and banking problems. Fiscal and financial consolidation in the Eurozone is likely to reduce growth in Europe, and could lead to renewed financial outflows from East Asia as banks shore up their capital coverage. Credit outstanding from European banks to developing East Asia amounts to US\$427 billion, or six percent of GDP. But high reserves and current account surpluses protect most East Asian countries against the impact of possible renewed financial stress.

The effects of flooding in several countries are likely to take a toll on growth this year. Because of widespread flooding, Thailand's GDP growth for 2011 was revised down to 2.4 percent, although the final tally of the damage done is yet to be made. Losses in production are being felt in the entire region, as the impact of the disaster is spreading through the industrial supply chains. While reconstruction after the flood in 2012 is likely to contribute to growth, the resilience of East Asia's production networks is being tested once more. Earlier in the year, after the March 11 earthquake and tsunami in Japan, East Asian countries suffered production losses from disrupted supply chains in electronics and automotive industries. However, these returned to their pre-disaster growth rates and production levels shortly after Japanese industry recovered in June. This time, recovery of production to pre-disaster levels in the region will also depend on the strength of global demand for electronics and cars.

With growing recognition that the current global economic slowdown could continue into the long-term, policymakers in East Asia are rethinking their policy options. With a few exceptions, notably Vietnam and Mongolia, the emphasis

has shifted from fighting inflation and dealing with excess capital inflows to sustaining growth, now the dominant concern.

In the short-term, striking a balance between stimulating growth and fighting the effects of global uncertainty is the primary challenge. Policymakers are likely to hold off further policy tightening and stand ready to act should further negative shocks to growth occur or in the extreme case of a disorderly resolution of the Eurozone debt problem. Monetary policy normalization has already been on hold in most countries in recent months and some central banks have started to cut official interest rates. In countries where the recent financial turbulence resulted in significant pressures on exchange rates, policymakers have also intervened in the currency markets. In this scenario it will also be important to take precautionary steps against financial risks arising from sudden downward movements in asset prices. Fiscal positions, while not as strong as before the 2008 crisis, leave sufficient space for fiscal stimulus in most middle-income countries should this become necessary.

Stimulus alone will not be enough to address the likely prolonged weakness in the global economy. Slow global growth presents an opportunity for East Asian governments to refocus on reforms that will enhance growth in the medium- and long-term. Increasing productivity and moving toward higher value-added production can be achieved through higher investment, including in productive infrastructure, education, and in building social security systems in most countries. Where levels of investments are already high, increasing the quality and efficiency of these investments should be the first priority alongside rebalancing growth towards domestic consumption. Improvements in public investment programs and regulatory frameworks will improve the quality of investments and increase investment rates. Further investment in disaster management and prevention is also becoming increasingly important for the region. Any fiscal stimulus should promote these structural reforms that support rebalancing and domestic sources of growth.

Once volatility in global financial markets recedes, capital flows are likely to return to East Asia. When that happens, a concerted effort in the region to use exchange rate flexibility to gain more independence in monetary policy, as well as to shift demand towards domestic sources, could become an option yet again. Efforts to deepen regional integration through existing regional initiatives can boost regional trade and demand and help establish the East Asia and Pacific region's new role in leading the global economy.