Executive Summary

The earthquake-related tragedy in Japan in mid-March 2011 resulted in terrible losses of life and property. The early and decisive actions by the Japanese government and the Bank of Japan have helped to contain the initial damage from the earthquake, but its aftermath continues to cast a pall over the region and indeed the world. The relatively limited negative impact of the tragedy on Japanese production and regional spillovers to the rest of Asia masks the scale of the humanitarian disaster and damage to the country's infrastructure and capital stock.

Meanwhile, in Asia as a whole, the recovery has matured as both exports and domestic demand have fueled rapid economic growth, which reached 8.3 percent in 2010. Exports have benefited from the global investment cycle as well as strong final demand from emerging economies in both Asia and other regions. Domestic demand has also been robust, reflecting still-expansionary fiscal policies as well as growing private demand. Private demand has been broad-based across both investment and consumption. Investment is being driven by the need in many Asian countries to overcome capacity constraints and to build infrastructure. Consumption, meanwhile, is being propelled by rising employment, wages, and productivity.

Near-term prospects are favorable, with growth in the Asia and Pacific region projected to average nearly 7 percent in both 2011 and 2012. Growth is expected to be led by China and India, whose economies are presumed to expand by 9½ percent and 8 percent, respectively, in the next two years. Their growth will have important spillovers for other countries in the region (and the world), particularly through demand for commodities. In Australia, for example, growth is expected to pick up to 3 percent and 3½ percent, respectively, in 2011 and 2012, as emerging Asia's demand for commodities increases and as private investment in mining emerges as the main driver of growth.

Risks to the growth outlook are evenly balanced. The prospects for sustained global growth have strengthened in recent quarters as uncertainties over private domestic demand in advanced economies have lessened. Meanwhile, new downside risks have emerged such as the turmoil in the Middle East and North Africa region—which could disrupt global growth and inflation—and spillovers from the earthquake-related tragedy in Japan. Meanwhile, fiscal and financial vulnerabilities continue to cloud the outlook for advanced economies, which are important trading partners for Asia.

Asia's rapid growth is accompanied by the emergence of pockets of overheating across the region in both goods and asset prices. Asset price pressures are reflected in strong credit dynamics as well as in certain segments of property markets in a few economies. Headline consumer price index (CPI) inflation has accelerated since October 2010, owing mainly to higher commodity prices; these prices, however, are also spilling over into core inflation. Core inflation is being further driven by still-accommodative financial conditions across the region that owe in part to procyclical monetary policy stances. Interest rates remain below levels that are consistent with stable growth and low inflation and in many cases are still negative in real terms. Inflation is expected to increase further in 2011, before decelerating modestly in 2012 as global commodity prices stabilize and central banks across the region make further progress with tightening macroeconomic conditions.

The task of policy tightening has been complicated by capital inflows, which surged in the first three quarters of 2010. Policymakers have sometimes feared that higher policy rates could attract even more inflows. Inflows have generally moderated since October 2010, although they have still been extraordinarily large in a few Asian economies and remain a key concern of policymakers. Capital is expected to continue flowing into Asia in 2011 and 2012, attracted by the region's strong growth prospects and fueled by abundant global liquidity and risk appetite. In this context, policymakers' concerns have shifted to the instability associated with potential capital flow volatility should these inflows come to a "sudden stop" or even reverse. Several economies have introduced macroprudential measures targeted at reducing the risk of overheating in asset prices, and of subsequent busts if capital flows reverse. Chapter II argues that although these measures have been helpful, they are best seen as complements and not as substitutes for macroeconomic policy adjustment.

Further monetary tightening is necessary in economies that face generalized inflation pressures. In addition to higher policy rates, exchange rate flexibility is a key line of defense against overheating pressures. Exchange rate appreciation would result in a tightening of monetary conditions and reduce the burden to be borne by higher policy rates. Several economies also have scope for more fiscal consolidation, which will help to expand the fiscal space that would allow governments to respond more effectively to future shocks.

Looking beyond the near-term macroeconomic policy challenges, Asia faces a need to strengthen the platform for sustained strong growth over the medium term. Such a platform would depend on reducing inequality; raising employment prospects, which would also guard against risks to social stability; and continued efforts to rebalance growth by strengthening private domestic demand. Intra-Asian exports are a growing source of demand for many Asian economies, including exports of intermediate inputs to China in the context of the Asian "supply chain," as Chapter III shows, but Asia is still reliant on demand from the rest of the world. In the absence of further measures to increase domestic demand, the region's external balances would reemerge as the global economy recovers and demand from advanced economies picks up. As discussed in Chapter IV, policymakers in many Asian LICs and Pacific Island economies will also face the challenge of managing the social impact of higher commodity prices, and of maintaining sound financial systems in the face of rising and volatile capital inflows.