

# Executive Summary

Asia has entered the second year of the global economic expansion still firmly in the lead of the recovery. Growth in the first half of 2010 proceeded well above trend in almost all regional economies, as global manufacturing continued to rebound and fueled exports and investment in the region. Private consumption also remained strong, as labor conditions continued to improve and confidence remained high despite greater market volatility as a result of global financial turbulence.

During the second half of 2010, economic activity has moderated toward a more sustainable pace, although it remains robust. In particular, industrial production and export growth rates have started to moderate. This in part reflects the maturing of the global and regional inventory cycle, particularly for the information technology products that are important for production and exports in many Asian economies.

The short-term baseline outlook for Asia remains positive, with growth expected to settle at more sustainable but still high levels. Growth is likely to remain particularly strong in the large, domestic-demand-driven economies of China, India, and Indonesia. The continuing, albeit sluggish, recovery in advanced economies during 2010–11 that is envisaged in the October 2010 *World Economic Outlook* should support firm growth in Asia's exports, although below the very high rates of 2009 and early 2010. A gradual pace of withdrawal of policy stimulus, sustained improvements in labor market conditions, and still accommodative financial conditions are expected to sustain private domestic demand. Ample global liquidity on the one hand, and the relatively robust growth and low public debt in Asia on the other hand, should continue to fuel capital flows to the region. Reflecting the slowing of export growth and strong domestic demand, Asia's current account surplus is projected to decrease to about 3 percent of regional GDP in 2010 and 2011, from about 5 percent in 2007, making a modest contribution to the narrowing of global imbalances.

The main risk to the outlook is the external environment. As discussed in the *World Economic Outlook*, while global financial conditions have improved since June 2010, underlying sovereign and banking vulnerabilities in advanced economies remain a significant challenge, and concerns linger over the strength of the global recovery. Despite Asia's strong economic and policy fundamentals, important trade and financial linkages with advanced economies suggest that a further deterioration in global financial conditions and a slowing of the global recovery would have important repercussions for the region.

In view of the strong economic expansion that is under way, and emerging signs of inflationary pressure in some economies, Asia has reached the threshold to normalize policy stances across the region. Many economies have started to take steps in this direction. But monetary and fiscal policies are still generally accommodative and, with output gaps closing rapidly, inflation pressures could intensify next year with the risk that policies are becoming more procyclical. In particular, tight capacity constraints could exacerbate the effect of supply shocks on inflation, as discussed in Chapter II. Continued capital inflows may also pose risks to financial stability if they are associated with excessively easy domestic financial conditions. Macroprudential measures have appropriately been taken in many regional economies to minimize these risks, but a further tightening of monetary policy conditions may be needed, including through greater exchange rate appreciation. A faster withdrawal of fiscal stimulus would also help guard against the risks of overheating and a buildup of financial imbalances. Should global conditions worsen, however, the region has the room to delay the normalization of policy stances.

Over the medium term, sustaining robust growth in Asia will require continued progress with rebalancing growth toward domestic demand. For Asia as a whole, only limited progress has been made toward reducing external imbalances. In 2009, while China's current account surplus narrowed as a percent of GDP, those of many other Asian economies, such as NIEs and ASEAN, increased. With external demand from advanced economies unlikely to return to precrisis trends in the foreseeable future, Asia will need stronger domestic demand to maintain robust growth. The normalization of policy conditions in Asia would, therefore, need to be accompanied by continued measures to reinforce private domestic consumption and investment. The challenge of raising private consumption was discussed in some detail in the April 2010 Asia and Pacific *Regional Economic Outlook*. In the present Asia and Pacific *Regional Economic Outlook*, Chapter III focuses on the challenge of raising investment and stresses the importance of measures to facilitate access to credit, particularly for smaller, domestically oriented, and service sector firms. The chapter also highlights the importance of reviving investment in infrastructure, which will contribute to rebalancing both directly and indirectly, by improving the environment for private sector investment.

In Asian low-income and Pacific Island countries, policy stimulus and rising global demand for commodities and garments have driven a strong recovery in recent quarters. But these economies face significant challenges in the near and medium term, including the need for fiscal consolidation to strengthen fiscal positions and create more policy space, and the need for structural reforms to raise potential growth and reduce vulnerabilities. Chapter IV discusses these issues.