

Executive Summary

Global economic prospects have improved somewhat in 2012. After a sharp slowdown at the end of 2011, there is growing evidence that global activity is set to strengthen in the second half of 2012. Financial conditions have eased considerably and risk appetite rebounded in the first quarter after policymakers circumvented an imminent crisis in the euro area.

Growth in Asia is also expected to gain momentum over the course of 2012. Although activity slowed markedly across the region in the last quarter of 2011, mainly due to weakening external demand, domestic demand has generally remained strong, as reflected in low unemployment, high capacity utilization, and robust credit growth. In the first months of 2012, leading indicators of activity strengthened, inflation expectations picked up, and capital inflows into Emerging Asia rebounded. Growth for the Asia and Pacific region as a whole is projected to be at 6 percent in 2012, broadly unchanged from last year, before rising to about 6½ percent in 2013.

Nevertheless, the global economy remains fragile, exposing Asia to serious downside risks. The debt crisis in the euro area has not been fully resolved, and financial turmoil could still escalate in the region and spread globally, while increased geopolitical risks could push energy prices sharply higher. So far, stronger economic and policy fundamentals have helped buffer Asian economies against the global financial crisis, including by limiting adverse financial market spillovers (Chapter 2) and ameliorating the impact of deleveraging by European banks (Chapter 3). But a sharp fall in exports to advanced economies and a reversal of foreign capital flows would severely impact activity in Asia, both directly and through knock-on effects on domestic demand. Moreover, a shock to commodity prices could create difficult trade-offs between inflationary pressures and budgetary risks from energy and food subsidies.

On the other hand, there are also upside risks to our central scenario. Because macroeconomic policy has remained generally accommodative, further stabilization of global economic and financial conditions over the course of 2012 could boost growth and revive overheating pressures in the region.

Against this background, Asian policymakers face the difficult task of calibrating the amount of insurance needed to support stable, noninflationary growth. Pausing the normalization of macroeconomic policies when the global recovery stalled in late 2011 was fully warranted, given the uncertainties at the time. Now, however, policymakers should be ready to shift gears and renew their tightening cycle as overheating pressures become evident. Of course, the balance of risks differs from country to country. Economies with greater exposure to downside risks and those closer to neutral monetary policy stances could afford to pause longer, but others with more accommodative conditions, stickier core inflation, and more buoyant credit growth may need a faster return to more neutral policy stances. Similarly, the pace of fiscal consolidation should be calibrated to country-specific circumstances, with a more rapid pace adopted in countries with large, cyclically adjusted deficits and elevated debt profiles.

The best form of creating insurance against the risk of external shocks remains strengthening domestic sources of growth. Lower trade surpluses in China have raised the likelihood that the shift of global demand to major surplus economies is finally taking place, but sustainable rebalancing will

nonetheless depend on China's successful transition from investment-led to consumption-led growth (Chapter 4). In India, improving the investment climate and infrastructure, and education, as well as facilitating trade and easing labor laws will be keys to maximizing gains from its ongoing demographic transition. Among ASEAN economies, public investment in infrastructure within appropriate medium-term frameworks would help crowd-in private investment and promote more broad-based growth while safeguarding fiscal sustainability.

Asian low-income and small island economies face particular challenges (Chapter 5). In low-income countries, attracting foreign direct investment (including from other Asian economies) will be key to helping these countries participate more fully in Asia's growth dynamics and benefit from the region's rebalancing. Pacific and other small island economies face the challenge of improving economic resilience in the face of adverse global economic spillovers and broadening sources of growth over the medium term.