EXECUTIVE SUMMARY

Economies in the East Asia and Pacific (EAP) region have generally remained resilient in 2012 amidst a lackluster and, at times, volatile external environment. In 2012, the region's economy is projected to grow by 7.5 percent, lower than the 8.3 percent growth recorded in 2011, but set to recover to 7.9 percent in 2013. Growth in EAP is still the highest of any developing region and constitutes almost 40 percent of global growth. With the weakness in global demand for exports, domestic demand has remained the main driver of growth for most economies.

In 2012, aside from weak external demand, the region's growth slowdown resulted from China's economic performance, which is projected to reach 7.9 percent in 2012, 1.4 percentage points lower than 2011 and the lowest annual growth rate since 1999. This decline is mainly due to lower domestic demand growth in the first part of 2012, driven by stabilization measures implemented in 2011. East Asia excluding China is expected to grow by 5.6 percent in 2012, one percentage point higher than in 2011. The rebound in economic activity in Thailand following the floods of 2011, strong growth in the Philippines, and relatively mild slowdowns in Indonesia and Vietnam contributed to this increase. Fiscal and monetary policies were generally supporting growth in 2012. More recently, monetary policy rates have rightly been held steady, as most economies now operate at or close to full capacity.

For 2013, we expect the region to benefit from continued strong domestic demand and a mild global recovery that would nudge the contribution of net exports to growth back into positive territory, a trend projected to continue into 2014. For China, we expect this year's monetary easing, local fiscal stimulus and more rapid approval of large investment projects to boost growth to about 8.4 percent. By 2014, China is projected to be growing at around 8 percent, which is in line with the country's potential growth rate. This rate is gradually declining as productivity and labor force growth are tailing off.

In the last few years, services contributed more to production growth in the region than manufacturing. In part, this reflects the strong growth in domestic demand relative to external demand. However, the current growth in the service sector represents longer-term trends that are driven by the growing middle class in the region, the low level of services-to-GDP ratios in many EAP countries, and the development of services export industries in the Philippines and elsewhere. As these trends continue, services can emerge as a new driver of growth for EAP.

Most countries in the region have retained their strong macroeconomic fundamentals and should be able to withstand external shocks—but considerable risks remain. While the probability of a catastrophic event in the Eurozone is substantially lower than before, delays in implementation of the plans to solidify the institutional foundations of the Euro could cause renewed financial market volatility and renewed slowdown in global growth. In addition, the by now well known fiscal cliff in the USA could result in a loss of growth for EAP. And while a gradual decline in China's investment growth is the base scenario, a sudden drop in investment growth could have ripple effects across the globe. In this eventuality, though, China's authorities could use their ample fiscal space to counter the impact.

Recent announcements by central banks in the G-3 have renewed concerns regarding the possibility of excessive capital inflows into the region that could render exchange rates uncompetitive, lead to asset price bubbles and excessive credit growth, raise the risk of future sudden outflows, or lead to costly sterilization measures from monetary authorities. At the same time, monetary easing in advanced countries need not lead to more capital inflows into the region: QE1 did but QE2 did not. Moreover, the bulk of capital flows into EAP consists of FDI, which creates jobs and growth in production capacity. Nevertheless, monetary authorities should closely monitor developments on the capital account, especially in countries that have recently experienced rapid credit growth. In the short term, capital controls could play a role in dampening excessive inflows, but capital markets development and appropriate exchange rate arrangements offer the best cushion against volatile capital flows in the medium term. The macro-prudential measures that some countries in the region have recently shored up also protect their banking systems against the risks of excessive credit growth.

If a shock to growth occurs, most countries could counter the impact by easing of fiscal policies. Countercyclical fiscal measures would ideally stimulate the economy in the short run as well as improve medium-term growth prospects. Investments in public infrastructure and other public goods are examples of such productivity enhancing measures. In practice, for EAP economies that face difficulties in budget execution, particularly of the capital budget, fiscal interventions aimed at increasing private domestic demand such as targeted social assistance or investment tax credits, are worth considering.

This edition of the East Asia Half-Yearly Update introduces two new sections—one that looks at selected emerging issues in the region, including Myanmar, covered for the first time in this Update. The section on the medium term regional development agenda focuses on jobs and disaster risk management.

Myanmar's emergence from decades of relative isolation offers new opportunities and challenges as the country's prospects for trade, investment and development aid improve. Growth in Myanmar in 2012 is expected at 5.5 percent, increasing to 6.3 percent in 2013. Myanmar is pursuing formidable reforms to create an enabling environment for the private sector, sustainably manage natural resources, effectively deliver public services, and alleviate infrastructure constraints. Tackling these challenges would allow Myanmar to capitalize on economic opportunities derived from its strategic location within a large regional and global export market, as well as vast untapped natural resources.

While economic growth in East Asia has created jobs, the quality of jobs has become a growing concern. For Pacific Island countries, the large number of youths without jobs is the focus of attention. Implications for policy reflect the diversity of economies in the region: For rapidly urbanizing countries, the jobs policy priority is to make cities work, including good urban planning to increase flexibility of land use. This gives incentives for firms in cities and towns to grow and create jobs. For resource rich countries, macroeconomic management and fiscal policy are the most important policy areas to sustain employment creation, in order to diversify the economy and manage resource related risks such as currency appreciation and inflation.

As the most disaster-stricken region in the world, disaster risk management is essential for supporting sustainable growth in EAP. Policy makers need to develop practical tools for risk identification and communication, invest in disaster preparedness and resilient development, and strengthen institutional capacity and coordination for recovery and reconstruction.