External Economic Environment

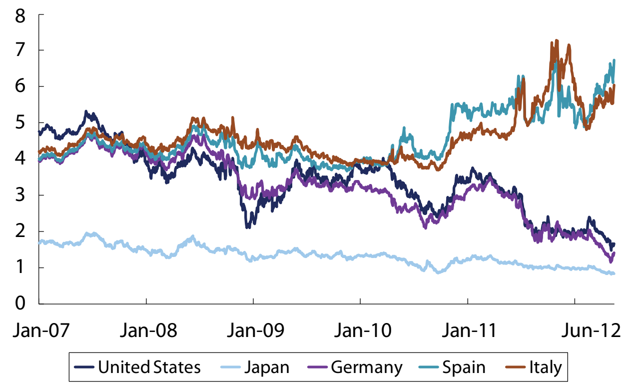
The external environment for Asia has worsened given Europe's continuing sovereign debt and banking crisis, and the weak US economic recovery.

Global financial conditions are increasingly uncertain with the health of European banks coming under closer scrutiny. Despite the Spanish bank rescue, bond yields remain hovering above 6%—reflecting worries over the depth of bank losses **(Figure 1)**. Weak fiscal and financial conditions in the eurozone will likely bring on a recession this year before recovering to modest growth in 2013. Growth in the United States (US) is expected to remain sluggish in 2012 with the job market remaining weak before improving slightly next year. Japan's economy, however, is perking up with reconstruction spending—and should show relatively strong growth this year before easing somewhat in 2013.

The US economy appears to be weakening once again amid slowing employment growth, waning investment demand, and little prospect of further stimulus.

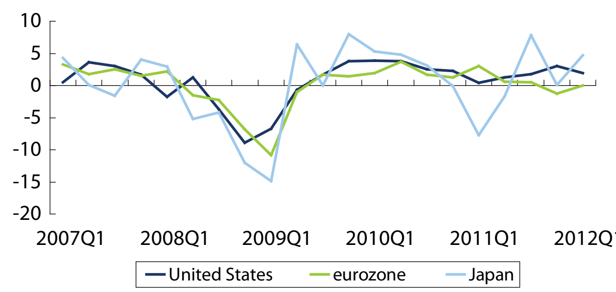
After signs that the economy was picking up, the downward revision to 1.9% quarter-on-quarter seasonally adjusted annualized rate (q-o-q, saar) of first quarter growth in gross domestic product (GDP) suggests the US recovery is failing to gain traction **(Figure 2)**. Leading indicators suggest the economy remained mediocre in the second quarter. Employment data show only 80,000 new jobs being created in June, well below expectations. Unemployment has remained above 8%—placing downward pressure on consumer income and spending **(Figure 3)**. The Purchasing Managers' Index (PMI) suggests that growth in manufacturing has been moderating—mainly from weaker external demand. Fiscal stimulus could help provide a boost to the economy, but public spending has been contracting. New fiscal stimulus is unlikely with the presidential election campaign intensifying and the Congressional deadlock. There is also the prospect of a "fiscal cliff" at the beginning of 2013, when several tax cuts expire and spending cuts come into effect. This would prune the federal budget deficit by $600 billion, severely affecting growth. The US Federal Reserve has confirmed it will extend "Operation Twist"—where it

Figure 1: 10-year Government Bond Yields (%)



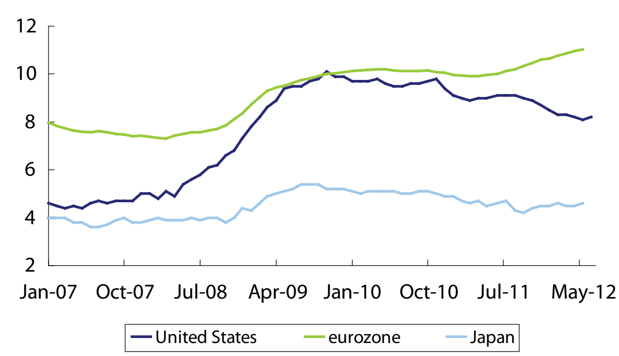
Source: Datastream.

Figure 2: GDP Growth—G3
(seasonally adjusted, annualized, q-o-q, % change)



eurozone = Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain; G3 = eurozone, Japan, United States (US); GDP = gross domestic product; q-o-q = quarter-on-quarter.
Source: ADB calculations using data from Cabinet Office, Government of Japan (Japan); Eurostat website (eurozone); and Bureau of Economic Analysis (US).

Figure 3: Unemployment Rate—G3
(seasonally adjusted, % of labor force)



eurozone = Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain; G3 = eurozone, Japan, United States (US).
Note: Data for eurozone and Japan until April 2012.
Source: US Bureau of Labor Statistics, European Central Bank, and CEIC.

uses proceeds from short-term Treasury sales to buy long-term securities—to keep long-term interest rates low and stimulate the economy. However, the efficacy of "Operation Twist" will likely be limited given low prevailing interest rates. As a result, US growth should remain weak—1.9% for 2012 and 2.2% for 2013.

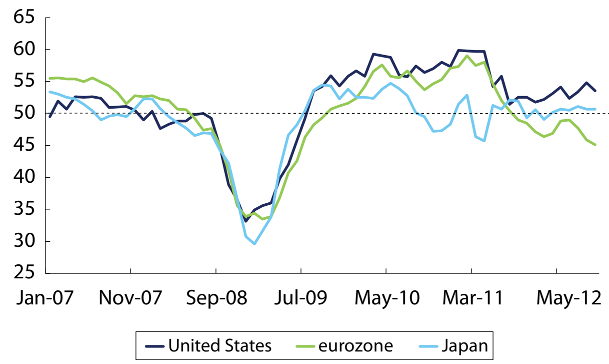
The eurozone—still trying to resolve its sovereign debt and banking crisis—continues to struggle with weak manufacturing and rising unemployment.

Economic growth in the eurozone during the first quarter of 2012 came to a standstill with considerable diversity in how each economy performed. Germany continued to grow, but others struggled. The eurozone sovereign debt and banking crisis intensified as the focus shifted to Spain—the area's fourth largest economy. The eurozone bailout of the Spanish banking sector managed to calm markets briefly, but bond yields soon rose to pre-bailout levels. The banking crisis has also spread to Cyprus, further highlighting the threat of contagion across Europe. This prompted European governments to allow the European Stability Mechanism (ESM) to directly rescue banks. The manufacturing outlook remains grim with the May PMI slumping to a 3-year low **(Figure 4)**. In particular, recent leading indicators suggest that weak global demand is starting to affect German manufacturing. Also, unemployment continues to rise, keeping growth in private consumption muted. Retail sales in the eurozone have been declining and consumer sentiment remains negative. Responding to the bleak outlook, the European Central Bank cut its policy interest rate by 25 basis points to a record low of 0.75%. The eurozone economy is expected to contract by 0.7% in 2012. As confidence gradually returns and the financial system stabilizes, eurozone growth is forecast to recover to 0.8% in 2013.

Japan's economy is recovering, helped by reconstruction; but its growth outlook is hampered by weak external demand and a strong yen.

Japan's growth rebounded strongly in the first quarter to 4.7% q-o-q, saar. However, this pace is not expected to continue for the rest of the year. While reconstruction—for which the government allocated ¥18 trillion (3.8% of GDP)—and consumption will continue to support growth, exports will be hampered by weakness in the global economy and slowing growth in the People's Republic of China (PRC). The yen's continued strength as

Figure 4: Manufacturing Purchasing Managers' Index—G3



eurozone = Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain; G3 = eurozone, Japan, United States.
Note: A purchasing managers' index reading above 50 points indicates an expansion in the manufacturing sector while below 50 points indicates a contraction.
Source: Bloomberg.

a "safe haven" currency will also hurt exports. There are also concerns over the plunge in business investment during the first quarter. Leading indicators suggest the economy moderated in the second quarter. Industrial production is leveling off and the manufacturing PMI is flat. Retail sales growth remains robust but is moderating. The recent agreement to increase the sales tax in stages could lead consumers to buy early in anticipation of higher taxes—thus increasing current growth at the expense of future growth. On the monetary front, Bank of Japan's expansionary monetary stance is showing signs of success with inflation holding above zero. Yet, with inflation still comfortably below the 1% objective, the current loose monetary policy is expected to continue. Japan is currently forecast to grow 2.2% in 2012 before moderating to 1.5% in 2013.

Regional Economic Outlook

The weak external environment plus slower growth in the PRC and India has lowered growth projections for developing Asia.

Growth in developing Asia moderated in the first half of the year partly on slower growth in the US and eurozone, which reduced demand for the region's exports. In addition, unwinding policy stimulus and some tightening in the PRC and some other countries also contributed to a weaker first half performance. The exception was Southeast Asia, which posted strong growth in the first quarter due to Thailand's rapid recovery from flood-induced disruptions. The external environment is expected to remain weak for the remainder of the year. But policy easing and

Table 1: Regional GDP Growth[1] (y-o-y, %)

	2009	2010	2011	ADB Forecast 2012	ADB Forecast 2013
Developing Asia	6.0	9.1	7.2	6.6	7.1
Central Asia[2]	3.2	6.6	6.2	5.8	6.2
East Asia[3]	6.8	9.8	8.0	7.1	7.5
PRC	9.2	10.4	9.2	8.2	8.5
South Asia[4]	7.5	7.7	6.2	6.2	6.9
India	8.4	8.4	6.5	6.5	7.3
Southeast Asia[5]	1.4	7.9	4.6	5.2	5.6
The Pacific[6]	4.3	5.5	7.0	6.0	4.2
Major industrialized economies					
United States	-3.5	3.0	1.7	1.9	2.2
eurozone	-4.4	2.0	1.5	-0.7	0.8
Japan	-5.5	4.4	-0.7	2.2	1.5

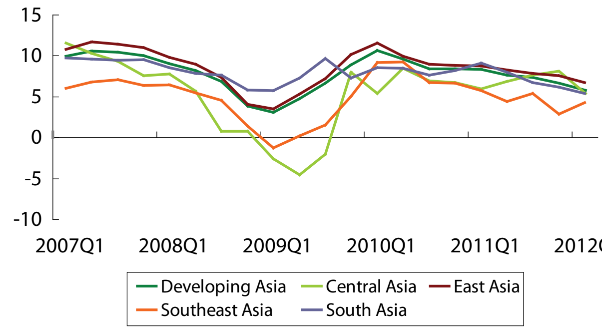
PRC = People's Republic of China, GDP = gross domestic product, eurozone = Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.
[1]Aggregates are weighted according to gross national income levels (Atlas method, current $) from *World Development Indicators*, World Bank.
[2]Includes Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
[3]Includes the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China.
[4]Includes Afghanistan, Bangladesh, Bhutan, India, Republic of the Maldives, Nepal, Pakistan, and Sri Lanka. Data for Bangladesh, India, and Pakistan are recorded on a fiscal-year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.
[5]Includes Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. Excludes Myanmar as weights unavailable.
[6]Includes the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

increased government spending—to stimulate domestic demand—as well as rising regional demand could help offset some of the slower demand from the US and eurozone. Thus, economic growth in developing Asia is expected to moderate to 6.6% this year before recovering to 7.1% in 2013 **(Table 1)**.

Growth in the highly open economies of East Asia is expected to moderate given the weak outlook in Europe and the US and the slowing PRC economy.

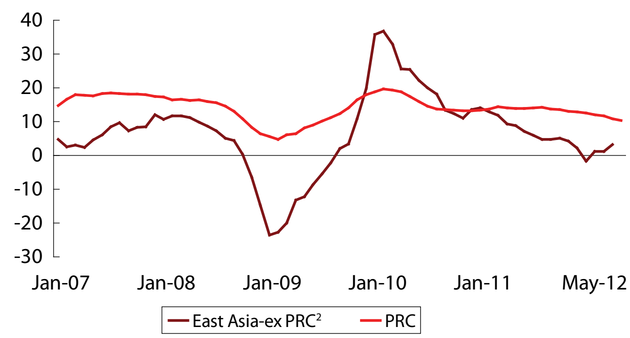
Economic growth in East Asia continued to moderate in the first half of 2012 on deteriorating external demand and volatile financial markets. The GDP growth fell to 6.7% in the first quarter, down from 7.6% in the last quarter of 2011 **(Figure 5)**. Hong Kong, China and Taipei,China barely avoided contracting in the first quarter—both economies growing by 0.4%. First-quarter growth in the Republic of Korea slowed to

Figure 5: Asia—GDP Growth (y-o-y, %)



GDP = gross domestic product.
Note: Developing Asia excludes the Pacific as quarterly data unavailable. Central Asia includes Armenia, Georgia, and Kazakhstan. East Asia includes the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China. Southeast Asia includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. South Asia includes India and Sri Lanka.
Source: ADB calculations using data from CEIC.

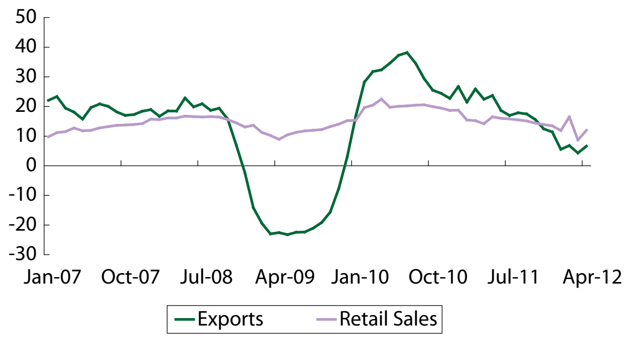
Figure 6: East Asia—Industrial Production Index Growth[1] (y-o-y, %)



PRC = People's Republic of China.
[1]3-month moving average. Data for East Asia- ex PRC until April 2012.
[2]Includes the Republic of Korea and Taipei,China.
Source: ADB calculations using data from CEIC.

2.8% from 3.3% in the fourth quarter of 2011, due to declining investment as businesses and investors grew more cautious. However, Mongolia's economic growth continued to be strong, with GDP rising 16.7% in the first quarter. Together, the five economies in East Asia grew by 8.1% in 2011, significantly below the 9.8% in 2010. Economic indicators for the second quarter point to continuing moderation, as growth in industrial production, retail sales, and exports moderate **(Figures 6, 7)**. The manufacturing PMI has also trended down in recent months, indicating manufacturing could grow more slowly in the Republic of Korea and Taipei,China **(Figure 8)**. With the weaker global outlook and a deepening eurozone debt crisis, growth in East Asia is expected to slow further to 7.1% in 2012 before recovering to 7.5% in 2013.

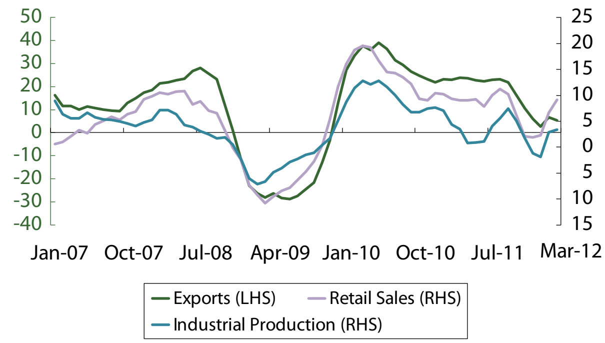
Figure 7: East Asia—Merchandise Export and Retail Sales Growth[1] (y-o-y, %)



[1]3-month moving average. Retail sales data does not include Mongolia as monthly data unavailable.

Source: ADB calculations using data from CEIC.

Figure 9: Southeast Asia[1]**—Merchandise Export, Retail Sales, and Industrial Production Growth**[2] (y-o-y, %)



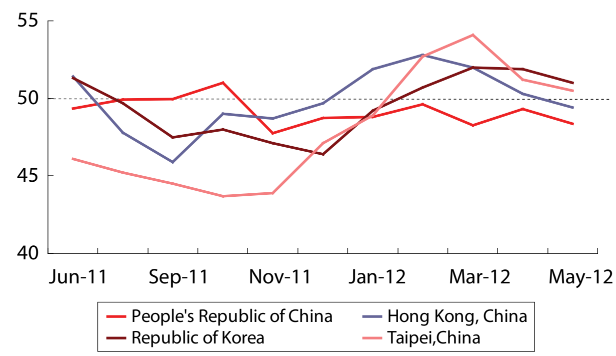
LHS = left-hand scale, RHS = right-hand scale.

[1]Export and industrial production data cover Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. Retail sales data cover the Philippines, Singapore, Thailand, and Viet Nam.

[2]3-month moving average.

Source: ADB calculations using data from CEIC.

Figure 8: East Asia—Manufacturing Purchasing Managers' Index



Note: Composite purchasing managers' index (PMI) for Hong Kong, China. A PMI reading above 50 points indicates an expansion in the manufacturing sector while below 50 points indicates a contraction.

Source: Markit Financial Information Services.

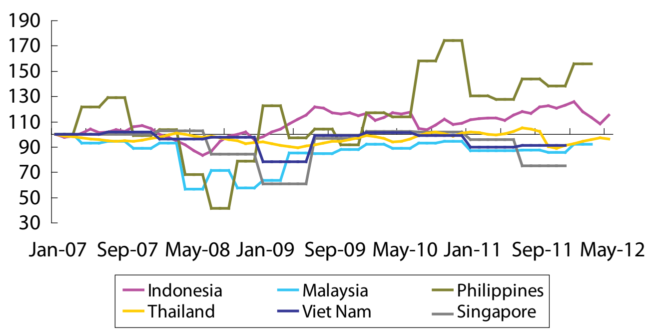
PRC growth is slowing as it unwinds policy stimulus; but it may receive a boost from recent macroeconomic easing.

The PRC economy moderated further in the first half of 2012. GDP grew by 8.1% in the first quarter, with lower net exports subtracting 0.8 percentage points from GDP growth. Economic growth slid further in the second quarter, growing by just 7.6%. Growth in industrial production fell further in June and the manufacturing PMI remained below 50 in recent months, indicating manufacturing is possibly contracting (see Figure 8). Despite the difficulty in the global economy, PRC's exports grew 11.3% in June, faster than 6.3% import growth in the same period. To stabilize economic growth, authorities began to ease macroeconomic policy. The People's Bank of China cut its reserve requirements three times—by a total of 150 basis points—and cut interest rates twice in June and July. Fiscal policy remains supportive as expenditures are growing faster than revenues. Authorities also rolled out measures to boost consumption and increase expenditure in education and health. They also expedited approval of large infrastructure projects. The stimulus so far has been modest and focused, in contrast to the massive stimulus package in late 2008. The economy is expected to pick up slightly during the second half, growing by 8.2% in 2012, before expanding 8.5% in 2013.

In Southeast Asia, strong domestic demand and flood-related reconstruction should keep GDP growth robust despite the weaker external environment.

Strong domestic demand and private investment helped drive Southeast Asian growth in the first half. The region's economies expanded 4.3% in the first quarter after a weak 2.9% performance in the last quarter of 2011. The improvement was due mainly to the strong rebound in Thailand's growth after the disruptions from last year's floods—and strong Philippine growth. However, more open economies such as Singapore and Malaysia posted slower growth in the first quarter. Viet Nam's first half growth came in lower than expected due to domestic policy tightening and weakness in the banking sector. The weaker external environment will likely contribute to slower export growth, hurting the more export-dependent economies in the region. Both export growth and industrial production are trending down **(Figure 9)**. However, private consumption remains strong, helping sustain the robust growth outlook for the region. Retail sales have been picking up and consumer confidence has remained strong, particularly in Indonesia and the Philippines **(Figure 10)**. The region's growth will also get a boost from Thailand's continued rapid recovery with the government expected to spend B480 billion (4.2% of GDP) for flood-relief and reconstruction. Most governments also retain sufficient policy space to ease monetary policy and provide fiscal stimulus if needed. As a result, Southeast Asian economies are expected to post faster growth of 5.2% in 2012 and 5.6% in 2013.

Figure 10: Southeast Asia—Consumer Confidence Indexes
(January 2007 = 100)

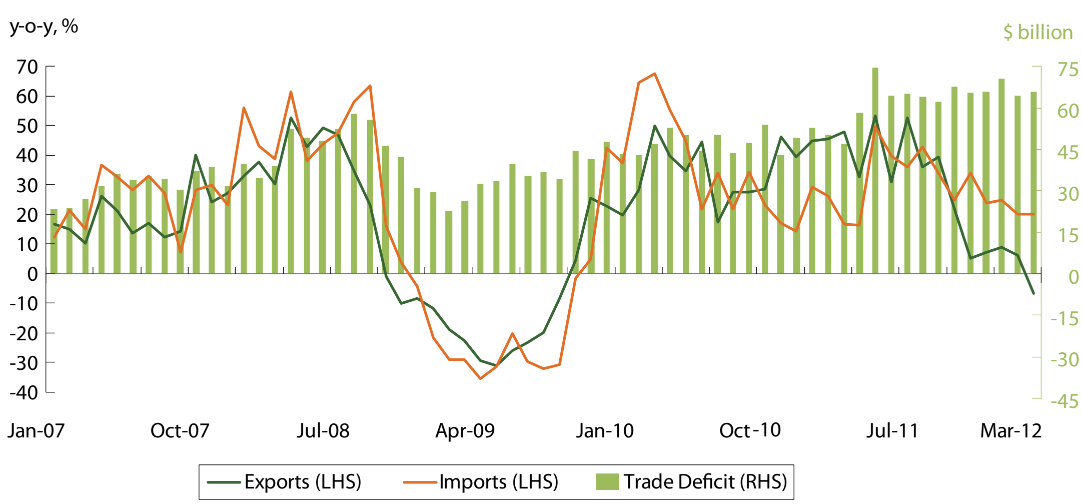


Note: Semiannual data for Singapore and Viet Nam (as of December 2011) are from MasterCard Asia Pacific Consumer Confidence Survey (the MasterCard Index score is calculated with zero as the most pessimistic, 100 as the most optimistic; the series were incremented by 50 points for consistency with other series—where neutral is equal to 100). Others are from national agencies.
Source: ADB calculations using data from Bloomberg and CEIC.

South Asia's economic growth will moderate as uneven domestic demand adds to weak external demand.

Lower commodity prices are helping reduce imports, which significantly spiked trade deficits in South Asia since the middle of last year. Exports have declined faster than imports causing trade deficits to widen **(Figure 11)**. Although offset somewhat by stable remittance inflows, the widening trade deficits contributed to currency depreciation in most South Asian countries. The deficits also helped push inflation up since early 2012 with some countries' inflation reaching above last year's levels. Foreign investment is also declining in India and Pakistan. Domestic conditions vary among major economies. Pakistan's real private consumption grew significantly higher in fiscal year (FY) 2012 than FY2011—supported by remittances—while private investments contracted. On the other hand, Sri Lanka's high 7.9% GDP growth in the first quarter was supported by construction and mining/quarrying as well as agriculture although growth in services slowed. The manufacturing sector across much of South Asia also slowed. Given the uncertain export outlook, South Asia may have to curtail imports to keep inflation at bay and currency values stable. Overall, South Asian economies are expected to grow by 6.2% in FY2012 and 6.9% in FY2013.

Figure 11: South Asia[1]—Trade Deficit and Growth of Exports and Imports



LHS = left-hand scale, RHS = right-hand scale.
[1]Includes Bangladesh, India, Nepal, Pakistan, and Sri Lanka.
Source: ADB calculations using data from CEIC.

India's GDP growth has been dampened by high inflation and trade deficits, which make it difficult to ease monetary policy.

India's weak domestic demand has hampered growth, adding to the effect of a weaker global environment. GDP growth during the last quarter of FY2011 was 5.3%—6.5% for the whole fiscal year—dragged down by low growth in capital formation and consumption. Leading indicators also confirm the continued slowdown—for example, motorcycle sales and the infrastructure index remained low in May. Business optimism also continues to be lackluster after the sharp decline last year **(Figure 12).** Domestic credit growth recovered only marginally after monetary easing by the Reserve Bank of India (RBI) in April, while money supply increased substantially, adding to inflationary pressures. The consumer price inflation reached 10.4% in May, pushed by food prices. However, wholesale prices were relatively stable at 7.6% in May, significantly lower than last year as the food price increase was offset by a fall in manufacturing prices. RBI's decision in June to keep policy rates unchanged highlights the challenges the monetary authority has to face in trying to balance short- and medium-term growth. India's GDP is forecast to grow 6.5% in FY2012 and 7.3% in FY2013.

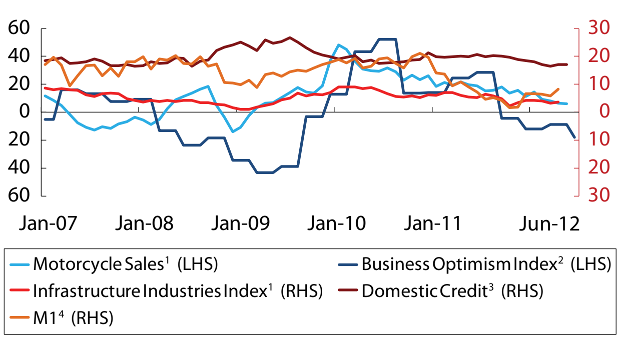
Lower oil prices and close links with the eurozone will likely hurt GDP growth in Central Asia.

Central Asian economic growth slowed in the first half of 2012. Kazakhstan's growth moderated to 5.6% in the first quarter of 2012 from 8.7% in the fourth quarter of 2011. Similarly, Armenia and Georgia recorded slower growth in the first quarter compared with the fourth quarter of last year. Some of the slowdown was due to weaker growth in Europe and the PRC—key markets for the region's exports. Indeed, export growth slowed and industrial production remained stagnant **(Figure 13)**. The Kyrgyz Republic has been hit by a drop in gold production, which accounts for half of total industrial production. Falling oil prices will hit government revenues across oil-dependent Central Asia. However, some of the impact on growth could be offset by drawing down oil windfall funds for government spending. Strong growth in public spending, the development of new oil fields in Kazakhstan, and expansion of new gas pipeline network in Turkmenistan should help support growth in the region. GDP growth in Central Asia is expected to moderate to 5.8% in 2012 before improving to 6.2% in 2013.

The resource-dependent Pacific countries will see slower economic growth due to commodity price declines; but smaller island economies are benefiting from strong tourism and development spending.

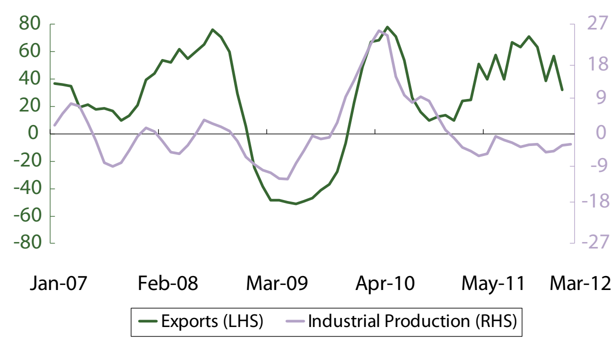
Growth in the Pacific is driven primarily by developments in the larger resource-exporting economies of Papua New Guinea (PNG), Solomon Islands, and Timor-Leste; which together account for two-thirds of the region's output. Growth in PNG and Solomon Islands is projected to ease in 2012, as international prices for their main exports decline, and some petroleum and forest reserves

Figure 12: India—Growth of Domestic Demand Leading Indicators (y-o-y, %)



LHS = left-hand scale, RHS = right-hand scale.
[1]3-month moving average. Data for motorcycle sales and Infrastructure Industries Index until May 2012.
[2]Quarterly data for Business Optimism Index until 2012Q2.
[3]Data for domestic credit until May 2012.
[4]Refers to money supply consisting of currency with the public and deposit money. Data until April 2012.
Source: ADB calculations using data from CEIC.

Figure 13: Central Asia[1]—Merchandise Export and Industrial Production Growth[2] (y-o-y, %)



LHS = left-hand scale, RHS = right-hand scale.
[1]Export data cover Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, and Tajikistan; data until February 2012. Industrial production data cover Armenia, Kazakhstan, the Kyrgyz Republic, and Tajikistan.
[2]3-month moving average.
Source: ADB calculations using data from CEIC.

show signs of depletion. Growth is expected to slow further in 2013, as the construction of the liquefied natural gas project in PNG and public infrastructure investments in Timor-Leste taper off. In other Pacific islands, which have generally grown more slowly, growth is expected to fall to about 2% in 2012 and 2013. In Fiji, floods early this year hurt key agricultural exports, maintaining the lull in investment and private sector growth the country has been beset with since 2006. Strong tourism has boosted growth in some smaller Pacific economies—such as the Cook Islands and Palau. Public expenditures on development partner-financed projects have also played a major role in driving growth. Economic growth in the Pacific region is projected to moderate from 7.0% in 2011 to 6.0% and 4.2% in 2012 and 2013, respectively.

Risks to the Outlook

The eurozone sovereign debt and banking crisis could worsen, causing a deep, prolonged recession.

Both Spain and Cyprus have sought bank bailouts from the European Union (EU). The burden of rescuing the banking sector has exacerbated fiscal conditions, resulting in continued high bond yields. This raises questions over the fiscal sustainability in both Italy and Spain (the two account for 28% of eurozone GDP). In turn, weaker government finances hurt the banking system that holds large amounts of government bonds. The 29 June announcement by the EU to allow the ESM to inject funds directly into weak banks is meant to break this cycle. Nevertheless, the multitude of efforts thus far has only postponed but not resolved the fundamental problems of high public debts and fiscal deficits in periphery countries. Pressure has increased to move away from the tight austerity stance. The recently elected Greek government has affirmed its commitment to remain in the eurozone but with the hope that the austerity measures are softened. Germany has shown signs of relenting on some austerity measures, but stopped short of agreeing to issue common eurobonds. Without further progress toward this form of risk pooling the already weak eurozone economies will continue to be vulnerable to a crisis. This could reignite panic in financial markets and lead to a severe liquidity crunch—with the effect of forcing the eurozone into a deeper recession, one which could severely impact the global economy.

The risk of large and volatile capital flows remains given uncertain global financial conditions.

Poor prospects in Europe and the US have resulted in capital flowing to the better performing Asian economies. The policy of near zero interest rates in advanced countries encourages investors to seek higher yielding assets. However, given uncertainty in the global economy and financial sector, a sudden change in risk perception can happen, and this will bring about wild swings in capital flows. This is especially the case with Europe's banks, which could cut back lending to the region if their domestic position weakens. The resulting sudden shifts in capital flows could bring large exchange rate fluctuations, detrimental to export and import transactions. Abrupt changes in risk sentiment could reverse capital flows, damaging the region's growth prospects and exposing otherwise hidden vulnerabilities. When left alone, large inflows of capital can also lead to high credit growth, which could result in asset price bubbles.

Economic growth in the PRC may be slower than expected as the country adjusts to a more sustainable growth path.

The PRC's plan to reduce reliance on exports and focus more on domestic demand is a step toward rebalancing the economy. However, the transition could bring some difficult challenges. The shift toward lower investment could drop growth to around 7.5% in 2012 rather than our forecast of 8.2%. Measures to cool the property sector have already brought house prices down, but they could fall more sharply. Although the central government is pushing for greater infrastructure investment, its scale will likely be much smaller than before. High local government debt accumulated during the stimulus-induced investment may limit further spending. There also appears to be a maturity mismatch between short-term debt and longer-term infrastructure gestation periods, making it difficult for local governments to repay bank loans. While plans to extend maturities of local government loans may help alleviate the risk of short-term default, the problem remains. All these could cause economic growth to slow more than expected.

Policy Issues

Should the eurozone financial crisis spread globally, some Asian countries may need to use monetary and fiscal stimulus to mitigate its impact.

With global economic conditions weakening and prospects for future recovery uncertain, the external environment for developing Asia is expected to remain difficult. This is further compounded by a faster-than-expected slowdown in the PRC and India. Therefore, policymakers may need to deploy another round of fiscal and monetary measures to safeguard economic growth and ensure that growth is inclusive. Several developing Asian economies have already begun loosening monetary policy or have introduced new fiscal stimulus—to offset some of the impact of the weakening global environment. The recent decline in oil prices and other commodity prices could reduce inflationary pressures and offer further scope for monetary authorities to support growth. Policymakers also need to ensure that financial systems in the region remain liquid and well-capitalized. At the same time, to support the poor and vulnerable it is necessary to have adequate social protection mechanisms in place.

Continued development of more efficient, liquid financial markets allows policymakers to better manage capital flows and promote financial stability.

Developing deeper, more broad-based, and transparent financial markets can help countries allocate financial resources more efficiently and strengthen the resilience of domestic financial systems against volatile capital flows. While countries in the region have made progress, rapid financial globalization requires policymakers to keep up with the fast changing financial environment and remain in step with financial innovation. A better financial system needs better regulation. It can help ensure that funds are allocated efficiently to their productive use while minimizing the risk of instability. It can also reduce the reliance on volatile capital flows.

Asia needs to continue its economic transformation in a "new normal" where advanced economies are undergoing long-term restructuring—and thus slower growth.

In the medium- to long-term, developing Asia must confront the more difficult task of adjusting to a new global environment in which both the US and the eurozone face the prospects of an extended period of structural weakness due to poor economic fundamentals. The region must continue diversifying its sources of growth, allocating its financial resources more effectively and efficiently toward productive and socially equitable investment, and bolstering domestic and regional demand. Given the sluggish growth in advanced economies, developing Asia should continue to expand trade, particularly within the region and with other emerging markets such as Latin America and Africa. Just as important, developing Asia must ensure its future growth path is not only sustainable but increasingly inclusive. Policies should be designed to improve social and environmental outcomes. Key features of public policy could include human capital development, building inclusive financial systems, using new technologies to improve service delivery in education and health, and innovating for environmentally sustainable development.

Increasing policy cooperation in developing Asia can boost its economic transformation and mitigate the effects of external shocks.

A prolonged period of weak growth and financial fragility in advanced economies highlight the urgent need for internationally coordinated policy responses and greater levels of regional cooperation. To address key global and regional development challenges and cope with the transformation process, regional economic cooperation is likely to play an increasingly important role. Developing Asia has weathered the 2008/09 global financial crisis rather well. Nevertheless, it should continue to push regional cooperation to the next level to build greater resilience against external shocks and help transform the region's economies to higher and more equitable income status. In the long run, an Asian economic community is not unlikely, where Asia is regionally more integrated yet remains connected with global markets.