Highlights

Recent Economic Performance

- East Asia’s GDP likely grew 5.2% in the first three quarters of 2006, spurred by strong and steady demand for the region’s exports and an expansion in domestic demand that peaked in several economies in the first half.
- The export recovery, which started in the second half of 2005, extended well into the second half of this year for most of the region’s economies, markedly boosting the contribution of external demand to the economic expansion.
- Growth in domestic demand began to weaken in the second half of 2006 in the NIEs and ASEAN-4, reflecting a drop-off in already low investment growth and, more generally, slightly softer but still strong growth in consumption.
- In the PRC, growth of investment in fixed assets peaked in June 2006 before slowing markedly as a result of the cumulative policy measures introduced to curb excessive investment in key sectors such as real estate.
- With the moderation in world economic expansion and softening global oil prices, inflationary pressures have eased across most of East Asia.
- Strong export growth and subdued import growth sustained current account surpluses through the first half of 2006, while net overall foreign inflows into the region continued into the second half of 2006, resulting in continued reserve accumulation.
- As inflationary pressures subsided, and with US policy rates unchanged since late June 2006, policy interest rates remained stable across much of East Asia in the second half of 2006, after substantial tightening in the previous six months.
- Financial sector indicators in East Asia generally remained strong, but progress in financial sector reform and restructuring has been uneven and vulnerabilities remain, such as growing exposure of banks to real estate.

Outlook, Risks, and Policy Issues

- With economic growth in the US and euro zone slowing to a more tempered pace, the external environment facing East Asia in 2007 is likely to be somewhat less supportive of economic growth, but more conducive to containing inflation.

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Coupled with an expected slowdown in growth in Japan and the PRC, the somewhat less favorable external environment should lead to a moderation of average GDP growth in East Asia from a postcrisis peak of 4.9% in 2006 to 4.4% in 2007.

Slow growth is expected to ease inflationary pressures across the region in 2007, continuing the trend of recent months, while current account surpluses are expected to remain relatively strong.

Several risks could upset the above outlook: (i) a sharper-than-expected slowdown in the US economy, (ii) a disorderly adjustment of global payments imbalances, (iii) significant global financial market turbulence, (iv) a sudden oil supply shock, (v) an insufficient slowdown of the PRC economy, and (vi) disruptions stemming from non-economic shocks such as geopolitical tensions and an avian flu pandemic.

While the threat of persistently high inflation in the US has not faded completely, the near-term risk of a sharper-than-expected slowdown—even the possibility of a recession—is higher now than in early 2006.

East Asia remains vulnerable to a disorderly adjustment of the still-growing global payments imbalance, especially because many economies in the region have significant exposure to the US through trade, investment, and finance.

There is a possibility of significant global financial market turbulence. Markets are increasingly jittery over the risk of a US recession, a sliding US dollar, and an uncertain path of US monetary policy.

Although international oil prices have fallen from the August 2006 peak, a sudden reversal could further slow growth in economies worldwide and reignite inflationary pressures.

Despite the recent easing of investment growth in the PRC, there remains the risk that growth may not slow smoothly to a more sustainable pace.

Given the outlook for slower growth and reduced inflationary pressures, the case for additional increases in policy interest rates is less clear in most East Asian economies.

The economic outlook offers limited rationale for aggressive fiscal expansion in the near term, although additional public spending on priority infrastructure may be desirable.

Structural vulnerabilities remain, however, and policy adjustments could focus on (i) alleviating constraints on productive investments in some economies and improving the quality of investment in others, (ii) applying greater exchange rate flexibility, (iii) increasing energy efficiency, and (iv) developing rapid-response systems to minimize damage from exogenous shocks.

Although there are many constraints on domestic market-oriented investment, policies that rebalance the sources of growth away from exports toward domestic demand are of particular importance.