Recent Economic Performance

• Stronger-than-expected economic growth in emerging East Asia during the first 3 months of 2008 gave way to moderation in the second quarter, as slower growth in industrialized economies began to impact the region.

• Even as economic growth showed signs of moderation in the second quarter, headline inflation rose sharply as global oil and food prices surged, with a rise in core inflation indicating that second-round effects may be underway.

• The balance of payments remained in surplus across much of the region, sustained largely by continued, if narrowing, current account surpluses and strong capital inflows.

• Trends in currency markets were mixed in the first half of 2008—some faced downward pressure against the US dollar from rising oil prices, inflation, and the effect of terms-of-trade deterioration, while others continued to strengthen, supported by strong balance of payments positions.

• Across much of the region, monetary policies are increasingly focusing on controlling inflation.

• Financial markets and institutions in the region remain vulnerable to the rough waters created by heightened investor risk aversion and a wave of asset re-pricing.

Outlook, Risks, and Policy Issues

• The external economic outlook for emerging East Asia has dimmed amid prospects for slower growth, tighter credit conditions, and higher inflation.

• Emerging East Asia is expected to see slowing yet solid growth as it weather the current global economic headwinds relatively well—GDP growth is projected to reach 7.6% in both 2008 and 2009.

• The region’s solid growth outlook is vulnerable to several potentially harmful risks—including higher-than-expected inflation, a sharper or protracted economic slowdown in the US, and another bout of global financial turbulence.

• Heightened inflationary pressures will require more decisive tightening of monetary policies across much of emerging East Asia, and in economies with healthy fiscal positions, carefully-designed fiscal support—though avoiding artificial price-fixing and subsidies—can cushion the most vulnerable from the immediate effects of food and energy price increases.
Other policy priorities could include (i) the required structural economic adjustment to accommodate the negative terms-of-trade shock; (ii) deeper and more comprehensive structural reforms to upgrade the investment climate in several emerging East Asian economies; (iii) nurturing more efficient and liquid financial markets to help channel capital into productive use and enable more effective management of capital flows and foreign exchange reserves; and (iv) measures to promote energy efficiency and conservation.

Dealing with Inflation: Policy Options for Emerging East Asia

- The current inflationary environment poses a dilemma for policymakers as controlling inflation depresses economic activity—forcing authorities to weigh the benefits of stabilizing prices against the costs of slowing growth.
- With monetary policy in many emerging East Asian economies behind the curve—there are growing signs that inflation expectations are beginning to drift, with second-round price effects beginning to burrow through the region’s economies.
- With the balance of risks tilted toward inflation, many of the region’s central banks need to be more decisive in tightening monetary conditions.
- Along with monetary tightening, selective use of fiscal measures can relieve the regressive tax effect of rising food and energy prices on the poor without necessarily undermining price stability.
- Allowing currencies to rise faster will help contain imported inflationary pressures, while increasing monetary policy autonomy.
- Enhancing the credibility of monetary authorities is an important challenge for many of the region’s central banks.