Regional Economic Outlook: Asia and Pacific

Executive Summary – November 2008

With the global economy entering a major downturn amid a deepening financial crisis, Asia is confronting the likelihood of sharply slowing growth and increased vulnerabilities. In particular, global financial stresses and the process of deleveraging by financial institutions are expected to continue beyond next year. This will dampen economic prospects in the region via a number of potential channels, notably lower demand for Asia's exports, tighter funding conditions, more volatile capital flows, depressed equity prices and confidence, and deteriorating loan quality.

As outlined in Chapter 1, our baseline scenario sees growth in Asia slowing substantially before beginning a recovery in late 2009. With the global slowdown dampening exports, growth in Asia is projected to come primarily from domestic demand, which is nonetheless expected to slow. With commodity prices easing and growth declining below potential, inflation should decline. In fact, there are signs that headline inflation—and to a lesser extent, core inflation—have already peaked.

Risks to the outlook are considerable and tilted firmly to the downside. A severe global recession, combined with a deeper-than-expected credit squeeze, would have significant spillovers to the region, through both exports—Asia's trade integration with the rest of the world has increased over the last decade—and a range of financial channels. In particular, it remains unclear how domestic demand would stand up to a sharp decline in export growth and tighter financial conditions.

In this volatile economic environment, policymakers in Asia need to be ready to react decisively to maintain financial stability and support growth:

- Policies to safeguard financial systems and maintain orderly credit conditions will be key. While the precise measures will vary across countries, efforts should include strengthening of crisis management systems and contingency planning, enhancing oversight of banks' liquidity management, and improving risk management to address the likely rise in nonperforming loans. Temporary credit guarantees may be necessary to ensure the normal flow of credit, and authorities have to stand ready to recapitalize banking systems if needed.

- In most Asian countries—where domestic demand is easing, financial conditions have tightened, and second-round price effects are modest—monetary easing would be appropriate. But with inflation still above targets or comfort levels in many of these countries, effective communication by central banks will be key to ensuring that inflation expectations remain well anchored. Beyond considerations of inflation, monetary policy will have to ensure sufficient provision of liquidity for orderly market functioning.

- Many countries would appear to have room for additional fiscal stimulus, which may prove necessary in particular should the current financial environment limit the effectiveness of monetary policy. Some countries have in fact already announced fiscal stimulus packages, in some cases sizable ones.

While attention now is rightly focused on near-term risks, longer-term issues will inevitably return to the fore when the worst of the crisis has passed. In this context, Chapter 2 examines the rising contribution of commodity prices in Asia's inflationary process and its potential implications for monetary policy. In the near term, sharply falling commodity prices may exert deflationary pressures on Asia. At the same time, commodity prices are tentatively expected to return to a high and volatile medium-term equilibrium, the result of underlying imbalances in commodity markets. Such gyrations in commodity prices may exacerbate already high inflation volatility, entrench wedges—both positive and negative—between core and headline inflation, and worsen output/inflation volatility trade-offs faced by central banks. Such an environment will require a careful consideration of policy frameworks and place a premium on effective central bank communication.

Looking further ahead, a number of countries in the region are set to age dramatically over the next 50 years, and for some the process has already begun. As discussed in Chapter 3, vastly differential rates of aging across Asia and globally can have potentially large effects on current accounts and capital flows—with capital tending to flow "uphill" from younger to older countries—as well as on financial markets and asset prices. Despite the longer-term nature of the challenge, governments can ease the potentially costly transition by beginning to take steps now. For aging countries this may involve an emphasis on pension and labor force reform, while for younger countries requiring substantial capital, enhancing financial intermediation and boosting productivity will take center stage.