Executive Summary

The spillovers from the global crisis have affected Asia with considerable speed and force. GDP in emerging Asia excluding China and India plummeted by no less than 15 percent on a seasonally adjusted annualized basis in the last quarter of 2008, and a further decline is expected for the first quarter of 2009.

In many ways, this severe impact was unexpected. Asia is far from the epicenter of the crisis, not just geographically but also in the sense that it did not indulge in the financial practices that led to serious problems in advanced economies' banking systems. Moreover, before the crisis the region was in sound macroeconomic shape, and thus in a strong position to resist the pressures emanating from advanced economies. In the event, however, the impact on Asia has been even swifter and sharper than in other regions.

What explains this outcome? As Chapter 1 explains, the answer lies in Asia's exceptional integration with the global economy. Much of Asia relies heavily on technologically sophisticated manufacturing exports, products for which demand has collapsed. At the same time, Asia's financial ties with the rest of the world have deepened over the past decade, exposing the region to the forces of global deleveraging.

Looking ahead, Asia's growth path will continue to run parallel to the global economy. For the rest of 2009, the external shock is expected to continue to spill over into private investment and consumption, causing many countries to register negative growth rates. Then, as the global economy revives in 2010, so too will Asia. But the recovery is likely to be tepid—and not only because the global economy will remain weak. As Chapter 2 argues, historical experience shows that investment tends to recover slowly from downturns, especially those that involve financial stress.

The risks to this baseline scenario are skewed to the downside. In particular, a delayed global recovery may trigger more insidious feedback loops between the real and financial sectors in Asia. As discussed in Chapter 3, continued weak demand and tighter financial conditions could lead to a surge in corporate distress that could feed back into Asian banks, making them even less able or willing to extend credit to the private sector. At the same time, a surge in corporate bankruptcies could spill over to domestic demand, with a sharper-than-anticipated increase in unemployment rates putting a dent in consumption.

Over the longer horizon, Asian economies are at risk of a structural decline in demand from advanced economies. Households in advanced economies have started repairing their over-leveraged balance sheets, as the era of easy credit to finance purchases of consumer durables could well be over. In that case, the growth rate of Asian manufacturing and exports could be structurally lower for many years, and Asia's export-led growth strategy may no longer pay the same dividends as in the past.

In this context, the challenge for Asia's policymakers is twofold:

- First, forceful countercyclical policies need to be sustained, to help Asia come out of the recession more quickly and vigorously, and to provide insurance against downside risks. On the fiscal policy side, it will be important to sustain the stimulus injected in 2009 into next year, not least as an insurance policy against risks that have yet to reveal themselves. At the same time, it will be critical to preserve fiscal credibility by signaling that such stimulus packages are extraordinary and will be unwound once the recovery is firmly established. On the monetary policy side, many central banks still have scope to reduce policy rates, while some may need to support credit to the private sector through unconventional measures. Japan's experiences with the crisis of the 1990s, examined in Chapter 4, suggest however that these measures may need to be accompanied by timely steps to address any underlying stress in the financial system as well as in household and corporate balance sheets.
- Second, Asia may need to rebalance growth away from exports and toward domestic demand in order to return to precrisis growth rates. China is already trying to catalyze private consumption, which has been falling for a decade relative to GDP. In principle, there should be scope to do this in many other Asian countries, particularly by building stronger social protection systems that will reduce the need for precautionary savings to meet necessities related to health, education, and retirement. Over the longer term, exchange rate appreciation also might help—by providing price incentives to shift resources toward production for domestic use and by raising real household income, thereby spurring consumption.