The global crisis hit Asia hard late last year. While Asia was not directly exposed to the financial assets that were at the epicenter of the global crisis, it was severely affected from the sharp downturn in the U.S. and Europe as the trade implications of the global downturn reverberated through the Asian supply chain, capital flowed out of the region, and trade finance also stalled. Exports fell throughout the region and, as demand from abroad collapsed, industrial production dropped precipitously.

The global economy is now beginning to pull out of recession (Chart 1). Real GDP in the second quarter surprised mostly on the upside, with an expansion in France, Germany, and Japan and a slower pace of contraction elsewhere, including in the United States. Emerging economies, led by China and India, are turning around even more strongly. As discussed in the IMF’s World Economic Outlook, released earlier this week, the global economy will contract by 1.1 percent this year with an expected growth of around 3 percent next year.

**Chart 1: Global Economic Activity Heat Map**

Sources: Haver Analytics; Bloomberg LP; and IMF, Global Data Source and staff calculations.

The above chart is based on the four economic indicators, including industrial production (IP), real retail sales (RS), merchandise exports (EX), and purchasing managers index (PMI). Some of the ratings—particularly for recent months—are based on both actual data as well as projections of the underlying variables.
The Asian recovery is leading the world…

Nevertheless, despite a very difficult first quarter across the region, an economic turnaround now appears underway in many countries and Asia looks set to emerge from the global downturn both faster and stronger than any other region. Our current estimates—shown in the latest World Economic Outlook that was released last week—are that Asia will grow 2.8 percent this year and 5.8 percent in 2010 (Chart 2). The employment losses during this downturn, while painful, in many countries have been much more mild than in past recessions. As in other parts of the globe, inflation has fallen as output gaps have widened and is expected to end the year at a regional average of 0.4 percent.

… benefiting from a highly effective policy response

This quick turnaround in the region benefited greatly from policymakers in Asia responding quickly and forcefully, on a broad range of fronts:

- Central banks quickly shifted toward an easing of monetary conditions;
- Currencies in many countries were allowed to move flexibly in response to the worsening trade prospects and capital outflows from the region;
- Expansionary fiscal and quasi-fiscal measures were put in place including significant reductions in taxes, a ramping up of infrastructure spending, financial support to smaller enterprises and those reliant on trade financing, and policies aimed at protecting the poor and those who had lost their jobs as a result of the downturn. The discretionary fiscal stimulus in Asia was substantial—larger than the G-20 average—and was quickly deployed.
- Some central banks in the region took advantage of swap facilities with the Federal Reserve to ease the pressures in U.S. dollar funding markets.
- And financial regulators resorted to a diverse and flexible set of measures to restore confidence—issuing blanket guarantees for bank deposits, backstopping the issuance of banks’ wholesale financing, and offering cover for corporations that had borrowed in foreign currency.

The net result was a stabilization of financial markets earlier this year and there are now clear signs that public stimulus is helping to drive the region’s recovery.
The strength of Asia’s rebound has been based on multiple forces

First, and foremost has been public demand. For the region as a whole, public demand has contributed around half of the 3.5 percent growth in the first half of this year, more than offsetting the drag from net exports.

Another major force behind the recovery in recent months has been the global restocking of inventories which had been drawn down to unprecedented levels earlier this year.

Financial systems in the region have been far less hit by events in the developed economies than elsewhere. Indicators of financial stress, credit growth, and counterparty risk have returned close to pre-crisis levels for much of the region. In addition, the region’s corporate sector entered the crisis with stronger balance sheets and lower levels of leverage than in past crises. Corporations have thus been more resilient to the downturn, have retained a larger part of their workforce, and have been able to quickly restore financing channels. They are now well positioned to take advantage of the economic rebound.

Finally, there are some signs of a strengthening of private demand growth. In many countries, consumer confidence is recovering, retail sales have picked up, and business confidence is improving. These broad trends are summarized in Chart 3.

Chart 3: Asian Economic and Financial Heat Maps

Sources: CEIC Data Company Ltd; Datastream; Haver Analytics; and IMF staff calculations.
1/ Three-month (or short-term) money market rate minus equivalent T-bill rate.
3/ Based on quarterly data.
Nevertheless, some of the current drivers of growth look set to wane

First, the turn in the inventory cycle in the U.S. and Europe should provide a boost to the region in the coming months but this will gradually lose impetus. We expect the process of restocking to have largely run its course by early next year. Similarly, many countries in the region, directly or indirectly, have benefited from incentive programs in the U.S. and Europe directed at stimulating purchases of new automobiles. As these programs run their course, global demand for autos and related inputs may dissipate, perhaps sharply if it transpires that these programs have done no more than change the timing of purchase decisions.

Second, based on current budget plans, some of the fiscal stimulus within the region looks set to be withdrawn during the course of 2010. Certainly there will still be some residual effects feeding through the economy from this year's large stimulus. Nonetheless, support to regional growth from the public sector is likely to taper off in 2010.

Japan's experience during its banking crisis in the 1990s also suggests reasons to be cautious on the sustainability of the incipient global recovery. On two occasions in Japan “green shoots” of recovery emerged allowing stimulus to be withdrawn. However, in both cases, the external environment deteriorated dramatically—first during the Asian financial crisis in 1997 and then the IT bubble collapse in 2000—with the shock to the economy magnified by a still fragile banking system (Chart 4). Each time a more severe downturn ensued, necessitating renewed stimulus to support activity. Indeed, an enduring recovery was achieved only when the financial and corporate problems at the heart of the crisis were addressed, allowing spillovers from policy stimulus and a more-favorable external environment to reinvigorate private demand.

Fiscal and monetary policies should, therefore, continue to provide stimulus

For the bulk of the region, monetary conditions will need to remain accommodative for much longer than has been the case in past cycles. The output gap in Asia widened during the downturn and, in general, the pressures from inflation are generally muted. The region’s central banks, therefore, generally have the room to maintain an accommodative monetary conditions until there are clear signs of a sustained growth in private demand. Beyond this broad picture, though, there is considerable heterogeneity within Asia. There are cases where inflation levels have declined less than the global average and have now started to turn upwards. Also, some countries—notably China—that have been experiencing rapid credit growth may need to gradually unwind loose financial conditions to avoid a build-up of future

Chart 4: Phases in Japan’s Banking Crisis

Source: Haver Analytics.
problems for banking systems. I would emphasize, however, that such cases are the exception rather than the rule. Nonetheless, these countries will need to weigh the balance of risks and potentially move toward a tightening bias in advance of much of the rest of the world.

Many countries in Asia have had a long history of fiscal discipline and this affords them significant scope to continue providing fiscal support to the economy. Given the uncertainties underlying the global environment, those that do not have pressing fiscal sustainability concerns can afford to maintain fiscal stimulus should this be necessary. Indeed, public support should be withdrawn only when there are clear signs that the recovery is self-sustaining and firmly anchored in renewed strength in private domestic demand. By contrast, other countries entered this downturn with relatively high levels of public debt and may have little choice but to begin the process of raising taxes and tightening spending at an early stage. Regardless of the pace of withdrawal of fiscal stimulus, it will be important for the region’s governments to lay out a clear path by which fiscal soundness will be restored. This will guide expectations and clarify the temporary nature of the fiscal stimulus, potentially increasing its effectiveness, including by limiting pressure on long term interest rates.

And the focus should be on bolstering private demand

Asia will not be able to count on strong external demand in the next 12 to 18 months. Past international experience suggests that, because this recession has been accompanied by a global banking crisis, the recovery will be slow and protracted. So far, the recovery in the US and Europe has been highly dependent on policy stimulus and public support to the financial system. Even as growth resumes in Asia’s main trading partners it will likely be protracted and sluggish, restrained by the drag from household balance sheet adjustment, difficult labor market conditions, and still-weak financial systems.

As a result, the impetus for Asia will need to come from within and policymakers will have to carefully manage the transition from public-led to private-sector led, domestic demand growth. The region will need to seek out the means to activate the private, domestic drivers of activity that are not yet in place. Efforts should therefore be directed at strengthening consumer confidence and facilitating a pick-up in private investment, particularly in those industries geared toward domestic markets. At the same time, Asia will need to continue to improve productivity. The fundamental shift in the drivers of demand—from the manufacturing of exports toward domestic sources and services—has the potential to lower productivity and employment, at least over the near-term. It will be essential to offset this depressing effect on growth through financial development, improvements in corporate incentives, and more efficient ways to allocate both capital and labor.
The IMF remains fully engaged with the region

In closing, let me just say a few words on the role of the Fund during this crisis and going forward. Over the past year:

- We have strengthened our efforts at both bilateral and regional surveillance and deepened our advice to regional policymakers based on our global perspective and near-universal membership. We are bringing that cross-country perspective to our analysis of the rapid changes in the policy environment, both within and outside the region, during this crisis and beyond. In this context, I would note that we will launch our Fall Regional Economic Outlook in Seoul and Tokyo at the end of October.

- The IMF has allocated US$ 54 billion in new resources to the region’s central banks through our recent allocation of Special Drawing Rights, bolstering reserves across the region.

- At the same time, the region has contributed significantly to providing the Fund with increased resources to support other countries and prevent them from succumbing to balance of payments crises as a result of global market pressures. All in all, through the New Arrangement to Borrow and Note Purchase Agreements, Asia has raised its contribution to the Fund by US$ 178 billion.

- The Fund has also been active in redesigning its lending facilities
  - increasing access and sharpening conditionality under our traditional loan facilities;
  - introducing a new precautionary lending vehicle (the Flexible Credit Line) to provide countries with very strong fundamentals, policies, and track records of policy implementation with substantial up-front resources, if needed;
  - expanding the options for supporting low income countries to better match their underlying circumstances, funded in part by a strictly limited sale of IMF gold. Indeed, within Asia we have entered into new, exceptional access loans with both Mongolia and Sri Lanka, averting potential balance of payments crises that would have had disastrous social costs. For example, following our program with Mongolia, financial markets stabilized quickly, capital outflows were reversed and the government looks set to soon agree a major mining contract with an international conglomerate that will have important benefits for the economy.

- At the recent G20 Summit there was a clear commitment to raising the quota share of the globe’s dynamic emerging markets and developing countries by at least 5 percent. This shift in representation will give Asia a larger voice in the IMF in accordance with its weight in the global economy.

- Finally, the Asia and Pacific Department has established a new regional advisory group, made up of renowned economic experts from Asia that will meet regularly with us and provide insight and advice on issues that are important to the region. I sincerely believe that this august group will prove an excellent means for us to hear important concerns and ideas from Asia.