EXECUTIVE SUMMARY

Developing East Asia is battling the forces of global recession. The impact of the crisis in the advanced countries was transmitted to the economies of the region with unusual speed. In the region, the initial global financial turbulence was marked by sudden reversals of capital flows in the middle-income economies, rapidly declining equity market prices, a sharp increase in the price of external private capital, a shortage of dollar liquidity, and in some cases, a depreciating currency. Now with aggregate global demand falling precipitously, region-wide declines in exports and industrial production are triggering widespread factory closures, rising unemployment, and lower real wages, with disproportionate effects on the poor and near-poor. Authorities in many countries are implementing social programs and cash transfers to assist those most in need. Where possible, policymakers have responded quickly with expansionary monetary and fiscal policies, including fiscal stimulus packages, although in most cases these measures will only mitigate, not overcome, the contractionary forces operating on their economies.

There are signs that the strongest economy in the region, China, is beginning to turn the corner. If it does so, what would be the implications for the rest of East Asia and the Pacific? A return to stronger economic expansion in China next year should help support growth among the countries of the East Asia and Pacific region, but a sustainable recovery will ultimately depend on developments in the advanced economies. Among developing regions, East Asia is best positioned to benefit from resumption in global growth, given its relatively open trade regimes, its infrastructure, and its strong and competitive production networks. Even so, the region's outward oriented economies are unlikely to enjoy the same success in the medium term as they did in the previous decade, in large part because the pressure to increase savings in East Asia's key export markets is likely to constrain their growth over the medium term. In addition, the risks to the outlook are weighted heavily on the downside. Continued banking problems or even new waves of tension in financial markets could lead to stagnation in global GDP or another year of declining GDP. The implications for East Asia would be increased pressure on labor markets and the fiscal accounts, and further deterioration in the portfolios of banks.

The countries of the East Asia and Pacific region have been deeply affected by the worst global economic and financial crisis in generations. In early 2008, these economies were tackling rising inflation from the surge in food and fuel prices, and some low-income countries were battling overheating pressures; but after the collapse of Lehman Brothers in the United States on September 15, 2008, they were all confronted by an acceleration in the financial turbulence that had begun in mid-2007. The region's middle-income countries — that are more integrated into global financial markets — were hit hardest, as nonresident sales of equity and debt securities and a sharp weakening in other capital flows caused market interest rates to rise, equity prices to plummet, and exchange rates to come under pressure.

The East Asian middle-income countries — Thailand, Malaysia, Indonesia, and the Philippines — withstood this financial turbulence well because they were better prepared for this shock after the 1997-98 Asian financial crisis. Over the last decade, these countries strengthened their external balances, increased foreign exchange reserves, reduced government debt and improved banking supervision. The direct impact of last year's financial turmoil on the low-income countries in the region was modest because their underdeveloped financial markets and limited integration with global financial markets provided some protection.

The financial crisis evolved into a global economic slowdown that is affecting all East Asian economies. A steep decline in wealth, confidence, and credit availability in the advanced economies has led to lower consumption, production, and investment. Economic expansion in developing East Asia decelerated sharply given the region's dependence on exports, with the slowdown spreading from the newly industrialized economies (NIEs) — Korea, Taiwan (China), Hong Kong (SAR, China) — to the rest of the region, including to the low-income countries in the Pacific. Indeed, among the developing economies in East Asia, the low-income countries are likely to be the worst affected by the crisis, given their small domestic markets, over-reliance on commodity exports, and virtual lack of fiscal space.

Throughout the region, the sharp decline in exports quickly led to production and investment cuts by the private sector followed by layoffs. Officially registered unemployment is reported to have increased by about 1 million from a year earlier in January to about 24 million for the region as a whole. Employment always tends to lag slowdowns in activity, thus recent numbers are likely to be only the beginning of a painful surge in unemployment throughout the region. Moreover, officially registered numbers present only a small part of the deteriorating employment situation, as evidenced by reports that in China alone an additional 25 million migrant workers have been laid off and returned to rural areas. As unemployment in the region and around the world begins to climb, migrant workers, wherever they are, are likely to be among the first to lose their jobs. This will mean lower remittance flows to the poorest countries in the region and, if the migrants return home, a worsening unemployment in those countries as well as further downward pressure on real wages, especially in the informal sector that would directly affect the poor.

To counteract the crisis, country authorities in the region have implemented expansionary monetary and fiscal policies. Monetary authorities in most countries have cut policy rates and implemented other measures to ensure adequate liquidity. Some central banks have also supported dollar liquidity, including through bilateral swaps with China, Korea and Japan in addition to those already in place under the Chiang Mai Initiative. Led by China, countries in the region have announced fiscal stimulus packages equivalent to 3.6 percent of regional GDP, with measures to be implemented in 2009 amounting to 1.7 percent. China's stimulus package is the largest in the region at about 12 percent of 2009 GDP to be implemented through the end of 2010, but Malaysia and Korea have also announced packages for 2009 projected to deliver as large a stimulus as China.

Governments are also acting with increasing urgency to cushion the impact of the crisis on the most vulnerable citizens, as unemployment is projected to rise further, remittances to fall and the pace of poverty reduction to slow substantially. The middle-income countries are expanding existing social safety net programs. In China, the government provided a one-time cash transfer, including to rural residents, and is emphasizing active labor market policies to limit the increase in unemployment. In Indonesia, the government's targeted cash transfer program (originally introduced in 2005), was reconstituted in 2008. Through the first quarter of 2009, 19.2 million families, or a third of the population will receive cash transfers. In addition, 2009 sees the completion of the rollout of a nationwide community development program (begun in 2007) and is continuing the piloting of a conditional cash transfer program. The Philippines authorities are scaling up the existing conditional cash transfer system and implementing a program to help returning overseas workers who lost their jobs. The low-income countries are facing greater challenges in helping the poor due to limited fiscal space and the absence of institutions to deliver assistance to their citizens. In Cambodia, the government has increased food-for-work assistance and is implementing a school-feeding program, thanks in large measure to support from foreign donors.

Economic activity in China is likely to bottom out by midyear, supported by the large fiscal and monetary stimulus now implemented. Decisive policy measures should help partly offset a projected decline in exports – the first in decades – and weak market-based investment to limit the slowdown in growth to 6.5 percent in 2009 from 9 percent last year. China's contribution to both incremental global GDP and imports has been the largest in the world since 2007 and will likely remain so for the medium term. China, however, is in the process of rebalancing growth toward consumption and services, away from investment, exports, and export-oriented manufacturing. Boosting the share of services and stimulating domestic consumption, especially of rural households, should help achieve higher and sustainable growth with substantial improvements in living standards and a further reduction in poverty. In the process, China's imports are also likely to rise at a faster pace than before, but most of the increase will probably be accounted for by raw materials, capital goods, services and increasingly sophisticated consumer products. Exporters of such goods are likely to benefit substantially. On the other hand, exports of electronic and other components to China for assembly and shipment to the rest of the world will probably remain depressed until growth in the developed world resumes and even then a return to the pace seen earlier this decade will seem unlikely.

Prospects for recovery among the developed countries are uncertain. This year, developed countries' output is projected to fall 3.1 percent with risks largely concentrated on the downside — in large part because of the possibility of further bad news emerging from the financial systems in these countries. Increased risk aversion, reduced household wealth, rising unemployment, weaker corporate profits and ongoing deleveraging will all constrain growth for a few more quarters. While most recessions in advanced economies over the last several decades have lasted slightly more than a year on average, recessions accompanied by banking crises, and housing and equity busts have tended to take at least twice as long, making it likely that a recovery among developed countries will be delayed until 2010. A recovery is likely to be characterized by subdued growth in output and demand for imports by these countries, amid sizable excess capacity, higher unemployment and efforts by households and governments to reduce high debt levels. Continued problems in banking sectors or renewed financial turmoil could lead to stagnation in global GDP or even another year of declining GDP.

Prospects for developing East Asia may be better than those in other developing regions, but concerns remain that a return to higher growth will be slow in materializing, with implications for employment generation, increases in living standards, and poverty reduction. All in all, despite determined policy easing, real GDP growth in developing East Asia is projected to slow to 5.3 percent this year from 8 percent in 2008. Some low-income countries will experience the largest declines in growth. In Cambodia, an expansion of 10.2 percent in 2007 stands in stark contrast to a contraction of 1.0 percent projected for 2009. The difference (11.7 percent) over two years is the largest in the region, and arises from a sudden drop in garment exports and tourist arrivals. The drop has been compounded by a sharp downward adjustment in credit growth that had earlier fueled overheating in the economy, reflected in a rapid increase in real estate prices. Mongolia, Lao, PNG and Timor-Leste, on the other hand, depend heavily on commodity exports and have been hit hard by the sharp decline in commodity prices. While PNG and Timor-Leste are relatively well positioned thanks to fiscal rules governing public savings, Mongolia and Lao will need to make tough adjustments in their fiscal and monetary stance to maintain macroeconomic stability.

Weaker growth will slow the pace of poverty reduction in the East Asia and Pacific region, with 10 million more people projected to remain in poverty compared with 2008 forecasts (30 million compared to 2007 forecasts). While the poverty rate for the region as a whole will still decline, Cambodia, Malaysia, Thailand and Timor-Leste are projected to experience absolute increases in poverty as a result of contractions in per capita income. Even for countries with positive growth in per capita income, there will be significant hardships as people shift in and out of poverty amid large increase in unemployment.

Over the medium term, the countries of developing East Asia can achieve high rates of economic expansion in a slowly growing world economy to the extent they are able to extract more growth from domestic demand, boost competitiveness, penetrate new markets, and further improve the attractiveness of the region as a key destination for foreign investment. Convergence to developed countries will depend to an ever greater degree on the ability of firms to move closer to the technological frontier and be driven more by innovation than imitation. Innovative firms need different public institutions and policies, including more openness, less government intervention, enhanced flexibility, a more educated labor force, and better developed and properly regulated private finance. Delivering on these institutions and policies will be an important component of the region's remarkable transformation into an ever more confident source of global growth and development.