

## SUMMARY

**East Asia's rebound from the economic downturn has been surprisingly swift and very welcome.** A year ago, exports and industrial production fell sharply across the region, layoffs were on the rise, and capital flowed out weakening asset prices and currencies. A vigorous and timely fiscal and monetary stimulus in most countries in East Asia, led by China and Korea, along with decisive measures in developed economies to prevent a financial meltdown after the collapse of Lehman Brothers, have stopped the decline in activity and set in motion the regional rebound. The shift to inventory restocking since mid-2009 has also helped boost growth. These factors have led us to revise our projection for real GDP growth in developing East Asia up by 1.3 percentage points since the previous forecast in April. All in all, real GDP growth is set to slow to 6.7 percent in 2009 from 8 percent in 2008, or much more moderately than after the 1997-98 Asian financial crisis.

**Developments in East Asia remain strongly influenced by China.** Take China out of the equation, and the rest of the region is recovering with less vigor. For 2009 as a whole, output is projected to contract in Cambodia, Malaysia and Thailand and barely grow in Mongolia and some of the Pacific islands. Even with solid growth in Indonesia and Vietnam, developing East Asia excluding China is projected to grow more slowly in 2009 than South Asia, the Middle East and North Africa, and only modestly faster than Sub-Saharan Africa.

**The aggregate numbers mask not only large differences in growth performance: they tell an incomplete story about the social and poverty impact of the crisis.** Lack of high frequency data on household incomes and expenditures makes it difficult to track how the poor are faring. Based on past patterns of poverty and growth – which may not hold during the current downturn and rebound – an additional 14 million people will remain in poverty in the region in 2010 as a result of this crisis. Reduced demand for labor during the downturn typically meant reduced work hours or lower wages, rather than outright layoffs. In some countries, where layoffs occurred, workers moved to the informal sector. In the end, labor incomes fell substantially in 2009, with adverse consequences for living standards. Poverty estimates do not capture these adverse consequences.

**The rebound has yet to become a recovery.** That is why the authorities in the region are mindful of the risks of a premature withdrawal of stimulus, given the large output gaps and concerns that developed countries are converging to a slower-growth equilibrium. Some governments in the region will have the fiscal space to sustain fiscal stimulus until recovery is on a firmer footing and private investment has been restarted. Others will be more restrained because of limited fiscal space. Overall, governments are aware that fiscal and monetary stimulus alone cannot sustain domestic demand for an extended period of time, especially if investors are not reassured that the authorities will have viable exit strategies in place and will bring government debt to levels that will not jeopardize long-term debt sustainability. There are limits, moreover, to what fiscal and monetary policies can accomplish if recovery in the developed countries, notably the U.S., remains weak for a longer period than currently deemed likely.

**The crisis has prompted countries in the region to rethink their development strategies.** For most, the choice between growth driven by exports, on the one hand, and growth driven by domestic demand, on the other, is a false one. Countries need to resist protectionism, remain open and become more, not less, integrated into the global economy to continue to reap the benefits of global knowledge, technologies and innovation. At the same time, governments are realizing that more growth can be extracted from domestic demand if they ease or eliminate incentives that favor the quick buildup of export-led, investment-heavy manufacturing supported by undervalued exchange rates and suppressed domestic consumption and services. Some governments are rethinking how to manage risks stemming from large and volatile capital inflows, especially given concerns about new asset price bubbles.

**The regional outlook for consolidation of the rebound into recovery and a return to rapid growth confronts downside and upside risks.** Downside risks include a double dip in economic activity in the advanced countries as stimulus measures and inventory restocking wear off. This will challenge many East Asian countries that have little fiscal space to continue to finance fiscal stimulus programs

without external assistance. But they will be assisted by China that has the resources to maintain its current fiscal stance for several years if necessary. There will be limits to China's capacity for further monetary stimulus, however, following the surge in credit by 30 percent of GDP in 2009. On the upside, a more robust recovery in the advanced countries could remove some of the imperative for rebalancing in developing East Asia and encourage sustaining the pre-crisis export-oriented growth model. The upside also carries with it the risk of larger capital inflows causing new asset price bubbles and complicating macroeconomic policies. Managing both risks will be a challenge that will require measures to rebalance growth while advancing integration with global markets and retooling institutions to encourage innovation.

**Over the medium term, can developing East Asia sustain rapid growth, even if the rest of the world grows slowly?** This will depend on whether East Asia can integrate further regionally – through better facilitation of trade in goods and by extending its liberal trade policies to services. Moving up the value-added chain in global production networks will present an additional impetus to growth, as the benefits of new technology and innovation spread more broadly through the countries in the region. The service sector holds enormous potential for East Asia. Measures to spur competition in the service sector, combined with policies to ease restrictions to internal migration and trade, bolster education and improve the environment for private investment and innovation, will allow countries to take a fuller advantage of the benefits of agglomeration, and create more favorable conditions for the emergence of innovative global companies.