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IMF Sees Long Path To Asian Recovery

The global crisis has hit Asia hard, and it may take some time before the region's economies recover, the International Monetary Fund (IMF) said today in its latest report on Asia and the Pacific. The report cautions that forceful countercyclical monetary and fiscal policies will consequently need to be sustained through 2010. It also warns that Asia will eventually need to rebalance its growth from exports to domestic demand, since consumption in advanced countries may remain weak for years to come.

"The spillovers from the global crisis have impacted Asia with unexpected speed and force," according to the *Regional Economic Outlook (REO) for Asia and Pacific*, which was released in Singapore on May 6. "The downswing has been even larger than in other regions, and sharper than at the epicenter of the global crisis." In fact, GDP in Emerging Asia excluding China and India fell at an astonishing 15 percent annual rate (seasonally adjusted) in the fourth quarter of 2008, and a further decline most likely took place in the first quarter of this year as well.

This severe impact is explained by the exceptional nature of Asia's integration into the global economy:

- Asia's growth has been reliant on exports, especially of technologically sophisticated goods such as motor vehicles and IT products – precisely those products for which worldwide demand has collapsed.

- Asia's growth has also been fueled by international financial flows, including corporate borrowing on international markets and foreign investments in local securities. These trends are working in reverse, now that financial systems in advanced countries are deleveraging.

These external shocks and stresses will make it difficult for the region to recover. As long as exports remain depressed, private investment will remain low. Meanwhile, consumption will be hampered by growing unemployment as firms retrench in order to restore profitability. So, a sustained recovery will need to await an improvement in the global economy – which the IMF does not expect before the middle of 2010. Accordingly, the IMF forecasts that Asian growth will decelerate to 1.3 percent in 2009 before rebounding to 4.3 percent in 2010, still well below potential and the 5.1 percent rate recorded in 2008.

What can Asian policymakers do to support economies in these difficult circumstances? The *REO* recommends:

- *Sustaining policy stimulus.* In many cases, there is scope for reducing interest rates further, and for adopting unconventional policies—such as flooding banking sectors with liquidity or intervening to support credit flows—as done in advanced countries. In addition, the fiscal stimulus provided in 2009 could be sustained into next year, while being placed in a medium-term framework that ensures a gradual return to fiscal rigor. Finally, authorities will need to maintain foreign exchange liquidity, drawing where necessary on bilateral swap lines or the IMF's new Flexible Credit Line, which provides qualifying countries with large upfront assistance with no policy conditions.

- *Rebalancing growth.* The past year has provided an ample demonstration of the dangers of relying solely on one growth engine. Moreover, the export model may not pay the same dividends as in the past, for households in advanced economies now need to save more, rather than spend. So, policy makers will need to rebalance growth toward domestic demand, for example by reforming tax and financial systems, and building strong social protection systems that will reduce the need for precautionary savings to meet health, education, and retirement expenses.

In the three analytic chapters, the *REO* deepens its analysis of the implications of the current global crisis for the region. Chapter II, entitled "*Recessions and Recoveries in Asia: What can the Past Teach Us about the Present Recession?*", examines past recessions and recoveries in Asia. The chapter finds that:

- Recessions accompanied by financial stress, notably in domestic banking sectors, are substantially longer and deeper than the norm;
- Deep recessions have resulted in substantial and long-lasting declines in potential growth;
- Recoveries have tended to rely on exports, which explains why they have typically been weaker than in other emerging markets, where the contribution from domestic demand has been stronger.

The chapter concludes that for Asia to minimize the depth and duration of the current downturn, it needs to preserve the stability of the core banking system and help sustain domestic demand to compensate for the expected weak recovery in exports.

Chapter III, "*How Vulnerable is Corporate Asia?*", analyzes the impact of the current crisis on the corporate sector in the region. Key findings include:

- The collapse of global demand is likely to lead to a surge in corporate sector defaults, which will spill over into the banking sector;
- Under the baseline scenario, losses are likely to be manageable, largely because Asian corporates entered the crisis in robust financial health;
- But if global demand plunges anew, the ranks of defaulters could grow to uncomfortably high levels, and Asia could become trapped in an adverse feedback loop in which the losses in the corporate and banking sectors imperil each other;
- So, prudence would suggest taking pre-emptive measures, especially to shore up banking capital and improve bankruptcy procedures.

Chapter IV, "*Resolving the Global Financial Crisis: Japan's Lost Decade in Translation*," discusses Japan's experience during the 1990s and explores its implications for efforts to deal with the current crisis. It concludes:

- As long as the economy remains weak, fiscal stimulus needs to be sustained, centered on high-impact areas, and reversed only when clear signs of recovery emerge;
- Direct measures to jump-start dysfunctional credit markets may be warranted, but they need to placed in a framework with well-defined objectives and a credible exit strategy that is communicated clearly to markets and the public;
- Even then, unconventional tools are not a panacea, as there are side-effects, including reduced incentives for restructuring;
- Indeed, Japan did not recover until forceful steps were taken to recapitalize the banks and restructure the debts of distressed borrowers, thereby eliminating the excesses of labor, debt, and capacity that had built up in the bubble period.