COMMENTARY

Asian Regional Policy Coordination

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Introduction

Let me first thank the organizers for inviting me to be part of this very important and interesting conference, and for giving me the opportunity to discuss Ted Truman's paper on Asian regional policy coordination. I hope my experience in the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) surveillance process will offer a useful perspective.[1]

Ted Truman's paper provides a comprehensive framework for a discussion of international coordination of economic policies. He argues that effective international coordination involves five key elements: identification, a shared diagnosis, agreed policy actions, scope for midcourse policy corrections, and learning lessons to prepare better for the future. Following this framework and examining three areas of actual or potential Asian policy coordination—macroeconomic policies, reserve management, and crisis management—he concludes that in Asia the identification of the problem is often incomplete, the diagnosis often is not broadly shared, and the policy responses are inadequate. Based on this assessment, Ted argues that Asian authorities should not overpromise what they can achieve via regional policy coordination, and warns against Asian exceptionalism, the view that Asia can and should be insulated if not disconnected from global policy coordination processes and their requirements.

Internationalism vs. Regionalism

I agree with Ted that Asian policymakers should not overpromise what they can achieve via regional policy coordination, given the diverse nature of the regional economies. At the same time, I am surprised by his view that the main risk against more effective regional policy coordination in Asia is a violation of the principle of open regionalism and an overemphasis of Asian separateness. The paper does not provide any evidence that Asian policymakers have shown tendencies of Asian exceptionalism or voiced such views. If anything, Asian policymakers appear to have erred on the side of excessive internationalism. A prime example of Asia's open regionalism is the link of the Chiang Mai Initiative to International Monetary Fund (IMF) programs.

I would argue that the risk of an overemphasis of Asian separateness is very small. This is based on what I perceive as the consensus view among Asian policymakers about the economic structure of the Asian region and its relationship with other parts of the world, particularly the major advanced economies. The consensus view articulated by Asian policymakers can be summarized as follows: While intraregional trade of goods and services for final consumption and capital flows within Asia are set to grow tremendously in the decade ahead, that process is likely to complement, rather than substitute for, the global process of further trade and financial integration. Thus, continued prosperity in Asia very much depends on continued healthy development of the global economy.

The approach to regional policy coordination is also conditioned by the characteristics of Asian business cycle synchronization. Recent work that we have done at the Hong Kong Institute for Monetary Research shows that output fluctuations in Asia have remained less synchronized with global factors than those in the industrial countries, but the role of global factors has intensified over the past 15 years for most of the economies in the region. Emerging Asian economies cannot decouple completely from the advanced economies, even though they have sustained a strong and increasingly more important independent cycle among themselves (He and Liao 2011).

The characteristics of Asian business cycle synchronization, together with the basic world outlook of policymakers, jointly determine that open regionalism is the most likely approach to regional policy coordination. However, the strength of Asian regionalism is likely to be a function of the willingness by the major advanced economies and global institutions to accommodate and engage the region. The incentive for the region to contribute actively to global policy coordination will be strengthened if Asia's representation in global institutions is considered fair and if its voices are heard, and its views are taken into account. Conversely, the incentive for Asia to be withdrawn from the global policy coordination process will be stronger if there is no quid pro quo. In other words, it takes two to tango.

Having said this, I think Ted is correct in pointing out that key issues remain to be resolved in setting up crisis management facilities both at the regional level and at the global level. Effectiveness of regional facilities such as the multilateralization of the Chiang Mai Initiative and bilateral swap lines between regional central banks remain to be tested. However, a stable and healthy international monetary system cannot be effectively sustained, and a global liquidity crisis cannot be effectively managed, without the support of central banks that issue major reserve currencies. In this sense, reserve currency issuing authorities bear a very large responsibility in ensuring global financial stability. It is in their own interests to take into account the potential spillover effects of their policies on the rest of the world that heavily uses their currencies for trade and investments.

Coordination of Exchange Rate and Reserve Management Policies

A central claim by Ted in discussing regional coordination of macroeconomic and reserve management policies is that policymakers in the region failed "to arrive at a common Asian regional diagnosis of individual current account positions and a collective current account position as well as to derive a coordinated set of policies based on that diagnosis." As a result of this failure, Asian economies overaccumulate foreign reserves and contribute to global imbalances.

Ted points out two basic problems with policy coordination in Asia: "First, China's exchange rate policy vis-à-vis the U.S. dollar conditions the exchange rate policies and exchange rate performance of its Asian neighbors, often adversely affecting their own external positions and exerting influences on their own domestic economies via spillovers from currency wars. Second, China's exchange rate policy actually imparts greater volatility and instability to effective exchange rates in the region not only for China but also for its neighbors." Ted attributes this failure to his observation that policymakers in the region "have problems . . . in speaking truth to neighbors as well as even greater problems in speaking truth to power."

To paraphrase, Ted argues that China's exchange rate policy is the root cause of the region's failure to solve the problem of persistent current account surpluses, because other currencies do not want to appreciate faster than the renminbi lest their economies lose competitiveness vis-à-vis China in other developing markets. And this lack of policy coordination is because China is such a power that authorities in other regional economies dare not raise their concerns.

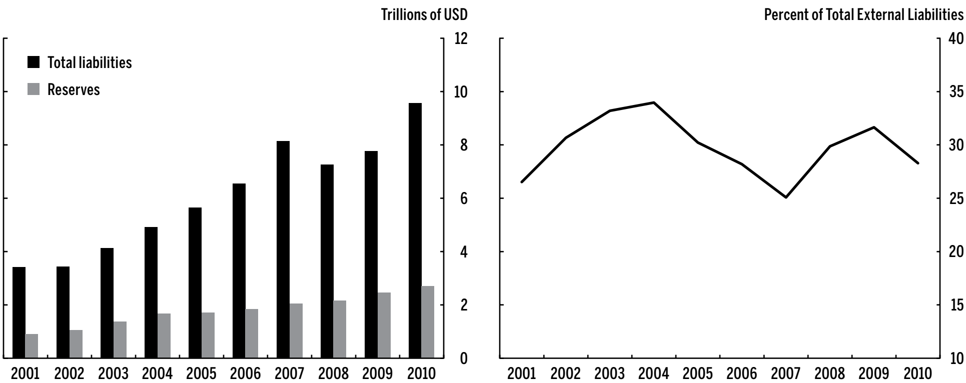
My first comment on this analysis is that it is not clear that central banks in the rest of Asia have intentionally managed their exchange rates to maintain stability vis-à-vis the renminbi. In Genberg and He (2009), we document that most regional central banks have adopted policy strategies in which domestic price stability is the principal objective of monetary policy, while monetary policy instruments remain rather heterogeneous. While monetary authorities do pay attention to the exchange rates of their currencies, foreign exchange interventions are primarily aimed at smoothing out excessive volatilities; in general, they are not used to target exchange rate levels.

In fact, even though the stock of foreign reserves has continued to rise, the scale of reserve accumulation has been fairly stable relative to the size of capital flows to the region. Figures 1A and 1B show that for non-China East Asia as a group, although foreign reserves increased from US$910 billion in 2001 to US$2.7 trillion in 2010, relative to the stock of total external liabilities, the ratio fluctuated mildly around a period average of 30 percent. The message of these charts is that foreign exchange interventions by most regional monetary authorities have been primarily for risk management purposes, aimed at maintaining a steady liquidity buffer against potential capital outflows.

In any case, the spillover effect from the renminbi exchange rate policy on the rest of the region is not obvious. This may have been an important reason why China's neighbors have not coordinated to complain about it, not that they have problems speaking truth to power. The emphasis on exchange rate coordination hinges on the assumption that China is a major competitor with the rest of the Asian economies. But the trade structure among the Asian economies is diverse, including trade that is oriented for domestic use within the region, processing trade through China, as well as trade with economies outside the region. Thus, appreciation and depreciation against the renminbi would have different consequences for these different forms of trade.

FIGURE 1
Reserve Accumulation in East Asia
(Excluding China)

A Foreign Reserves and Total External Liabilities **B Foreign Reserves**

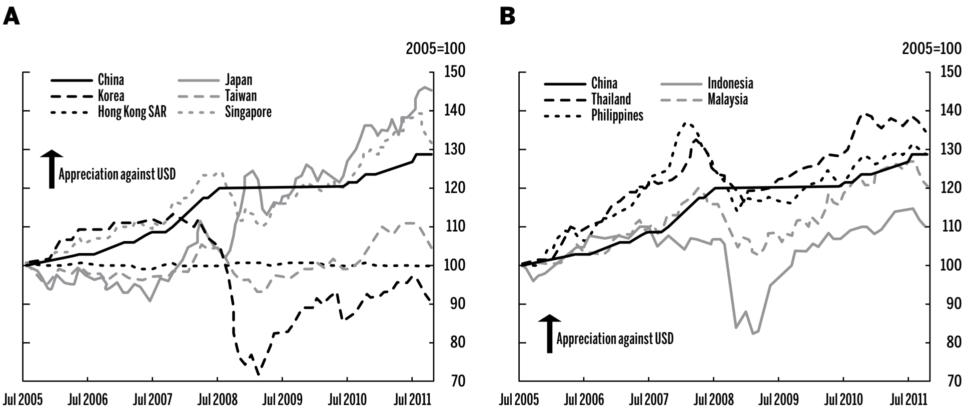


Sources: For 2000–07, author compilation using updated and extended version of the External Wealth of Nations Mark II database developed by Lane and Milesi-Ferretti (2007); for 2008–10, author compilation using IIP data of national authorities.

Notes: Includes Hong Kong, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand. Total liabilities = foreign direct investment liabilities + portfolio equity liabilities + debt liabilities + derivatives liabilities.

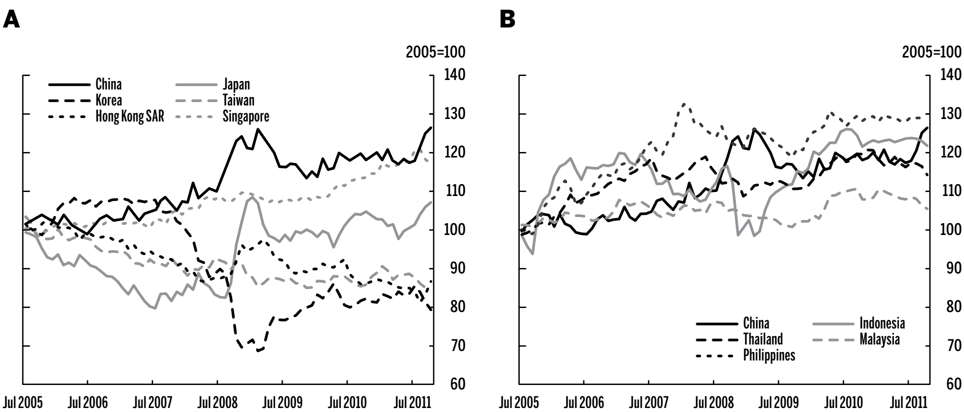
Second, Ted's argument is in fact counterfactual in that it does not recognize that there has been significant inter- as well as intraregional exchange rate adjustments in the past six years (Figures 2 and 3). Since July 2005, when China announced a more flexible exchange rate regime, the renminbi has appreciated by 30 percent against the U.S. dollar and by 27 percent in real effective terms, according to the Bank for International Settlements. Of course, it is possible to argue that adjustments should have been even larger in view of the remaining

FIGURE 2
Nominal Exchange Rates
Bilateral Exchange Rates vis-à-vis the U.S. Dollar



Sources: Bloomberg and author's calculations.

FIGURE 3
Real Effective Exchange Rates



Source: Bank for International Settlements.

global current account imbalances, but this presumes that nominal exchange rate adjustments are the most appropriate vehicle for dealing with such imbalances. This presumption is the second shortcoming of the coordination failure argument. While real exchange rate adjustments typically accompany current account adjustments, it is generally believed that changes in nominal exchange rates can influence real exchange rates only temporarily.

In fact, China's current account surpluses are attributable to a set of structural factors and institutions embedded in the economy. For all these reasons, the burden of adjustment cannot be shouldered alone by the nominal exchange rate. Undertaking a comprehensive analysis of the underlying causes of China's external imbalances, a recent IMF report shows that a wide variety of structural factors, such as income distribution across the corporate, government, and household sectors, incomplete social welfare reforms, and factor price distortions, systematically encouraged savings in China (IMF 2011). Research by Professor Shang-Jin Wei and his coauthors shows that population structure and policies can account for a significant part of the actual increase in the household saving rate since the early 1990s (see Wei and Zhang 2011). While continued flexibility of the renminbi exchange rate would certainly need to be part of the solution, it alone is unlikely to be effective in reducing the external imbalances.

Conclusions

To conclude, I believe that the progress in regional policy coordination in Asia is commensurate with the degree of trade and financial market integration within the region. Asian policymakers are pragmatic. They coordinate if they see the need for it. The process of economic policy coordination in Asia has not been driven by political objectives, which appear to have been the case in some other parts of the world. Having said this, I believe that Asian policymakers will have stronger incentives to coordinate policies, as regional economic integration is set to deepen and policy spillovers become more widespread. However, rather than focusing on coordination on the setting of policy instruments such as the exchange rate, Asian policymakers are focusing on developing more liquid financial markets and fostering institutions that could be the basis of deeper forms of cooperation in the longer-term future.

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NOTE

1 Founded in 1991, EMEAP is a cooperative organization of central banks and monetary authorities in the East Asia and Pacific region. Its primary objective is to strengthen the cooperative relationship among its members. It comprises the central banks and monetary authorities of the following 11 economies: Australia, Mainland China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand.