February 2007

EABER

East Asian Bureau of Economic Research www.eaber.org

NEWSLETTER

Welcome to the East Asian Bureau of Economic Research (EABER). EABER aims to be the premier East Asian economics research forum and provide a single point of reference for the economics, finance and governance research community throughout the region and beyond. Through building research capacity and partnering initiatives, EABER facilitates the creation of high-level analysis and forward thinking on issues of importance to the East Asian economy.

Analysis

The Asian Consensus and Regional Exchange Rate Policies

Dr. Yiping Huang*

There is now what can only be described as a growing 'Asian Consensus' on economic policy strategy within our region. The Asian Consensus differs significantly from the Washington Consensus, the body of policy advice that was initially attributed to the Washington-based international organizations. Ten years of Asian Consensus policies have significantly improved the fundamentals of most East Asian economies and set the ground for increasingly flexible East Asian exchange rate policies going forward.

The core elements of the Asian Consensus include conservative exchange rate policies that avoid overvaluation; a rapid build up of strategic foreign reserves; cautious liberalization of the capital account; and closer financial and trade arrangements with Asian neighbors. While these policies do not represent a fundamental shift in the direction of policy in the region, they signal increasing pragmatism within Asian capitals toward the question of financial liberalization.

A clear objective is to reduce the risk of another balance of payments crisis in the region. Asian governments reduced public and external debts during the post-financial crisis years. Korea, Thailand and Indonesia all paid back their IMF loans well ahead of schedule and other economies exited their (de facto) currency pegs.

Asian policymakers have also been focusing on building regional policy infrastructure, moving fast from trade integration to monetary and financial cooperation. ASEAN + 3 has contributed to this, developing initiatives such as regional economic surveillance, regional arrangements to assist with short-term financial crises, and to promote the development of local currency bond markets. The Asian Development Bank appears to support efforts to create an Asian currency unit. While it is very unlikely that Asia will move to European-type monetary integration anytime soon, these efforts do help encourage dialogue and promote financial cooperation within the region.

The volatility of key macroeconomic indicators such as GDP growth and inflation has declined sharply. Southeast Asia's average current account balance moved from a deficit of -5.2 per cent of GDP in 1996 to a surplus of 2.7 per cent in 2005. Total foreign reserves of non-Japan Asia increased from US$600 billion to US$2 trillion during the same period. In fact, in all East Asian economies except Indonesia, foreign reserves account for more than 20 per cent of GDP. Indonesia, Korea, the Philippines and Thailand have all adopted inflation targeting. These economies are now more likely to tolerate currency appreciation in the face of domestic inflationary pressures.

Even in the absence of explicit mechanisms for policy coordination, Asian exchange rates are more likely to move together now than ever before due to deeper economic integration. Some observers even claim that Asia has de-coupled from the US. While such claims are premature, given that close to 20 per cent of Asian exports go to the US, there is no question about the increasing economic inter-dependence among Asian economies.

Paper of the Month

The paper of the month for January is **Exchange Rate Regimes and Monetary Independence in East Asia** by Prof. Chang-Jin Kim and Prof. Jong-Wha Lee

Upcoming Events

Institutional Strategies for Improving Micro Economic Policy Foundations: Country Policy Meetings

Tokyo: 26 February 2007
Beijing: 27 March 2007

Advancing East Asian Economic Integration:The Institutional and Financial Foundations of Economic Growth and Integration in East Asia

Date: 22-23 February 2007
Hosted by: The Fiscal Policy Research Institute, Ministry of Finance, Thailand and The Australian National University, Canberra

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Emerging Asian currencies will probably lead the second phase of the US dollar weakness. In 2003 and 2004, on real trade weighted terms, the US dollar depreciated by 9.9 per cent and 4.8 per cent, respectively. But the burden of this adjustment was shouldered mainly by other global currencies. The Euro appreciated by 10 per cent in 2003 and 4.8 per cent in 2004, almost a mirror image of the weakening dollar.

A structural shift occurred in 2005, when the US dollar depreciated by 2 per cent, and by a further 1.1 per cent in 2006, but the Euro weakened by 1.9 per cent and 1.4 per cent, respectively. In contrast, emerging Asian currencies strengthened by 1.5 per cent in 2005 and by 4.7 per cent in 2006. The same trend is likely to continue in 2007.

However, this requires that the renminbi will become more flexible. China began its exchange rate policy reform in July 2005, the most important event explaining the structural shift in the global currency market that year. Renminbi exchange rates, however, stayed relatively rigid until recently. But for a number of reasons, it is likely that the renminbi will appreciate by approximately 6 per cent against the dollar (or 1.9 per cent in real trade weighted terms) in 2007.

Policymakers have recently identified dealing with mushrooming trade surpluses and rapidly accumulating foreign exchange reserves as a key policy priority in 2007. Large current account surpluses and rigid exchange rate policies have contributed to floods of liquidity in the domestic market, curtailing the central bank's monetary policy autonomy. The risk of trade protectionism from the US is much higher after the election of Congress in late 2006. And progress made since 2005 has increased policymakers' confidence about the economy's ability to cope with a more flexible exchange rate.

Over the next five years, there is greater scope for the appreciation of the Chinese renminbi, Indonesian rupiah, Philippine peso, Thai baht, and Indian rupee. There will continue to be significant differences in degree of exchange rate flexibility among Asian currencies. The real trade-weighted exchange rates of most Asian currencies are significantly below their historical averages, about 25 per cent in the case of the Malaysian ringgit and Chinese renminbi. The Korean won is the only major regional currency that is already 13 per cent above its historical average.

The appreciation of Asian currencies is unlikely to occur in a straight line. Market fluctuations following the recent policy measures to curb short-term capital inflows by the Bank of Thailand offer clear evidence of this. While most Asian central banks will probably not repeat what the Bank of Thailand did, they are likely to resist excessive appreciation in the face of exactly the same challenge – how to deal with appreciation pressures caused by surging short-term capital inflows.

The Asian Consensus may be evolving, but its core – a preference for gradual adjustments over too much volatility – is unlikely to change for a long time.

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(Views expressed in this article do not necessarily reflect those of the Citigroup)

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EABER would also to like to thank the following for their support:

Bulletin of Indonesian Economic Studies