Challenging times for Asian economies

Asia has experienced deeper economic integration and greater macroeconomic interdependence in the process of economic recovery. Empirical evidence suggests that Asia has become more "autonomous" in the sense that the long-run output variance is less influenced by global shocks in the post-crisis period than previously. One must hasten to add that this did not come at the expense of closer macroeconomic ties with the rest of the world.

The hypothesis that Asia has "decoupled" from the rest of the world has no empirical support. Although intra-Asian trade now comes close to that of the European Union, the fact remains that the final destination for a large proportion of it still lies outside the region. It is also important to underline that non-Asian investments do play an important role in Asia, contributing to both intra-regional and extra-regional trade flows.

It is important to recognize that Asia is not immune to external disturbances, although it has grown increasingly resilient to the external ups and downs. The current slower growth in the region is also partly due to sluggish external demand from North America and Western Europe. To be sure, Asia is still vulnerable to external shocks. The US economic woes weigh heavily on Asia. A US recession will have deleterious impacts on Asia both directly and indirectly. The US market is important for nearly all the Asian economies and a recession in the US will have adverse effects on these countries.

Now that Asian economies are more closely integrated, the secondary impact will be even more severe than the primary impact, due to the knock-on effects. China, which has emerged as the factory of the world, will transmit the impact to other Asian economies through reduced imports of raw materials and intermediate inputs, although China itself may not suffer as much thanks to the sheer size of its domestic economy. All this suggests a strong presumption of positive business cycle synchronization in Asia in the years to come.

Although the crisis-hit Asian economies have rebounded remarkably, economic growth in the post-crisis period pales in comparison with the pre-crisis period. This may be attributed to the slow pace of private investments and the current focus on export-led growth. Capacity utilization in the region's manufacturing sector in the post-crisis period has been relatively low due to the slack on the demand side. Private consumption growth has also decelerated considerably in recent years, contributing to the overall weak demand. With so much excess capacity still in place, the space for rapid investment growth is somewhat limited.

The slower pace of growth in the post-crisis period, after all, is not as bad as it may sound. The blazing growth rates registered in the pre-crisis years were simply unsustainable. Obviously, some Asian economies were growing too fast for their own good, causing their economies to overheat. The rapid growth then was essentially input-driven, as total factor productivity (TFP) in these economies were on the decline. One might argue that the current pace of expansion is more sustainable, with TFP kicking in once again.

Saving-investment function holds the key to the economic performance of Asia. Evidently, Asia has been saving too much and spending too little. Asia can grow faster if Asian savings are invested in Asia, instead of being diverted to the rest of the world. Asia's financing of the US trade imbalances is a case in point. The policy of financing the US current account deficits so that Asia can continue to export to the United States is simply not sustainable. An alternative would be to invest Asian savings within the region so that Asian economies can provide markets for Asian exports. This would help raise the existing limits on export-led growth for the Asian economies.

Empirical evidence suggests that macroeconomic policies in the region have remained divergent, despite the increased macroeconomic interdependence. This is not surprising, as the region is by no means homogeneous. Nevertheless there has been some convergence with respect to inflation and exchange rate movements. Real exchange rates have tended to converge in recent years, due mainly to the secular trends in the US dollar exchange rate and consumer price. Nearly all the Asian currencies have appreciated against the US dollar, although there are some important exceptions.

Some analysts do think that Asian monetary authorities need to either keep their currencies stable against the yen or allow their currencies to depreciate with the dollar. For countries with substantial current-account surplus and huge external reserves, sliding with the dollar is hardly an option. The main reason for their dollar preference thus far has been the stability of the greenback, which is no longer the case. Whether or not the yen would help fill the void would depend greatly on the stability of the yen. It is not clear if Japan will have the nerve to maintain the stability of the yen responsibly at all costs.

There is no guarantee that the benign environment, characterized by price and nominal exchange rate stability, will continue into the distant future. There is no guarantee that the so-called benign environment will continue even into the near term, let alone the distant future. Indeed, there are serious fault lines in the world economy, which warrant both real sector and financial sector adjustments. There is a 30-35 per cent chance that the US economy will go into a recession in the near term, with the dollar depreciating by another 15-20 per cent. Exchange rate management will be the greatest challenge for Asia in the near term.

It is important for Asia to have exchange rate stability among the Asian currencies so that intra-Asian trade and investment flows are not jeopardized. Macroeconomic consultation and exchange rate cooperation would be helpful. A single currency for Asia may sound too outlandish at this point in time, but a road map towards a monetary union is not unthinkable, to say the least. A more down-to-earth approach would be to aim at some kind of exchange rate coordination mechanism for the Asian currencies. How about a common exchange rate regime for Asia? To be more precise, how about exchange rates for Asian currencies based on common currency baskets?

Asian economies need to talk to one another more often and more formally. Asian central banks do talk to one another informally. There is a need to formalise and institutionalise such relations so that they can evolve into something far greater and far grander.

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