Exchange rate management critical for East Asia

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East Asia has learnt a lot from the 1997-98 financial crisis. East Asian Tigers may have lost some stripes during the crisis, but they are still Tigers. Crisis-hit countries have managed to put their houses in order and to move on. They are rebounding, one might add, with a vengeance.

All indications are that East Asian economies, including the crisis-hit ones, are poised for fairly rapid growth in the near term, based on Asia-Pacific Consensus Forecasts (February 2004). Even Japan, which has remained sedated for more than a decade, is showing signs of revival. For the first time in many years Japan could register four consecutive quarters of positive growth in 2003. What is more, Japan is expected to post 2.2 per cent GDP growth in 2004 and 1.7 per cent in 2005. China, the economic powerhouse of East Asia, will likely remain the star performer with a GDP growth of 8.7 per cent in 2004 and 7.7 per cent in 2005. No other economy in East Asia or indeed anywhere can match China in terms of growth rate. Close on China's heels are South Korea, Hong Kong and Taiwan. GDP forecasts for South Korea are upbeat with a growth rate of 5.3 per cent in both 2004 and 2005. Hong Kong is projected to grow at 5.5 per cent and 4.4 per cent this year and next year, respectively, while the corresponding growth rates for Taiwan are 4.9 per cent (2004) and 4.5 per cent (2005).

Southeast Asia is catching up with Northeast Asia in terms of growth prospects. In Southeast Asia, Thailand appears to be front runner with GDP growth forecasts of 6.8 per cent in 2004 and 6.0 per cent in 2005, trailed closely by Malaysia which is expected to garner a GDP growth of 5.6 per cent in both 2004 and 2005. MIER is more optimistic, forecasting a GDP growth of 6.7 per cent for Malaysia this year. Singapore, which went through rough waters lately, is expected to bounce back, with GDP growing at 5.4 per cent and 4.4 per cent in 2004 and 2005, respectively. Indonesia's hardest-hit economy is also on the mend with creditable growth rates, which are forecast to be 4.6 per cent and 4.7 per cent this year and next year, respectively. The Philippine economy is also expected to perform better in 2004 and 2005 with a GDP growth of 4.5 per cent and 4.2 per cent, respectively.

While the picture down the road looks very promising, there are pitfalls that East Asia must not overlook. It will be foolhardy for East Asian economies to pursue high GDP growth single-mindedly. Double-digit growth rates are neither feasible nor desirable. In any case, high GDP growth will come only at high costs in the form of subsequent painful corrections and environmental degradation. It would be wiser to stay closer to the potential growth rates so as to avoid overheating. East Asian countries will also have to exercise considerable caution in their handling of short-term capital flows, which by nature are extremely volatile.

There are concerns over China biting off more FDI than it can possibly chew. China will have to closely monitor the financial trends in the country, especially the health of its banking sector. All signs suggest that China's banking institutions will become increasingly over-stretched, as they keep on lending to debt-laden state-owned enterprises (SOEs). It is really worrisome that bad loans (NPLs) in China have reached alarming proportions of over 50 per cent. If China fails to rein in on its soaring budget deficits, fledging SOEs and unhealthy bank loans, it may end up as the epicenter of the next financial crisis in East Asia. Bad loans may not pose an immediate problem so long as China continues to grow and grow. But even China cannot go on growing non-stop. At this stage it is difficult to figure out what would spawn a financial crisis in China. The trigger could be anything ranging from electronics deceleration to capital account liberalization. Be that as it may, a crisis of this magnitude may have severe implications for the rest of East Asia, as China's linkages with other economies in the region are likely to grow over time.

Speaking of the next possible crisis, there is a need for East Asia to organize itself with muscles to meet such challenges. Considerations such as this call for a regional financial architecture, which must include the creation of a regional monetary fund but care must be exercised to ensure that such a Fund would complement and not duplicate the IMF. It is encouraging to note efforts in this direction are currently underway.

The biggest challenge that East Asia will face in the near term relates to exchange rate management. There are variations in the exchange rate regimes of East Asia. China's yuan, Hong Kong's dollar and Malaysia's ringgits are tied to the US dollar. Japan, South Korea and Taiwan have been actively intervening in the foreign exchange market to curb appreciation of their currencies against the US dollar, which is depreciating. The main reason why the US dollar is depreciating is readily clear: the huge current account and budget deficits in the US. The fact remains that the decline in the US dollar is not deep enough to correct the US imbalances. So far the exchange rate depreciation of the US dollar has been largely against the euro, but the problem of current account deficit of the US is not with Euro-zone countries but with East Asia where exchange rate adjustments for the US dollar remain either nil or muted.

It appears that East Asian economies are unwilling to let their currencies appreciate against the dollar, lest it would hurt their export competitiveness. By doing this, they are obstructing current account adjustments in the US. Clearly, US trade deficits are good for East Asia, as it enables East Asian exports to expand and seen in these terms a weak US dollar is not in their interest. Therefore, East Asia would rather help finance the US deficits by buying US treasury papers, a softer option in comparison with stronger home currencies. It is noteworthy that the top six East Asian central banks have accumulated US$1.7 trillion in exchange reserves by the end of 2003 and that most of these reserves are held in American government securities.

East Asia must realize that their actions only serve to prolong, and not solve, the deficit problem of the US. The low rates of return on US Treasury securities have not deterred Asian investors. It appears that East Asia is playing a dangerous game by refusing to allow their currencies to appreciate. East Asian central banks will have to continue to buy American securities, as any let-up will cause the dollar to fall more sharply. They may end up holding too many risky, low-yielding bonds. When the crunch finally arrives, the outcomes can be very painful. A gradual appreciation of home currencies now, through an orderly relaxation of exchange rate policies is certainly preferable to a drastic change later on that will cause shocks, which will not be easy to come to terms with.

The US can correct its current account deficit in two ways, through exchange rate adjustments by cheapening the greenback and/ or by cutting expenditures. The less flexible the exchange rate, the greater the need for expenditure adjustment. If East Asia refuses to budge in the exchange rate front, the US may have to resort to drastic expenditure adjustments which will be very painful not only for the US but also for East Asia for which the US is an important export destination. Thus, in the final analysis, it is in the long-term interest of East Asia to let its currencies gradually appreciate against the US dollar. For export competitiveness, East Asia should cut costs and raise productivity, instead of relying on undervalued home currencies.

Thus, in no uncertain terms, exchange rate management will be critical for East Asia in the near term. It will be in the interest of East Asia, if the region's major players can put their heads together and take a common position on the exchange rate issue. This also warrants some form of cooperation and coordination among the region's central banks. In the medium term, East Asia's agenda may well be to figure out how to iron out fluctuations in the intra-East Asian exchange rates. For greater stability in intra-regional exchange rates is good for intra-East Asian trade and investment flows.

In a sense, economic crises are a blessing in disguise. For crises force politicians, technocrats, entrepreneurs and other decision-makers to step out and take a hard look at themselves in a critical fashion. This would enable them to identify their missteps and mistakes. Crises are good, because they are good teachers. Lessons learnt would help the players make better decisions in the future. East Asia now knows what went wrong before the crisis and what needs to be done to avoid another similar crisis. This however does not mean there will be no more financial crises. For one thing, no two crises are identical in terms of causes or impacts. For another, all market economies are susceptible to cyclical ups and downs, which are easily transmittable, under the globalization mode, from one country to another.

The 1997-98 financial crisis was essentially homegrown. It was structural rather than cyclical in character. External factors had little to do with it. Speculative attacks on the regional currencies were no more than a manifestation of the crisis and not the cause of it. This, however, does not necessarily mean that all crises have domestic origins. Close commercial ties between economies do provide avenues for the transmission of crises from one economy to another, which is often referred to as the contagion.

The 1997-98 financial crisis has exposed the fault lines in the East Asian nexus. The crisis could have been handled differently, if not contained, had East Asia organized itself. There was hardly any consultation or cooperation on macroeconomic matters among East Asian economies prior to the crisis or in managing the crisis. The Chiang Mai Initiative, in the ASEAN+3 context, to provide financial assistance, through a network of currency swaps, to the crisis-hit countries, was no more than an ad hoc or haphazard response to the situation. East Asia can mitigate, if not avert, future crises through closer networking among the central banks in the region. A coordinated exchange rate management approach, if institutionalized, would make the region less vulnerable and more resilient.

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