

Preventative Medicine

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Publication: South China Morning Post

Published: 15 January 2008

The adage used to be that when the US sneezed, Asia caught a cold. These days, some people are saying that when the US catches a cold, Asia merely sneezes. Or, in other words, they say the Asian economy is decoupling from the US. In actual fact, in an increasingly globalised economy, it matters little who sneezes or who catches the cold. It is about formulating the right medicine - the right policy mix - to stay healthy and avoid a germ becoming a systemic infection.

For emerging East Asia, which is made up of open and export-dependent economies, a cautious policy design for 2008 is critical. What's needed is a judicious mix of macroeconomic policies and continued strengthening of financial systems, and improving risk management and the regulatory and supervisory framework. China appears on the way to greater exchange rate flexibility, for example, but more could be done, along with speeded up financial sector reform and capital outflow liberalisation.

Gross domestic product growth in the region remains strong, but it is expected to ease from the estimated 8.5 per cent in 2007 to 8 per cent this year. A soft landing of the US economy - which will also help avoid a global slowdown - should mitigate the effects of the expected regional moderation in economic growth.

Thus far, the US is likely to avoid a sharp recession, though a prolonged slowdown may be in the offing. It is clear the US wants to avoid catching a cold - even if the nasty germ originated there - and maintains an array of policy tools that can supply the required medication. This is important for emerging East Asia, because while the US may avoid a recession this time around, a hard landing and ensuing global slowdown would significantly affect the region's economic performance, particularly given the continuing strong direct and indirect trade ties.

But, within the region, inflationary pressures are building. Rising prices in both goods and assets limits authorities' ability to lower policy rates. China's juggernaut economy hit an inflation rate of 6.9 per cent in November - the highest in 11 years. It needs to continue raising interest rates to stem inflation and avoid the economy overheating further. The rest of the region is also showing rising inflationary pressures - largely from oil, food and other commodity prices - and the potential of asset bubbles forming in sectors such as property and equities is worrisome. Then there is the US dollar depreciation, which translates into continued strong appreciation pressures on the region's currencies. Market intervention by central banks to ease those pressures leads to increased liquidity in the financial system, adding to inflation and asset prices. Thus, slower growth coupled with rising inflation and appreciating currencies pose major policy challenges.

The limited impact of the US subprime turmoil on emerging East Asian economies has led some economists to wonder whether the region is decoupling from US economic influence.

True, the region's resilience stems a great deal from better economic policies and a strengthened institutional framework since the 1997-1998 Asian financial crisis. But, with few exceptions, emerging East Asia's financial systems remain relatively unsophisticated. That is another major reason why it remained largely immune to the US subprime mess.

Nevertheless, continued financial volatility must be monitored closely as tighter short-term funding, persistent risk aversion, along with credit risk repricing, could result in a reversal of capital flows to the region. In several emerging East Asian economies, these inflows, along with rapid money supply and credit growth, have led to the potential for significant asset bubbles forming.

So it is really not that important whether emerging East Asia is decoupling from events in the US. The point is that emerging East Asia's potential weakness is evident not merely in the financial sector, but also in its ability to build and sustain monetary stability that best provides preventative medicine against external shocks.

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