

Macroeconomics

for Emerging East Asia

Chapter Summaries

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Foundations

Chapter 1. Macroeconomics is defined as the study of movement in aggregate activity with the focus of this book identified as short-term fluctuations around long-term potential growth. Long-term potential is explained with reference to the Solow growth model. The inapplicability of standard U.S. macroeconomic instruction to Emerging East Asia is discussed. Stabilization policy is introduced and the need to tailor an approach to Emerging East Asia is motivated. A graph of real GDP growth rates since 1960 for each of the 13 economies covered in the book illustrates economic volatility.

Chapter 2. The broad economic measure of Emerging East Asia is taken. The economies of the region are shown to differ greatly with respect to size, level of development, engagement in international trade and finance, and roles of state versus market. These factors are examined for their bearing on macroeconomic volatility and the policy environment.

Chapter 3. The fundamentals of microeconomics are conveyed. The focus is on the mechanics of demand and supply and development of the argument that competitive markets achieve efficiency in the allocation of resources. The concepts of market power and economic rent are introduced. Application of demand and supply tools to markets at the macro level is foreshadowed with respect to the market for loanable funds in which the interest rate is determined and the market for foreign exchange in which the exchange rate is determined. This is the first of two chapters that are purely theoretical.

Accounting Framework

Chapter 4. The National Income and Product Accounts are elaborated. Three approaches to estimating GDP are presented: the product approach; the expenditures approach; and the income approach. The expenditures approach is used to develop the identity $S-I=X-M$ as the basis for linking internal and external balance. Emerging East Asian economies are compared by sectoral composition and by saving and investment rates. Historic data for Taiwan capture systematic changes associated with the economic development process.

Chapter 5. The balance of payments accounts are laid out. The point is driven home that the balance of payments must balance across the current account, the capital and financial account, and the official settlement account. The foundation is put in place for a central bank role in the

foreign exchange market. The record of recent decades shows Emerging East Asia having run big balance of payments surpluses resulting in substantial reserve accumulation. Because China's reserve accumulation has been so extraordinarily large and politically charged, and later reversals in this accumulation so sharp, its balance of payments history is examined in detail.

Money, Finance, Exchange Rates

Chapter 6. Money is defined and its creation as liabilities of the banking system is explained. Creation of base money is viewed through the central bank balance sheet with a parallel drawn between transactions in government securities and transactions in foreign exchange. The age old debate on the effect of money supply increases on the price level versus real output is discussed. Data across economies show a clear correlation between money growth and inflation. Myanmar makes for a telling case study as money supply growth there has been so erratic over time.

Chapter 7. The role of the financial system in creating debt beyond that narrowly defined as money is discussed. Insights are drawn from Minsky as to the potential for the financial system to generate destabilizing impulses, with this foundation to be built on in the chapter on business cycles. Market determination of interest rates and asset prices is explained. Comparison across economies is drawn for bank security indicators and stock price volatility, both before and after the Great Financial Crisis. Hong Kong serves as the case study.

Chapter 8. Foreign exchange market mechanics are explained for both floating and fixed exchange rates. The principles of purchasing power parity and interest parity are articulated. Exchange rate arrangements for the economies of Emerging East Asia are outlined. Balance of payments adjustment under fixed and floating exchange rates is elucidated. A case study of Indonesia examines movement in the USD rate, the NEER, and the REER since 1994 with attention to the roles of market forces and central bank intervention. The upshot is that an exchange rate management strategy of "leaning against the wind" can be effective in moderating the impact of balance of payments shocks.

Macro Theory

Chapter 9. A rapid-fire overview is presented of the core models of macroeconomics: aggregate demand/supply; income-expenditure; and IS-LM/Mundell-Fleming. Students who have not seen these models before will get a general sense of the reasoning. Students who have learned this material previously will gain perspective on alternative specifications of macroeconomic relationships and competing schools of thought. A thorough command of model mechanics is not required for subsequent chapters (a section of the fiscal policy chapter excepted). This is the second of two purely theoretical chapters.

Chapter 10. The dominant paradigm for contemporary analysis of business cycles takes full-employment equilibrium as the norm and attributes temporary and self-correcting deviations from this norm to exogenous shocks. The historical literature (Bagehot, Minsky) offers an alternative paradigm that treats business cycles as endogenously driven by credit behavior. Both paradigms are developed in this chapter within a historical narrative of thought and thinkers. A

synthesis is proposed in which an endogenous cyclical process influences vulnerability to affect the way exogenous shocks play out. The Philippines provides the case study.

Stabilization Policy

Chapter 11. Monetary policy is expounded with attention to the interplay between the interest rate and the exchange rate. Articulation of the Trilemma provides a basis for comparing Emerging East Asian economies according to the IMF classification system for exchange rate arrangements and monetary policy frameworks. Evidence from balance of payments reserve asset flows and exchange rate movements reveals a pattern of “leaning against the wind” in exchange rate management. Singapore’s exchange rate based monetary policy is considered for the case study. Sterilization is explained and illustrated with cases from Indonesia and China.

Chapter 12. The consequences of government spending, taxation, and borrowing for internal and external balance are explained. The relevance of capital market openness and exchange rate arrangement for fiscal policy effectiveness is illustrated using the Mundell-Fleming model. Automatic stabilizers and the consequences of alternative channels of debt financing are discussed. The condition for fiscal sustainability is derived as a function of the GDP growth rate and the interest rate. Vietnam’s experience with rapidly rising government debt is examined. The economies of Emerging East Asia are compared for their implementation of fiscal stimulus during the Great Financial Crisis.

Chapter 13. The Swan diagram is developed to analyze policy for internal and external balance. The policy framework involves the fiscal budget and the exchange rate as monetary policy instrument, but can be adapted to treat the interest rate as instrument. Three hypothetical cases are considered, followed by the Malaysian case for the late 2010s. To reduce Malaysia’s external surplus, the model recommends monetary tightening offset by fiscal stimulus to maintain internal balance. Malaysia’s high government debt level, however, militates against expansionary fiscal policy. As an alternative approach, structural causes and solutions for the external imbalance are investigated.

Further Topics

Chapter 14. To be written. The growing use of macroprudential policy in Emerging East Asia will be examined. Korea will provide the case study.

Chapter 15. To be written. Alternative causes of crisis will be reviewed and the policy responses considered. Three crisis events will be studied: the Asian Financial Crisis; the Great Financial Crisis; and the Covid Crisis. Thailand is the case economy, chosen for its kickoff of the Asian Financial Crisis. The country has also been hit hard by the Covid crisis, despite have done well in containing the virus, due to the importance of international tourism.

Chapter 16. To be written. Epilog.