Macroeconomics

for Emerging East Asia

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16. Epilog

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> *Macroeconomic stabilization in emerging economies calls for managing both internal and external balance within a policy space constrained by global capital flows and debt sustainability pressures. Emerging East Asia has worked out an approach to meeting this challenge that involves the exchange rate. But while the economics of the system have proved effective, the politics can run afoul of US strictures on currency manipulation. This is a source of ongoing tension.*

Emerging East Asia has honed a well-functioning model for stabilization policy. Through a span of two decades between the Asian Financial Crisis and the Covid pandemic, the region sustained healthy growth with low inflation. External shocks from the bursting of the dot-com bubble in 2001 and the Great Financial Crisis in 2008 brought growth slowdowns, edging into modest contractions for a few, but recovery was quick (see Figure 1.2). With the onset of the global pandemic in 2020, the region was, for the most part, well positioned to undertake supportive policies.

In this final chapter, we present a brief recap of the Emerging East Asia macro policy model. The model involves management of the exchange rate as a stabilization tool, which is fine as such. A problem arises, however, when the currency is "manipulated" to achieve advantage in trade. On this front the US has taken up a watchdog role, with threat of penalty tariffs at stake. We analyze the issues.

And then we conclude.

A. Macro Policy in Emerging East Asia

The Emerging East Asia policy model is distinctive enough to warrant a textbook dedicated to the subject. We recap the model in this section, then consider the region's positioning for responding to the macroeconomic shock of the pandemic.

Policy model recap

For the economies of Emerging East Asia, both internal and external balance demand attention in stabilization policy where external balance involves payments inbound versus outbound on the current account and internal balance involves growth versus inflation domestically. In US textbooks, external balance makes no appearance as a macro policy issue, nor does the exchange rate enter as a policy instrument. When a country prints the world's reserve currency and its payment obligations are denominated in that currency, external shocks are easily absorbed and the exchange rate can be left to go where it will. Emerging East Asian economies do not have that luxury. Payment obligations in the region are specified mainly in foreign currency, and the exchange rate is pivotal for being able to meet those obligations. Maintaining confidence in the value of the domestic currency is paramount in this setting.

To pursue balance in two dimensions, two arms of policy are used in complementary fashion, as explained in Chapter 13. Consider that an expansionary monetary policy stimulates the economy and pushes the current account balance in a positive direction by lowering interest rates and the value of the currency whereas an expansionary fiscal policy also stimulates the economy but pushes the current account balance in a negative direction by raising interest rates and the value of the currency. So delineated, the two arms of policy may be played off each other. For example, suppose an economy is operating with growth at potential and inflation low and stable, but the current account is in deficit to a troubling degree. The straightforward remedy for the current account deficit would be a central bank intervention to depreciate the currency. This has the undesired side effect, however, of inducing monetary expansion to stimulate the domestic economy which was initially in balance. To offset this unintended consequence, fiscal policy can be tightened, with the added benefit of reinforcing an increase in the current account balance.

Within this policy framework, the exchange rate acts in tandem with the interest rate. Either can be used as an instrument for targeting monetary policy; the two cannot, however, be made to work independently given an open capital account. Lowering a policy interest rate triggers a capital outflow which depreciates the value of the currency. On the other hand, intervening in the foreign exchange market to depreciate the currency causes an expansion in the monetary base which lowers the interest rate. The exchange rate can thus serve as a monetary policy instrument in the same way the interest rate does, the difference being the central bank intervenes in the foreign exchange market rather than in the domestic bond market. Empirical evidence presented in Chart 11.2 shows Emerging East Asia has systematically intervened in the foreign exchange market to lean against shocks to external balance. Such action is integral to the region's monetary policy framework.

The exercise of monetary and fiscal policy is subject to constraints in the Emerging East Asia context, with this topic, too, lying beyond the scope of US macro texts. Open capital markets limit the space available to manipulate interest rates in pursuit of internal balance without triggering cross-border capital flows that disrupt external balance. Indeed, Hong Kong and Singapore base their monetary policies entirely on exchange rate targeting given the lack influence over interest rates under their globally integrated financial systems. But the exchange rate, too, is of limited avail for stabilization purposes. Pushing toward appreciation or leaning against depreciation requires the central bank to sell foreign currency against the hard limit of its reserve stock. On the other hand, pushing toward depreciation or leaning against appreciation can be inflationary, or if the intervention is sterilized through bond purchases will impose interest costs on the central bank over and above the return received on its holdings of safe foreign assets. As for fiscal policy, the big constraint is that creditors will become uneasy if public debt gets too high. Loss of confidence in the government's ability to meet its obligations can trigger interest rates to rise and the value of the currency to fall with spiralling repercussions for the economy.

Importantly, sound policy involves preserving latitude to respond to shocks. That means building a healthy trove of official reserves during good times and keeping government debt at a moderate level. This will ensure space for government to increase spending and maintain exchange rate stability should bad times hit.

Pandemic response

Bad times in fact hit with a vengeance in 2020. Lockdowns due to the Covid pandemic undermined tax collection for most Emerging East Asian economies even as the need escalated for governments to spend on public health and social welfare programs. Externally, the impact of the pandemic on the region's exports was mixed as sales of some manufactures were strong while trade in services plummeted (see Chart 15.3).

Fiscal space to respond to the crisis varied within the Emerging East Asia region (see Table 15.1). Those well positioned (e.g., Hong Kong and Singapore) took advantage of it to ramp up government spending. Those with already high debt-to-GDP ratios either responded with more reserve (e.g., Malaysia) or tipped further toward imprudence (e.g., China). In between these poles, most of the region met the pandemic with budgets close to balance and sufficient fiscal space to raise deficits to around 3-4 percent of GDP without undue concern. Of course, as the pandemic stretches out, stress on government budgets will mount.

Space for monetary policy is influenced by global capital markets. Flows into Emerging East Asia remained buoyant in 2020 as evidenced by rising currency values coupled with increases in official reserves (see Chart 15.6). An expansionary monetary policy in the US kept interest rates low through the first year of the pandemic, which created space for Emerging East Asia to follow suit. However, should inflation threaten to take hold in the US, a monetary tightening would not be far behind. That could bring capital outflows and declining currency values with pressure to raise interest rates. Given uneven access to vaccines in the region, return to normal economic functioning will be staggered. Yet the US will call the tune on interest rates.

B. Woe to the Currency Manipulator

As its trade deficit with China soared in the 2000-aughts, the US became much exercised over China's management of its exchange rate. Cries of "currency manipulation" resounded, the idea being that China was deliberately depressing the value of the renminbi for the purpose of gaining an unfair advantage in exports. In this section, we consider the concept of currency manipulation and then examine the cases of China, Vietnam, and Taiwan.

Trouble with the concept

Central bank intervention in foreign exchange markets does not in itself constitute "currency manipulation". Currency manipulation as a technical matter is all about intent, and intent is very difficult to discern. As stipulated in the IMF's Articles of Agreement, members shall "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." (p. 6) Under this rubric, the IMF has never designated a country a currency manipulator despite much pressure to do so. It is simply too difficult to distinguish *intervention* intended for macroeconomic stabilization from *manipulation* intended for gaining unfair advantage in trade.

This subtlety has not deterred the US from applying the label. An investigation into currency manipulation by the US Treasury Department is triggered based on an economy meeting three criteria during a year's time: net official purchases of foreign exchange exceeding 2 percent of GDP; a current account surplus exceeding 2 percent of GDP; and a bilateral trade surplus with the US exceeding $20 billion. If the investigation finds in support of currency manipulation, the Treasury Department enters into bilateral engagement to seek remedies. The threat of penalty tariffs acts as leverage. The currency manipulator designation was applied to China in 2019 and 2020 and to Vietnam in 2020, and back in the 1980s and '90s, to Korea, Taiwan, and China.

In its April 2021 report, the Treasury Department concluded that evidence was insufficient to designate any currency manipulators even though Vietnam and Taiwan had met all three criteria for investigation. Countries tagged for the watch list as meeting two of the three criteria included China, Korea, Malaysia, Singapore, and Thailand. The April 2021 report was the first of the administration of President Biden. There would seem to be plenty of room for different US administrations to interpret similar facts differently in reaching their conclusions given the ambiguity surrounding intentions. A role for politics cannot be denied.

The macro stabilization argument

The US outcry over currency manipulation has been most vociferous with respect to China. The US Treasury Department conferred its formal manipulator designation on the country for three consecutive years from 1992 to 1994, then not again until 2019 and 2020. Incongruous as it may seem, between 1994 and 2018 the US trade deficit with China rose from $32 billion to $419 billion with no manipulator designations applied, then fell to $346 billion in 2019 and to $311 billion in 2020 with the designations reinstated.

Rather than trying to penetrate US motives and processes, let us consider the effectiveness of China's exchange rate policy from a macroeconomic standpoint for what that may suggest about intent. This subject was broached in Chapter 8, Section C, with a claim that China effectively steered its exchange rate toward a path of long-run stability. Against a surging current account surplus through the 2000-aughts and rising capital inflows following market liberalization late in the decade, the Chinese central bank held the line against renminbi appreciation while building massive reserves (see Chart 5.1 and related discussion). By 2015, however, the renminbi's tie to a rising US dollar brought a shift to perceived overvaluation relative to other currencies triggering fear of depreciation and inducing capital flight. Defending the renminbi against downward pressure cost the central bank nearly $800 billion of its $4 trillion in reserves within just two years. Since then, however, China's reserve trove has held steady against a stable renminbi and a current account surplus that in 2018-19 lay well under one percent of GDP.

Did a low renminbi valuation during the 2000-aughts encourage exports and discourage imports to bring about large trade surpluses? No doubt. But was the trade imbalance a transitory aberration within the context of an exchange rate policy aimed at long-term stability? With the benefit of hindsight, a case for this can be made. China's trade surplus opened up in the 2000-aughts due to factors that raised the saving rate to drive a wedge between saving and investment, and strong net exports kept the economy going in the face of a shortfall in domestic demand. The major factors behind the rise in saving were temporary in nature, however, involving extraordinarily rapid growth in income and a demographic bulge that concentrated population in prime working and saving ages. As growth has slowed and the population has aged, the saving rate has come down, and with that the external imbalance has eased. Had the renminbi been allowed to appreciate under the pressure of the 2000-aughts, China's growth would have slowed and loss of confidence in an eventually overvalued renminbi could have resulted in even more precipitous capital outflows than those that actually materialized in 2015-16. China's exchange rate policy astutely avoided this fate and can therefore be justified on grounds other than "manipulation".

Vietnam was subjected to the manipulator treatment by the US Treasury under the Trump administration in 2020 but avoided this fate under the Biden administration on the strength of negotiations that had the country promising to refrain from engaging in “competitive devaluation”. A latecomer to global trade, Vietnam has achieved quick success while yet remaining a small-time player in global capital markets. As a reforming command economy, its recourse to market forces for absorbing shocks is somewhat inhibited. Within this context, the country has kept a tight hold on its exchange rate relative to the US dollar even as this has led to percentage changes in reserves relative to a small base that have run to extremes (see Chart 11.1). Even by 2020, Vietnam had accumulated reserves of just 27.8 percent of GDP, a modest stock by the standards of the region (see Chart 11.3). Before it relaxes its exchange rate control, before it opens its capital markets, before it exposes its economy more fully to international engagement, Vietnam needs to build a reserve stock that will allow it to defend its currency if and when the need arises.

Meanwhile, at the time of the manipulator charges, Vietnam was taking on supply chain relocations out of China in response to tensions fanned by the US. Such a balance of payments shock can be absorbed even under a stabilized exchange rate through increased imports or net capital outflows, but these responses take time. As with China then, within a longer-term context of adjustment to shock and the development of market mechanisms, this stage in Vietnam’s exchange rate policy may be viewed as supportive of macroeconomic stabilization. As such, the behavior does not qualify as “currency manipulation”.

Taiwan was last branded a currency manipulator in 1992. Since then, its reserve accumulation has reached 83 percent of GDP putting it behind only Hong Kong, with its US dollar-backed monetary base, and Singapore (see Chart 11.3). In 2021, Taiwan met all three conditions for an investigation by the US Treasury but escaped a manipulator designation. In taking a position of leniency, the Treasury noted that the pandemic had “drastically affected global trade” (p. 1), favorably so for Taiwan’s exports of semiconductors and high-tech equipment, and also highlighted Taiwan’s success in controlling Covid transmission to keep its economy running. The Treasury went on to warn, however, that exchange market intervention practices “have resulted in a structurally undervalued exchange rate that has failed to adjust in the face of Taiwan’s persistently large current account surpluses.” (p. 4) Still, the Treasury recognized that Taiwan is a special case with respect to its need for buffers against risk pointing to its “geopolitical situation, its lack of IMF membership, and its dependence on imported energy and external demand”. (p. 43) That brings us back to the point that building reserves as a buffer against risk is an essential aspect of macroeconomic stabilization policy.

C. Final Thoughts

The premise of this textbook is that as diverse as the economies of Emerging East Asia are in obvious respects, they can be subsumed within a common analytical framework for the purpose of understanding macroeconomic phenomena, with this framework differing notably from that presented in standard US macro texts. Key features of the framework are: attention to both internal and external balance; intertwining use of the exchange rate and the interest rate as monetary policy instruments; and management of policy under constraints imposed by international capital flows and government borrowing inhibitions. Within the framework, capacity to absorb shocks is strengthened by keeping public debt at a moderate level and building a healthy stock of foreign reserve assets. Reserve accumulation depends largely on running current account surpluses. And that can provoke the ire of the US. But a fair response is that US macro policy as expressed through its impact on interest rates and global capital flows is one of the most overbearing and uncertain elements of the global economic environment that emerging economies must contend with. Against the slings and arrows of US policy, then, reserves help provide resilience.

Finally, let us consider whether Emerging East Asia has honed an approach to macroeconomic policy that other emerging economies might learn from. A comparison with Latin America on the use of foreign exchange market intervention to lean against external shocks as viewed through the framework of Chart 11.2 would suggest so (see the Asia Economics Blog, 8 May 2021). For Emerging East Asia, the data show a clear pattern of leaning against currency appreciation in the face of a positive balance of payments shock and against currency depreciation in the face of a negatiave balance of payments shock. For Latin America, by contrast, the relationship between exchange rate movement and reserve changes appears quite random. Relatedly, Latin American economies for the most part hold much lower reserves relative to GDP than Emerging East Asian economies making it harder for their central banks to intervene against currency depreciation by selling foreign exchange. To develop the capacity that Emerging East Asia has for two-sided intervention, Latin American economies would have to follow the East Asian model of running current account surpluses for an extended period to accumulate reserves. This may not be easy. We see the pushback East Asia has come up against.

Data Note

Figures on the US trade deficit with China are from the IMF Direction of Trade Statistics database.

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