Unwinding Policy Stimulus: Options for Emerging East Asia

Why unwind?

With emerging East Asia's V-shaped economic recovery firmly on track, monetary and fiscal stimulus must begin to unwind, and macroeconomic policy should return to normal.

As most emerging East Asian economies are relatively assured of a V-shaped recovery from the 2008/09 global recession, several emerging East Asian economies have begun to unwind the fiscal and monetary stimulus that prevented severe economic recession. Nonetheless, macroeconomic policies in the region generally remain accommodating. This special section addresses key policy questions over the timing, policy mix, and appropriate pace for removing stimulus and how best to balance attendant risks. There are three key conclusions:

- even though economies in the region need to begin removing stimulus, the withdrawal will generally be able to proceed at a relatively modest pace except in a small number of economies where inflationary pressures are strong or rising;
- (ii) in most cases, removing monetary stimulus supported by greater exchange rate appreciation—should proceed more rapidly than fiscal consolidation, given the region's generally manageable budget deficits and development priorities; and,
- (iii) unwinding stimulus should ideally be coordinated across the region to increase the benefits of mutually reinforcing feedback effects and—as an add-on benefit—to contribute to global payments rebalancing.

The magnitude of stimulus in emerging East Asia has been more modest compared with advanced economies; therefore, the scale of unwinding needed is smaller.

The process of establishing macroeconomic policy neutrality is different for advanced economies and emerging East Asian economies. Major advanced economies cut interest rates close to zero and resorted to quantitative easing, which led to a huge expansion of central bank balance sheets during the crisis (Table 13). Fiscal deficits in many advanced economies increased massively and public debt rose significantly, in some cases surging to 100% of GDP or higher (Tables 14, 15). Therefore, in advanced economies—particularly the United States (US) larger European economies-unwinding and involves manipulating a wide range of policy levers over several years, with governments gradually getting out of the financial system. In contrast, policy interest rates in emerging East Asia were not cut to their zero floors,⁴ and quantitative easing was not used⁵ (see Table 13). Although increasing, budget deficits in the region generally remain manageable (see Tables 14, 15) and public debt to GDP ratios mostly remain at 40-50%. The region is not facing the scale of the deep-seated fiscal problems currently seen in crisis economies.

The main challenge is to unwind stimulus without disrupting recovery.

Notwithstanding the much smaller macroeconomic policy stimulus, the region's policymakers still

 $^{^{4}\}mbox{Except}$ in Hong Kong, China under its Linked Exchange Rate System with the US dollar.

⁵In Hong Kong, China the balance sheet of the Hong Kong Monetary Authority (HKMA) expanded relatively sharply under the Linked Exchange Rate System in 2009. The expansion was largely driven by strong capital inflows related to equity investment. In the PRC, large and expanding central bank assets are due to its large and increasing holdings of foreign exchange reserves.

	2007	2008	2009		2007	2008	2009
Emerging East Asian Ecor	omies			Philippines	12.8	13.0	—
Brunei Darussalam	7.9	8.3	—	Singapore	10.5	12.5	13.7
Cambodia	14.3	14.6	—	Taipei,China	15.1	16.7	18.4
China, People's Republic of	38.2	41.1	42.3	Thailand	10.5	11.0	11.8
Hong Kong, China	19.8	30.2	61.9	Viet Nam	27.6	25.5	—
Indonesia	11.1	8.6	8.9				
Korea, Republic of	5.8	6.3	6.4	Advanced Econo	omies		
Lao People's Democratic	9.8	10.3	—	Euro area	15.5	21.0	21.1
Republic				Japan	18.6	20.0	22.3
Malaysia	10.0	9.2	8.1	United Kingdom	n 5.1	6.6	14.1
Mvanmar	20.1	15.9	_				
,				United States	5.8	11.7	13.6

Table 13: Central Bank Assets¹ (% of GDP)

– = data not available, GDP = gross domestic product.

¹Refers to central bank monetary base for the following countries: Brunei Darussalam; Cambodia; Indonesia; Malaysia; Philippines; Taipei,China; Thailand; Japan; and United States. Refers to monetary authorities' reserve money for the following countries: People's Republic of China; Hong Kong, China; Republic of Korea; Lao People's Democratic Republic; Myanmar; Singapore; Viet Nam and United Kingdom. Refers to currency issued and liabilities of depository corporations for the Euro area.

Source: International Financial Statistics, International Monetary Fund; national sources; and CEIC.

Economy/Grouping	2005	2006	2007	2008	2005— 2008 Average⁴	2009
China, People's Republic of	-1.2	-1.0	0.6	-0.4	-0.5	-2.8
NIEs ¹	-0.6	0.2	2.8	-0.4	0.5	-1.3
ASEAN-5 ²	-1.7	-1.3	-1.5	-1.5	-1.5	-4.3
Hong Kong, China ³	1.0	4.0	7.7	0.1	3.2	0.8
Indonesia	-0.5	-0.9	-1.3	-0.1	-0.7	-1.6
Korea, Republic of	-2.5	-2.6	0.4	-2.1	-1.7	-3.9
Malaysia	-3.6	-3.3	-3.2	-4.8	-3.7	-7.0
Philippines	-2.7	-1.1	-0.2	-0.9	-1.2	-3.9
Singapore	0.7	0.0	3.0	0.1	1.0	-1.1
Taipei, China ³	-0.6	-0.3	-0.4	-0.9	-0.5	-4.0
Thailand ³	0.2	0.1	-1.1	-0.3	-0.3	-4.8
Viet Nam	-3.6	-1.2	-5.5	-4.1	-3.6	-11.8
Advanced Economies						
France	-2.6	-2.0	-2.3	-2.8	-2.4	-6.0
Germany	-2.1	-1.5	-0.8	-0.6	-1.3	-1.6
Japan ³	-6.2	-5.4	-4.9	-6.7	-5.8	-11.3
United Kingdom	-3.0	-2.7	-2.7	-4.7	-3.3	-11.2
United States	-2.6	-1.9	-1.2	-3.2	-2.2	-9.9

Table 14: Fiscal Balance of Central Government (% of GDP)

GDP = gross domestic product.

¹Newly industrialized economies = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China. ²ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand) plus Viet Nam. ³Fiscal year (FY). ⁴Refers to simple averages only.

Source: Asian Development Outlook March 2010, Asian Development Bank; Eurostat; United States Congressional Budget Office; national sources; and CEIC.

Economy/Grouping	2005	2006	2007	2008	2005— 2008 Average ^s	2009
China, People's Republic of ¹	17.8	16.5	20.2	17.7	18.1	21.0 ^p
NIEs ²	39.8	38.5	37.6	39.0	38.7	30.7
ASEAN-5 ³	54.5	48.7	44.3	44.3	48.0	54.3
Hong Kong, China ¹	2.2	1.8	1.5	1.3	1.7	3.4
Indonesia ⁴	45.6	39.0	35.1	33.2	38.2	31.1 ^p
Korea, Republic of4	27.6	30.1	29.7	29.0	29.1	32.6
Malaysia⁵	43.8	42.2	41.7	41.5	42.3	53.7
Philippines ¹	82.2	73.3	63.1	64.3	70.7	65.3
Singapore ¹	99.1	92.4	90.5	95.9	94.5	113.1
Taipei,China⁴	30.2	29.6	28.8	29.8	29.6	33.1
Thailand	46.4	40.3	37.4	38.2	40.6	43.8
Viet Nam	44.5	44.1	46.3	44.4 ^e	45.0	47.5 ^p
Advanced Economies						
France ⁶	66.4	63.7	63.8	67.5	65.4	77.6
Germany⁵	68.0	67.6	65.0	66.0	66.7	73.2
Japan⁴	162.1	164.0	162.5	166.8	163.8	183.8
United Kingdom ⁶	42.2	43.5	44.7	52.0	45.6	68.1
United States ⁷	63.5	63.9	64.4	69.2	65.3	83.4

Table 15: Public Sector Debt (% of GDP)

e = estimate, GDP = gross domestic product, p = projection.

¹Refers to government debt. ²Newly industrialized economies = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China. ³ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand) plus Viet Nam. ⁴Refers to central government debt. ⁵Refers to federal government debt. ⁶Refers to government consolidated gross debt. ⁷Refers to gross federal debt. ⁸Refers to simple averages only. Source: *Article IV* consultation reports, International Monetary Fund (including estimate/projection);

Source: Article IV consultation reports, International Monetary Fund (including estimate/projection); Eurostat; United States Office of Management and Budget; and CEIC.

face difficult challenges, and the most important is to reduce stimulus without disrupting growth. This involves appropriate timing, policy mix, and pace of implementation. Timing is critical to avoid withdrawing support before recoveries have gained sufficient self-sustaining momentum. The policy mix should support private demand to replace policy stimulus. And the pace of unwinding needs to sustain recovery while removing public support. All these argue that public support for economic recovery should be maintained as long as possible. However, in seeking to provide appropriate public support, it will be necessary to avoid a buildup in inflationary pressures or any threat to mediumterm fiscal sustainability. Uncertainties over the strength and sustainability of the global recovery suggest that conventional short-term

macroeconomic considerations will need to be balanced against various risks in determining appropriate exit strategies.

Appropriate exit strategies would not only sustain the region's recovery, but also help the region rebalance its sources of growth toward domestic and regional demand.

A fundamental factor influencing the region's exit strategies may be the role the region will have to play in global rebalancing. While the region could contribute to global rebalancing by stimulating domestic demand, maintaining macroeconomic stimulus for too long in the region would not be appropriate, risking the creation of new internal imbalances. Instead, rebalancing will need to depend primarily on adopting a range of structural reforms to address weaknesses in private consumption and investment that contributed to the imbalances. To sustain the recovery, strategies of unwinding macroeconomic stimulus should depend primarily on the strength and resilience of economic recovery and the risks to the economic outlook. Moreover, the mix of monetary, fiscal, and exchange rate policies in the region's exit strategies can play an important role in facilitating the required shift of demand toward the region. This strategy of "Money First—with somewhat faster appreciation" may help the region achieve its rebalancing goals.

When should unwinding begin?

The timing of unwinding stimulus should depend primarily on the strength and resilience of the recovery in each economy and the risks to its economic outlook.

As recovery firms, emerging East Asia should unwind policy stimulus and "normalize" macroeconomic policy **(Box 2)**. In principle, withdrawing monetary and fiscal stimulus should proceed at a rate commensurate with the strength of each economy's recovery, unless there are either compelling concerns over policy sustainability that require a more rapid adjustment, or risks to the recovery that would point toward a more cautious approach.

Unwinding policy stimulus is more urgent in economies where recovery is strong, output gaps are narrowing quickly, and inflationary pressures are emerging.

Indeed, economies such as the People's Republic of China (PRC); Republic of Korea (Korea); Malaysia; Singapore; Taipei,China; and Thailand have already begun to tighten monetary policy through either increases in short-term policy interest rates (Korea; Malaysia; Taipei,China; and Thailand), increases in reserve requirements and administrative measures (PRC), or through effective exchange rate appreciation (Singapore). And, in some economies in the region, including the PRC; Hong Kong, China; and Singapore, there have already been concerns that the very accommodating monetary policies may be fueling excessive asset prices, particularly in real estate. In these cases, macroprudential measures are also being tightened.

However, in economies where recovery is more fragile, output gaps remain large and inflation is benign, policymakers could be more cautious.

Authorities in some economies may decide to hold back on removing stimulus until they are convinced the recovery is firmly on track. They may worry that the recovery in advanced economies depends more on public than private sources of demand and inventory restocking. And they may also be concerned about emerging East Asia's high dependence on external demand. This is more pronounced where there is uncertainty that private demand in the region might not be able to sustain the recovery if public stimulus is curtailed and external demand becomes weak. Holding back on unwinding stimulus is effectively "buying" insurance against the recovery faltering. However, delayed tightening may lead to a gradual build up of inflationary pressures, implying the need for even more aggressive tightening later. Policymakers should constantly assess these risks and adjust exit strategies and implementation accordingly.

What's the best policy mix?

The policy mix of unwinding stimulus in emerging East Asia must be calibrated to specific domestic economic conditions and even potential spillovers from "normalization" elsewhere.

Unwinding policy stimulus in emerging East Asia will be done against the backdrop of how crisisaffected economies pull back. There, unwinding fiscal stimulus will likely precede monetary normalization as public finance shot up during the crisis while inflation remained under control. These mostly advanced economies may adopt a "Fiscal First" exit strategy: a mix of fiscal tightening while keeping interest rates low. This strategy has several desirable features—not least that shortand long-term interest rates can be kept low for an extended period to fuel private sector investment and job creation after inventory restocking is completed. Moreover, credible back-loaded fiscal consolidation can boost confidence and mitigate negative short-run demand effects associated with budget cutbacks and tax increases.

The "Fiscal First" strategy by advanced economies could create a wave of capital outflows and depreciate their exchange rates.

The "Fiscal First and Money Second" strategy would improve international competitiveness of major crisis economies and increase the contribution of net exports to growth. Therefore, global payments imbalances tend to narrow. Although helping the recovery in major crisis economies and facilitating global rebalancing, such a strategy could lead to more volatile capital flows and thus complicate macroeconomic management in emerging East Asia. Loose monetary policy could also depreciate advanced economies' currencies, weakening demand for emerging East Asia's exports.

In comparison, emerging East Asia is better attuned to a "Money First" unwinding strategy—in which policymakers normalize monetary policy first and consolidate fiscal policy subsequently.⁶

Emerging East Asia does not face the severe fiscal problems of advanced economies. So there is little rationale to pursue a "Fiscal First" stimulus exit strategy (with a few exceptions). National development agendas and the desire to rebalance sources of growth more toward domestic demand keeps targeted fiscal stimulus attractive. A "Money First" exit strategy allows fiscal policy to continue to support domestic demand in the near term. However, the money lever could produce sharp increases in interest rates should inflationary pressures rise excessively. So authorities need to carefully assess sensitive private domestic demand when crafting the appropriate policy mix for unwinding stimulus. Monetary tightening first could also lead to large surges in capital inflows as interest rate differentials widen against policy rates in major advanced economies.

Considering the need to rebalance the region's sources of growth, there is merit in normalizing monetary conditions through a judicious mix of currency appreciation and interest rate adjustments rather than entirely through policy rate hikes.

To offset the upward pressure on currencies resulting from a "Money First" strategy, regional authorities may continue to intervene in foreign exchange markets while sterilizing the domestic monetary consequences of such interventions-a return to the pre-crisis norm in many economies. Whether this works cannot be guaranteed, however, and costs could rise over time should interest rates in the region remain above those in the crisis-affected economies. It would be better to allow a somewhat faster rate of currency appreciation in the short term, raising policy rates to "normal" levels later or more gradually. This way, policy rates can remain relatively low while inflationary pressures are dealt with through exchange rate appreciation. This policy mix has several advantages: it allows both fiscal policy and low interest rates to support private demand in the near term; and it lessens the stress of managing large capital inflows or sterilization. The add-on benefit is that appreciation of regional currencies helps global rebalancing. The issue of asset price bubbles due to low interest rates could affect some economies, and can be addressed by macroprudential policies. This type of policy mix, however, is not an alternative to the structural reforms required to reduce the region's high

⁶With the exception of Hong Kong, China as a result of its US dollarbased Linked Exchange Rate System.

dependence on external demand, and in essence, buys time for reforms to be implemented.

How fast to unwind stimulus?

The pace of unwinding stimulus should be in step with the speed of the region's V-shaped recovery—though evermindful of the risks facing the overall global recovery.

With the region's relatively rapid recovery from the global slowdown, there is a presumption that unwinding macroeconomic stimulus should relatively quickly. The continued proceed uncertainty about the strength of the global recovery, however, makes the appropriate pace of stimulus withdrawal unclear, and several economies have recently placed exit strategies on hold as they assess the implications of the sovereign debt problems in Europe. This cautious approach reflects the increasing role that the risk-based approach to macroeconomic policy formulation is playing in the region. The pace of macroeconomic policy normalization depends on economic conditions in each economy, and ultimately needs to be based on several factors: the size of output gaps, the forward momentum of recovery, the outlook for inflation, and uncertainty of the recovery.

Output gaps have been narrowing rapidly across most of emerging East Asia—and have in fact closed in some economies.

With output trends extrapolated from log-linear trends estimated over the sample 2000-2008 period, most economies in the first guarter of 2010 continued to show negative output gaps—in which output is below trend-but the gaps have been narrowing relatively rapidly since the recovery began in the second half of 2009 (Table 16). In the PRC, Indonesia, and Singapore, there is virtually no output gap left. With inflation rising across much of the region, a simple Taylor-type interest rate rule with narrowing output gaps and rising inflation clearly indicates that interest rates in most economies should rise toward more normal levels relatively quickly. In the current uncertain conditions, however, policymakers may lower the speed of unwinding stimulus and not accelerate its withdrawal. Moreover, policymakers will need to determine whether a required tightening of monetary conditions should come from raising

Economy	2009Q1	2009Q2	2009Q3	2009Q4	2010Q1	2010Q2
China, People's Republic of	-2.1	0.9	0.9	0.9	-1.4	1.3
Hong Kong, China	-8.7	-7.1	-7.9	-6.9	-5.9	—
Indonesia	1.2	0.2	0.4	0.8	1.9	-
Korea, Republic of	-6.8	-5.6	-3.7	-4.5	-3.6	_
Malaysia	-9.7	-7.9	-5.8	-3.1	-6.0	—
Philippines	-4.1	-3.3	-4.1	-4.0	-2.4	-
Singapore	-9.6	-7.0	-6.0	-7.6	0.0	4.4
Taipei,China	-10.9	-7.7	-6.2	-3.6	-2.0	-
Thailand	-10.2	-9.2	-9.1	-6.6	-4.3	-
Viet Nam	-3.2	-2.9	-3.2	-1.3	-4.3	-3.8

Table 16: Output Gap1 (%)

– = data not available.

Note: Figures are based on seasonally adjusted real gross domestic product (GDP) except for People's Republic of China (PRC); Indonesia; Malaysia; and Viet Nam; where original series were used as official seasonally adjusted series are unavailable.

¹Output gap is computed as the percentage deviation between actual and trend real GDP. Trend GDP is estimated using log-linear trend regressions of the GDP levels over the period 2000–2008 and extrapolating the trend to the period 2009–2010. For the PRC, Indonesia, Malaysia, and Viet Nam, four log-linear trend regressions were done for each of the four quarters (Q1, Q2, Q3, and Q4) over the period 2000–2008.

Source: OREI staff calculations based on data from CEIC; International Financial Statistics, International Monetary Fund; and Oxford Economics for PRC data only.

interest rates or exchange rate appreciation (see Box 2).

With the exception of Viet Nam, recovery across the region continues to gain momentum.

The degree of forward momentum in each economy can be determined based on how far year-onyear growth rates of real GDP, consumer prices, industrial production, retail sales, and exports deviate from their 2000-2008 averages. If they are far below average, then the economy would be in a "blue" state and has the weakest growth. On the contrary, if indicators are well above average, the economy would be in "red" and has the strongest growth. Therefore, the shading on the maps ranges from dark blue, denoting cyclical weakness, to dark red, denoting cyclical strength. The economy is gaining stronger momentum if the indicators move from blue to red faster. The recovery map for GDP growth (Figure 66) shows that while Malaysia; Singapore; Taipei, China; and Thailand had the strongest growth momentum in the past few quarters, Viet Nam is losing some steam. Moreover, most economies in the region have displayed strong GDP growth momentum for more than one quarter, showing the generally very

Inflation

Figure 66: Recovery Map-Inflation and Real GDP¹



GDP = gross domestic product. ¹Based on analysis of quarterly average of monthly year-on-year (y-o-y) growth rates for inflation, and y-o-y growth of quarterly real GDP. ²Inflation data for 2010Q2 refers to April for Myanmar; and the average of April and May for Hong Kong, China; Lao PDR; Malaysia; and Singapore. ³Refers to the minimum value over the period 2000-2008 in each economy. ⁴Refers to the average monthly (for inflation) or quarterly (real GDP) y-o-y growth rates for the period 2000-2008 in each economy. 5Refers to the maximum value over the period 2000-2008 in each economy.

Source: OREI staff calculations based on data from CEIC and International Financial Statistics, International Monetary Fund.



Figure 67: Recovery Map-Exports, Industrial Production, and Retail Sales¹

¹Based on analysis of quarterly average of monthly year-on-year (y-o-y) growth rates. ²Data for 2010Q2 refers to the average of April and May for Hong Kong, China; Indonesia; Malaysia; Philippines; Singapore; and Thailand. Data for 2010Q1 refers to February for Brunei Darussalam, Cambodia, Lao PDR, and Myanmar. ³Data for 2010Q2 refers to April for Indonesia and Philippines; and the average of April and May for Korea; Malaysia; Singapore; Taipei,China; and Thailand. For the PRC, value of industry is used. For Hong Kong, China and Thailand, manufacturing production index is used. For the Philippines, the volume of production index for key manufacturing enterprises is used. ⁴Data for 2010Q2 refers to April for Hong Kong, China; Indonesia; Philippines; Singapore; and Thailand; and the average of April and May for Korea; and Taipei,China. For the Philippines, net sales index of key manufacturing enterprises is used. ⁵Refers to the minimum value over the period 2000–2008 in each economy. ⁶Refers to the average monthly y-o-y growth rates for the period 2000–2008 in each economy. ⁷Refers to the maximum value over the period 2000–2008 in each economy. ⁸Conomy. ⁹Conomy. ⁹Conomy. ⁹Conomy ¹Conomy. ¹Conomy ¹Cono

strong growth in the first quarter of 2010 was not an aberration.

Inflation is rising, particularly in the PRC; Hong Kong, China; Singapore; and Viet Nam.

The recovery map for consumer price inflation (see Figure 66) shows that the momentum in inflation is strongest in the PRC as the color changed from dark blue to light red in the period. Inflation in other economies remains below the 2000–2008 average. Even though most economies in the region have seen inflation increase in recent months—from very low rates during the global crisis—it is

not an immediate problem and remains mostly manageable. For Indonesia, Korea, Philippines, and Thailand—which use inflation targeting inflation is in the middle or lower end of the target zone.

Monthly data show a strong recovery momentum in the second quarter particularly in the PRC; Hong Kong, China; Korea; Philippines; and Taipei,China.

With few exceptions, the growth rates in these indicators have been in red and above the 2000–2008 averages in the past two to three quarters

(Figure 67). Before the third quarter of 2009, these indicators were almost all dark blue, denoting very weak growth, with the notable exception of the PRC where policy stimulus was largest and implemented soonest. In the second quarter of 2010, seven economies saw at least one indicator dark red, denoting the strongest growth compared with the 2000–2008 benchmark period. The PRC; Hong Kong, China; Korea; Philippines; and Taipei, China saw all three indicators moving from blue to red during the period, indicating strong forward momentum in the recovery.

While rising in some economies in the second quarter, uncertainty over the strength of recovery has declined markedly in the first half of 2010.

The degree of uncertainty is captured through the standard deviation of Consensus Forecasts of GDP growth for each economy. Generally, as country-specific uncertainty is reduced, the range of GDP forecasts tends to narrow. Uncertainties declined markedly in the first quarter as the economic recovery was robust **(Table 17)**. With the European sovereign debt crisis deepening in April and some signs of moderating growth emerging, the degree of uncertainty over the recovery in 2010 has risen, particularly for more open economies.

In these uncertain circumstances, policymakers should pay more attention to risks, and recognize the potential benefits of less aggressive normalization of macroeconomic policy.

What should policymakers do?

With economic recovery in emerging East Asia firmly on track, unwinding policy stimulus has already begun in many economies.

Timing, policy mix, and pace will define how unwinding stimulus is done. And arguably, the substantive policy question about unwinding stimulus should concern its speed and manner, rather than when unwinding should start. Based on the discussions above, the economies in the region can be placed into three broad groups according to the pace at which unwinding policy stimulus might proceed.

In Korea; Malaysia; Singapore; Taipei,China; and Thailand tightening has begun, and should continue at what appears an appropriate pace.

The first group of economies has begun to unwind policy stimulus. And without any major

Survey Period:	Dec-09	Mar-10	Jun-10	Mar-10	Jun-10
Forecast Year:	2010	2010	2010	2011	2011
China, People's Republic of	0.8	0.7	0.6	0.5	0.6
Hong Kong, China	1.1	0.8	0.7	0.6	0.6
Indonesia	0.4	0.3	0.2	0.4	0.3
Malaysia	0.9	0.8	0.5	0.5	0.5
Philippines	1.0	0.8	1.0	0.6	0.4
Singapore	1.3	0.6	0.9	0.6	0.5
Korea, Republic of	0.4	0.5	0.5	0.5	0.4
Taipei,China	1.0	0.7	1.3	0.7	0.6
Thailand	1.1	1.0	1.4	0.3	0.4
Average:	0.9	0.7	0.8	0.5	0.5

 Table 17: Consensus Forecasts of Annual GDP Growth—Standard

 Deviation

GDP = gross domestic product.

Source: Asia Pacific Consensus Forecasts.

deterioration in inflation outlook, there is no clear need to speed up macroeconomic policy normalization. Rapidly closing output gaps and strong growth momentum suggest these economies can continue to gradually unwind stimulus. Due to a still large output gap and three rises of interest rates, Malaysia may not need to tighten further until 2011, unless inflation picks up unexpectedly this year. Singapore will need to continue to follow its exchange rate-centered monetary policy in a flexible manner. Korea; Taipei,China; and Thailand increased policy rates recently (by 25 bp, 12.5 bp, and 25 bp, respectively), signaling the start of policy normalization.

Building on recent measures to slow credit expansion, the PRC should accelerate policy normalization by, among other things, letting the currency appreciate at a pace appropriate to domestic economic conditions.

Given inflation momentum, the PRC should accelerate policy normalization to avoid excess inflation or a "hard landing". Monetary and, to a lesser degree, fiscal normalization has already begun and must continue if inflation is to be contained. The PRC has shown strong growth momentum in GDP growth and a sharply narrowing output gap. Over the next 12-18 months, interest rates may need to rise significantly depending on how exchange rate policy is handled, the degree of fiscal consolidation, and whether-in the case of the PRC-growth moderates from its recent high rates. The PRC's recent move to make the renminbi more flexible indicates that its exchange rate may appreciate, mitigating rising inflationary pressures, and this could suggest a slower pace of interest rate normalization.

Hong Kong, China; Indonesia; Philippines; and Viet Nam may soon need to start unwinding policy stimulus.

Although there are differences in macroeconomic conditions across these economies, each will require some macroeconomic tightening as the recovery continues. Inflation in these countries remains relatively benign, although output gaps have narrowed quite sharply in some cases. In Hong Kong, China; and Viet Nam, inflation momentum has been relatively strong in recent months, yet there is still a large output gap. Over the next 12-18 months, interest rates in Indonesia and Philippines may need to rise with the size and timing depending on exchange rate policy and the degree of fiscal consolidation.

Even as policymakers across the region unwind policy stimulus, continued uncertainty over the strength of the global recovery underscores the need of retaining sufficient flexibility to quickly fine-tune policy levers.

Should the recovery strengthen further and grow more robust, there may be a need to speed up the unwinding of macroeconomic policy. Conversely, should Europe's problems create strong headwinds to global recovery, authorities may decide to keep stimulus in place a while longer. Still, the longer macroeconomic stimulus is maintained, the greater the potential threats to medium-term economic and financial stability. Whatever the pace, macroeconomic policies must eventually return to more normal settings.

Collaborating and coordinating exit strategies among emerging East Asian economies, particularly on exchange rate policy, can help sustain recovery and facilitate economic rebalancing.

National policies can have significant spillover effects on other economies—it helps if everyone knows what the other is doing, with the regional goal well-defined without compromising national priorities. There are three key benefits to a coordinated approach to exit strategies, especially exchange rate policy.

• Regional coordination would allow for a virtuous circle in which higher domestic demand in some economies spills over to other economies in the region.

- Exchange rate policy cooperation would promote trade and investment within the region by encouraging exchange rate stability among the region's currencies, and flexibility of the region's currencies against other major internationally traded currencies.
- Regional coordination would avoid free rider problems, in which some economies might seek to depreciate their currencies to gain competitiveness.

Needless to say, these benefits are not guaranteed. There would be advantages to use an existing framework, perhaps a special regional meeting under the ASEAN+3 Economic Review and Policy Dialogue process, where authorities can review their exit strategies and agree on overall policy frameworks. The region's economies may agree on broad rules for conducting exchange rate policy including intervention and reserve management to promote intraregional trade and facilitate economic rebalancing. Agreement on a coordinated approach to exit strategies and rebalancing could be an important milestone in the region's efforts to deepen economic policy cooperation.

Box 2: What is "Normal" when "Normalizing"?

When the global financial crisis deepened in late 2008, emerging East Asian economies drastically eased monetary policy and applied significant fiscal stimulus. As recovery firms, monetary and fiscal stimulus needs to unwind and macroeconomic policy starts to return to normal. This box discusses the benchmarks for unwinding stimulus-the required degree of policy normalization in the region.

During the crisis, most of emerging East Asia eased monetary policy by sharply cutting short-term policy interest rates. But there were also reductions in reserve requirements, increases in credit targets, and the introduction of credit or interest rate subsidies in, for example, Republic of Korea (Korea) and Viet Nam. The decline in policy rates ranged from a little over 100 basis points (bp) in Malaysia to 600 bp in Lao PDR and Viet Nam (Figure B2.1). Singapore eased its monetary policy primarily by re-centering its currency band and temporarily stopping its policy of a gradual appreciation of the Singapore dollar. Under its Linked Exchange Rate System, Hong Kong, China's interest rates followed those of the United States (US) relatively closely and fell sharply in late 2008. Currency depreciation across the region during the crisis also contributed to monetary easing (Figure B2.2). In several economies, including the PRC, administrative and related measures were also used to help ease monetary and credit conditions.

Policy interest rates in the region will ultimately need to return to normal, which in turn depend primarily on where economies are in the economic cycle and targeted levels of inflation. One simple approach to defining an interest rate benchmark is to calculate long-run average real interest rates over a sample period—which has а similar start and end inflation rate. These long-run average real interest rates could be proxies for "neutral" real interest rates.1 Using this approach, interest rate "gaps"-the difference between

¹This is analogous to using the average unemployment rate over periods with no net change in inflation to estimate a constant "natural" rate of unemployment (or NAIRU).



¹Policy rates for each economy are as follows: 1-year lending rate (People's Republic of China); Hong Kong base rate (Hong Kong, China); Bank Indonesia rate (Indonesia); Korea base rate (Republic of Korea); Bank of Lao lending interest rate—less than 1 week (Lao PDR); overnight policy rate (Malaysia); reverse repurchase (repo) rate (Philippines); discount rate (Taipei,China); 1-day repo rate (Thailand); prime rate (Viet Nam); interest rate on main refinancing operations (Euro area); bank base rate (United Kingdom); uncollateralized overnight call rate (Japan); and federal funds rate (United States).

Source: OREI staff calculations using data from CEIC, Bloomberg, Datastream, and Bank of the Lao PDR website.



¹Based on monthly average of the local currency value per US dollar. Negative figures indicate depreciation of local currency; positive figures indicate appreciation of local currency.

Source: OREI staff calculations based on Reuters data.

current policy rates and rates needed to stabilize inflation—can then be determined. Across most of the region, real interest rates calculated from annual consumer price inflation have been below "neutral" levels since late 2009, and the average gap is between 150 bp and 300 bp **(Table B2)**. Only in Indonesia and Malaysia are real policy rates close to "neutral" levels.

The results from this simple approach are similar to those from the International Monetary Fund (IMF), which uses a Taylor-type interest rate rule, linking policy rates to output gaps, deviations of inflation from target rates, and any risk premium in financial markets.² Using this approach, the IMF found that short-term

policy rates in emerging East Asia would need to rise by around 25-50 bp in Malaysia (where shortterm policy rates have already been increased by 75 bp) to around 200 bp in Indonesia, Korea, and Thailand over the next 12 to 18 months. Unfortunately, the IMF study did not include estimates of the required degree of interest rate normalization in the PRC and Viet Nam, two economies where inflation has recently edged up and monetary policy has already started tightening. There are, however, questions over the degree monetary policy in the region can be adequately

Table B2: Real Policy Rate Gap¹ (percentage points)

Economy	2009Q3	2009Q4	2010Q1	2010Q2 ²
China, People's Rep. of	1.5	-1.2	-1.7	-2.3
Hong Kong, China	-4.8	-5.6	-6.3	-6.7
Indonesia	1.8	1.9	1.2	-0.4
Korea, Rep. of	-1.2	-1.8	-1.3	-1.6
Malaysia	2.8	-0.2	-0.2	-0.2
Philippines	2.0	-1.7	-1.7	-1.7
Singapore	0.4	0.4	-1.7	-3.4
Taipei,China	-0.9	-1.6	-3.1	-2.7
Thailand	2.5	-2.1	-2.0	-1.9
Viet Nam	3.7	0.6	-2.3	-2.0

¹Difference of actual real policy rate (adjusted by headline inflation) from the average of Jan 1999–June 2010. Policy rate refers to 1-year lending rate (People's Republic of China); Hong Kong base rate (Hong Kong, China); Bank Indonesia (BI) rate (Indonesia); Korea base rate (Republic of Korea); overnight policy rate (Malaysia); reverse repurchase (repo) rate (Philippines); 3-month deposit rate (Singapore); discount rate (Taipei,China); 1-day repo rate (Thailand); and prime rate (Viet Nam). ²Average inflation for April and May was used for People's Republic of China; Hong Kong, China; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

Source: OREI staff calculations based on Bloomberg, Datastream, and CEIC data.

²See *Regional Economic Outlook Asia Pacific April 2010*, International Monetary Fund.



PRC = People's Republic of China; INO = Indonesia; MAL = Malaysia; PHI = Philippines; THA = Thailand; HKG = Hong Kong, China; KOR = Republic of Korea; SIN = Singapore; and TAP = Taipei, China.

Note: Assuming 1% exchange rate appreciation has the same effect on monetary conditions as an interest rate increase of 0.5 percentage point, the dash line would be the neutral line above which monetary conditions are tightened and below which monetary conditions are loosened. For Viet Nam, the monthly average of the local currency value per \$ is used. Source: OREI staff calculations based on data from Bloomberg, Reuters, Bank for International Settlements, Datastream, and national

Source: OREI staff calculations based on data from Bloomberg, Reuters, Bank for International Settlements, Datastream, and national sources.

described by Taylor-based rules, and the stability of these rules over time has not been clearly demonstrated. Moreover, they may not pay adequate attention to the risks policymakers care about.

The special section suggests a possibly better approach, using a range of indicators to assess the appropriate pace of unwinding stimulus. This addresses concerns over the rigid links between interest rates, output, and inflation gaps underlying the Taylor rule, and supplements the analysis with variables measuring

the forward momentum of economies and the degree of uncertainty about economic recovery.

Another consideration in monetary policy normalization concerns the role exchange rate policy plays in helping bring about required changes in monetary conditions. Because many central banks in the region have been intervening in foreign exchange markets to limit currency appreciation, it is possible exploit short-run tradeoffs to between increases in interest rates or exchange rate appreciation in bringing about а required

tightening in monetary conditions. Nominal monetary conditions can be assessed through changes in both short-term interest rates and effective exchange rates.³ While different weights can, in principle, be applied to these variables-with a larger weight on the exchange rate for more open economies, a simple un-weighted index can also be used (Figures B2.3a, B2.3b). Movements along the horizontal axis imply changes in monetary conditions brought about by changes in exchange rate, and

³Asia Economic Monitor, July 2006.

movements along the vertical direction imply changes brought about by interest rates.⁴

This framework shows that any given tightening of monetary conditions can be done through relatively small rises in interest rates, if accompanied by currency appreciation. This tradeoff can be used to limit the degree to which interest rates might need to rise in the near term to address inflation. The substantial monetary easing in the region from late 2008 to August 2009⁵ in response to the global slowdown happened by both interest rate reductions and currency depreciation, except in the PRC and Hong Kong, China, where currency appreciation somewhat offset effects the of interest rate cuts. From September 2009 to mid-2010 when the recovery took hold, monetary conditions in all major economies in the region have been tightened, mostly by currency appreciation, except in Malaysia and Taipei, China, where policy rates have risen.

Normalizing fiscal policy in emerging East Asia would possibly involve consolidating budget

⁵The last cut in interest rates during the crisis was in August 2009 by Indonesia.

deficits back to pre-crisis levels. If the benchmark is assumed to be the average ratio of budget deficit to GDP during the 4 years preceding the global crisis, this would imply the need for a deficit reduction averaging almost 2% of GDP, with potentially larger adjustments in economies with relatively large fiscal stimulus programs (see Table 14 on page 46). Deficit reductions have already begun in several economies as recovery has boosted tax revenues and some temporary public expenditure programs have lapsed. As automatic fiscal stabilizers across the region are generally small, the minimum required degree of discretionary fiscal policy normalization in the region over the medium term may be slightly lower than 2% of GDP, but will vary significantly across economies.

Unlike monetary policy, in deciding the benchmarks for unwinding fiscal stimulus, the region may want to return to stronger fiscal positions than before the crisis. There are several reasons why economies might wish to do so in the postcrisis period. Because public debt ratios have risen as a result of stimulus, some economies may choose to run larger primary fiscal surpluses to keep public debt more sustainable when interest rates revert to more normal levels. In some economies, fiscal positions were relatively weak before the crisis and thus they may decide to accelerate fiscal consolidation. And, because the global crisis has underscored the advantages of maintaining adequate fiscal space for countercyclical purposes, emerging East Asian economies choose stronger fiscal mav policies now than before the crisis. Not only would this increase fiscal space for future downturns, but it would also help insure against the risk of adverse spillovers from Europe's fiscal problems.

Fiscal policy normalization should be done within the context of medium-term comprehensive fiscal frameworks to anchor expectations over fiscal policy sustainability. One key advantage is that by helping establish the credibility of fiscal adjustment, inflation expectations and thus interest rates can be kept low to crowd in private demand. And, if private spending is crowded in, negative short-run effects associated with fiscal consolidation may be reduced. Publicizing credible medium-term fiscal consolidation frameworks can play a critical role in helping lessen short-term output costs of fiscal policy normalization.

⁴If 1% exchange rate appreciation is assumed to have the same effect on monetary conditions as an interest rate increase of 50 bp (similar to those described in July 2006 *Asia Economic Monitor*), then the dash line in Figures B2.3a and B2.3b is a neutral line, above which monetary conditions are tightened and below which monetary conditions loosened over the period.