SOUTHEAST ASIAN MACROECONOMIC MANAGEMENT: PRAGMATIC ORTHODOXY?

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ABSTRACT

This article provides an introductory analytical survey of macroeconomic policies and outcomes in seven Southeast Asian economies, Cambodia, Indonesia, Malaysia, The Philippines, Singapore, Thailand and Vietnam. It draws on the framework proposed by Corden (1996) to explain the generally good macroeconomic outcomes in the earlier World Bank study of the East Asian 'miracle economies'. The main conclusion is that, notwithstanding the institutional and economic diversity of the seven, macroeconomic outcomes have generally been good. However, there are some notable exceptions to this generalization, and the unfinished reform agenda is substantial in some countries

Keywords: Macroeconomic, Pragmatic, Asian economies

INTRODUCTION

Max Corden (1996) provided a comprehensive analytical framework for understanding and explaining the generally effective macroeconomic management in seven East Asian economies through to the early 1990s. Commencing with the observation that inflation rates in most of these economies were relatively low most of the time, he characterized the policy stance as one of 'pragmatic orthodoxy', drawing attention to policy makers' aversion to inflation, grounded on prudent fiscal policy, and also to their capacity to respond quickly to potential crises caused by external shocks. The focus of his paper was the seven East Asian 'miracle economies' that were the subject of the World Bank's 1993 volume, namely (South) Korea, Taiwan, Hong Kong, Indonesia, Malaysia, Singapore and Thailand.

This article revisits the subject with reference to seven Southeast Asian economies, and employs a similar framework and methodological approach. The countries are Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam. Four of these were in the original 'Miracle' study, and have continued to grow quite strongly in the two decades since the Corden study, except briefly during the Asian financial crisis. Two of the additions, Cambodia and Vietnam, would now be on the verge of qualifying for inclusion into the high-growth club. The Philippines has maintained positive growth throughout the period, albeit at a slower rate. It is included in the study primarily because its major macroeconomic reforms in the early 1990s have delivered consistently low inflation, thus constituting a decisive break with its earlier macroeconomic history.

Two major economic events have occurred since the Corden paper. One is the Asian financial crisis of 1997-99, which resulted in a sharp but brief contraction in economic activity, and which prompted a major rethink of macroeconomic policy tools and instruments. The second is the ongoing global economic recession since 2008 which, while originating outside the region, had a major effect on the region's growth dynamics as well as prompting renewed interest in regional and global macroeconomic coordination, including specifically the issue of regional financial safety nets.

The scope of this subject matter is very large, well beyond the scope of one short article. Our intention is to sketch, by way of a bibliographic essay, an analytical framework to be employed as part of a larger ongoing study of macroeconomic management in Southeast Asia. Consistent with the theme of pragmatic orthodoxy, we highlight the diversity of policy mixes and institutional capacities. For example, Singapore, with its highly open economy and well-developed institutional capacity, continues to employ the exchange rate as its principal inflation policy tool. Indonesia and the Philippines, with histories of higher inflation and weaker institutional capacities, have opted quite successfully for independent central banks that do not have to accommodate fiscal deficits. The two small Indochina economies, Cambodia and Laos, have limited scope for monetary policy owing to high levels of dollarization, reluctantly accepting the proposition that this serves as their effective monetary policy anchor. Vietnam also has quite high levels of foreign currency in circulation, in the context of a central bank that remains very much an arm of the central government. Brunei and Timor Leste have opted to forego US dollar respectively as their currency.[1]

We focus initially on inflation outcomes, asking the question, to what extent the countries have achieved low and stable inflation (section 2). Section 3 then investigates fiscal policy, specifically budget balances and public debt management. In section 4 we examine the other key building block of stable macroeconomic management, monetary and exchange rate policy, and the performance of central banks. Section 5 sums up.

Owing to space limitations and the need to establish an analytical framework, the article aims for breadth more than depth. We also eschew a range of additional factors that are relevant to macroeconomic policy. One is the quality of financial market supervision. Crises often have their origins in this sector and, since the resolution of financial crises frequently requires government bailouts, apparently conservative fiscal policy may suddenly be derailed by the large-scale socialization of these private debts.[2] Another factor is the changing institutional context in which macroeconomic policy is conducted, including notably the increased autonomy of central banks, the reduced flexibility of labour market policy, and the scope for greater regional monetary policy cooperation. There is also the issue of country reputation and credibility, including the ability to assure financial markets that public finances are on a sound footing.

This is also not the place to examine the broader issue of the relationship between macroeconomic management and economic growth. The general presumption in the literature is that there is a positive relationship, in the sense that low and stable inflation is conducive to faster economic growth. However, it is likely to be a non-linear relationship, in that inflation becomes a drag on growth only above some threshold level, or if there is considerable inflation

[1] The three very small economies, Brunei, Laos and Timor Leste, are not included here. Note that the major foreign currency in circulation in Laos is the Thai Baht, and that it is far more widely used that the Lao currency, the Kip. We also do not include Myanmar (Burma) in the study, owing to the paucity of statistics and information on that country's macroeconomic settings. Until its recent currency unification, it had the distinction of having the world's largest discrepancy between the official and black market exchange rates, in the order of 250:1, that is 6 Kyat to the US dollar officially, as compared to 1,400-1,500 on the black market (Odaka forthcoming).

[2] This was the case recently in several European economies, notably Ireland. See the special issue of *Asian Economic Policy Review*, Vol. 7, no. 2 (2012) on fiscal policy, edited by Takatoshi Ito, for a broad study of global fiscal policy experiences in recent years.

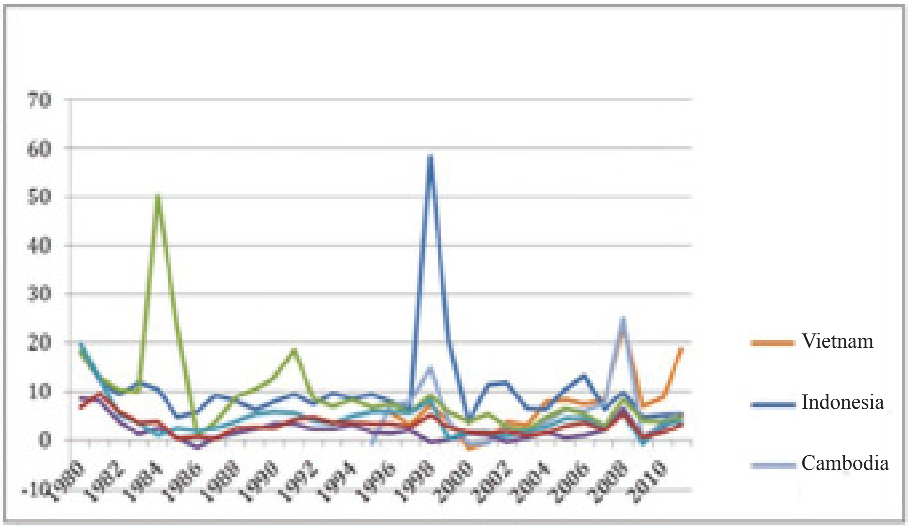
volatility.[3] Within Southeast Asia, the three strongest-performing economies, Malaysia, Singapore and Thailand, have had the best macroeconomic record, but obviously one should not draw strong conclusions from single-variable explanations. An additional caveat is that we are not comparing the Southeast Asian record with that in other developing regions. Globally, inflation has been a less serious problem since around 1990, as compared to earlier periods, particularly in Latin America with its history of hyperinflation. In this sense, East Asia is no longer the exception that it was for the period in Corden's survey. Arguably also, the criteria for evaluating macroeconomic performance have changed, embracing not just inflation outcomes but also maintaining economic growth, preventing financial crises, and managing external shocks.

THE INFLATION RECORD

Figure 1 shows annual inflation rates for the Southeast Asian economies since 1980. Two major outcomes are evident. First, annual inflation has been consistently low, less than 10 per cent, for over 95 per cent of the observations, and always for Malaysia, Singapore and Thailand. Second, the rare cases of double-digit inflation have been quickly contained, with inflation returning to less than 10% within a year or two. These achievements are particularly noteworthy: not only do they confirm Corden's conclusion of inflation-aversion and prompt responses to occasional inflationary episodes, but they have been achieved during one of the most tumultuous periods in global economic history, including two major crisis periods, food and commodity price volatility and, in several countries, considerable domestic political turbulence.

[3] Anne Krueger has argued that 'Analysts [cannot] assert with any conviction that there is, for example, a certain rate of inflation, a particular size of the fiscal deficit, or a specified maximum average rate of protection, above which rapid growth is impossible.' Sala-I-Martin (1997) in his growth econometrics survey notes the fact that inflation or fiscal deficits do not appear among the fundamental determinants of growth is probably due to the presence of some unmeasured non-linearities in the relationship.

Figure 1
Inflation Rates, 1980-2012



The vertical scale has also been drawn to display the occasional inflationary episodes. There are two serious inflation peaks evident, two cases where prices rose by about 20 per cent and some further cases of inflation briefly in the range 10-20 per cent. First, the high-inflation cases, in excess of 50 per cent on an annual basis (and higher still on a quarterly basis), These are the Philippines in the mid-1980s and Indonesia in 1998. Both episodes occurred in the context of disarray, featuring deep economic and political crises. Long-lived authoritarian regimes collapsed, Marcos after twenty years in power, and Soeharto after thirty-two years. The economies contracting by over 12 per cent in one year (1998) in the case of Indonesia, in two years (1985-1986) in the Philippines. Both inflationary periods had their origins in large fiscal deficits that were quickly monetized.[4] In the case of the Philippines, the deficit was primarily the result of the then President Marcos's desperate attempt to cling to power in the forthcoming election through reckless spending in the context of slowing economic growth, rising capital flight, mounting political unrest

[4] This analysis draws on Gochoco-Bautista & Canlas 2003 for the Philippines, and several "Surveys of Recent Developments" in the *Bulletin of Indonesian Economic Studies* for Indonesia.

and the repayment of large debts contracted a decade earlier in a phase of aggressive borrowing.[5] In the event, the strategy backfired, the inflation spike was short-lived, and the monetary authorities were able to quickly control the inflation, aided by the economic collapse.

The Indonesian case differs in the sense that the fiscal expansion was directly crisis-related. Unlike in the Philippines, pre-crisis fiscal policy had been conventionally prudent. However, the capital flight that gathered momentum in late 1997 resulted in exchange rate collapse, and in turn a widespread banking and corporate collapse. Almost all domestic debtors had no foreign currency hedging and few had the automatic insurance of a secure foreign currency income flow. Thus they were unable to repay their debts, the Rupiah value of which had suddenly risen several hundred per cent. In an attempt to secure financial and corporate stability, the government – by then incapacitated politically – entered into large-scale and largely ad hoc blanket guarantees, which fuelled further capital flight and dramatically increased public debts, which were quickly monetized. Here also the inflationary episode was quickly brought under control, aided by an anaemic economy. However, consistent with its longer-term macroeconomic history, while Indonesia has generally kept inflation to single digits, it has struggled to maintain very low inflation, of less than 5 per cent.

Over the past decade, Cambodia and Vietnam have experienced episodes of moderately high inflation, but in both cases the inflationary pressures have been contained, and not allowed to escalate into a more serious monetary crises. The origins of these events differed, although there are some common explanatory factors linked to the inadequacy of the usual macroeconomic policy tools at the disposal of the central banks. Cambodia experienced a brief period of hyperinflation around 1990, in the wake of the sudden withdrawal of Soviet aid, then equivalent to about 15 per cent of GDP, and a government, clinging to power in a protracted civil war, resorting to deficit financing. The result was a brief period of triple-digit inflation.[6] This was quickly brought under control following the Paris peace settlement of 1991, which resulted in large-scale foreign aid flows and hence non-inflationary deficit financing. The large foreign presence, combined with a lack of trust in monetary policy,

[5] It is worth remembering that these borrowings were sanctioned by the international financial institutions as a means of recycling accumulating ‘petro dollars’.

[6] See Menon 2008 and references cited therein for a fuller discussion.

also resulted in high levels of dollarization, as much as 80 per cent of the money supply, and this in turn stabilized prices, which increasingly came to be denominated in US dollars. Subsequently, Cambodia's inflation has generally been moderate, except for brief double-digit increases in 1998 and of heightened domestic political tensions, in which the government briefly introduced counter-cyclical fiscal policy responses. In the latter period, high food and oil prices exacerbated the problem.

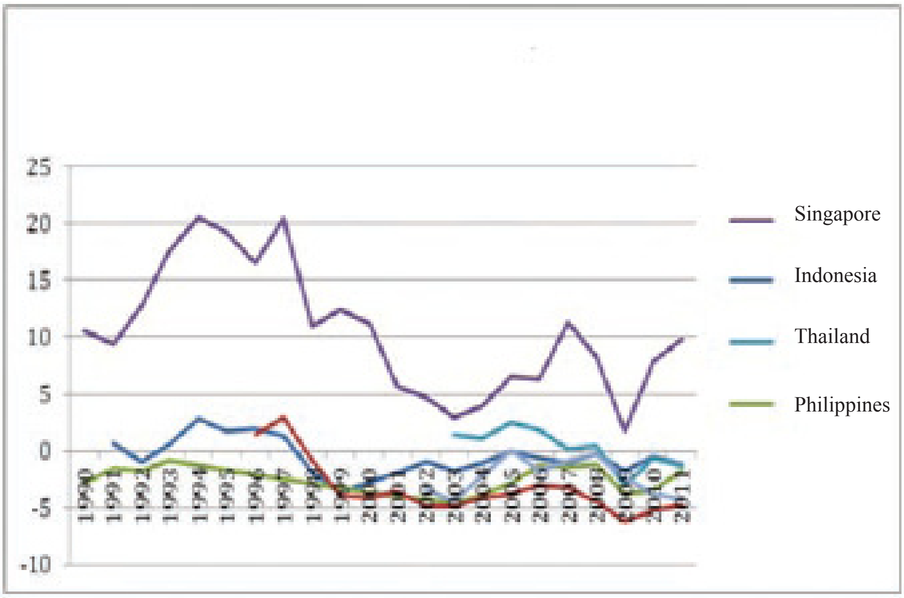
Vietnam has experienced two periods of double-digit inflation in recent years. In their comprehensive analysis of the country's monetary policy, Pham and Riedel (2012) place less emphasis on fiscal policy, and rather argue that the basic problem is Mundell-Fleming's 'impossible trinity'. That is, it is not possible for governments to simultaneously maintain a fixed exchange rate, an open capital account, and an independent monetary policy, combined in Vietnam's case with an underdeveloped financial sector in which the State Bank of Vietnam, the nation's central bank, has limited scope for pursuing open market operations. Thus the government has attempted to maintain a peg to the US dollar, through a fixed but adjustable exchange rate. It has also opened the capital account, which for several years prior to 2009 resulted in very large capital inflows, peaking at the equivalent of about 25 per cent of GDP at the time of Vietnam's accession to the World Trade Organization in 2007. There were also speculative bubbles in the country's real estate and nascent stock exchange. The government has sought to sterilize these large inflows, primarily through changes to reserve requirements and compulsory transactions with the commercial banks. But the interventions have been insufficient to contain inflationary pressures. The resulting volatility in money supply, and therefore in interest rates, has created an unstable economic policy environment and also impaired the quality of bank loans. Pham and Riedel recommend a package of policy reform measures, including financial deepening and controls over capital mobility, with the desirable goal of greater exchange rate flexibility postponed until the first of these measures is soundly established.

FISCAL POLICY

As noted, fiscal policy is central to macroeconomic management, since the monetization of fiscal deficits is typically the most important explanation of inflationary episodes. The general Southeast Asian record of fiscal prudence over the past quarter century of volatility and crises has therefore been all the more commendable.

Reinhart and Rogoff (2011) observe that ‘Debt crises tend to come out of the blue, hitting countries whose debt trajectories simply have no room for error or unplanned adversity.’ Crises frequently lead to large increases in public debt, owing to the effects of automatic stabilizers, and as governments resort to deficit financing to expand social safety nets, and as a result of the socialization of corporate and banking debt. This is arguably the most important macroeconomic impact of the GER in OECD economies. US general government debt (federal, state, local) has now surpassed the post-war record of 120 per cent of GDP. Japan is more than 200 per cent while several other OECD economies are approaching 150 per cent.[7] Moreover, this is in peacetime, and low interest rates are restraining debt service costs.

Figure 2
Fiscal Balances, 1990-2011 (% of GDP)



[7] See the special issue of the *Asian Economic Policy Review*, Vol. 7, no. 2 (2012), and also Reinhart & Rogoff 2011.

Figure 2 shows fiscal balances for selected years for the seven Southeast Asian economies. Prior to the Asian financial crisis, most countries ran small fiscal deficits or surpluses, a reminder that the early IMF policy conditionality towards fiscal tightening constituted a general misdiagnosis of policy settings in the affected economies. For the reasons mentioned above, budgets swung from surplus to deficit in the late 1990s, except for Singapore where its extraordinary record of fiscal thrift resulted only in a smaller surplus. Although most of the countries have run fiscal deficits since the late 1990s, they have been modest for several reasons. First, the tradition of prudent and powerful finance ministries somewhat immune from the political pressures that intrude into other portfolios has been maintained, and if anything strengthened. Second, the establishment of independent central banks that do not have as their remit the responsibility to finance a budget deficit has added a layer of fiscal policy caution. Third, explicit legislative restrictions on the size of fiscal deficits have been introduced or reinforced, most notably in Indonesia and Thailand.

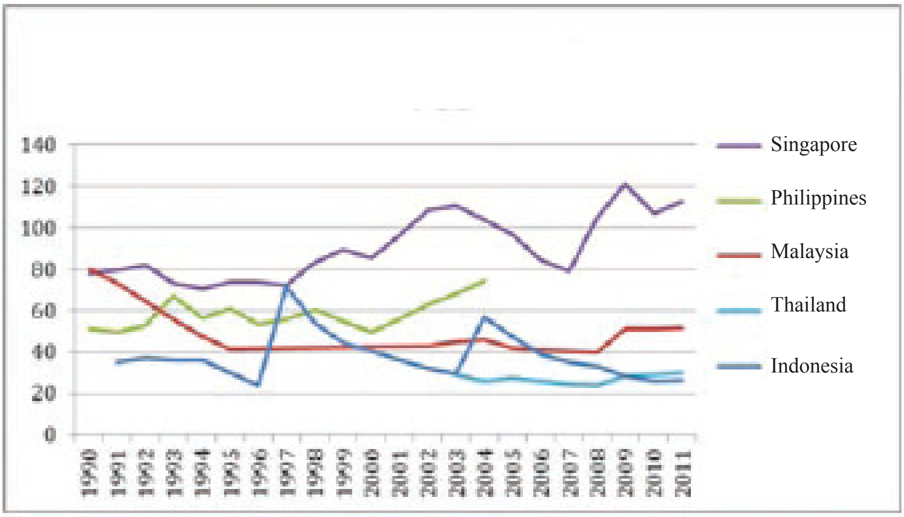
As a result, public debt rose in the wake of the Asian financial crisis, but since then it has either declined, or been stable relative to GDP (Figure 3).[8] That is, in the latter case, deficits relative to GDP have been no greater than the rate of growth of GDP, resulting in a stable ratio. Some governments ran larger fiscal deficits during the peak of the global economic recession in 2008/09, either deliberately or as a result of the automatic stabilizers, but these were largely one-off injections that did not change the fundamental debt dynamic. Hence the medium-term fiscal consolidation challenges for these economies are not nearly as serious as in most OECD economies.

Of course, these aggregate figures conceal both considerable country diversity and a range of looming fiscal policy challenges. Some countries have been able to carry considerable larger debt than others without difficulty. For example, Malaysia’s has run persistent fiscal deficits since the late 1990s, and these deficits have not been used to finance long-term productive investments (Narayanan 2012). Malaysia is able to run consistently larger deficits than for example neighbouring Indonesia and the Philippines for at least three reasons. First, like Japan, the debt is almost entirely domestic. Therefore it is less likely

[8] The Singapore figure refers to gross public debt. On a net basis for the consolidated public sector account (that is, including its large government-linked corporations), it would be a net creditor.

to suddenly exit the country, and it is not subject to a sudden increase caused by currency depreciation, on the scale that occurred in 1997/98. Second, and related to the first, Malaysia has long been a high-saving nation, in addition to the fact that its compulsory national savings scheme, the Employees Provident Fund, has provided a pool of quasi-captive domestic resources. Third, the country has a long-established reputation for effective monetary policy, centered on its credible central bank, Bank Negara Malaysia.

Figure 3
Central Government Debt (% of GDP)



In most Southeast Asian economies, fiscal policy has been at best mildly counter-cyclical and often pro-cyclical. Traditionally, the explanation in developing economies has been that, when hit by a crisis, they did not have alternative fiscal financing means at their disposal: they could not borrow internationally, the domestic bond market is underdeveloped, and printing money would be inflationary and would anyway be prohibited by an IMF program if operative. Bhanupong (2013), for example, attributes the absence of counter-cyclical fiscal policy in Thailand during the past decade to weak institutions and a highly politicized environment. As in Indonesia currently, public servants are also reluctant to sign off on major infrastructure projects, especially those prepared in haste as part of a crisis-related spending program, for fear that the inevitable cutting of corners would subject them to the scrutiny of anti-corruption agencies and NGOs.

Governments have also frequently lacked the administrative capacity to quickly push up expenditures, especially in much-needed infrastructure, with the result that crisis responses have tended to focus on the revenue side, which is less effective as tax cuts are more likely to be saved in times of uncertainty. Most Southeast Asian governments introduced fiscal stimulus packages in response to the global economic recession of 2008/09. These varied in both size and composition, with the richer economies Singapore and Malaysia introducing larger packages, of 5 per cent of GDP or more, while in the lower-income economies the magnitudes were typically 1-2 per cent. The composition of these packages also varied. The government in the highly-open economy Singapore economy, worried about the import leakage effects of a stimulus, focusing inter alia on measures that would encourage firms to retain their workforces as a means of limiting the rise in unemployment, in a country where no formal support for the unemployed exists. In Thailand and Indonesia, where the stimulus magnitudes were much smaller, for political economy reasons the former opted mainly for increased expenditures, while the latter resorted mainly to tax cuts (Kanit & Basri 2012). The Indonesian stimulus was introduced as a one-off measure, and was also constrained by the looming election. The Thai stimulus was more open-ended, and is part of a general trend in that country towards more populist fiscal and labour market policies (see further Ammar 2011).[9] In the case of Vietnam, its rapid economic growth was underpinned by liberalization and macroeconomic stabilization in the late 1980s. However, public debt began to rise rapidly during the 2008/09 global economic crisis, owing to slower global growth and a home-grown crisis referred to below. Although the policy response has been quite effective, Adams (2012) highlights continuing ongoing vulnerabilities related to potential contingent liabilities in the state-owned banking sector, to the narrow coverage of the budget, and to exchange rate and interest rate sensitivities.

In addition, the medium-term fiscal policy agenda is substantial in many of these countries. The revenue effort is often weak. There are low levels of public sector efficiency and probity. More cost-effective social safety nets are required,

[9] For example, by mid-2013, the controversial 'rice pledge' program is estimated to be costing the equivalent of more than 3 per cent of GDP.

in place of large, poorly targeted subsidies. In particular, the two net energy exporters, Indonesia and Malaysia, have wasteful energy subsidies that are inequitable and contrary to environmental objectives. The fiscal implications of the region's rapidly ageing populations are yet to be addressed. Large public sector projects are often corruption-prone, while state enterprise sector reform is slow. Moreover, the facilities for longer-term debt markets for infrastructure are underdeveloped. In the latter respect, fiscal policy may actually be too cautious, in the sense that there is a case for public sector borrowing for high-return infrastructure spending, providing it can be undertaken on purely technical grounds, insulated from narrow political interests.

One reform that is gaining currency in the wake of the global economic recession is the establishment of independent fiscal advisory councils, to elevate public understanding of the issues, to force governments to acknowledge the hidden costs of their guarantees and off-balance sheet costs, and to help overcome the very strong deficit bias inherent in the political cycle. Several countries are discussing the possibility of independent fiscal watchdogs, such as the United States Congressional Budget Office, but these typically have limited analytical capacity and they generally accept official budget documents at face value. More powerful bodies might be created, with an independent charter analogous to that of many central banks. Nevertheless, the US budget shutdown of October 2013 serves as a reminder that the creation of formal institutional structures is no guarantee of improved fiscal policy.

MONETARY AND EXCHANGE RATE POLICY

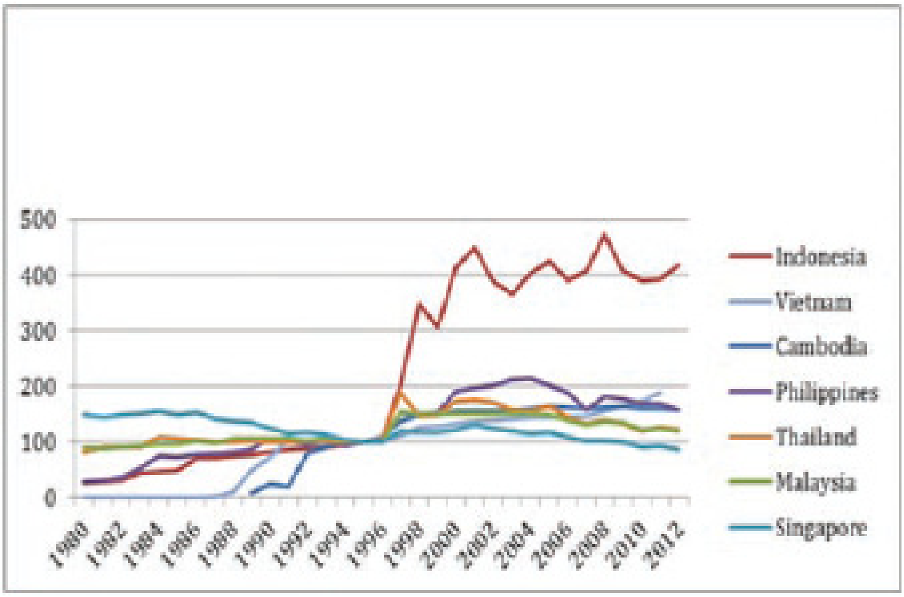
This has been the one area of significant policy advance in the region since the Asian financial crisis, as emphasized in retrospective studies of this event.[10] Most countries have gradually adopted a regime of independent central banks, inflation targeting and greater exchange rate flexibility. That is, there has been recognition that 'fixed but adjustable' crawling peg regimes do not work in the case of large and sometimes volatile capital flows (and terms of trade movements), in which private borrowers assume no exchange rate risk.

Exchange rates fell steeply during the Asian crisis as central banks found they could no longer defend their fixed rates, but after this sharp adjustment, over the past decade, including during the global economic recession, they have

[10] See for example Corden 2007 and Ito 2007.

generally remained quite stable (Figure 4). Financial markets and corporates are becoming more comfortable with flexible exchange rates. This flexibility also acts as a discipline on government excesses.

Figure 4
Exchange Rate
(per U.S. Dollar, end of period, based at 1995= 100)



These reforms are consistent with the proposition that economic crises are often triggers for major policy reform.[11] Elsewhere (Hill 2013) I have argued that the reforms in the two most crisis-affected economies, Indonesia after 1997/98 and the Philippines after 1985/86, were driven by a constellation of forces. First, they were introduced after very deep crises. There was a broad recognition of the costs of bad policy, and a predisposition to reform. Second, the reforms did not confront any immediate and powerful vested interests. They were not controversial, and there was no grand ideological debate over them. In fact, especially in the Indonesian case, they were introduced without much fanfare,

[11] In the words of Lal and Myint (1996: 288), in summing up a large comparative project on the political economy of reform, '[t]urning points [in economic policy] are invariably associated with macroeconomic crises.'

almost ‘reform by stealth’. Third, they had strong backing inside government, from key technocrats in the central bank and ministry of finance. Fourth, they occurred under the presidency of leaders who were either predisposed to reform (Ramos in the Philippines) or inclined to listen to their technocratic advisers.[12] Fifth, the reforms occurred while the countries were under IMF programs, which is presumptive evidence that the Fund played a role. But in both countries, the Fund’s role was then controversial (and still is in Indonesia), and so it is unlikely that the reforms could have been achieved if any of the four factors mentioned above were strongly negative. Moreover, Indonesia’s fiscal law was introduced precisely because the government wanted to exit the Fund program a year ahead of schedule, owing to its unpopularity, and this strengthened the hand of President Megawati’s advisers, who urged that some institutionalized restraints on fiscal policy needed to be in place prior to the exit.

Within the context of a generalized shift towards greater exchange rate flexibility, the experience of the three Indochina transition economies is of particular interest.[13] The process of dollarization has been the most extensive and persistent in Cambodia, which is one of the most heavily dollarized countries in the world. High levels of dollarization commenced mainly during the United Nations (UNTAC) transitional period of 1991–1993, and in this sense it can be viewed as a direct legacy of the destruction of economic and financial institutions after the 1970s, economic mismanagement in the 1980s, and the large inflows of US dollars in the early 1990s. Recent estimates put the share of foreign currency deposits (FCDs) in broad money (M2) to be about 80 per cent.

Quasi-dollarization has costs and benefits. Arguably the main costs are the loss in seigniorage and the reduced ability of the monetary authority to implement discretionary monetary policy, that is in foregoing access to a major macroeconomic policy tool. The monetary authority also loses its capacity to act as lender of last resort in order to guarantee the payments system in the event of a banking crisis. There is a loss of seigniorage, but this is estimated to be small, in range between 0.1 to 0.5 per cent of GDP. Nevertheless, the benefits have been substantial. The hyperinflation of the early 1990s soon dissipated as the level of dollarization increased exogenously, and as noted the country’s inflation rate since then has generally been modest.

[12] The Indonesian reforms occurred during the administrations of Presidents Habibie (central bank independence) and Megawati (the fiscal law).

[13] The following discussion draws on Menon *et al.* 2009.

With dollarization, Cambodia's nominal exchange rate acts as a nominal anchor to manage inflation. In an environment of price and exchange rate stability, both trade and growth have increased sharply. This contrasts with the recent experience in neighbouring Vietnam, for instance, where declining dollarization has been accompanied by significant increases in the volatility of prices and exchange rates. There is an understandable 'nationalist' frustration in government circles over their inability to control monetary policy. But thus far, an approach of pragmatic non-interference has generally been maintained. Presumably dollarization will decline only when the community's faith in the capacity of the monetary authorities to run prudent monetary policy is restored. In this sense, dollarization acts as both a restraint on policy excess and an incentive to strengthen policy reform.[14]

Returning to the general issue of exchange rate flexibility, this regime only work of course if the overall policy settings are supportive. For example, many observers would judge that the single most important economic policy reform in the post-Marcos Philippines has been the establishment of an independent and effective central bank, the BSP. Nevertheless, as Desierto and Ducanes (2013) also point out, effective monetary policy cannot alone achieve high growth. It cannot overcome the problems of occasional deep political impasse between the executive and the legislature, of a weak revenue effort starving the country of much needed investments in infrastructure, education and health services, and of structural rigidities in the goods and factor markets. More generally, especially for poorer countries, to the extent that exchange rate fluctuations introduce greater food price volatility, in countries where 30-50 per cent of the population is clustered very close to the poverty line, cost-effective social safety nets are required to protect the poor in the face of large external shocks transmitted through the exchange rate.

There continues to be a debate over whether, and how far, capital accounts should be opened. The extensive international literature regarding the effectiveness of these controls is ambiguous and cautious.[15] If they are to be implemented, this historical evidence suggests that they are likely to be

[14] Conversely, one might argue that, given the country's devastating historical traumas and small economy – its GDP is about $16 billion – surrounded by its much larger neighbours of China, Vietnam and Thailand, it might never make sense to aspire to monetary policy independence, as in the case of smaller emerging economies in the Americas, the Pacific Islands, and Eastern Europe.

[15] See Gochoco-Bautista, Jongwanich & Lee 2012 for some recent Asian evidence.

more effective when they take the form of market-based mechanisms, such as unremunerated reserve requirements, 'analogue' measures that can be more easily altered to adjust to flows, and they are not 'over-engineered' and too detailed. Obviously, also, they should not be employed to prop up a fundamentally disequilibrium exchange rate, there needs to be a clearly communicated exit strategy, and there needs to be a distinction between short and long-term capital flows. Moreover, in the context of any globally coordinated measures, it is important to focus on the 'push' factors, principally the extremely loose monetary policy in the rich economies as much as these 'pull' factors.

Another lesson from the Asian financial crisis is that such capital account opening needs to be accompanied by a reform package centered on effective financial supervision. For example, Bhanupong (2013) concludes that, in the case of Thailand, 'The major deviation from the long-term [growth] trend can be attributed to the premature liberalization of the capital account.' As noted, Pham and Riedel (2012) caution against Vietnam liberalizing its capital account until the country has achieved greater financial depth. However, there is a contrary case, from the experience of other countries in the region. Indonesia decided to open its capital account relatively early, in 1971, after a long and bitter experience with the distortions and rampant corruption associated with multiple exchange rates. The Philippines opened its capital account in the early 1990s for similar reasons (Gochoco-Bautista & Canlas 2003). Cambodia has such porous borders and high levels of dollarization that it would be virtually impossible to attempt to close its capital account. Moreover, there is not much evidence that, once capital accounts are opened, capital controls can be effectively re-imposed.

One related exchange rate issue in Southeast Asia concerns the availability and effectiveness of financial safety nets. These have been actively discussed and formally progressed since the Asian financial crisis, owing principally to deep dissatisfaction with the IMF intervention in the late 1990s. The first step was the creation of the Chiang Mai Initiative (CMI) in 2000. When the CMI proved inadequate in the 2008/09 global economic recession, it was first multilateralized (CMIM), and then doubled in size to $240 billion, while the IMF de-linked portion was increased to 30 per cent of the available country quotas. A surveillance unit, the ASEAN+3 Macroeconomic Research Office (AMRO), was set up in 2011. These are apparently significant developments, but have they created a workable institution? Without clear and rapid-response procedures to handle a fast-developing financial emergency, Hill and Menon (forthcoming) argue it is unlikely that the CMIM will be used even as a complement to the IMF. Moreover, currently it seems even less likely that it could be used as a stand-alone option: its size, or the IMF de-linked portion of funds, needs to be further increased, as does its membership to add diversity. AMRO also needs to be developed into an independent and credible surveillance authority before it could reasonably be in a position to lead a future rescue.

Faced with this uncertainty, and the continued unpopularity of the IMF, governments have mainly resorted to two main options. The first is foreign exchange accumulation, which has risen steadily in all countries, both absolutely and relative to GDP (Figures 5 and 6). For most countries, this has now become the front-line macroeconomic insurance mechanism. But it is a costly strategy, as it locks up funds in low (or even negative) return assets, most notably US government treasury bills.

Figure 5
Foreign Exchange Reserves ($ billions)

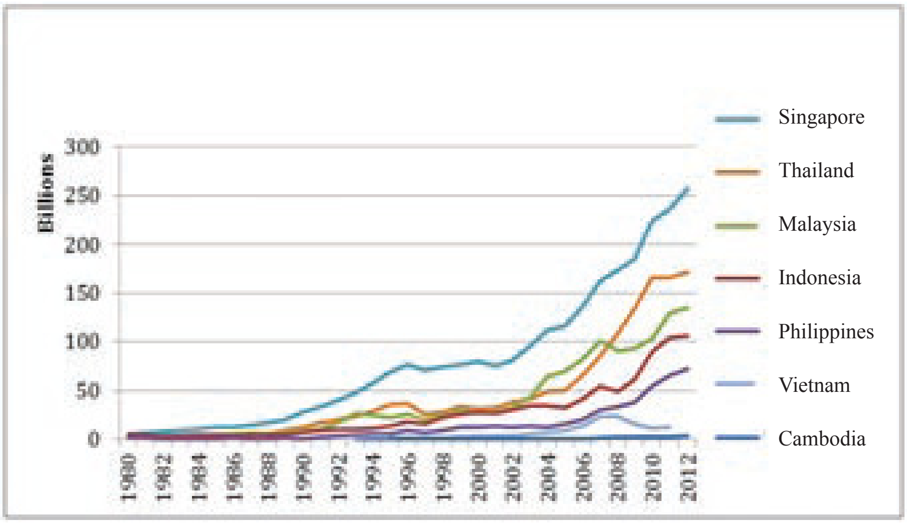
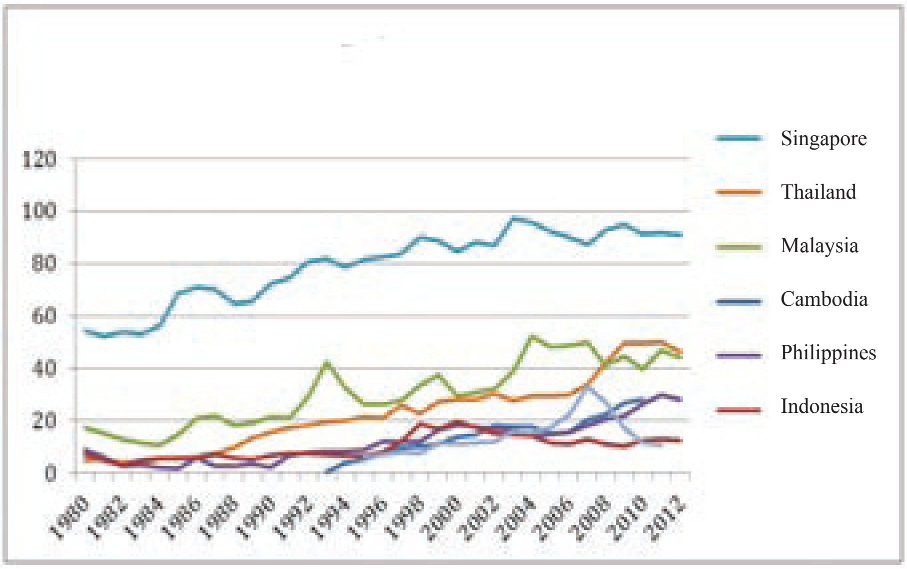


Figure 6
Foreign Exchange Reserves (% GDP)



Some central banks have to bear a direct balance sheet cost in holding these reserves, to the extent that they offer significantly higher interest rates on their security instruments, which are used to sterilize the large capital inflows of recent years. Large foreign exchange reserves are also potentially risky, to the extent that they may be seen as prima facie evidence of mercantilist international commercial policy, in the form of deliberately suppressing the exchange rate. For example, since the late 1990s Singapore, Malaysia and occasionally Thailand have run current account surpluses which, relative to their GDPs, are significantly larger than that of China. It is only their relatively small size that has presumably spared them from the threat of United States retaliatory action. The second defence strategy has been various bilateral swap agreements with larger economies, principally the United States, China and Japan. Whatever the merits of these arrangements, they are administratively burdensome as they require protracted negotiation renewals, and may not necessarily be available when a crisis suddenly emerges.

CONCLUSION

In rapidly changing global and domestic political circumstances, the major Southeast Asian economies have generally maintained the region's reputation for prudent macroeconomic management. With only two brief exceptions, inflation has been low, almost always in single digits and often less than 5 per cent for the past thirty years. This low inflation has been achieved through generally prudent fiscal policy, sometimes enshrined in legislative restraint, and competent central banks that are increasingly independent from political pressures. Although this is broadly a continuation of the earlier macroeconomic record, particularly among the three more advanced economies, governments have also learned some major policy lessons from the 1997/98 Asian financial crisis. The crisis generally reinforced the bias towards fiscal prudence by strengthening finance ministries. Central banks were given greater autonomy, and greater exchange rate flexibility has been introduced. Financial sectors are now more carefully supervised, thus lessening the macroeconomic risks associated with financial crises.

There are a variety of policy approaches and institutional arrangements that underpin these outcomes, thus underlining the continuing relevance of Corden's 'pragmatic orthodoxy' framework, of policy approaches that broadly deliver the desired outcomes in diverse institutional and economic contexts. Thus the latecomer Indochina economies have experimented with partial dollarization with reasonable success. The Philippines has achieved major central bank reform while broader policy reform still lags. Malaysia experimented with short-term capital controls in the wake of the Asian financial crisis, and its intervention was judged to be a success (Athukorala 2012). Indonesia has reduced its public debt dramatically, from equivalent to about 100 per cent of GDP in 1999 to about 25 per cent currently.

For every success, however, there are new challenges. First, there continue to be moderate inflationary episodes, especially in the lower middle-income group, and so the inflation dragon has not been exterminated. Second, the requisite financial deepening, on which central bank open market operations rely, is developing slowly in some countries. Third, one of the region's historical macroeconomic success stories, Thailand, now appears to be abandoning its traditional fiscal prudence. Malaysia also may be headed in the same direction. Fourth, the partial dollarization measures employed in the Indochina economies are at best only temporary strategies. Fifth, foreign reserve accumulation in several economies is arguably excessive, and reflects in part the fact that workable and trusted financial safety nets are not in place. Sixth, labour markets in several economies have become much more tightly regulated, in the process weakening the economic flexibility – and by extension the capacity to achieve major real exchange rate depreciations – that has been a hallmark of the region. Seventh, although the macro fiscal indicators mostly appear impressive, the micro foundations of fiscal policy are much weaker. Serious challenges are present, with regard to the efficiency and equity of tax and expenditure policies, in addition to the looming contingent liability of unfunded national pension schemes in the context of rapidly ageing societies. Moreover, these challenges are occurring against an international backdrop where the region is no longer such a standout performer in the developing world, as Latin American reforms in particular have resulted in that region no longer being the macroeconomic outlier that it once was.

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