Comments by Anwar Nasution, **on Managing Economic Stability under Volatile Capital Flows: East Asia Perspectives**

Anwar Nasution: I do not have much to comment on this excellent and well-written paper. This comment merely compliments the paper by describing the essence of stringent macroeconomic stabilization policy that has been adopted in East Asia, particularly in three countries (Thailand, Indonesia, and Korea) that were hit by the Asian financial crisis (AFC) in 1997. The policy has strengthened their economic performance and made them more resilient to global shocks and volatile capital flows.

As noted in the paper, the emerging East Asia countries have faced many external shocks since 2010 that have reduced their foreign exchange earnings and economic growth, increased inflation rates, enlarged external debt, encouraged capital outflows, and plunged currencies. First, the shocks are due to the slowdown in the global economy, particularly China, and has led to the sharp drop both in the demand as well as prices of their exports of primary products. Second, there were capital outflows and financial market uncertainty after the end of the quantitative easing policy in the United States and negative interest rates in many advanced countries including Japan, the EU, Switzerland, and Scandinavian countries. Third, some Asian countries, such as the Philippines and Indonesia, were hit by long periods of drought in 2015 that negatively affected production of their agriculture sector and led to higher fiscal costs for putting out a forest fire. The haze from the forest fire has affected the economies and public health in neighboring countries, such as Malaysia and Singapore. In addition, Indonesia and the Philippines also suffered from the cutback in workers' remittances due to the global recession.

The macroeconomic policy that has been introduced in East Asia since the AFC in 1997 can be divided into several parts. The first component of the stabilization policy is strict monetary policy. The second component is prudential fiscal policy with affordable budget deficit. Indonesia adopted the fiscal and debt rules of the EU. The fiscal rule limits the budget deficit to 3 percent of annual GDP and maximum debt-to-GDP ratio to 60 percent. The third component of the macroeconomic policy is structural adjustment to improve efficiency and raise productivity. Prime Minister Shintaro Abe of Japan calls these macroeconomic policies the "three arrows."

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1. Monetary policy

There are a number of policy measures in monetary policy that have been introduced in emerging Asia. First, one measure is to replace the fixed exchange rate system with a more flexible one. China, Malaysia, Myanmar, and Vietnam still peg their currencies to the U.S. dollar. Hong Kong and Brunei Darussalam use the currency board system.

Because of the fear of floating, however, the central banks of this region still intervene in the market to avoid dangerous exchange rate stability. To be able to intervene, they accumulate "unproductive" external reserves. In addition, the ten members of ASEAN (Thailand, Malaysia, Singapore, Indonesia, the Philippines, Brunei Darussalam, Vietnam, Cambodia, Laos, and Myanmar) and the Plus Three countries (China, Korea, and Japan) created the Chiang Mai Initiative (CMI), a network of bilateral currency swap arrangements, in 2000. CMI serves as a regional safety net mechanism to complement the IMF. In May 2007 the CMI was changed from bilateral to multilateral arrangements. The CMI multilateralization pools reserves in a single contractual agreement. Hence it reduces rigidities and obtaining approval from each provider of the fund. In addition, the financial resources of the CMI have been increased and its link to the IMF program reduced.

The second policy measure under the monetary policy is to liberalize the capital account of the balance of payments. China maintains its strict capital control, however. Malaysia temporarily introduced control during the AFC in 1997 but gradually relaxed it after stabilization of the ringgit was fully restored.

The third measure is to end financial repressions, including program lending and interest rate setting below the inflation rate. Prior to the AFC, financial repression and export-led industralization had been the main strategy to promote rapid economic growth in this region.

All East Asian countries have since introduced greater independence to their central banks to maintain internal and external stabilities of their economies.

Japan, Korea, Singapore, Indonesia, Malaysia, Thailand, and the Philippines formally adopted (soft) inflation targeting (IT). The operating mechanism of the IT is the short-run policy interest rate of the central bank, which is calculated based on the Taylor's rule:

$$\begin{aligned}\textit{Short-term policy rate} &= \textit{inflation rate} + \textit{real long-term equilibrium interest rate}\\ &\quad + a.(\textit{inflation gap}) - (\textit{desired inflation rate}) + b.(\textit{output gap})\end{aligned}$$

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Inflation gap is the difference between the real and target inflation rates and the output gap is the gap between the real output and the potential GDP. Subsequently, the policy rate of the central bank affects the deposit and loan interest rates of the banking system and allocation of financial resources.

It is difficult to estimate potential output in emerging economies in Asia because of limited data on the labor market, financial market and capital stock, as well as capacity utilization. In a dual economy, the role of informal and non-traded sectors with low productivity is still substantial. Moreover, in an open small economy, the exchange rate affects both the interest rate as well as core inflation and CPI by means of a pass-through effect.

2. Rebuilding the financial system

Sound macroeconomic policy requires a strong financial system. In terms of asset and branch network, the banking system is the core of the financial system in Asia. Banks mobilize savings and provide most of the credit to the economy. The emerging economies of East Asia have introduced a number of policy measures to rebuild their banking system that collapsed during the AFC in 1997. The first policy measure is the bail out of the banking system by injecting sovereign bonds to restore capital adequacy and clean up the bank's books from non-performing assets. The second measure is to establish deposit insurance companies to restore confidence in the banking system and stop the bank rush and flight to quality. The next measure is to adopt Basel standards and prudential rules and regulations on capital, liquidity, and solvency. The fourth measure is to strengthen bank supervision. For example, modeling the United Kingdom before the global financial crisis in 2007–08, Japan, Korea, and Indonesia have each established an independent Financial Services Authority to supervise all financial institutions. The final measure is to establish a Financial Stability Board to closely monitor the stability of the financial system.

To promote further growth and financial inclusion, emerging economies in East Asia modernized their financial systems by moving from a bank-based system to a market-based system and a postal saving system (PSS). In the market-based system economic units raise funds in the capital market by selling equity shares and bonds. All countries need to develop bond markets to market the recapitalization sovereign bonds. Utilizing the wide branch network of the post office, building a PSS is much easier and cheaper than developing institutional investors such as insurance industry and pension funds.

Only Japan has a well-developed and rich PSS. The PPS is a narrow bank and not a full fledged bank. It stores financial wealth by collecting deposits and selling life insurance policies to the general public, partcularly to low income groups. It also plays in the

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payment system through money transfers and by acting as a payment point to many institutions such as electric or telephone companies. The PSS, however, does not give credit as it only channels the funds through government programs, banks, or capital markets. The PSS in Japan is heavily invested in nearly zero-risk government bonds, infrastructure projects, and credit financing to small- and medium-scale enterprises.

3. Fiscal policy

Monetary policy needs to work with fiscal policy to promote economic stability, econonic growth, and equity. The key to growth-friendly fiscal consolidation is the composition of adjustment. On the expenditure side, the government needs to cut consumption (such as oil subsidies) while promoting investment particularly in infrastructure to improve connectivity in Asia. Some economies in this region still have space to stimulate their economies through fiscal expansion.

On the revenue side, there is still potential to increase tax revenue in some Asian countries, such as Indonesia, which has a low tax ratio of 12 percent of GDP because of poor tax administration. Without adequate tax revenues, the economic growth can only be lifted through sovereign debt.

4. Structural adjustment

Structural reforms are essential to raise productivity and efficiency and boost employment. Structural adjustment includes improvements in business climates and investment regulation. It also includes improvements in the legal system to minimize transaction costs, protect private ownership, and enforce business contracts. The improvement in the legal system includes improvements in judicial procedures to speed up bankruptcy actions and increase the recovery rate as well as to reduce the time and costs for setting up a business. The more liberal market-based system will attract more FDI and reduce reliance on volatile short-term capital inflows.

The signing of the Trans Pacific Partnership (TPP) agreement by a number of Asian countries brings a new hope to eliminating man-made internal distortions in this region. The TPP will transform the economic management in Vietnam from a government-led economic system to a more efficient market-based one. Under the TPP agreement, Malaysia is expected to end its distorted *pribumi* [sons of the soil] policy that has encouraged capital flight and an exodus of skilled workers from the country. The TPP will force Indonesia, Vietnam, and other countries in this region to adopt the Singaporean way of corporatization of inefficient state-owned enterprises.

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