Asia and Global Stagflation
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The world economy is poised on a knife edge. The United States may or may not be technically in a recession, but it is undoubtedly experiencing a sharp growth slowdown. Having been in Ireland last week, where informed opinion doubts that growth will be positive this year, I suspect that not just Ireland but also the UK, Spain, Portugal, Italy, and the Baltics (that is, nearly everyone in Europe excluding France and Germany) – are in a similar position. So much for decoupling.

I am similarly skeptical about the prospects for decoupling in Asia. Asian countries can trade parts and components amongst themselves all they like – everyone talks about the growth of intra-Asian trade – but they still need someone to buy their final products. And with growth slowing to a standstill in the U.S. and Europe, it is not clear who that someone is.

Credit market turbulence has also affected Asia in negative ways. In the Philippines, sovereign spreads jumped by 200 basis points between August 2007 and February 2008. In the same period, spreads went up by 131 basis point in Indonesia, 93 basis points in Korea, and 70 basis points in China. Since the Bear Stearns rescue, these countries have seen their spreads decline, reflecting the belief or at least hope that the worst of the credit crisis is over. But more recently there have been capital outflows from Thailand, Vietnam and the Philippines. None of this means that growth in Asia will stop, but it does mean that a slowdown is likely. For those who say “there is not much evidence of this yet,” I say “just be patient.”

The new development, along with this growth slowdown, is the acceleration of inflation. In April headline inflation in Asia ex Japan was 7.5 per cent, a 10 year high. (You will remember, of course, what was happening in Asia ten years ago.) Core inflation was 4 per cent.

As for where this inflation came from, it came mainly from the United States. Starting last summer, in response to the subprime crisis, the Fed cut interest rates sharply. One can debate whether Bernanke and Co. overdid it, or whether they should have relied more on credit injections at penalty rates; such criticisms have an element of Monday-morning quarterbacking. But whether one agrees with this or not, it is indisputable that those cuts were not appropriate for Asia. The Asian economy was growing full out in 2007. The last thing it needed was lower interest rates. But that's what it got, given the habit of limiting the fluctuation of Asian currencies against the dollar. Allowing Asian interest rates to rise more sharply against U.S. rates would have caused Asian currencies to appreciate against the dollar more strongly. And for all their talk of greater exchange rate flexibility, this was not something that Asian governments and central banks were prepared to countenance.

As a result, Asian economies that needed demand restraint got demand stimulus instead, what with the impact of central bank policies showing up first but slower growth in the U.S. and Europe taking time to develop and then feed through to other regions. There would have been more inflationary pressure in Asia in the first half of 2008, in other words, even without the geopolitical uncertainty, oil-market speculation, bad weather and ethanol programs that have garnered the headlines.

Note that this is quite the opposite of the now fashionable argument that Asia is exporting inflation to the West. To the contrary, the Fed, by cutting interest rates so dramatically, exported inflation to the East. To be sure, the failure of Asian central banks to tighten more aggressively does tend to re-export inflation back to the West. But to start there is to tell only the second half of the story.

What should Asian central banks do now? They should raise rates. There have been half-hearted efforts in this direction, but they have not done the job. Indonesia's central bank rate is 8.5 per cent, but its inflation rate is above 10 per cent. The Philippines' central bank rate is 5.25 per cent, but its inflation rate is 10 per cent. Vietnam's central bank rate is 14 per cent, but its inflation rate is 25 per cent. It makes no sense when most Asian countries are growing at or near capacity that they should have negative real interest rates. Negative real rates are an unhealthy subsidy for borrowing by households and firms. They encouraged inefficient investment and excessive leverage in Asia in the first half of the 1990s, and we all know what followed.

These negative interest rates and their artificial stimulus to consumption and investment are also why we haven't seen more of a slowdown in Asia – why we haven't seen more recoupling. But now that Asian central banks are being forced to tighten, we will see more evidence of their economies slowing down. Asian currencies will appreciate against both the dollar and the euro. Although the Fed and the ECB may raise rates as well, both inflation and growth are weaker than in Asia, so they will have reason to respond more moderately.

Critics of inflation targeting will say that central banks have a dual mandate not just to fight inflation but also to foster growth and that Asian central banks have no business raising rates in a deteriorating growth environment. But the fact of the matter is that they now face a very serious test of their credibility, leaving no alternative to tightening. The alternative to painful interest rate increases now will be even more painful increases later.

Fortunately, there is another instrument for sustaining demand in these circumstances, namely fiscal policy. Higher interest rates will push up the exchange rate and damp down inflation. Tax cuts and increases in public spending on locally-produced goods will limit the contraction of aggregate demand. Insofar as these fiscal actions stimulate the demand for locally-produced goods, they will push up the exchange rate still further, which will moderate the rise in import prices and further contain inflationary pressure.

Which Asian countries have scope for responding this way? In China, there is likely to be a high return on additional infrastructure investment, especially in the relatively underdeveloped west where producers still find it difficult to get goods to the market. There is the need for public spending on reconstruction in the wake of the earthquake. There is the need for increased public expenditure on health care, education and pensions. That the public sector is running a current surplus of 4 to 6 percent of GDP, depending on who is doing the measuring, points to the existence of maneuvering room.

Elsewhere in Asia, tax cuts and public spending increases should be calibrated to the U.S. and global slowdown – in contrast to the case of China they should be explicitly temporary. Korea, Malaysia, Singapore, and Taiwan are at the top of my list of countries with room to expand public spending temporarily to offset the dampening effects of higher interest rates.

I am aware that what I am arguing Asia needs now – monetary tightening, currency appreciation and fiscal stimulus – is the same thing that the Bush Administration has been arguing for three years. But the fact that the advice is old hat and that it comes with unwelcome associations should not lead to its rejection. Now, when inflation expectations threaten to become unanchored and the outlook for global growth is increasingly clouded, the need for a change in the Asian policy mix is more urgent than ever.

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