

Policy Challenges in a Diverging Global Economy: Conference Summary

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The Federal Reserve Bank of San Francisco's Center for Pacific Basin Studies held the fourth in its biennial Asia Economic Policy Conference (AEPCC) series with a program on "Policy Challenges in a Diverging Global Economy" on November 19–20, 2015. The program focused on the challenges faced by policymakers in advanced and emerging economies as the U.S. economy continues to strengthen and the Federal Reserve pursues policy normalization by raising its policy rate. Participants considered many questions, such as what will be the impact of U.S. policy normalization on emerging markets? What is the desirability and feasibility of international policy coordination? And what are the prospects for China's continued economic growth and currency internationalization? To explore these issues and others, the conference brought together experts from around the world and commissioned papers and other presentations by distinguished speakers. This chapter briefly summarizes the papers presented.

In opening remarks on "Emerging Asia in Transition," Vice Chairman Stanley Fischer of the Federal Reserve Board of Governors observes that, after a long period of rapid economic growth, Asia's emerging economies, including China, appear to have entered a transitional phase of slower growth. He provides four reasons for this growth slowdown. First, emerging Asia has been negatively affected by slow demand growth elsewhere, particularly in advanced economies. Second, economies generally decelerate as they develop, a pattern already seen in many of Asia's growth pioneers, such as Japan and Korea. Third, the tremendous growth of trade in the region, driven by the process of global integration and expansion of production-sharing networks, may be flattening. Lastly, demographic aging and slower labor force growth across the region is dampening growth. The transition to slower growth in emerging Asian economies, as well as a shift toward domestic demand and consumption and away from external demand and investment in the region, is likely to have significant implications for the global economy.

In “Monetary Policy ‘Contagion’ in the Pacific Basin: A Historical Inquiry,” Sebastian Edwards of the University of California at Los Angeles examines the extent to which Federal Reserve actions have affected monetary policy in emerging markets in the past. In particular, he analyzes the impact of U.S. interest rate changes on policy rates in Asian and Latin American emerging economies during the 2000s prior to the recent global financial crisis. He finds that federal funds rate changes had significant effects in these countries, particularly in Latin America. He also finds that Asian countries with more capital mobility were more affected than countries with less capital mobility. He interprets this cross-country co-movement of interest rates as evidence of policy “contagion.” This suggests the possibility that the current policy of interest rate normalization by the Federal Reserve may create more macroeconomic volatility in emerging markets.

The increasing globalization of financial markets has increased the risk of financial contagion. Stephen Cecchetti of Brandeis University and Paul Tucker of Harvard University in their paper “Is There Macroprudential Policy without International Cooperation?” ask if global finance requires a common prudential standard, if macroprudential policies need to be coordinated internationally, and whether effective enforcement requires coordination of dynamic regulatory policy adjustments. They argue that a common prudential standard—what they term a level of “required resilience”—is needed to treat similar risks in a comparable manner across all countries and markets in the global financial system. They argue that macroprudential policy is not possible without international cooperation, since exposure to risk across sectors, institutions, and borders requires cooperation and transparent information exchange.

Demographic factors have played a role in China’s economic development. In a keynote address entitled “Freer Choice, Lower Growth, and Higher Welfare: Recent Changes in China’s Population Control Policy and the Impact on Its Economy,” Shang-Jin Wei of the Asian Development Bank and Columbia University discusses how China’s population control measures of one child per couple implemented in 1979 have affected its macroeconomy through different channels. First, it strongly increased the incentive to work by causing the fertility rate to fall more rapidly than the natural decline that typically occurs with rising income levels. Second, it increased the dependency ratio—as measured by the share of the working aged in the total population—and increased the incentive to save. Third and most interestingly, he argues that it increased the ratio of males to females, creating a gender ratio imbalance. This imbalance added to the incentive to work, save, and accumulate wealth in order to enable

males to find partners in the “marriage market.” He concludes that the recent relaxation of China’s population control policy—to allow for two children per couple in general—will likely lessen the incentives for work and saving over the next two decades. While this may lower China’s growth rate, the greater freedom of choice should raise the welfare of Chinese citizens.

Jeffrey Frankel of Harvard University discusses the potential for improved global policy cooperation and coordination in his paper “International Coordination.” Frankel begins with the observation that the presence of global spillovers raises the potential for improved welfare outcomes with cooperation and coordination. Moreover, he notes that attention to policy coordination has increased in the wake of apparent spillovers from monetary policies pursued by advanced economies, such as the United States, to other—often vulnerable—emerging market economies. Frankel considers the possibilities for coordination by examining outcomes in a variety of alternative strategic games, identifying beneficial coordination outcomes as those that yield superior welfare to all players relative to a noncooperative equilibrium. These may include agreements to jointly engage in fiscal expansion or, alternatively, adopt fiscal discipline measures, as well as agreements to jointly pursue expansionary or contractionary monetary policies. However, he acknowledges that countries may disagree on the potential gains from coordination, particularly because side payments in a global context are challenging to implement. These issues are likely to arise in situations where economic conditions differ across countries, creating differences in desirable fiscal or monetary policies among countries. In these instances, the scope for successful policy coordination may be limited.

The implications of an increasing role in global markets for China’s currency, the renminbi, is considered in a paper by Eswar Prasad of Cornell University, “The Renminbi’s Ascendance in International Finance.” Prasad notes that the use of the renminbi as a currency of both denomination and settlement is on the rise. He also argues that the renminbi is already a reserve currency, in the sense that the renminbi is held by central banks as reserves and also is used in swap arrangements. Prasad acknowledges the progress China has made in liberalizing both its closed capital account and its managed exchange rate regime, which still follows the dollar closely. However, he argues that its heavily distorted financial sector continues to limit the potential for the renminbi to continue its progress toward becoming one of the true “global currencies,” enjoying similar standing to the currencies of other large global economies. Moreover, he cautions that China’s pattern of “sequencing” capital account liberalization before liberalizing the financial sector may result in exposing that

sector to greater instability. In particular, Prasad does not expect the renminbi to surpass the U.S. dollar as the primary global currency in the absence of continued reforms to China's financial markets and capital account policies.

While China's economy has achieved remarkable growth in the past 30 years, many distortions remain. Loren Brandt of the University of Toronto in "Policy Perspectives from the Bottom Up: What Do Firm-Level Data Tell Us China Needs to Do?" seeks to resolve the puzzle that China's economy is extremely dynamic, yet also quite distorted. Turning to firm-level analysis, he argues that this paradox is explained by the fact that the most dynamic sectors in China are those that are exposed to the greatest amount of competition and that the firms in these sectors have made great strides in reducing productivity gaps with multinational competitors. In contrast, firms in sectors that are identified by the Chinese government as important and strategic, or that are in industries with heavy shares of state-owned enterprises, are protected from competition to allow them to grow and to avoid failure. However, Brandt shows that on average firms respond to this protection by increasing size rather than productivity. He expresses concern that as China rebalances away from export-oriented activity and toward services, this problem could get larger, as firms in the service sector may be protected from outside competition and respond with a reduction in their pace of innovation.

The conference continued with a policy panel. The first speaker, Sayuri Shirai, Monetary Policy Board member of the Bank of Japan, delivered prepared remarks entitled "Monetary Policy in a Diverging Economy: Japan, the United States, and the Asia-Pacific Region." Shirai discussed the Bank of Japan's implementation of "quantitative and qualitative easing," its version of unconventional monetary policy at the zero lower interest rate bound, and its impact on Japanese inflation. Although these policies have encouraged positive inflation in Japan, Shirai observed that both Japan and the United States have much ground to cover to meet their respective inflation targets. She did note that well-anchored inflation expectations in the United States around the 2 percent level should aid in reaching the Federal Reserve's target. Turning her attention to Asia, Shirai noted the proliferation of inflation-targeting regimes, welcoming this development as indicating greater commitment in the region to the pursuit of price stability.

The second panel speaker was Joon-Ho Hahm, Monetary Policy Board member of the Bank of Korea, whose remarks were entitled "Safeguarding Financial Stability in a Diverging Global Economy." Mr. Hahm stressed that the policy normalization process undertaken now by the Federal Reserve differed from prior episodes because it was taking place at a time when economic

conditions in many emerging markets were relatively weak. Consequently, despite extensive efforts to mitigate excessive credit expansion through macroprudential policies, the impact on emerging market economies could be more severe than during previous episodes of tightening by monetary authorities in advanced countries. This impact of U.S. monetary policy will also be magnified by the effects of the simultaneous China slowdown, which is negatively affecting countries in the Asia-Pacific region. In response to these external shocks, the Bank of Korea has expanded its macroprudential efforts and also sought to ease volatility through accommodative monetary policy.

Lastly, the panel heard from Bank Indonesia Deputy Governor Perry Warjiyo, whose prepared remarks were entitled “Indonesia: Global Spillover and Policy Response.” In his remarks, Deputy Governor Warjiyo noted that the combination of the slowdown in China, an important destination for Indonesian exports, and the onset of monetary policy normalization in the United States posed challenges for the Indonesian economy. China’s recent liberalization of its exchange rate also exacerbated financial volatility in the region. Deputy Governor Warjiyo reviewed the policy responses pursued by Bank Indonesia, including its conduct of standard monetary policy practices, the undertaking of macroprudential actions, and efforts to deepen the country’s financial system. The Deputy Governor concluded by acknowledging the need for further structural reforms, both in the short run to stabilize the economy and over the medium to long term to promote economic growth. He argued that the liberalization measures needed to achieve these goals are complementary, and that those already pursued for short-run stabilization, particularly those intended to shore up Indonesia’s financial sector, should also serve the country well over the medium- to long-term horizon.

Barry Eichengreen, of the University of California at Berkeley, tended the formal portion of the conference with closing remarks. Eichengreen reviewed the themes of previous conferences where he had performed this same role, noting that prior conferences had proven quite prescient, particularly the ongoing theme that the Asia region would remain integrated with the rest of the world and hence be exposed to external global shocks. Eichengreen noted that a number of developments would facilitate the further integration of global financial markets, including China’s slow, but ongoing, liberalization of its financial markets and growth in offshore borrowing. However, he acknowledged that this growing integration has created new sources of potential vulnerability for local economies. He then summarized the papers in turn.

The conference proceedings concluded with a dinner keynote address from International Monetary Fund Research Director and Counselor Maury

Obstfeld. Obstfeld noted that global economic recovery now depended importantly on the performance of emerging market economies, including China, and noted what a departure this represented from prior periods when advanced economies alone drove global economic growth. Among the factors influencing growth now, Obstfeld mentioned the debt overhangs facing many countries, remaining scarring from the recent global financial crisis, and declining productivity. Obstfeld also noted that China's rebalancing toward domestic consumption would weigh on global trade flows and commodity prices.

In terms of policy prescriptions, Obstfeld stressed the value of implementing macroprudential policies in advanced economies and the need for many emerging economies to diversify their export markets to find substitutes for China. He also observed that increases in infrastructure investment are warranted for almost all global economies and that structural reforms may be required to escape the current low-growth environment. He acknowledged that the nature of the reforms that will work to accelerate growth remain uncertain and that this was an important topic for ongoing research at the International Monetary Fund.