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Policy coordination among the ASEAN-5: A global VAR analysis

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ABSTRACT

This paper aims to analyse the feasibility of policy coordination among the ASEAN-5 economies. This is done by determining whether they experience symmetric responses to common shocks. Given that the problem of dimensionality plagues large-scale macroeconomic modelling, a Global VAR model by Pesaran, Schuermann, and Weiner (2004) and Dees, Mauro, Pesaran, and Smith (2007) is used. The results in this paper provide some weak evidence of symmetric responses to the common (global) shocks of interest: a US monetary policy shock, a US output shock, a Chinese output shock; an oil price shock. Shocks from the US produced the most symmetric responses. The lack of symmetry in some cases has implications for further policy coordination. Since migrant remittances could provide an adjustment mechanism, further labour market integration is needed as it currently lags behind trade and financial integration in the region.

1. Introduction

1.1. Background

The Asian Financial Crisis (AFC) in 1997 was a defining event for the East Asian economies, particularly the ASEAN[1] economies. It highlighted the increasing interdependence among them in the period leading up to this crisis created through trade and financial linkages. The regional experience of the AFC is consistent with Eichengreen and Bayoumi (1996) and Glick and Rose (1999) who find that the pattern of crises is often regional. As such, managing these linkages needs to be a regional effort. Some of the suggestions put forth post-AFC were influenced by the successful launch of the Euro. However, the ASEAN members lack the political commitment to follow through with a common currency such as the Euro. Coupled with the Greek crisis that has unfolded through the Global Financial Crisis (GFC), these nations are wary of such an arrangement especially if their fundamentals are starkly different from the economy of the anchor currency. Unlike the path taken by the European Monetary Union (EMU), the nature of the ASEAN economic integration and the way they arrived at the present levels of integration differ. The regional integration process in the ASEAN-5 group is driven by market forces rather than by political ones. Large firms, particularly multinational corporations (MNCs), rather than governments instigated trade and financial flows in this region and continue to drive their movements now, even though this is now also reinforced by formal arrangements at the governmental levels (Brennan & Manning, 2015).

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[1] Association of Southeast Asian Nations (ASEAN) includes Brunei, Cambodia, Lao PDR, Myanmar, Vietnam and the founding five countries also known as the ASEAN-5: Indonesia, Malaysia, the Philippines, Singapore and Thailand.

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1.2. Exchange rate stability

Instead of managing the economic linkages through a common currency, the creation of an ASEAN Economic Community (AEC) by 2015 was planned as part of the member countries' efforts towards a more holistic approach to integration known as the ASEAN Community. The other two pillars of this community are cooperation among member states focused on socio-cultural development (ASEAN Socio-Cultural Community) and political security (ASEAN Political-Security Community). According to the ASEAN Secretariat, the AEC would be the goal of regional economic integration and will exhibit four main characteristics: it will be a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the global economy. It was therefore a milestone for the ASEAN economies when the AEC was launched in 2015. The creation of such an economic entity allows these small open economies to compete at the global level with larger economies such as China and India.

Exchange rate stability, whether through policy dialogue and surveillance, or through formal arrangements regarding exchange rate movements, is not only necessary to prevent crises similar to the AFC in the future, but will be needed to maintain a stable production base underpinned by bilateral trade flows and to encourage inclusive growth among these economies. While the majority of recent literature is consistent with Tenreyro (2007) and does not find strong evidence showing that nominal exchange rate volatility dampens the volume of trade, there is evidence that real exchange rate volatility has a negative effect on trade – particularly when financial markets are not well developed as was found in Héricourt and Poncet (2013). Exchange rate uncertainty could also lead to increased bilateral trade volatility that then impacts on aggregate trade flows, and eventually macroeconomic volatility as well, according to Baum and Caglayan (2010).

1.3. Policy coordination

The ADBI (2014) study was conducted in consultation with ASEAN governments on the future of ASEAN towards the year 2030. In this report, it was suggested that rather than being complacent with the achievement of successfully launching the AEC, this milestone should be a stepping stone to deeper regional integration. Policy cooperation and coordination appears to be the way forward for these countries. Monetary and exchange rate policy coordination was first suggested by Branson and Healy (2009) and ASEAN (2005). They occur in tandem because according to the Mundell–Fleming model, fixed or rigid exchange rates under a high degree of capital mobility implies that there is only one effective monetary policy instrument.

Truman (2011) helpfully points out that there is a spectrum when it comes to the manner of policy coordination. The first level of policy coordination involves occasional exchanges of views while the second level of policy coordination involves surveillance or reviews of the economic and financial policies in the respective economies. The ASEAN group already has such an arrangement in place with a research group known as the ASEAN Macroeconomic Research Office (AMRO) and the ASEAN Bond Market Initiative (ABMI) which is a bond market surveillance team. Beyond these two initial means of policy coordination are two further approaches which are now under consideration. The third level of policy coordination involves an agreement upon joint policy actions towards a common agreed objective. Such objectives are specifically targeted to a particular issue or is conducted on an ad hoc basis. As Truman (2011) elaborates, joint action may target anti-money laundering or represent a coordinated effort to deal with a financial crisis. The fourth and highest level of policy coordination according to Truman (2011) involves a continuous adjustment of policies towards a common objective. In this paper, policy coordination refers to this fourth level of economic commitment. More specifically, macroeconomic policy coordination (both in monetary and exchange rate policy coordination) would firstly enable economies to conduct domestic macroeconomic stabilisation policies but has the added benefit of forcing member countries to internalise policy externalities that spills over into other member economies owing to the increasingly strong trade and financial linkages (Kawai & Motonishi, 2005).

1.4. Optimum currency area literature

The optimum currency area (OCA) literature stemming from Mundell (1961) is valuable in this discussion as it elaborates on the conditions for feasible monetary and exchange rate policy coordination. An OCA is optimal if it enables participating economies to achieve full domestic employment and maintain stable domestic prices. The literature recognizes that the criterion of common and symmetric shocks is important. Domestic policies would previously have been used autonomously to help the domestic economy adjust to shocks. However, under an OCA arrangement, national interests will have to be ceded in place of regional interests whenever differences in domestic and regional needs arise. The direction of a coordinated policy response to asymmetric shocks is less certain, whereas with symmetric responses these economies have the option of agreeing to do nothing or make a concerted adjustment depending on the type of shock that occurs. Therefore, the presence of asymmetric shocks creates significant costs for member economies of the OCA. In addition to this, symmetric responses to a common source of shocks indicate that their economic structures or policy preferences (that is, inflation-output trade-off preferences), are similar (Fleming, 1971; Haberler, 1970). As such, the presence of symmetric responses to common shocks suggests that macroeconomic policy coordination in the form of monetary and exchange rate policy coordination is feasible.