

Asian governments to central banks – it's our mess, you fix it

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Asia's central bankers are being forced to juggle their day jobs with what their governments have failed to do – stealing their economies for the hard times.

Critics say many governments have done too little to remove barriers to domestic and foreign business investment, cut red tape, upgrade infrastructure and develop deep, well-functioning financial markets when the region was flush with cheap money.

Now that economic rocks are emerging as the tide of the Fed's easy cash recedes, central banks are having to step in, detouring from their price and financial stability mandates, to shore up weak economies.

India and Indonesia were first in the firing line of investors last year when the Fed's plans to scale back its \$85 billion (RM282.6 billion) in monthly cash injections started to take shape. Both took emergency steps, intervened in markets and raised interest rates to shore up battered currencies.

Since then the Fed has started winding down its stimulus in earnest, putting emerging markets on the back foot once again as investors look to target the most vulnerable economies.

Indonesian and Indian authorities have improved their defences against rapid outflows but their governments have failed to tackle supply bottlenecks and market rigidities that fuel inflation and limit room for policy manoeuvre, economists say. Both face national elections this year that could lead to populist measures and further delay reforms.

In Thailand, months of political turmoil have paralysed government, leaving the central bank as the mainstay of economic support.

"Government and monetary policies should be fairly balanced," says Rob Subbaraman, chief Asia economist at Nomura in Singapore.

"In India, and increasingly Thailand, the governments have not done their part. There's a risk Indonesia goes this way as the elections draw closer," said Subbaraman, who since mid-2013 has been warning of emerging Asia's growing exposure to market turmoil.

Even in Japan and China, with their strong and stable political leaderships, central banks appear to be doing most of heavy lifting.

In Japan, a blast of central bank money has boosted the economy and markets, but Prime Minister Shinzo Abe's economic reforms have disappointed. China's central bank is trying to rein in an explosion of off-balance sheet and risky lending as cautious government regulators resist speedier financial reform that would force markets to price risk more realistically.

Asian central bankers rarely air their frustrations in public. India's former central bank governor Duvvuri Subbarao was an exception, regularly sparring with New Delhi over economic reforms and rates.

Sometimes though, their concerns do bubble to the surface.

After a series of rate hikes by Indonesia's central bank, an official there in October voiced his vexation that the government was not tackling the root cause of a widening trade and current account gap – its own spending.

"We need to address the cause of illness when running a fever," Dody Budi Waluyo, executive director of Bank Indonesia economic and monetary policy department told Reuters at the time. "The medicine should not only be Panadol to lower the fever."

In picking up the reins from government, the risk is that central banks will deliver neither the stability they seek, nor the economic support that is needed.

In Japan, for example, the concern is that optimism spurred by the Bank of Japan's massive cash injections will fade without reforms to unshackle the economy's untapped growth potential and help overcome the problems of a fast ageing society.

The Chinese central bank's attempts to curb risky lending by calibrating supply of money market funds have triggered repeated cash crunches that threaten to ignite market panic.

Indonesian and Indian central banks may be forced to tighten monetary policy more than their slowing economies would otherwise have warranted because of fragile market sentiment and sticky inflation that remains high even when growth cools. In an ominous sign for India, foreign investors have been net sellers of the country's stocks this year.

Thailand's central bank is under pressure to fill the void left by stalled infrastructure spending and provide the struggling economy with stimulus, but is well aware of the risks.

"Maintaining monetary policy in an accommodative mode for a long period of time runs the risk of delays in reforms as they may seem less pressing and the risk of financial imbalances build up," Bank of Thailand spokeswoman Roong Mallikamas told Reuters.

In Japan, one concern is that without fundamental reforms promised as part of Abe's "Abenomics" revival plan, markets will reverse and Japan lurch back into its deflationary equilibrium or "stagflation" – a spell of tepid growth and rising prices. Japan Risk Forum, which groups risk managers from Japan's major financial institutions, sees nearly a 50-50 chance of that happening.

"We cannot rely solely on monetary policy forever and the time will come when the government's resolve will be tested by markets, likely around summer," said Hiroshi Watanabe, head of state-run lender JBIC and Japan's former top financial diplomat.

To be fair, central bankers may have contributed to their own predicament by keeping monetary policies too loose for too long after the global financial crisis, either because of political pressure or fear of more turmoil.

Nomura estimates that taken as a whole, real interest rates measured as a difference between official rates and inflation in Asia's 10 biggest economies excluding Japan were negative for more than half the time since 2008 – a recipe for rapid debt buildup and property and stock market bubbles. By contrast rates were negative for only 16% of the 1996-2007 period.

"By over accommodating the Fed's easing, central banks allowed asset price inflation to occur, causing an intoxicating party in full swing," said Thirachai Phuvanatanarubala, former Thai finance minister and deputy central bank governor. "With tapering, the party is over. Some emerging markets will now have to deal with the bubbles that crept up while everybody dreamily enjoyed himself."

There are also some signs of change. India is embarking on an ambitious monetary policy overhaul that would make it harder for the government to lean on the central bank, while the government has curbed gold imports and secured \$34 billion in overseas financing to try to close its current account deficit.

Indonesia's ban on ore exports drew fire, but it is a sign Jakarta at least recognises the need to reduce its reliance on raw commodities exports. It has also taken steps to shore up public finances.

Still, central bank efforts can easily unravel once elections are in motion, said Toru Nishihama, senior emerging markets economist at Dai-ichi Life Research Institute in Tokyo.

"As elections are looming in many emerging countries this year, no matter how central banks tighten policy to control inflation, their governments are tempted to loosen fiscal policy, offsetting central banks' efforts," Nishihama said. – Reuters, February 5, 2014.

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