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Asia Surfs the Bernanke Money Tide

By FREDERIC NEUMANN

For decades, and despite frequent talk of "decoupling," the U.S. Federal Reserve has led the way for Asia when it comes to monetary policy. But increasingly there are signs that this needs to change.

The latest red flag is Ben Bernanke's press conference Wednesday. His message: For now, and possibly for longer than anyone in Asia had expected, things will remain as they are. The Fed, owing to its stated concern about the U.S. economy, is in no mood yet to tighten the reins.

That's a problem for Asia. Over the past two years, the Fed's enormous monetary stimulus has swept through the region, whipping up inflation and asset prices in the process. For a while, of course, this served Asia well. But, the strains are beginning to show.

Food is becoming too costly. Rents are growing unaffordable. House prices are breaking record after record. Only this week, the International Monetary Fund, in its Regional Economic Outlook report, highlighted overheating as one of the main risks facing Asian economies.

Asia, plainly, needs to step out of the Fed's shadow. It's time to tighten policy to put the region's economies on a more sustainable path. Asset bubbles and runaway inflation, after all, can happen here as well.

The lessons of the 1997 crisis should well be heeded: Leverage can reverse more quickly than it is accumulated, with potentially devastating effects on everything from property markets to growth. Inflation, too, as 2008 showed, can spiral quickly out of control and knock even Asia's determined shoppers off balance. In both cases, as today, the cost of capital was too low relative to growth. With output gaps now closed, further monetary stimulus will only put impressive recent gains at peril.

The job ahead, though, is tough. After closely managing exchange rates for decades, Asian governments must adopt a more flexible approach. The Fed's actions—or,

rather, inaction—will only put the dollar under more pressure. In response, Asia will have to let is currencies rise much faster.

This, clearly, will cut against the grain of powerful export lobbies. But that should not deter officials. Simply holding exchange rates steady against the falling greenback would only add fuel to the inflationary fire. In recent weeks, local currencies have indeed started to appreciate a little more convincingly vis-a-vis the dollar. But whether this amounts to a whole-hearted change in policy, sustained for many more months, remains to be seen. Foreign-exchange reserves still rose at a near record pace in the first three months of 2011, suggesting that dollars continue to flood into the region.

Of course, exchange rate appreciation is not the only option on the table, nor is it advisable everywhere. Hong Kong, for example, has fared well under its currency board regime and will stick to it. But, elsewhere, more flexible currencies are urgently needed to temper inflation and counter the Fed's ongoing stimulus.

Interest rates have a role to play, too, and need to head much higher, and faster, than officials so far seem prepared to deliver. Real interest rates in emerging Asia remain at a record low.

That said, interest-rate rises alone also will be insufficient to cope with the dollar tide. And in some important economies—chiefly Hong Kong, with its dollar peg—rate hikes will not be possible at all.

So policy makers must also look to regulatory tightening. While neither exchange-rate adjustments nor interest-rate hikes may be entirely sufficient to dam the dollar flood, regulators can limit the extent to which those dollars inflate potentially dangerous credit bubbles. Such measures will be especially important in Hong Kong, where efficient oversight at least makes such measures more effective than elsewhere.

Those three measures together will constitute a monetary first line of defense, but on their own they still won't be enough. The Fed's powers, transmitted by a sinking dollar, are simply too forceful to be countered by monetary antidotes alone.

Fiscal policy needs to play a role, too. Bursting price pressures, and soaring asset prices, can also be dealt with by a determined spending restraint, and, possibly, the judicial use of taxation.

So it's worrying that across the region, fiscal policy still remains highly accommodative. Only two economies, Singapore and Hong Kong, are projected to run budget surpluses this year. Elsewhere, deficits remain large and persistent, even though interest expenses on public debt are near record lows and growth running at full capacity.

This needs to change. Determined fiscal tightening would curb inflation as well as lower buoyant growth expectations, which are partly responsible for soaring asset prices. There's another advantage too. Building up fiscal reserves in times of plenty, as the West has now become painfully aware, helps cushion economies when things go into reverse.

Since the dollar remains, for the foreseeable future, the world's reserve currency, the Fed will continue to exercise a strong influence in Asia for some time to come. But that fact doesn't absolve Asian policy makers of their responsibility to do what they can to shield their economies from emerging excesses.

With America's central bank poised to maintain its stimulus a while longer, it is thus high time for Asia to finally strike a more independent path. Policy makers have the tools. The trick is to deploy them swiftly and with determination.

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