External Shocks, Transmission Mechanisms and Deflation in Asia

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Summary

This paper examines the inflation experience of seven small economies in East Asia: Hong Kong, Malaysia, Korea, Philippines, Singapore, Taiwan, and Thailand. It documents common elements in the inflation processes across countries that are not only due to the reaction of the countries to the crisis in 1997-98. Using a particular recursive form of a vector autoregression model the paper finds empirical support for the view that developments in the world economy, as measured by inflation, growth, and interest rate developments in the United States, have very strong influences on each of the countries. The importance of the United States is explained by the historical tendency of the countries in the region to limit fluctuations of their exchange rates vis-à-vis the dollar.

With the help of a small analytical model, the paper also identifies reasons why reactions to external shocks are not exactly the same in all countries. Potentially important factors include differences in price and wage adjustment processes combined with non-linearities in the reaction of aggregate demand, differences in trade structure which condition the competitive effects of price and exchange rate changes, and, most importantly, differences in monetary policy response. Observed differences in the degree of dependence on the US can indeed be ascribed to differences in exchange rate/monetary policy responses to external shocks. The empirical results also show that Mainland China has been a less important source of external shocks than is commonly thought.