

Policy Recommendations

East Asia's Role in Resolving the New Global Imbalances

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In collaboration with members of the NEAT Working Group on
“Resolving New Global Imbalances in an Era of Asian Economic Integration”
Sponsored by Research Institute of Economy, Trade and Industry (RIETI)
Tokyo, Japan, 1 August 2005

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Introduction

1. The world economy hangs in a precarious balance
2. The U.S. large current account deficits at 6% of US GDP, or three-quarters of the world sum of current account deficits
3. East Asian surpluses: about 45% of both the world sum of current account surpluses and of the U.S. global deficit

The Nature of the New Global Imbalances

A. *U.S. Current Account Deficits, driven by*

I. driven by

1. private investment boom during the late 1990s
2. drastic reversal of the fiscal balance from surplus (2% of GDP) to large deficit (near 4%) after the recession of 2000-01
3. low consumer saving rates from 1997 to the present

II. Private capital inflows into U.S.

1. between 1997 and 2001

- sufficient to finance U.S. current account deficits
- the real effective exchange rate of the dollar appreciated 17%

2. from 2002-2004

- (a) fallen short of current account deficits
- (b) the real effective exchange rate of the dollar depreciated 17%
- (c) real effective exchange rate of the dollar now close to its average value over the past quarter century

B. East Asian Current Account Surpluses

I. Dramatic change after the Asian Capital Account Crisis of 1997-98

1. current account balances in East Asia have either moved from deficit to surplus (crisis-hit economies), or
2. from surplus to larger surplus (non-crisis hit economies)
3. lower investment/GDP ratios than saving/GDP ratios

In contrast ,

4. China continued to increase both investment/GDP and saving/GDP ratios, maintaining relatively small surpluses/GDP ratios

II. Exchange rates in crisis-hit East Asian economies

1. initially collapsing by 50% or so during the crisis
2. kept on average 15-20% below pre-crisis levels,
3. similar experience for non-crisis East Asian economies
4. 8.27 RMB per dollar remained unchanged from 1994 until 20 July 2005

III. Massive accumulation of foreign reserves

1. since 2002, about 40% of U.S. external deficits have been financed by foreign (primarily Asian) central banks

2. The objectives of Asian central banks in accumulating large quantities of reserves ,
 - (a) to be prepared for another capital account crisis
 - (b) to maintain competitive exchange rates to sustain the export-oriented thrusts

The Sustainability of the New Global Imbalances

A. *The Sustainability of U.S. Current Account Deficits*

1. judged by considering whether foreign investors will willingly hold the amount of to finance U.S. continued deficits
2. dynamic changes in interest rates and risk premia on U.S. liabilities
3. after 10 years net external debt will reach 65% of GDP, or 18% of the wealth of the rest of the world

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4. interest rate dynamics get progressively worse over time
 5. in 2004 U.S. net external liabilities at 21% of GDP
 6. nevertheless, net international investment income slightly positive for the U.S. and thus the net interest rate still negative (hence favorable for the U.S.)
 7. massive amount of U.S. liabilities accumulating over the next 10 years will raise the net interest rate to almost 1%

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8. the long run debt/GDP ratio would be 150% of GDP
($6\% \div (5\% - 1\%)$)
 9. equal to 45% of the financial wealth of the rest of the world
 10. at the net interest rate of 2%, net external debt/GDP would reach 200% and US net external debt/ROW wealth would be 60%
 11. demanding a higher rate of return, especially if they feared that the dollar would depreciate
 12. if current account deficits remained below 3% of GDP, the eventual debt/GDP ratio remain below 60% of GDP : sustainable, particularly given the key currency status of the dollar

B. The Sustainability of Reserve Accumulation by Asian Central Banks

I. Sterilization policies

1. foreign reserve accumulation → base money
excess liquidity → the money supply → inflation
to offset this → sterilization policies
2. sterilization policy successful controlling money
supply and CPI inflation

II. Several limits to sterilization operations

1. eroding bank profitability and interfering with the allocation of credit of banks
2. interest rates on the sterilization instruments rise
higher interest rates attract further capital inflows defeating the purpose of sterilization
3. increasingly inefficient allocation of resources, compared with higher private and social rates of return for domestic investments

Necessary External Adjustment Policies in the U.S.

1. increasing national saving: fiscal consolidation and raising household saving rates
2. absorption-reducing policies are recessionary, hence, to be offset by dollar depreciation
3. if the dollar depreciated alone without any absorption-reducing policies, inflation could accelerate
4. optimal policy mix: fiscal consolidation combined with a depreciation of the dollar : to maintain both external and internal equilibria (i.e., a sustainable current account balance and full employment with low inflation)

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5. if fiscal consolidation were not undertaken, market forces could drive the dollar down
 6. to reduce the U.S. current account deficit by 1% of GDP, the dollar must depreciate by around 10%.
 7. 30% reduction dollar (as a working hypothesis) required to reduce the U.S. current account deficit from of 6% to sustainable level of 3% of GDP

East Asia's Role in Resolving the Current Global Imbalances

- A. Basic rationales for concerted appreciations to maintain mutual exchange rate stability in the region*
1. intra-regional trade of about 55% in total trade
concerted appreciations small effective
exchange rate changes (e.g., 13.5 % against 30%
appreciations against dollar)
 2. encouraging continued FDI flows and providing a
stable backdrop for regional production and
distribution networks
 3. overcoming prisoner's dilemma problems

B. Appropriate Policy Mix for the Region

1. how can the benefits of concerted action be reconciled with the need to accommodate differences in individual economic conditions?
2. concerted action would be more effectively implemented under more flexible exchange rate regimes
3. more flexible regimes characterized by 1) a multiple currency basket-based reference rate instead of a dollar-based central rate, and 2) a wider band around the reference rate

4. these two elements

- (a) provide greater flexibility in managing the speed and magnitude of any necessary appreciation,
- (b) while still taking into account their own individual economic conditions

5. a free float,

- (a) more accurately reflect market fundamentals
- (b) however, the shallow and narrow domestic capital markets a free float generates excessively volatile exchange rates

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6. neither a free floating regime nor a fixed dollar peg but a multiple currency basket-based reference rate with a band
 7. recessionary impact of appreciations could be offset by appropriate macroeconomic and structural policies
 - (a) fiscal and structural policies to build both physical and human infrastructure (particularly in rural areas) and
 - (b) structural policies to promote competition and productivity in the non-tradable sector

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8. appropriate policy mix: combining absorption-increasing policies with currency appreciations
 - (a) without appreciations, increasing domestic demand alone could overheat economies
 - (b) without domestic demand expansion, appreciations alone would be contractionary

 9. this appropriate policy mix:
 - (a) moves away Asia from excessive reserve accumulation
 - (b) simultaneously achieves external and internal equilibria in Asian own interests

 10. these policies contribute to easing global imbalances: a harmonized way of advancing regional and international interests

Conclusions

1. the primary step necessary to resolve global imbalances is for the U.S. to increase domestic saving
2. absent I-S imbalance corrections, the dollar could depreciate substantially (though, its timing and speed are unknown)
3. Asian economies engage in concerted action to keep exchange rates as stable as possible, given their individual economic differences
4. more flexible regimes characterized by
 - (a) a multiple currency basket-based reference rate and
 - (b) a reasonably wide band are indispensable

5. several advantages of such policy coordination

- (a) reducing the magnitude of “effective” exchange rate appreciation and hence contractionary impact of appreciations
- (b) facilitating the flow of FDI and promoting production and distribution networks which would dynamically evolve
- (c) overcoming prisoner’s dilemma problems

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6. exchange rate appreciations accompanied by absorption-increasing policies: consistent with the new economic strategy of encouraging domestic demand
 7. strengthening surveillance mechanisms and peer pressure in the context of coordination policies of exchange rates, macroeconomic and structural issues
 8. the coming East Asian Summit in Kuala Lumpur should be an appropriate venue to discuss policy options outlined here