

Rationalizing Emerging Asia's Foreign Reserves Build-up

A Global Ponzi Scheme

US CA deficit

Asia reserve build-up

US growth

Demand for US
T-Bills buoyant

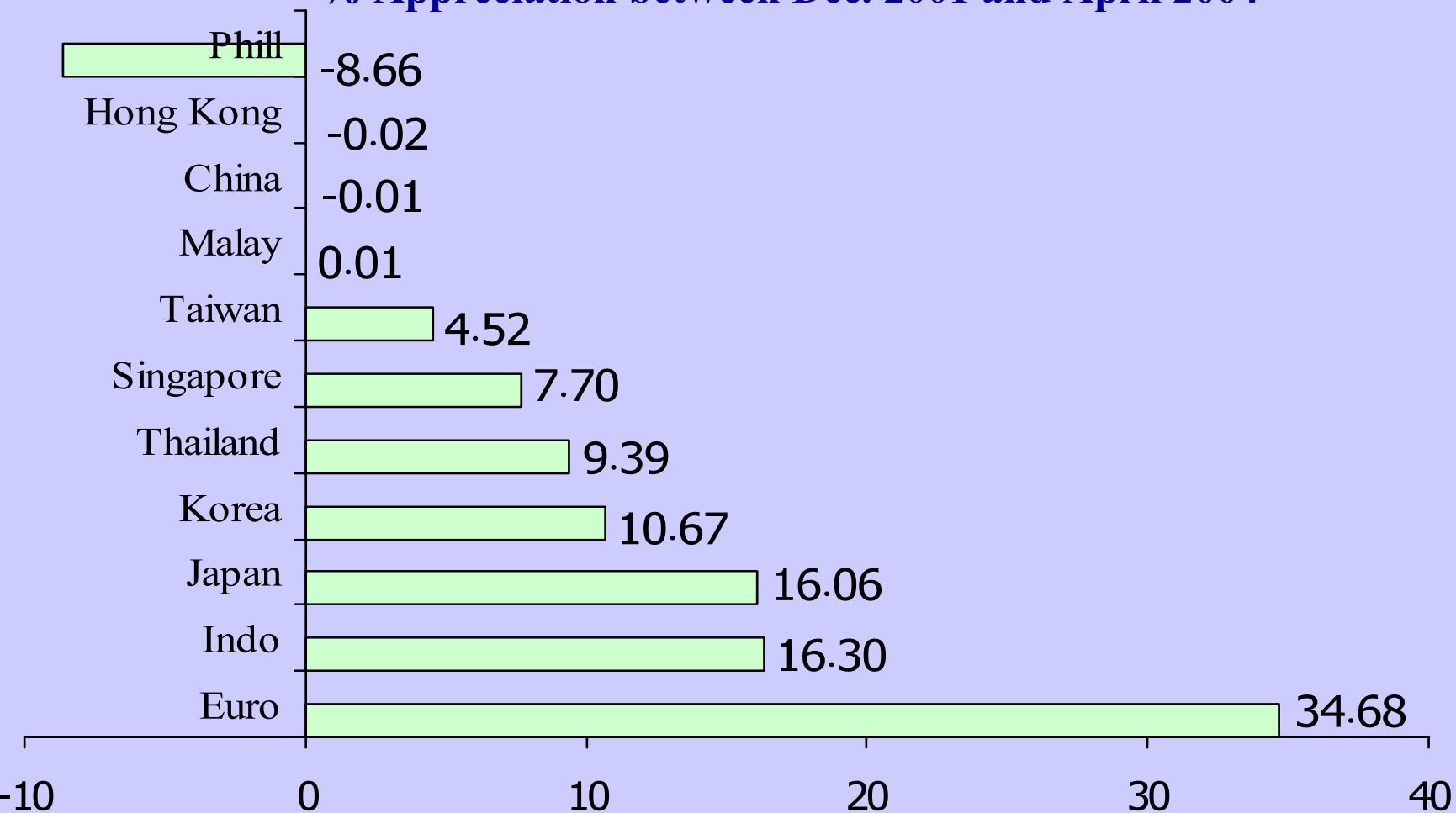
Capital
Inflow

US consumption
and fiscal binge

- US\$ supported
- Low US interest rates

A reluctance to allow rapid exchange rate appreciation...

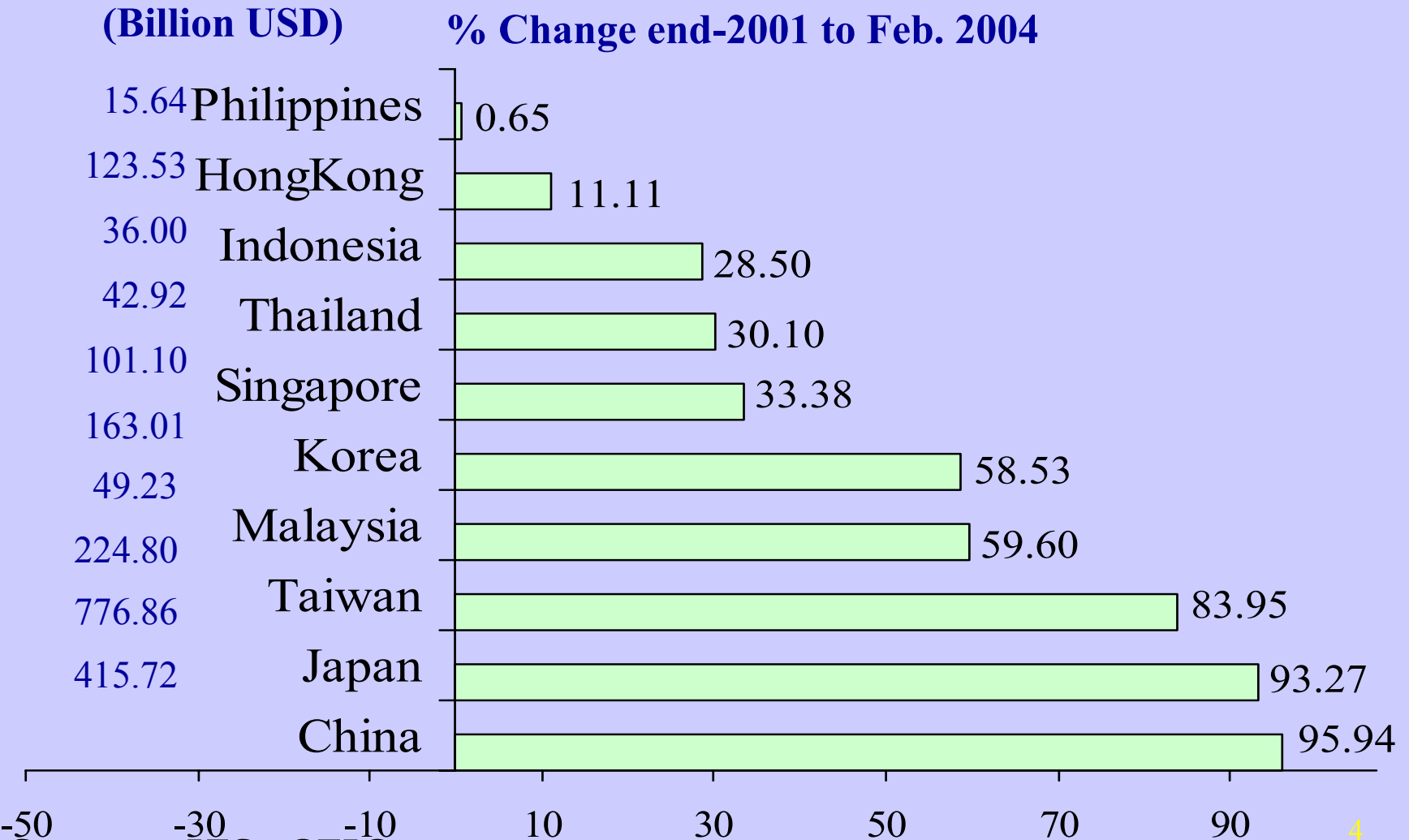
% Appreciation between Dec. 2001 and April 2004



Source: CEIC

... has led to reserve accumulation

Reserve Outstanding Feb. 2004

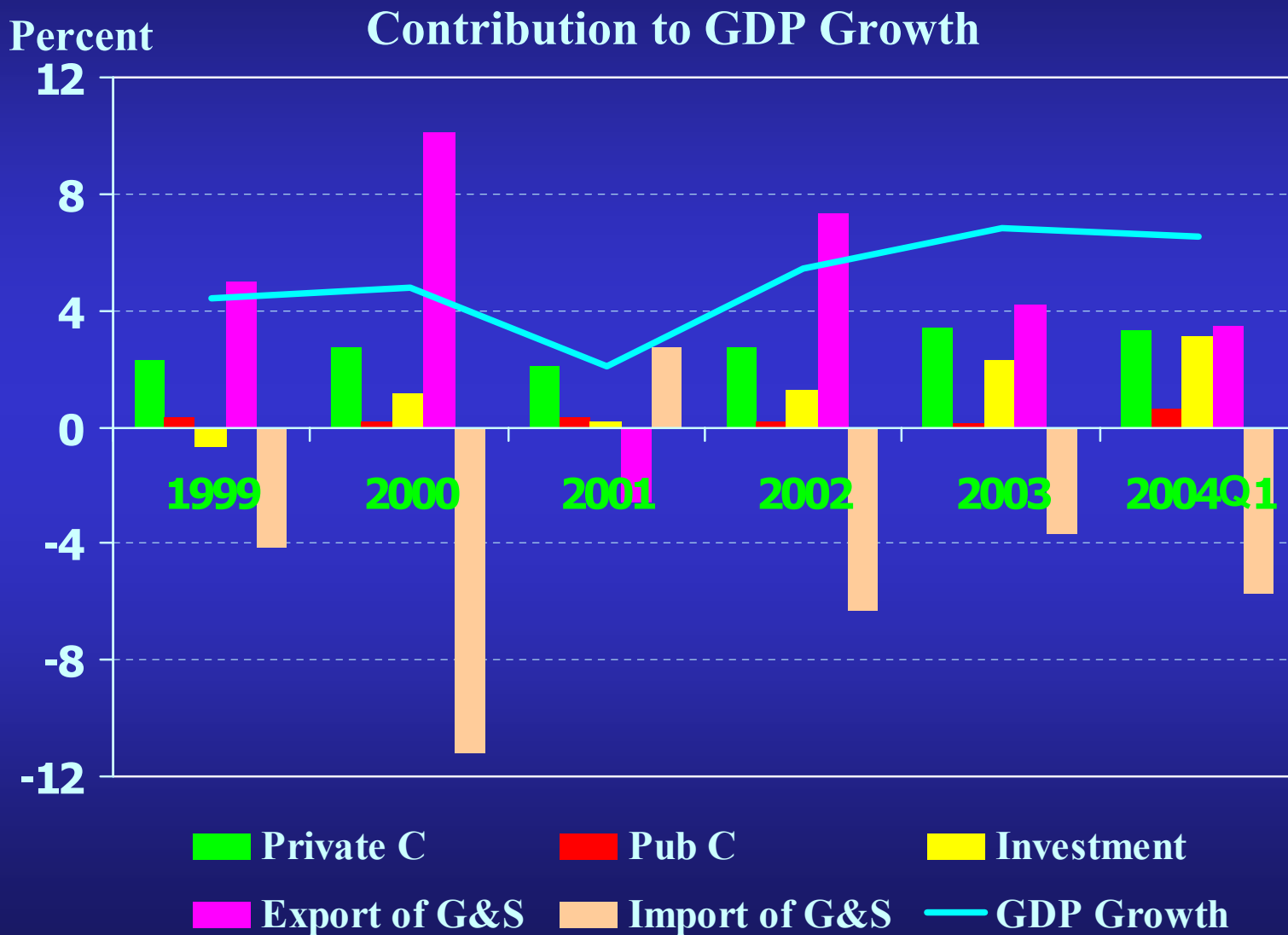


The Domestic Perspective

- Situation reminiscent of early 1990s
 - Insufficient outflows as opposed to excessive inflows
- Resistance to rapid appreciation not unwarranted
 - Local financial markets may not be sophisticated enough to allow effective hedging
 - Reserves bestow important benefits
- But sustained sterilization entails significant costs that should not be overlooked

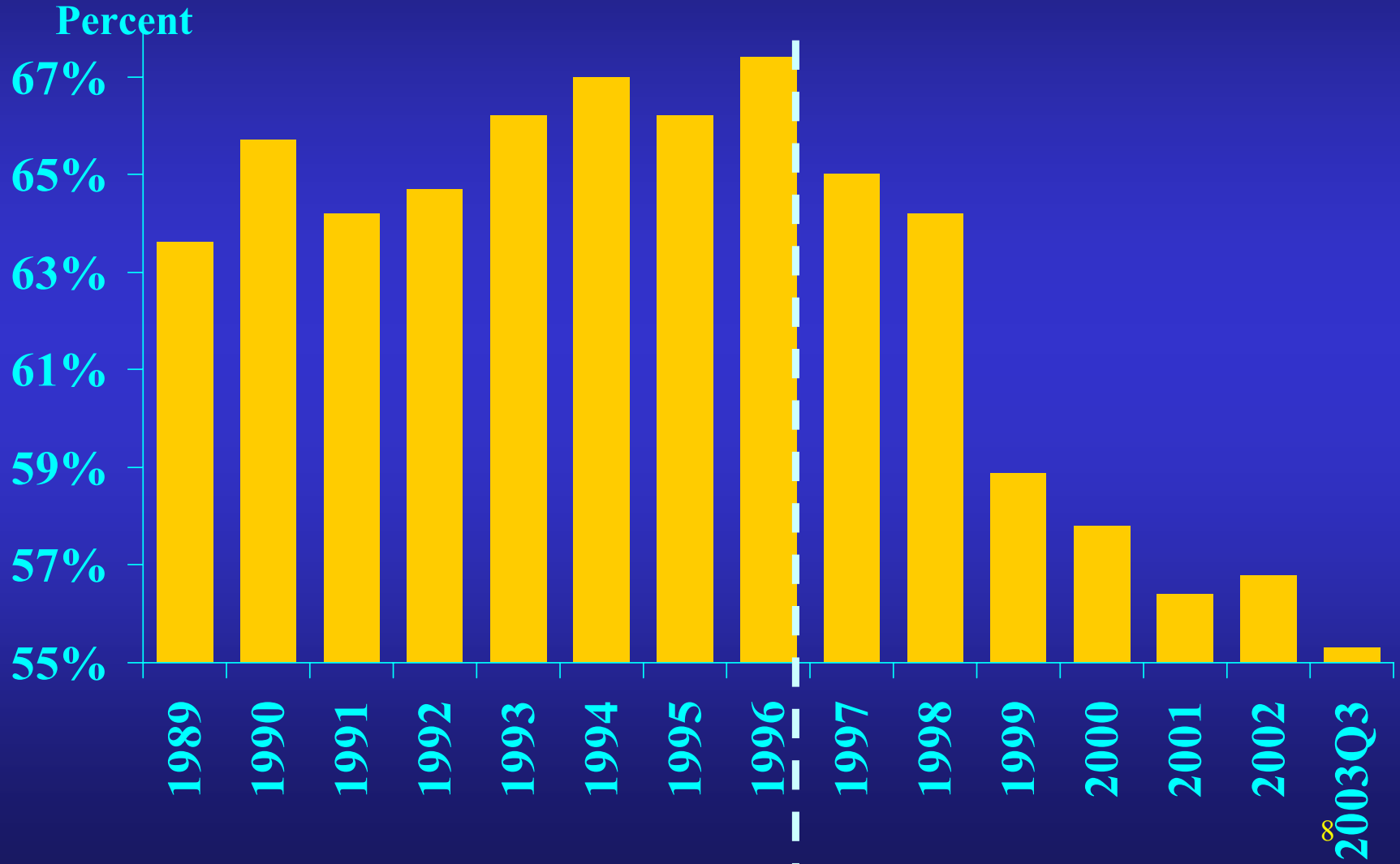
The Domestic Perspective: The Thai Case

Growth rebound driven by exports and private consumption...



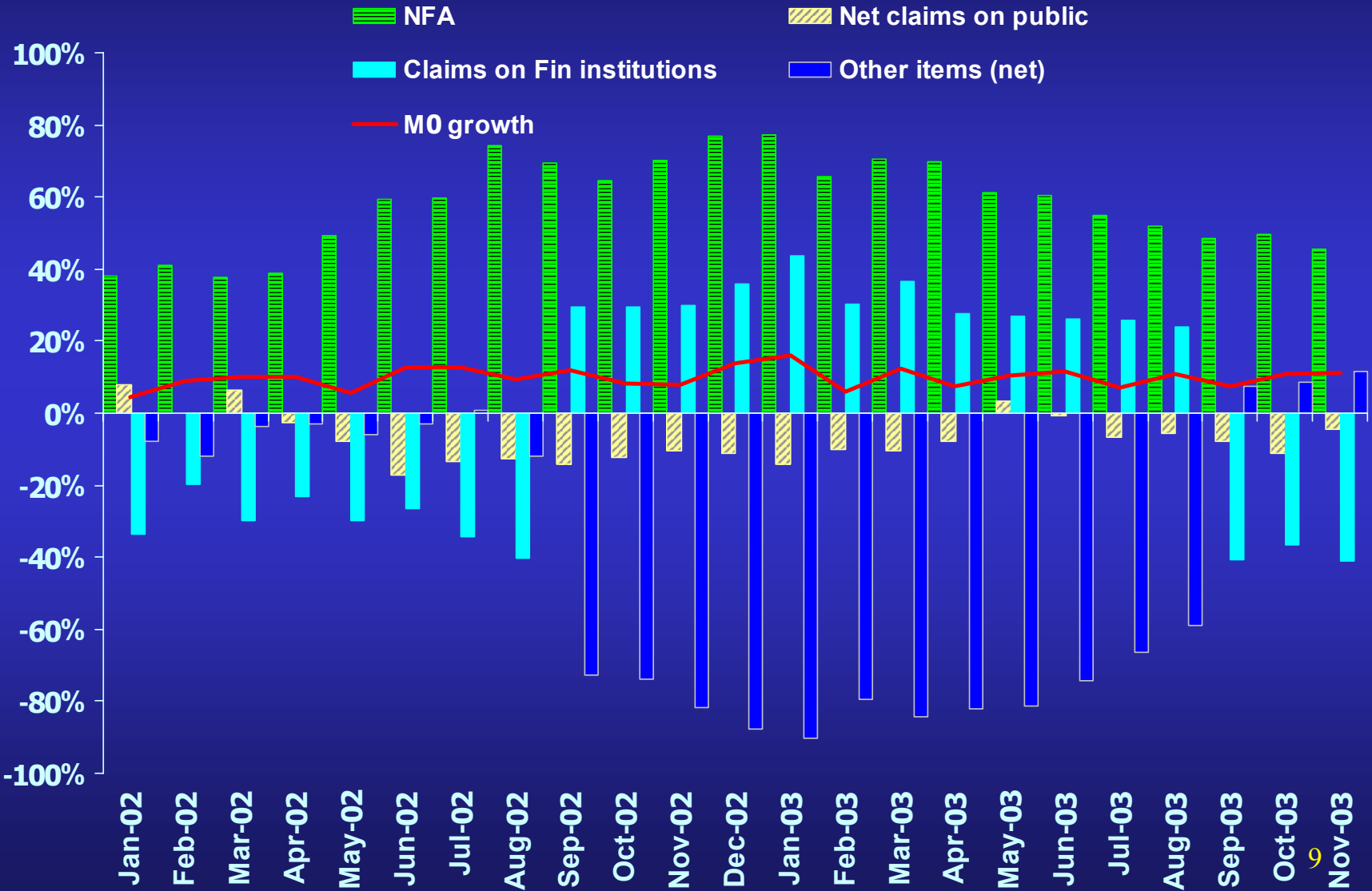
...resulting in an asymmetric growth pattern

Non-Traded/Traded GDP



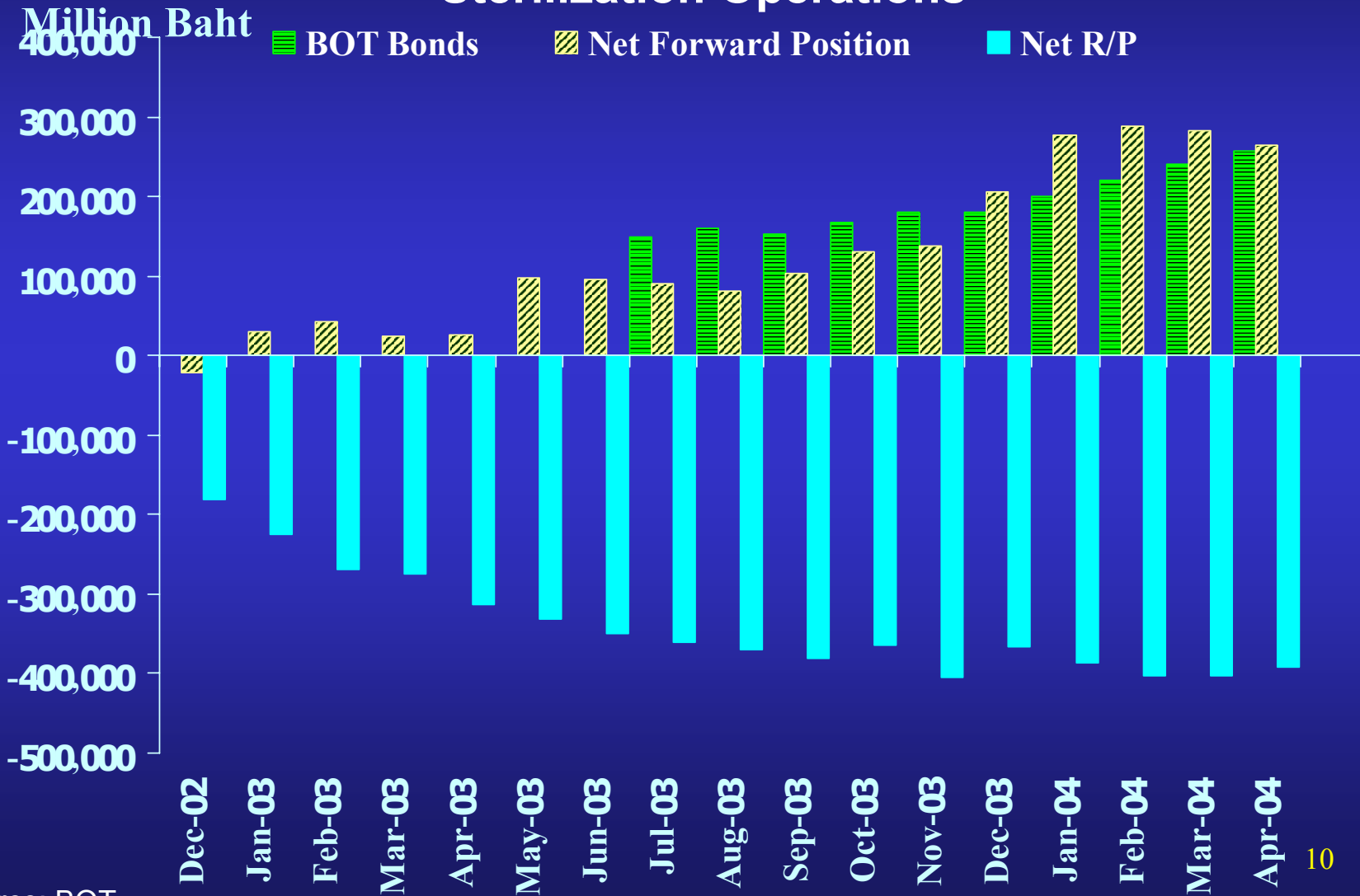
Significant reserve accumulation...

Contribution to Monetary Base Growth



...has had to be sterilized

Sterilization Operations

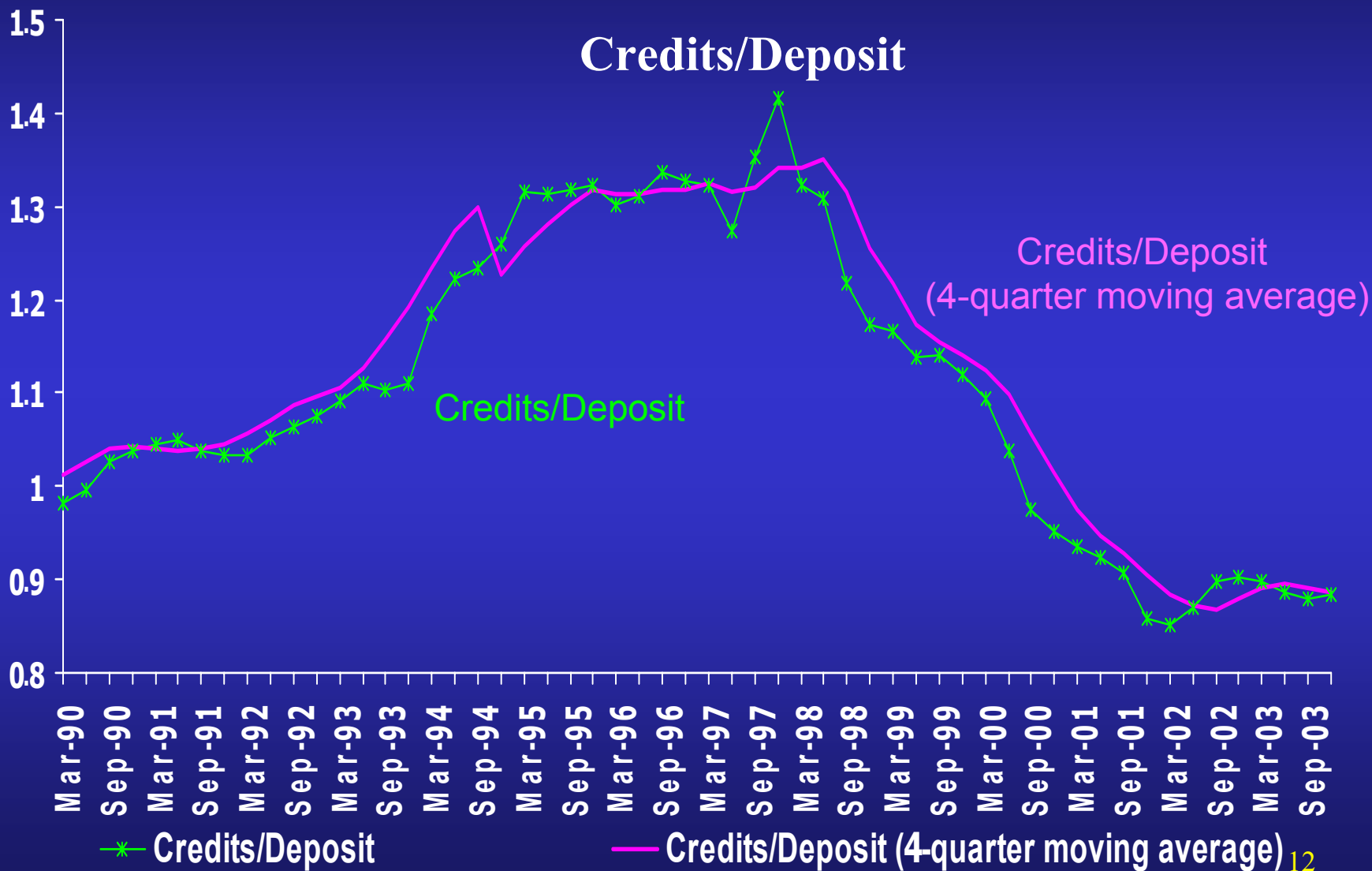


While inflation continues to remain subdued...



...potential for loans to surge should not be discounted

Credits/Deposit



Domestic Implications

- Sterilization is really fiscal policy
 - But no adjustment impetus
 - Resources could be spent on facilitating adjustment instead
- Undervalued exchange rate no more desirable than overvalued one
 - Build up imbalances and potential risks in the future
- Onus of adjustment more on inflation rather than nominal appreciation

The Lender's Curse

Resist appreciation

Reserve build-up

Delay structural adjustment

- Discourage investment

- Significant quasi-fiscal costs
- Balance sheet exposure

- Reduced incentive to hedge
- Encourage speculation
- Credit boom

- Export sector subsidized
- Risk-bearing subsidized

The Way Out

Orderly adjustment in the US dollar

- Continue financing US deficit to help support near-term global recovery, but allow adjustment to take place

US dollar depreciation unlikely to be enough

- Ultimately, the US needs to save more (preferable to less domestic investment)
- More reliance on domestic demand in Asia
- Need cooperative strategy that facilitates rebalancing of demand across countries

Policy Environment

- Determine appropriate balance between nominal exchange rate and price adjustments
- Use fiscal policy, structural reforms, or micro-based initiatives to facilitate adjustment
- Greater exchange rate flexibility
 - Puts the onus of adjustment more on external demand
 - Can impart needed tightening of macro-conditions
 - Further liberalization of capital account
- If resist appreciation then tighter fiscal policy may be appropriate
 - But involves contraction in domestic demand

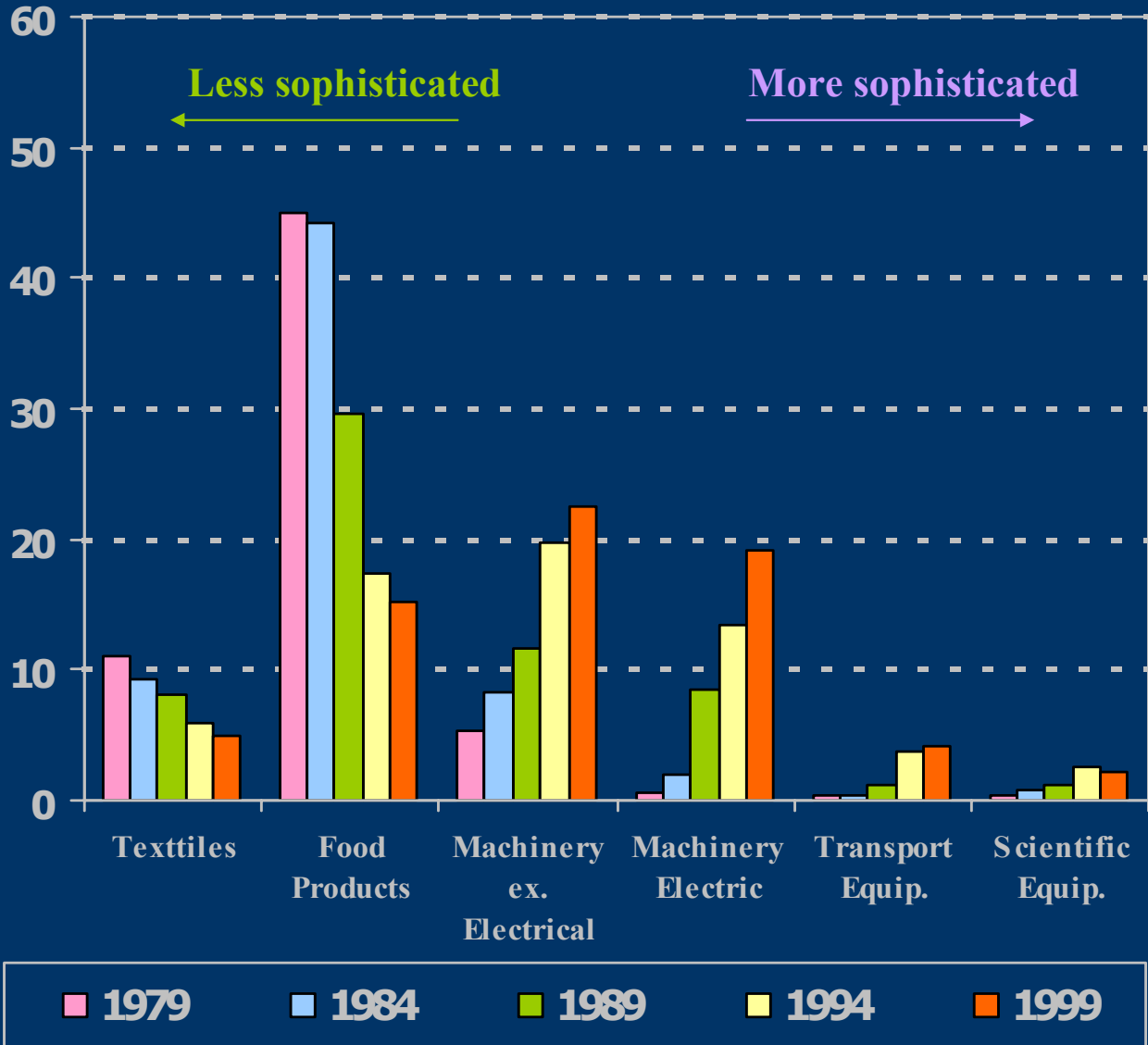
Structural Reforms

To facilitate shift towards domestic-oriented growth and cope with heightened competition

- Shift focus from demand management towards supply creation
 - Infrastructure and industrial expansion
 - Increase productivity through competition
- Move up value-added chain
 - Concentrate on services sector
 - Improvements in training and education system
 - Attract more FDI

Moving up the product ladder: the case of Thailand

Share of Thai Exports



Structural Reforms

To increase institutional flexibility and resilience

- Strengthen and deepen financial markets
 - Banking and corporate reforms
 - Improved financial access and risk management
 - Legal and judicial reforms
- Increased flexibility
 - Social safety net and labor market reforms