July 9, 2004

Pros and Cons
International Symposium "Resolving New Global and Regional Imbalances in an Era of Asian Integration"

On June 17-18, 2004, the Research Institute of Economy, Trade and Industry (RIETI) hosted an international symposium, "Resolving New Global and Regional Imbalances in an Era of Asian Integration." During the symposium, the following topics generated lively debate: (1) the United States' massive external deficit; (2) networks of production and distribution developing throughout East Asia and the formation of a pattern of global "triangular" trade; and (3) currency regulation, including that for the Chinese renminbi, and foreign exchange regimes in Asia. The objective of this report is to summarize "pro" and "con" arguments on important issues that were discussed at the symposium, and to clearly define those issues. We would appreciate hearing your views on the comments and analyses presented here.

Let us begin by outlining the major developments and trends that form the "background for debate."

I. The Background for Debate

1) The United States' enormous current account deficit reached 5 percent of GDP in 2003. In sharp contrast, East Asia, as a whole, is characterized by trade surpluses and foreign currency reserves that are expanding at remarkably rapid rates. America's current account deficit was financed by inflows of foreign capital that increased dramatically in the second half of the 1990s. In the fourth quarter of 2001, however, these flows of private capital, especially from the European Union, began to slow. Reflecting this change, the U.S. dollar lost ground in currency trading from the end of 2001 through the beginning of 2004, with the value of the Euro and Japanese yen rising 33 percent and 16 percent, respectively. In East Asian currency markets that also came under pressure from the dollar's depreciation, government interventions helped maintain fixed exchange rates in some cases (China, Malaysia), dampened fluctuations in others (the

Thai baht appreciated by approximately 10 percent and the Singapore dollar by roughly 6 percent), and increased the amount of dollars held in foreign currency reserves by countries in the region. These changes fueled speculation that the large U.S. deficit might precipitate currency exchange adjustments on an even larger scale. Other concerns included the possibility that the dollar's rapid fall would force a sharp rise in the value of the renminbi and other Asian currencies, the potential that this could depress economies throughout the region, and uncertainties about what sorts of policy responses would be most appropriate.

2) In comparison to the 1980s when, following the Plaza Accord, the U.S. dollar fell precipitously against the Japanese yen (from ¥250/$1 to ¥120/$1), the importance of China and East Asia in today's global economy is large and growing at a phenomenal rate. In addition, foreign direct investment flowing into China from Japan and newly industrializing economies (NIEs) is contributing to the development of production and distributions networks in East Asia. Within this context, China is importing parts, intermediate goods, and other materials from Japan and NIEs that incorporate advanced technologies, and using comparatively cheap labor to process them before exporting finished products, mainly to the United States and the European Union. These trends have fostered the development of a relative small Chinese trade surplus with the world as a whole, amounting to approximately $11.7 billion in 2002 (including Hong Kong – IMF data), and a much larger Chinese trade surplus with the United States, totaling roughly $108.6 billion in the same year. The sizeable gap between these two surpluses illustrates the volume of Chinese imports from Japan and NIEs in East Asia of parts and semi-finished goods. Whether a "triangular trade relationship" such as this that is characterized by such extreme interregional imbalances is sustainable remains in doubt.

3) Finally, there is also the important issue of what shape anticipated currency adjustments, and the macro policies, structural policies, and new currency exchange regimes in East Asia that will accompany them, might take that would make them compatible with the region's pattern of triangular trade and its process of economic integration. Of particular concern is the question of how best to respond to the overheating of China's economy. Yet another important question, especially when viewed in light of what has already been mentioned about the conspicuous role that exports of products manufactured from

imported parts and materials play in China's trade, is whether an appreciation of the renminbi could engender an effective reduction of this country's external surplus. In China's case, most of the expansion of its foreign currency reserves is the result of huge net inflows of foreign direct investment (totaling approximately 5 percent of GDP). Much of this FDI is attracted to China by regional governments there that offer excessive incentives, special treatment, and other measures that should be overhauled. Many other issues require consideration as well. For example, might the same structural reforms used to eliminate problems in China, such as the massive non-performing loans held by its state-owned banks and large disparities in income between its rich and poor, also have considerable potential to help alleviate overheating in the Chinese economy? What effects would changes in exchange rates have on East Asia as a region that has become the world's factory? What kinds of currency exchange regimes are best for Asia – those based on fixed rates, floating rates, or a hybrid system that employs crawling bands? In particular, what sort of system would work best for the Chinese renminbi? How might the inter-currency stability that is so important for economic integration in Asia be achieved? What about a basket of several major currencies?

II. Question: The Sustainability of the United States' Current Account Deficit: Is a Drastic Exchange Rate Adjustment Unavoidable?

"Pro" Viewpoint: The United States' current account deficit is not sustainable, and a drastic exchange rate adjustment is unavoidable.

Reason: ***Amounts of international capital of sufficient size to finance the United States' huge current account deficit will cease to flow into this country.***

a) Flows of private capital from Europe into the United States are decreasing, and official interventions in East Asia (by governments that purchase short-term U.S. treasury bonds) cannot be expected to cover the resulting shortfall. This is because the U.S. external deficit appears unsustainable when any of the following three factors in the American economy are taken into consideration: savings and investment balances, net exports, and foreign capital flows (cointegration analysis). In addition, a significant currency exchange adjustment (involving depreciation of the dollar and appreciation of other national currencies) is unavoidable given that the U.S. external deficit will, at some point, fuel inflation and prompt interest rate hikes in East Asian countries. [Ogawa, Brook]

b) To reduce the U.S. current account deficit by approximately 1 percent of GDP, the dollar would need to depreciate by roughly 10 percent. [Brook, Obstfeld & Rogoff]

"Con" Viewpoint: The United States' current account deficit is sustainable, and a drastic exchange rate adjustment is avoidable.

Reason 1: ***The U.S economy is strong, and countries in Asia with fixed exchange rate regimes will continue to concentrate on exporting.***

a) The underlying strength of capital flows that come as the result of high-return investment opportunities, supported by the fundamental strengths and high rates of productivity found in America's "New Economy," should not be underestimated. [Keidel, Hisatake]

b) Savings rates in other countries are high in comparison to those in the United States. However, economic stagnation in advanced economies and desires for stable exchange rates in strongly export-oriented countries in Asia stimulate outward flows of surplus savings. The United States is under pressure to absorb most of this savings on its own (and if it does not, the global economy will stall). Policymakers in East Asian countries are more concerned about growth in their national economies than they are about capital losses that might result from low-return investments in U.S. treasury bonds or depreciations of the dollar. Because of this, countries in East Asia are maintaining the status quo as far as the pegging of their currencies to the dollar is concerned (by purchasing U.S. treasury bonds). [Garber]

Reason 2: ***The sustainability of fiscal deficits viewed in a positive light.***

a) The U.S. fiscal deficit is sustainable for at least the next several years, and is the result of unusual circumstances such as the war in Iraq. Of course, it would be desirable to reduce this deficit, and doing so would help eliminate macro-level imbalances and reduce the current account deficit as well. Correcting the U.S. fiscal deficit is thus a task of the highest priority, and something that this country is capable of doing on its own. [Keidel, Ito]

Remaining Issues:

1) The size of a sustainable U.S. current account deficit is not necessarily zero. What factors determine the size of such a sustainable deficit (or stated differently, the size of a "natural deficit")? Is it the aggregate savings of countries outside the United States? Similarly, what role might "home bias" play?

2) When will the U.S. current account deficit become difficult to maintain? Analyses should be performed of factors determining the inward flows of private capital that in turn influence the sustainability of this deficit.

III. Question: Is a Rise in the Value of the Renminbi Necessary?

"Pro" Viewpoint: A rise in the value of the renminbi is necessary.

Reason: ***Appreciation of the renminbi is necessary to eliminate inflationary overheating in China's domestic economy.***

a) An undervalued renminbi contributes to the expansion of China's external imbalances and the acceleration of inflation in its domestic economy. A rise in the value of the renminbi is required to alleviate these problems. [Kuroda]

"Con" Viewpoint: A rise in the value of the renminbi is not necessary.

Reason 1: ***Inflation is being controlled by appropriate economic policies.***

a) Overheating in China's economy is being properly managed. Most notably, Chinese policymakers are employing not only routine monetary policies, but also credit allocation to correct structural distortions inherent in their country's economy. [Keidel, Ito]

b) When the Chinese economy overheats, there is a tendency to apply textbook economic theories. However, it is also beneficial to alleviate overheating by correcting structural distortions. For example, the curbing of loans to state-owned enterprises from state-owned banks is effective both in preventing the creation of non-performing loans and in bringing overheating under control. During the quarter century that has elapsed since China began reforming itself and opening up to the world, its integration into the international community has progressed markedly. At the same time, an examination of the Chinese economy as a whole reveals this to be still fragmented in the sense that flows not only of labor, but also of capital and goods across provincial boundaries are restricted. If Chinese domestic markets were better integrated, this alone would unleash latent economic potential that could in turn increase China's growth by 2-3 percent. [Liu, Yoshitomi]

c) China's entry into the WTO was accompanied by tariff reductions that had a negative effect on this country's rural regions. Appreciation of the renminbi would increase imports of cheap agricultural goods and deliver yet another blow to Chinese farmers. In contrast, making improvements to China's underdeveloped rural areas would stimulate domestic demand. [Yoshitomi, Liu]

Reason 2: ***Taking into consideration China's trade structure, both the necessity and effectiveness of currency adjustments are in question.***

a) A distinguishing characteristic of China's trade structure is the fact that processed goods account for such a large proportion of this country's total exports (approximately 55 percent in 2002). However, since so many of those processed goods are made from sophisticated parts and semi-finished goods that were imported, it is estimated that manufacturers inside China probably add no more than approximately 15 percent to the value of final products being exported. If that is the case, then an appreciation of the renminbi is unlikely to contribute much at all to improvements in China's balance of trade. [Lemoine]

b) China's current account surplus is equal to approximately 2 percent of GDP and has essentially stabilized at this level. In fact, it is quite possible that the process of trade liberalization that WTO membership has triggered will reduce this surplus in the future. [Lemoine]

c) When the renminbi rises in value, how does this affect the price-setting activities of foreign companies? Walmart supposedly absorbs an eighth of China's total exports. It will probably react to an appreciation of the renminbi by leaving dollar-denominated prices in the U.S. domestic market as they are, and work instead to cut costs in China. In addition, since China holds large masses of unemployed and surplus workers in reserve, such a limitless supply of labor is, as the Lewis Model of developmental economics would predict, generating downward pressures on wages. There is also the politically salient problem faced by the Chinese government of ensuring that at least 10 million new workers are absorbed into the active labor force each year. The power that Walmart has to control prices by, for example, creating pressures for lower wages, will function effectively. [Liu, Garber, Brook]

Remaining Issues:

1) What about the sustainability of the triangular trade pattern? How will the upgrading of China's trade structure change the triangular trade relationship? What about the current state and future prospects of the division of labor relationships between China and countries in ASEAN (and the activities of multinational enterprises located there)?

2) If productivity increases, but wages follow the Lewis Model and fail to rise, will the share of capital income in national income continue to expand? Is a large gap observed between traded and non-traded sectors in terms of how the relationship between productivity and increasing wages functions in each? (Debate on the presence or absence of the Balassa-Samuelson Effect.)

IV. Questions: What is the most appropriate currency exchange regime for Asia – fixed, floating, or a hybrid of the two? How can this regime be created? Is securing inter-currency stability in Asia desirable?

"Con" Viewpoint: Currency exchange rates should be determined by the market (free float or wider band)

Reason 1: ***In the midst of a "trilemma," monetary policy independence must be prioritized over exchange rate stability.***

a) Achieving (1) free flows of capital, (2) exchange rate stability, and (3) monetary policy independence simultaneously is a difficult undertaking ("trilemma"). When capital flows liberalize, maintaining the requirement of monetary policy independence (unaffected by fluctuations in foreign currency reserves) increases the importance of flexible exchange rate regimes. Nonetheless, this independence is necessary in Asia, especially in China as a large country. At the same time, systemic strengths (rule of law, banking oversight, disclosure, corporate governance, etc.) and financial market depth provided by derivatives and other exchange futures are also important. [Keidel]

Reason 2: ***A gradual rise in the value of Asian currencies is desirable.***

a) Accumulation of foreign exchange reserves in Japan, China, and other countries in East Asia, including Thailand, worked through an expansion of base money to contribute to the elimination of deflation in the region. Expansions of base money beyond this are contained by sterilization policies. In Thailand's case, success was also achieved in dampening core inflation (0.5 percent). In addition, pressure generated by a moderate appreciation of the baht (approximately 6 percent in 2003) is helpful in promoting structural adjustments in the domestic economy. From this point forward as well, it is necessary within a context of moderate currency appreciations to foster domestic demand-led growth in Asia. [Piti]

"Pro" Viewpoint 1: Exchange adjustments are not necessary; the status quo for

exchange regimes should be maintained.

Reason: ***There are concerns that a rapid liberalization of capital flows could trigger a financial crisis in China similar to that which occurred in Asia in 1997.***

a) Especially in China's case, the current weakness of this country's domestic systems infrastructure makes the combination of a fixed exchange rate system and capital flow controls desirable. Pegging the renminbi to the dollar as an anchor is also helping to stabilize domestic inflation. However, what if the dollar suddenly loses 30 percent of its value? In that case, pegging to a higher level system makes it possible to compensate for the lag that occurs while the Chinese system is still weak. In addition, this provides time to upgrade domestic systems and prepare for the introduction in the future of an elastic exchange rate. [Liu]

b) The quality of systems required for financial markets to function smoothly (ranging from the rule of law to corporate governance, etc.) was scored (quantified) across different countries (by the Asian Development Bank Institute). With 10 as a perfect score, Japan received a 7, Hong Kong and Singapore a 6.5, and countries in Asia that were battered by the Asian Financial Crisis, a 4.5. In contrast, China's score was only 1.6. If the quality of China's systems infrastructure is in fact only at this level, there is concern that a liberalization of capital flows could trigger a financial crisis in that country similar to that which occurred in Asia in 1997. [Yoshitomi, Liu]

c) It is possible that membership in the WTO will accelerate the liberalization of domestic financial services. It is also possible that the penetration of foreign financial institutions will result in the de facto liberalization of capital accounts with free exchange of renminbi and foreign currencies. If capital account liberalization takes place while the upgrading of systemic infrastructure remains inadequate, some sort of crisis may occur. China thus finds itself in a race against time to build this infrastructure as quickly as possible. [Yoshitomi]

d) In general, although exporters in emerging economies are quite vocal in their demands that fixed exchange rates be maintained, political and social resistance to the liberalization of capital flows is quite limited. As a result, there is a tendency to conclude that borrowing from abroad is a good idea if the interest rates offered are attractive. An emerging economy where systemic infrastructure is fragile, it is easy for this to create mismatches between the timing of lending and borrowing, as well as currency mismatches. The danger that a crisis much like the 1997 Asian Financial Crisis will occur in China is therefore increasing. [Keidel]

"Pro" Viewpoint 2: Coordinated currency adjustments and new exchange regimes in East Asia are required to cope with a situation in which the value of the U.S. dollar declines sharply.

Reason 1: ***A coordinated appreciation of Asian currencies and the yen will lighten the burden of adjustment for a Japanese economy struggling with deflation.***

a) In the event that the value of the U.S. dollar drops sharply, the effect on the Japanese economy will differ greatly depending upon whether only the currencies of advanced countries, including Japan, appreciate and other Asian currencies are fixed, or all currencies, including Asian currencies, appreciate together. For example, imagine a scenario in which the dollar suddenly loses 22.5 percent of its value. If Asian currencies are fixed, the currencies of advanced countries, including Japan, will appreciate by an effective rate of 30 percent. If, however, the values of Asian currencies rise along with other currencies, the large proportion of trade with Asia in Japan's total trade will hold the yen's appreciation to an effective rate of only 6 percent. Other estimated effects are the following: If Asian currencies are fixed, Japan's real GDP will decline 2.1 percent, and the inflation rate will be -5.7 percent. If Asian currencies rise with other currencies, real GDP will decline 1.4 percent and inflation will be -1.7 percent. These figures demonstrate how extremely difficult it would be for Japan to rid itself of deflation if currency adjustments in Asia are not coordinated. [Brook]

Reason 2: ***It is important to be mindful of the integration of commerce in regions characterized by triangular trade.***

a) The pattern of global triangular trade has a large impact on bilateral trade imbalances, and this is especially true in the case of the China-U.S. trade imbalance. Bilateral trade imbalances such as this can easily become politicized. However, while the issue of exchange rates should be discussed in the context of multilateral trade imbalances, it should not be raised in the context of bilateral trade imbalances. In fact, the appreciation of the renminbi will contribute little to a correction of the China-U.S. bilateral trade imbalance. [Lemoine]

Reason 3: ***If compatibility with Asia's economic integration is valued, stability among currencies is important.***

a) As much as is possible, East Asia should be integrated along the three dimensions of trade and FDI, capital flows, and currencies (exchange rates) even further. For example, even if Asian currency rates from 1999 to 2003 had adopted a basket of currencies consisting of the yen, the dollar, and the Euro (i.e., the G-3 currencies) and used a weighted average calculated from relative amounts of trade with Japan, the U.S., and EU, the exchange fluctuations of individual currencies would not have differed markedly from their actual fluctuations during this period. Moreover, if this basket of G-3 currencies is used, volatility among Asian currencies can be reduced. Finally, efforts to establish greater inter-currency stability require the creation of mechanisms and structures that provide for more rigorous oversight of each country's macro economy. [Yoshitomi, Tanaka]

Remaining Issues:

1) Discussions should take place on what type of comprehensive economic policies (stimulation of domestic demand, structural reforms, etc.) can be utilized in Asia to cope with a rapidly declining dollar. Further, what sort of economic policies in the United States would be most effective in helping reduce external deficits while at the same time producing minimal drag on economic growth?

2) Another potential topic for discussion is concrete measures to deepen currency cooperation. For example, what would be necessary to create an Asian Currency Unit (ACU) consisting of a basket of Asian currencies that excludes the dollar and the Euro

(which, along with the yen, make up the basket of G-3 currencies)?

(Editors: Hiroya Tanikawa and Masaru Yoshitomi)

<Reference 1>

RIETI Policy Symposium

Resolving New Global and Regional Imbalances in an Era of Asian Integration

PROGRAM

Day 1: Thursday, June 17, 2004

13:30-13:45 Opening Remarks: Sozaburo OKAMATSU (RIETI Chairman)

13:45-15:45 **Session 1: Determinants of the sustainability of the U.S. external deficit and the right policy mixes for adjustments**

Session Chair: Masaru YOSHITOMI（RIETI President and Chief Research Officer）

Paper Presentation

Eiji OGAWA (Professor, Graduate School of Commerce and Management, Hitotsubashi University)

Anne-Marie L. BROOK (Economist, Money and Finance Division, Economics Department, Organisation for Economic Co-operation and Development)

Discussants

Yoshiaki TOJO (Special Assistant to the Vice Minister for International Affairs and Director,International Economic Affairs Division, Trade Policy Bureau, Ministry of Economy, Trade and Industry)

〈Q&A〉

15:45-16:00 Coffee Break

16:00-17:30 **Session 2: The triangular trade pattern and its implications for global and regional imbalances**

Session Chair: Hiroya TANIKAWA (RIETI Senior Fellow)

Paper Presentation

Françoise LEMOINE (Senior Economist, Centre d'études prospectives et d'information internationales)

Discussants

Kyoji FUKAO (RIETI Faculty Fellow / Professor, Institute of Economic Research, Hitotsubashi University)

Peter M. GARBER (Global Risk Strategist, Global Market Research, Deutsche Bank Securities)

〈Q&A〉

18:00-20:00 Reception

Day 2: Thursday, June 18, 2004

9:00-10:30 **Session 3: Competition and collaboration among economic agglomerations and fragmentation of corporate functions**

- What lies beneath the increasing economic integration in Asia

Session Chair: Haruhiko KURAMOCHI (RIETI Vice President)

Paper Presentation

Fukunari KIMURA (Professor, Faculty of Economics, Keio University)

Masato HISATAKE (RIETI Senior Fellow)

Discussants

Tatsuo HATTA (RIETI Faculty Fellow and Research Counselor / Professor, Division of International Studies, International Christian University)

Masahisa FUJITA (Professor, Institute of Economic Research, Kyoto University / President, Institute of Developing Economies, JETRO)

〈Q&A〉

10:30-10:45 Coffee Break

10:45-12:45 **Session 4: Designing appropriate adjustment policies in Asia**
- Searching for the right policy mix of currency adjustments, monetary and fiscal policies, and structural reforms
Session Chair: Masaru YOSHITOMI（RIETI President and Chief Research Officer）

Paper Presentation

- Global and Regional Issues

Peter M. GARBER (Global Risk Strategist, Global Market Research, Deutsche Bank Securities)

Ichiro OTANI (Economic Policy Consultant / former Head, IMF Resident Representative Office in China)

- Country Issues

Li-Gang LIU (Assistant Professor of Public Policy and Finance, School of Public Policy, George Mason University)

Piti DISYATAT (Senior Economist, Monetary Policy Group, Bank of Thailand)

Discussants

YU Yongda (Professor, School of Public Policy and Management and Development Research Center for 21st Century and Director, Institute of Economic Cooperation, Tsinghua University)

Haruhiko KURODA (Professor, Hitotsubashi University / ex-Vice Minister of MOF of Japan)

〈Q&A〉

12:45-14:00 Lunch

14:00-16:00 **Session 5: Optimal exchange rate regime for Asia**
Session Chair: Ichiro OTANI (Economic Policy Consultant / former Head, IMF Resident Representative Office in China)

Paper Presentation

Soko TANAKA (Professor of International Finance, Faculty of Economics, Chuo University)

Albert KEIDEL, III (Deputy Director, Office of East Asian Nations, U.S. Department of the Treasury)

Discussants

Yunjong WANG (Vice President, SK Research Institute for SUPEX Management)

YU Yongda (Professor, School of Public Policy and Management and Development Research Center for 21st Century and Director, Institute of Economic Cooperation, Tsinghua University)

16:00-16:15 Coffee Break

16:15-18:00 **Session 6: Panel discussion**
- Searching for optimal adjustment policies in both the U.S. and Asia
Moderator / Panelist: Masaru YOSHITOMI（RIETI President and Chief Research Officer）

Panelists

Takatoshi ITO (Professor, The Graduate School of Economics and Research Center for Advanced Science and Technology, The University of Tokyo)

Li-Gang LIU (Assistant Professor of Public Policy and Finance, School of Public Policy, George Mason University)

Peter M. GARBER (Global Risk Strategist, Global Market Research, Deutsche Bank Securities)

Tadakatsu SANO (Vice-Minister for International Affairs, Ministry of Economy, Trade and Industry)

Others (to be announced on the day)

18:00-18:05 Closing Remarks: Tadakatsu SANO(Vice-Minister for International Affairs, Ministry of Economy, Trade and Industry)

*The agenda is subject to change.

<Reference2: Bibliography>

Brook, Sedillot & Ollivard (2004) "Channels for Narrowing the US Current Account Deficit and Implications for Other Economies" Conference Paper for RIETI

Garber (2004) "A Map to the Revived Bretton Woods End Game: Direct Investment, Rising Real Wages and the Absorption of Excess Labor in the Periphery" Conference Paper for RIETI

Hisatake (2004) "Changes in East Asian Regional Economic Structure during the Synamic Process of Economic Integration – from the point of view of New Geographical Economics" Conference Paper for RIETI

Keidel (2004) "Exchange-Rate Regimes and Capital Flows in East Asia" Conference Paper for RIETI

Liu (2004) "China's Role in the Current Global Economic Adjustment Process" Conference Paper for RIETI

Lemoine (2004) "China's Integration in Asian Production Networks and Its Implication" Conference Paper for RIETI

Obstfeld & Rogoff (2000) "Perspective on OECD Economic Integration: Implications for US Current Account Adjustment"

Ogawa & Kudo (2003) "The US Current Account Deficit is supported by the International Capital Inflows?" Hitotsubashi University, *Faculty of Commerce and Management, Working Papers, No92*

Ogawa & Kudo (2004) "How much depreciation of the US dollar for sustainability of the current accounts?" Conference Paper for RIETI

Piti (2004) "Rationalizing Asia's Foreign Reserve build-up" Conference Paper for RIETI

Tanaka (2004) "An Empirical Consideration of Monetary Cooperation in East Asia –In View of Experience with the European Monetary Cooperation" Conference Paper for RIETI

Yoshitomi & ADBI Staff (2003) "Post-Crisis development Paradigms in Asia" Asian Development Bank Institute

Points by Kuroda and Ito, and a part of points by Yoshitomi are taken from their respective remarks at the symposium.