

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?

(Editors: Hiroya Tanikawa and Masaru Yoshitomi)