Prospects of the East Asian Economy: The Global Imbalance and Challenges to East Asian Economies

Hyungdo Ahn
Director, Center for Northeast Asian Economic Cooperation, KIEP

1. Introduction

Transpacific imbalances have become the major point of dispute as to whether they will pose a threat to world economic stability. There are different views on the plausible risks that imbalances could cause. Sustained transpacific imbalances could pose a huge threat to the economic stability of the East Asian region. China, Japan, Korea, Taiwan, Hong Kong, and Singapore, and ASEAN 4 are at the center of the transpacific imbalance, accounting for more than 52.3 percent of the US current account deficit in 2006. China, Japan, and Korea, and Taiwan also hold the lion’s share of foreign exchange reserves, nearly 70 percent of the world’s foreign reserve holdings.

That being the case, we need to understand the risks faced and perceived by these economies and, more widely, East Asia to better formulate the agenda for policy cooperation in East Asian economies. This paper reviews the development and possible causes of transpacific imbalances over recent years. It also looks into the policy options available to East Asian economies to minimize the risks and considers an agenda for cooperation.

2. Development of Transpacific Imbalances

The US current account deficits have continued to worsen in recent years. In 2006, the US deficit stood at 869 billion US dollars (6.6 % of GDP) and is expected to continue to rise up to a record 959 billion dollars in 2007, which is about 6.9 percent of the US GDP. The current account deficit is more than six times that of 1997. The US has run a current account deficit for about a quarter of a century so far, except for 1990, and the growing speed since 2004 is alarming. The strategic devaluation begun in the second quarter of 2002 has failed to correct the growing current account deficit (Table 1).

The current account surpluses on the other side of Pacific Ocean, however, continue to rise. The current account surplus of Japan fell to 165.7 billion dollars (3.7 percent of GDP) in 2006 after it reached its peak of 172.1 billion dollars (3.8 percent of GDP) in 2004. The surpluses are expected to remain over the 3 percent level until 2007. The current account
surpluses of newly industrializing economies ("NIEs") hit a peak of 7 percent of combined GDP in 2004 and then fell to 5 percent in 2006. It is expected to stay at the 4.9 percent in 2007 according to IMF forecasts. The current account deficit surplus of Korea has shown a remarkable turnaround after it hit 4.1 percent of GDP in 2004. The Korean deficit fell down to 0.4 percent in 2006. In the meantime, the current account surpluses of Taiwan, Hong Kong, and Singapore will stay at a higher level. The current account surplus of China hit a historical record of 7.2 percent of GDP in 2005 and is expected to stay at that level in 2007.

3. Causes and Theories of Transpacific Imbalances

There are different views on the cause of transpacific imbalances. Dooley et al. (2003, 2004) argue that East Asia’s export-led strategy is the principal cause of the growing global imbalances and that it will block the adjustment that will reduce the transpacific imbalances. In their view, US trade deficits have persisted because East Asia is willing to finance them by accumulating an unlimited amount of dollar reserve assets in order to keep exchange rates undervalued.¹

Lee, Mckibbin and Park (2004) argue that low levels of private and public savings rates relative to investment is the principal cause of the US current account deficits. In 2005, the US gross national savings rate stayed at 13.6 percent of GDP. The national savings rate dropped continuously from over 19 percent in the 1980s. In particular, recent worsening of the US current account deficits reflects deterioration of public savings. On the other hand, East Asian current account surpluses reflect its high savings rates relative to investment.

Bernanke (2005) states that the global savings glut has encouraged savings outside the US and forced the US to live beyond its means. Balancing the federal budget will reduce the US current account deficit by less than one percentage point of GDP over the medium term.

The new economy view (Cooper, 2004; Clarida, 2005; Backus and Lambert, 2005) argues that the US deficit reflects the attractions of investing in the US and the consequent capital inflows that finance the country’s current account deficit. US consumption exceeds US production because Americans stand to benefit disproportionately from the high return on investment in the US.

Caballero et al. (2006) propose global portfolio balance models. This focuses on capital flows to the US, given its superior economic growth relative to Japan and the euro area, and the inability of other countries to create attractive financial assets at the same pace. Observers point to the superior growth and productivity performance of the US since the mid 1990s compared to Japan and Europe as the reason that both US residents and foreign investors

¹ Trade surplus of East Asian Economies reached a historic record of 373.6 billion US dollars in 2005 (Table 4).
are attracted by the rosy economic prospects and expected high returns from investing in the US rather than abroad.

According to the global bank view (Gourinchas and Rey, 2005), the US could run large deficits and carry large external debt relatively easily because US foreign investments earn a significantly higher return than foreign investments in the US. They assert that statistics are misleading and the US deficit is not a deficit at all. The US as the bank of the world offers liquid and low-risk, low-return assets while buying higher-yield assets from the rest of the world.

4. Risks of Transpacific Imbalances

Roubini and Setser (2005) claim that a correction is inevitable because the US external indebtedness is on an unsustainable path. The current account deficit is approaching 7 percent of the US GDP. Assuming policies remain unchanged at home and abroad, this deficit balance will continue to widen, approaching 10 percent at the beginning of the next decade. Eichengreen (2004) claims that there will have to be a significant adjustment: that neither foreign investors nor foreign central banks will be prepared to continue financing US current account deficits at the current levels indefinitely. They believe the US deficit has to fall to some 3 percent of the US GDP in order to reduce the rate of growth of foreign claims on the US to a sustainable 60 percent of the US GDP. In turn this will require a further real effective depreciation of the dollar of at least 20 percent. The longer the adjustment is delayed, the larger will be the existing stock of US external liabilities, and the sharper will have to be the increase in net exports in order to service it.

According to the World Bank (2005), there are channels through which a sharp depreciation of the dollar and a sudden compression of the US current account deficit will impact emerging markets. On the positive side, a declining dollar will reduce the cost of servicing dollar-denominated debt. This effect favors relatively heavily indebted countries, where the reduction of debt burdens is particularly valuable, and dollar borrowers, where the exchange rate change works in their favor. On the negative side, rising US interest rates and declining US Treasury prices could precipitate a flight to quality that heightens volatility in emerging financial markets. Emerging markets will also feel a negative wealth effect from capital losses on their foreign reserves.

The abrupt elimination of foreign financing for the US current account would force the country’s net imports to decline by 7 percent of the US GDP. This could have serious consequences for emerging markets, even more serious than the impact of higher interest rates. A disorderly correction of the US current account imbalances will have the largest impact on

---

2 Chinn and Ito (2005) share the same view.
emerging markets mostly dependent on exports to the US. East Asia is more vulnerable than Latin America mainly because the East Asian region is more open and more linked to the US.

We may consider three resulting scenarios from the transpacific imbalances. First, the sharp depreciation of the US dollar and sharp appreciation of East Asian currencies in the process of adjustment will disrupt the foreign exchange markets, and a situation similar to the financial crisis in 1997 may arise again. Sudden compression of US demand as a result of the sharp depreciation of the dollar means sharp decline of East Asian exports to the US and a subsequent recessionary outcome to both the US and East Asian economies. Second, East Asian economies will take severe capital losses as these economies hold a large share of their reserves in the US dollar. The competitive adjustment efforts by Central Banks of East Asian economies will cause disruption in foreign exchange markets around the world. Third, trade imbalance will provoke trade disputes between the US and East Asian economies and protectionism in the US. The liberalization efforts of the world trading system will be negatively affected and the process delayed.

5. Perspectives from China, Japan, and Korea: Causes and Remedies

China is running a current account surplus that was mostly moderate during the 1980s and 1990s, but has been increasing dramatically since 2002. China’s international balance of payments structure characterized by the so-called twin surpluses emerged in the middle of the 1990s. The persistent twin surpluses have resulted in the continuous increase in foreign exchange reserves. In the past, the main contributor to China’s accumulation of foreign exchange reserves was the capital account surplus, more precisely, foreign direct investment (FDI) inflows. However, the current account surpluses superseded FDI to become the more important contributor to the increase in the foreign exchange reserves. Why does China run a current account surplus consistently while attracting large amounts of FDI?

The first and most popular explanation is the savings-investment gap. While China’s investment rate is very high, its savings rate is even higher. Especially, after the middle of the 1990s, China’s savings rate has become persistently higher than its investment rate. It seems that there is a strong correlation between current account surpluses and the savings-investment gap. (Yu, 2006).

The second factor contributing to China’s current account surplus is the government’s export promotion policy, which includes self-balancing regulation, exchange rate policy, and tax rebates. In the early stage of reform and opening, how to avoid a balance of payments crisis caused by excessive borrowings and persistent trade deficits was the main concern of the government. Therefore, the government demanded foreign investors guarantee the self–
balancing of foreign exchange for important foreign investment projects. In other words, FDI must be export-oriented. As a result, while FDI was introduced, corresponding trade deficits were minimized.

The third factor is China’s position in the global division of labor. Until quite recently, the economic relationship in East Asia was characterized by the so-called flock formation of flying wild geese. In the later 1980s, a new pattern of regional division of labor began to take shape. As a result of the development of international production networks, processing trade became the dominant form of trade among less developed countries. The increasing dominance of processing trade means that China must run increasingly more current account surpluses. In this sense, China’s current account surplus is structural and something that cannot be changed in a short period of time.

To reduce the twin surpluses from the Chinese perspective, comprehensive measures should be taken, including macroeconomic policy, trade and FDI policy, deepening of financial reform, and capital account liberalization. To reduce the current account surplus, the savings-investment gap should be reduced. To narrow the savings-investment gap either consumption or investment should be increased. Because China’s current investment rate is already too high, the focus should be on increasing consumption. In order to do so, government expenditures on public goods must be increased. Preferential policies towards FDI should be abolished so that domestic and FDI are given equal treatment in terms of credit access, tax treatment, environmental requirements, and so on. As a result, round-tripping FDI will be reduced, and FDI that is not viable without all sorts of subsidies will stop flowing into China. Export promotion policy should also be abolished gradually. More money should be spent on buying more foreign goods, especially those of strategically important goods and materials. China’s enterprises should be encouraged to invest abroad both in the form of greenfield investment and mergers and acquisitions. The renminbi exchange rate should continue to appreciate gradually. This is a more efficient way of correcting China’s imbalances; however, to use the exchange rate change as an instrument to achieve trade balance might lead to great exchange rate fluctuation. After the Plaza Accord, despite the dramatic revaluation of the Japanese yen and the slide in the US dollar, US trade failed to improve in any significant way but succeeded in causing tremendous hardship to the Japanese economy.

Japan has run higher rates of current account surplus since the Asian financial crisis. In 1997, the current account surplus was 2.3 percent of GDP and it rose to 3.7 percent in 2006. In the 1980s, Japan was criticized for its high current account surplus. As a result of the Plaza Accord, the Japanese yen was revalued as much as 53.7 percent in 1988. Despite this magnitude of revaluation, Japan didn’t see much improvement in its trade balance against the US mainly due to a stable real effective exchange rate.
Japan’s large current account surplus reflects the weakness of investment and consumption demand, which are symptoms of a decade-long slump. Therefore, the most important thing the country can do to resolve the global imbalances is to revive its economy. Unless Japan is prepared to absorb more goods and services not only from the US but also from other East Asian economies, the external pressure on the rest of East Asia to expand domestic demand will not be heeded. Recent forecasts show that Japan is finally emerging from its decade-long deflation. The recovery is powered by exports. Macroeconomic forecasts suggest that the growth of exports should in turn stimulate investment and consumption spending. Japan’s recovery will be good for economies that export heavily to Japan and for countries whose export structure closely matches the composition of Japanese import demand. Recently though, the yen has weakened against the dollar. As a result of this weakness and the deflationary trend, over the three-year period beginning in 2003, the yen has depreciated in real effective terms by almost 15 percent in contrast to a large appreciation of the won and a strengthening of the renminbi. The yen’s depreciation complicated exchange rate policy in other East Asian countries. If the appreciation of East Asian currencies is to be engineered to resolve global balances, the yen’s depreciation has to be reversed.

Given the modest pace of recovery, there is the concern that any increase in the interest rate intended to restore the normalcy of monetary policy could choke off growth and plunge the economy back into recession. Higher interest rates would slow investment demand and thereby further limit Japan’s contribution to global rebalancing. In sum, the most important contribution Japan can make to the resolution of the global imbalance is to sustain its fragile recovery.

In the case of Korea, sharp adjustment of the current account surplus has occurred in 2006. This is quite a different phenomenon from China and Japan. The Korea Development Institute forecast that the current account surplus of Korea will fall down to 3.3 billion dollars in 2006, an extraordinary drop from the previous year’s16.6 billion dollars. Korea sustained a fiscal deficit after the Asian crisis and the ratio of national debt to GDP went up to 31.9 percent in 2005. Recent revaluation of the Korean won seems to be a major force that makes current account adjustment possible. Korea seems to be the only country in the region that resolves the imbalances through market forces. However, since the current account surpluses of China and Japan remain still high and these countries show few efforts to resolve the global imbalances in the region, the risks from global imbalances still remain. Korea has been most active in implementing an expenditure switching policy by combining an increase in government spending with an exchange rate appreciation.

6. Cooperation Agenda in East Asia
Across the board appreciation of East Asian currencies will constitute the most important component of the resolution of global imbalances. However, if China insists on maintaining its limited flexibility, other countries will not likely let their currencies appreciate against the renminbi. This requires policy coordination. China’s move to a more flexible exchange rate in July 2005 was significant. In recent strategic dialogue, China and the US further agreed to allow more flexibility in the Chinese exchange rate system. However, Japan’s yen is depreciating against major currencies, counter to the movement of other East Asian economies. It is a problem if Japan does not want to participate in a regional framework for exchange rate coordination. This is because the yen is a free-floating international currency and Japan has a relatively small external sector, making it less sensitive to currency fluctuations.

This suggests that East Asian economies except Japan have to work out an agreement to coordinate exchange rate adjustment. Japan is running a trade deficit with all of the East Asian economies. The group of East Asian emerging economies on the other hand has been running a surplus in its trade with China but a large deficit with Japan. Because of their nature of bilateral imbalances, if the yen is not expected to appreciate, China and other emerging economies will not go along with the joint appreciation for fear of deepening their persistent structural trade deficits with Japan. This underscores the need to bring Japan into a regional arrangement for exchange rate policy coordination. Regarding exchange rate policy, unless China is ready to move to a more flexible regime, no other economy will be able to provide leadership. China produced a triangular trade relationship among China, the US, and Japan plus East Asia’s emerging market economies. In this relationship, Japan and East Asia’s emerging market economies export capital goods and intermediate inputs to China. China in turn uses these capital and other intermediate goods to produce a wide variety of manufactured goods that are exported to the US, EU, and other countries. The implication of this vertical integration in production is that China holds the key to exchange rate adjustment in East Asia.

Unless Japan is prepared to absorb more goods and services not only from the US but also from the other East Asian economies, the external pressure on the rest of East Asia to expand domestic demand will not be heeded. If Japan makes headway in reviving its domestic economy, other East Asian economies will also fall in line to cooperate with Japan and the US to take appropriate action to resolve the imbalances. Since it is essential that East Asia as a whole embrace a more domestic demand-based growth strategy to readjust the transpacific imbalance, Japan should take the lead. Unless Japan moves out of its economic doldrums, one cannot have much hope for restoring balance between the two sides of the Pacific.

Some of East Asia’s emerging economies, including Korea, have undertaken or are planning to initiate large public investment projects while others have loosened capital account
controls to facilitate capital outflows. The currencies of Korea and ASEAN 4 have recently appreciated in real effective terms and will continue to do so if the dollar depreciates against the euro and yen. Many forecasts suggest that the current account surplus will continue to remain at 3 to 4 percent of GDP in Japan and 7 percent China in 2007 and thereafter. This implies that transpacific imbalances between East Asia and the US will largely become an imbalance between Japan and China on the one hand and the US on the other. This means that leadership in resolving imbalances should come from these two countries.

References


