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RIS Policy Briefs

Managing Global Macroeconomic Imbalances:

The US Current Account Deficit, Exchange Rate Flexibility and Asian Reserves

Behind the Global Imbalances

It would be only a slight exaggeration to suggest that many of the macroeconomic imbalances that currently plague the global economy are connected in some way to the persistent and burgeoning US current account deficit (CAD) which has ballooned to over 5 per cent of GDP. The CAD, which is a reflection of national dissavings, is expected to be even higher by the end of 2004 once the projected increases in US defence-related spending and tax cuts materialise.

There are broadly two perspectives regarding the cause of this global imbalance, viz. those that focus on the current account itself, and those that deal with the financial or capital account. As we shall see, both converge to a broadly similar judgment regarding its solution.

The commonly held view is that the US can improve its external competitiveness by allowing the US dollar to weaken against major trading partners, particularly those with which it runs large bilateral deficits, viz. China and Japan.

The US dollar has declined significantly in recent months against many currencies but not against the Chinese yuan which is rigidly pegged to the dollar. While the Japanese yen has appreciated somewhat against the US dollar, implicit or explicit intervention in the foreign exchange markets by the Bank of Japan has limited the rise of the yen (though the yen has appreciated significantly since the G-7 meeting in Dubai in September 2003).

Thus, the bulk of the adjustment of the US dollar has hitherto primarily been vis-à-vis the Euro, British Pound, the Australian, Canadian and New Zealand dollars and some Latin American currencies. On a real trade weighted basis, the US dollar remains higher than its recent trough in 1995, suggesting significant scope for further decline in the currency. It is in this light that many observers have advocated that the Asian currencies, particularly the Chinese yuan, be allowed to be more market driven or flexible.

Against the background of weak domestic employment and looming elections, some US congressmen have demanded that punitive trade sanctions be imposed on China by the US Trade Representative (USTR) or the World Trade Organization (WTO) if it fails to revalue the yuan. These overt protectionist calls are of concern, though thus far remain a minority opinion largely aimed at appeasing domestic constituencies.

A less commonly expressed – but growing – point of view regarding the US CAD is based on the financial or capital account side of the ledger. The argument here goes something as follows. The US CAD is nothing but a reflection of a desire by non-residents to hold US assets. A large part of this demand in turn arises from Asian central banks' holdings of foreign reserves, much of which is denominated in US dollars. In other words, the US financial account surplus is viewed as driving the country's CAD rather than merely being a function of it.

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RIS 20 Years (1984-2004)

Reserve Stockpiling in Asia

To be sure, Asian central banks hold about two thirds of global reserves (amounting to about US$ 2.3 trillion), about three quarters of which is denominated in liquid US dollar assets (usually US Treasuries). In just over six years, global international reserve holdings rose markedly from US$ 1.5 trillion in 1996 to US$2.3 trillion by mid 2003. The bulk of the reserves growth has been concentrated in Asia, much of which is invested in relatively low yielding liquid US assets such as Treasury bills. Accordingly, it is sometimes noted, tongue-in-cheek, that "Asian frugality is financing American excesses".

The large and rising reserve holdings by Asian countries is presumed to be a consequence of undervalued exchange rates as their monetary authorities have attempted to keep their respective currencies stable in the face of significant buying pressure by selling their currencies. If these countries forsaked their mercantilist currency policies and permitted a greater degree of flexibility of their respective currencies, this ought to reduce demand for international reserves, curb capital inflows into the US, and thus moderate the US current account.

If, however, one accepts that capital flows are in fact driving rather than passively financing the current account, sudden offloading of US Treasuries could either lead to a sharp US dollar depreciation or necessitate a marked interest rate hike, either of which could be acutely destabilising to financial markets and the global economy. In any event, the relevant point here is that there is a convergence of opinion regarding the need for greater flexibility in Asian currencies.

Nonetheless, as long as there is no change in the US national dissavings position, inroads will not be made in reducing the country's CAD. One could, for instance, envisage a case where a rise in Asian currencies (particularly the yuan) could lead to a reduction in the domestic prices in China, such that real exchange rates remain more or less unchanged. In such circumstances, the consequence of a yuan appreciation is simply to exacerbate global deflationary pressures.

The most effective way of reducing the US CAD is to attack the problem head on by reducing the US budget deficit or raising household savings. Any other proposed remedy is akin to the "tail wagging the dog" and is destined to fail.

Exchange Rate Inflexibility in Asia: Mercantalism or Risk Aversion?

But where does that leave the issue of Asian currencies and reserves? Calls for greater flexibility of Asian currencies (as recently done by the IMF as well as the G-7 members following the September meeting) and consequent reduction in reserves ought not to be based on whether they help trim the US CAD. Rather, the most convincing case for more flexible currencies is the benefits they offer to China and other Asian economies (such as Hong Kong and Malaysia).

Among the most important of benefits of a flexible exchange rate regime pertains to adjustment to adverse external shocks. In the absence of some degree of exchange rate flexibility, adjustment to these shocks will have to take place domestically via changes in output and employment or costs and prices. This can be extremely long lasting and painful, as experienced by Argentina and Hong Kong in recent years.

Even if the Asian countries like China are convinced about the virtues of more flexible exchange rates *at* some stage in the future, as long as there is a desire to stockpile reserves, there will remain a degree of currency undervaluation vis-à-vis the rest of the world. In other words, reserve accumulation by many Asian countries may not entirely be a consequence of the *de facto* mercantilist policies pursued by some Asian countries. What evidence is there of this?

First, a country like India which has generally not been known for pursuing aggressive mercantilist exchange rate policies (compared to its East Asian neighbours), has seen an exceptionally brisk growth in reserves. India's reserves grew from about US$ 30 billion in 1997-98 to about US$ 75 billion by 2002. (A further build up of US$ 25 to 30 billion took place during 2003 largely due to US dollar weakness.)

Second, the rapid reserve build up in Asia began in earnest 1998, a time when the US dollar was at its peak, many East Asian countries had depreciated sharply (a result of the 1997-98 crisis), and there were consequently few fears of loss of export competitiveness.

Third, notwithstanding some obvious exceptions, there has undoubtedly been a generalised move to *relatively* greater degree of exchange rate flexibility in Asia. Other things being equal, one would expect that this reduced exchange rate rigidity would imply a concomitant moderation in reserve levels as payments imbalances ought to self-adjust with movements in the exchange rate.

The key here is "other things being equal". The rapid reversals in capital flows and the ensuing crisis of 1997-98 appear to have led to a paradigm shift in the way many Asian policymakers perceive capital account openness and the risks associated with them. There is a general belief, partly substantiated by facts, that countries with larger reserve holdings have by and large been better able to shield themselves from contagious spillovers than those with smaller reserves.

It is apparent from the above that reserves are viewed as a means of managing financial insecurity and as safeguards against unanticipated exogenous shocks. Indeed, even a country like New Zealand, which operates a highly flexible exchange rate, has chosen to maintain a certain war chest of reserves so as to improve foreign investor confidence (though most of the reserves are borrowed).

Implications for Asia and India

Seen in this light, Asia's stockpiling of reserves might be an objective in itself rather than merely a residual outcome of exchange rate or monetary policy. However, the costs of this policy are not insignificant, as the country is effectively swapping high yielding domestic assets (or forsaking the use of these reserves for domestic development projects) for lower yielding foreign ones (US T-bills and bonds). Highly conservative estimates put this cost at anywhere between 0.5 and 2 per cent of GDP annually.

Beyond efficient management of reserves, regional economies could benefit from scale economies by pooling some part of their reserves. An obvious starting point in this regard would be to reinforce and augment the existing regional swap arrangement (Chiang Mai initiative) as well as extend it to a broader set of countries in the region with high reserve levels. Intensive discussions are ongoing in policy circles in Asia on various possibilities along these lines.

Given India's increasing economic dynamism, rising level of reserves, and progressively deepening real sector economic integration with some East Asian countries, it should actively engage its East Asian neighbours and attempt to become a key player in these regional monetary and financial initiatives. In particular, India could participate in the Chiang Mai Initiative among other initiatives which would be consistent with India's growing economic integration with East Asian countries in general and with ASEAN countries in particular.

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- *Indian Industrial Tariffs: Towards WTO Development Round Negotiations* by Rajesh Mehta. 2003.
- *Protecting Foreign Investment: Implications of a WTO Regime and Policy Options* by Carlos Correa and Nagesh Kumar, Zed Books Ltd., London and Academic Foundation, New Delhi in association with RIS, 2003.
- *Globalization and the Quality of Foreign Direct Investment* by Nagesh Kumar, Oxford University Press, New Delhi, 2002.
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