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Asia faces capital conundrum
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In discussions of international payments imbalances, the focus has been on the United States's current account deficit. This is understandable — it is the largest, and a deficit is always viewed as more serious than a surplus. But in terms of resource misallocation, the substantial surpluses in East Asia's emerging economies are just as important.

These are intrinsically dynamic economies. If capital were flowing to the highest-value use, these countries would be capital importers rather than exporters, with the flows funding current account deficits. Instead, they are running current account surpluses, with the excess funding going into low-return holdings of foreign exchange reserves.

Instead of the surplus savings of mature capital-abundant countries flowing to emerging countries with many unfulfilled profitable opportunities, international capital is flowing in the opposite direction — to the US to fund, among other things, the war in Iraq and tax cuts for the rich.

How did this come about, and what might be done to address this anomaly?

In the first half of the 1990s, the flows were not only in the right direction but were very large. In the five years before the 1997 Asian crisis, the affected countries averaged private capital inflow equal to about 5 per cent of gross domestic product each year.

The crisis changed this: as exchange rates fell, foreign investors fled, and domestic residents who had borrowed in foreign currency attempted to cover their exposure. Almost instantaneously, these countries had to adjust from running large current account deficits funded by inflow to achieve large current account surpluses to fund the outflow, and the only way this could be done was for the currency to depreciate dramatically (overshooting the equilibrium in the process) and for GDP to contract sharply, together producing a huge fall in imports.

Nearly eight years have passed since the crisis, but the memory of the economic chaos and exchange rate overshooting has made domestic borrowers and foreign lenders very conscious of currency risk, with the result that they now build a large risk premium into their capital flow decisions.

The only country now receiving substantial flows of foreign direct investment is China (where the expectation is that the yuan will appreciate at some stage, which would give foreign investors a windfall profit). Governments in the crisis countries have been content to take out insurance against a repeat of this capital reversal by building up foreign exchange reserves, helping to hold down any appreciation of their currencies.

For all the post mortem analysis that has taken place since the crisis, this paradox has not yet been resolved in a convincing way.

The conventional wisdom coming out of the crisis was that these countries should have had flexible floating exchange rates, and if they had done this, all would have been well: residents

borrowing in foreign currency would have been sharply aware of their foreign exchange risk and would have hedged their borrowing, protecting themselves when the crisis came.

Floating, in this view, not only solves the problem of volatile capital flows but is the panacea urged on China and the other Asian surplus countries to address the post-crisis current account imbalances.

Let us quickly pass over the uncomfortable fact that floating exchange rates, for all their merits, have been inexplicably volatile even in countries with deep financial markets, and ask the narrow question: would floating exchange rates have protected these countries from volatile capital reversals?

There is a fatal flaw in the conventional logic: if the capital flows are large, it will be difficult or impossible for all (or even most) of the country's currency risk to be hedged. An individual borrower can hedge the currency risk by shifting it to another resident. There may be some opportunities to shift the risk to a resident who has some natural offsetting currency exposure — for example, exporters who earn income in foreign currency.

But for capital inflow countries, there is an overwhelming imbalance in the opportunities for natural hedges. Importers as well as borrowers will be seeking to hedge currency exposure, and imports are larger than exports, so the available natural hedges for borrowers are essentially already used up.

Can the market sort this out through the price of hedging? Interest arbitrage requires that the basic cost of hedging should be equal to the interest differential between the two currencies, so the only way the market can sort this out is by buying foreign assets. But this purchase of foreign assets reverses the capital inflow, so doesn't help the basic problem of facilitating capital flows towards emerging economies.

If hedging is not the antidote to capital reversals, there is another way the domestic borrower might be protected from currency risk: by persuading the foreigners to make loans denominated in local currency. It is, however, very difficult to persuade foreigners to take on this currency exposure.

Even if foreigners could be persuaded to lend in local currency, this addresses only a part of the problem. Domestic borrowers would no longer suffer large balance sheet losses when the exchange rate fell — the foreigners would be bearing this loss. But the critical issue is the capital reversal, not where the balance sheet loss resides.

Foreign investors, seeing the exchange rate fall and extrapolating this into the future, will take their capital out, and the traumatic adjustment process seen in East Asia in 1997 will be repeated.

Once the capital reversal occurs, the current account must go through a corresponding dramatic adjustment because its funding has been lost. The only way of achieving this sort of rapid adjustment is through large exchange rate and GDP falls, which together bring about the necessary fall in imports.

The nature of the trauma may be different if the foreigners are holding the currency risk, but traumatic it will still be.

No trick of financial engineering or risk shifting can make much difference to the basic underlying reality that when there are capital flows — borrowing and lending across national

borders with different currencies — one of the parties is left with currency exposure, and when exchange rates start to move, this party will wonder whether it should get the money back before more is lost

There may be some Australian history relevant to this conundrum. In 1986, when the Australian dollar fell suddenly by more than 25 per cent, there was no evidence of significant capital reversal — in fact, the overall inflow remained hugely positive, funding a continuing large current account deficit.

Did investors behave as the textbooks suggest they should, and see each movement of the exchange rate as achieving a new equilibrium, without extrapolating the fall into the future? Or did they accept that they couldn't pick the turning point in the dollar and were prepared to sit it out, knowing that in the long run, the currency movements were cyclical rather than secular?

The answer isn't clear, but a more general proposition may be relevant: that the combination of a managed float (obviating the possibility that the exchange rate would fall by 80 per cent, as experienced by Indonesia in 1997), sensible macro-economic policies and a sound institutional framework meant that there was, in fact, no chance of Australia falling into the "banana republic" camp.

If speculators got their timing exactly right, they might make a killing by shifting currency; but longer-term staid investors who stuck it out would not be seriously disadvantaged.

So the answer is not to be found in some configuration of currencies but in establishing a broad degree of investor confidence in macro-economic policy, the financial and legal institutions and good governance (in the narrow sense applying to corporations, and more broadly to cover the way the economy is run).

Restoring a normal inflow of foreign capital to South-East Asia is not a matter of a single change. One element will be rebuilding confidence in the climate for investment, through improvement of institutions and governance.

When the attractiveness of investment rises, so will the readiness of foreigners to fund and participate. They bring more than their funds: they often bring technical knowhow and export-market access, so there are powerful reasons to think the present outflow of capital and current account surpluses is a symptom of forgone opportunities.

So these countries should be eager to play their part in correcting the overall global imbalances, with their surpluses falling in lock-step with a reduction in America's deficit.

An increasingly globalised world implies bigger capital flows in the future, and the huge flows to the East Asian countries before the crisis are a reminder that the current direction of flow is an aberration. But when these inflows return, greater stability of the flows seems essential if their potential benefits are to be realised.

It is naive and irresponsible to suggest that floating the exchange rates will satisfactorily resolve these issues. If nations are to collectively discuss remedies for global imbalances, haranguing China to float its exchange rate is not only counterproductive but also ignores valid concerns.

The exchange rate is one element in the equation, but it seems unlikely that a textbook free-float is the right answer, at least until these countries develop deeper financial markets and

strong governance. There must be confidence that the exchange rate will not be subject to balance-sheet-destroying shifts.

The "best-practice" model for emerging countries may be Singapore, with its floating but sometimes heavily managed rate, which exposes capital flows to modest short-term exchange rate risks and gradual secular shifts, but provides strong implicit backing to prevent a large sudden movement.

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