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**The Asian side of the coin**
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IT TAKES TWO TO ADJUST

| | Foreign exchange reserves ($bn, end 2003) | Current account ($bn, IMF est for 2004) | Current account as % of GDP |
|---|---|---|---|
| US | | -649 | -5.4 |
| China | 408 | 38 | 2.4 |
| Japan | 663 | 158 | 3.4 |
| Korea | 155 | 20 | 3.1 |
| Taiwan | 207 | 22 | 6.9 |
| Hong Kong | 118 | 16 | 10 |
| Thailand | 42 | 6 | 3.8 |
| Indonesia | 36 | 7 | 2.9 |
| Philippines | 13 | 2 | 2.8 |
| Malaysia | 45 | 14 | 12.4 |
| Singapore | 96 | 26 | 25.7 |

Almost everyone agrees that the US current account deficit is unsustainable. But there are two sides to every balance of payments adjustment: to the extent that East Asian surpluses are the counterpart of the US current account deficit, there has been less attention on how the adjustment will play out in the region.

What discussion there has been focuses on China, usually accompanied by demands that the yuan be allowed to float, perhaps with simultaneous removal of capital controls.

The received wisdom is that East Asian countries have actively intervened to hold down their currencies, adding to their already huge foreign exchange reserves, and these currencies should also appreciate. Indeed, Asian reserves have risen since 2001 by $US1.2 trillion ($1.54 trillion), equal to about two-thirds of the cumulative US deficit over that period.

The coda to this argument is that this situation is only sustainable while these countries are prepared to increase their US dollar foreign exchange reserves, which becomes increasingly doubtful because of the US dollar's depreciation.

So Asia is both the facilitator of the continuing US imbalance and the potential catalyst for sharp adjustment.

As is usual with East Asia, the generalities do not capture the diverse reality. Where are the counterpart current account surpluses?

Take China first. Surplus countries are inevitably under less pressure to adjust than deficit countries.

China's current account surplus is not all that large: it had been running at 1 to 2 per cent of GDP, and this year it is expected to be 2.4 per cent of GDP, or about $US40 billion. What attracts attention in the US is the bilateral balance, which is running at about $US120 billion.

True, reserves are more than adequate (now more than $US500 billion), but this reflects capital inflows (running at well over $US100 billion) more than current account surpluses, and foreign investment (nearly half this inflow) brings with it technology and access to markets.

A build-up of low-earning reserves may be an acceptable price to pay for liquidity in an uncertain world (where, for example, every $US5 of oil price increase worsens the current account by 0.3 per cent of GDP).

Further, the adjustment process should be analysed not just in terms of exchange rates and trade elasticities but also in terms of the counterpart savings-investment balance.

The US savings-investment imbalance can be easily identified (huge budget deficits and abysmally low private savings), but it is not so easy to spot the imbalance in China. To reduce its current account surplus, China has to increase investment (which many observers think is already excessive) or reduce savings. Should the world be telling the Chinese not to save so much?

That said, a more active Chinese role in the adjustment is in its own self-interest. While the direction of the yuan seems a "sure bet", this will encourage speculative capital inflow. The Chinese economy is still running hot, and an appreciation will tip some of the excess demand into imports and help keep inflation in check.

The issue may be more about the technical implementation. The US and the IMF seem to be encouraging the Chinese to adopt a free float. But China would have good reason to be wary of this advice — even currencies with mature financial sectors and a long history of floating have experienced disruptive short-term swings.

A better path may be the one suggested by Morris Goldstein of the Institute for International Economics: a once-off appreciation of sufficient magnitude to remove the one-way bet on the yuan (a 15 to 25 per cent shift), together with a restructuring of the new peg in terms of a basket of currencies (in the past two years the Chinese effective exchange rate has perversely depreciated by more than 10 per cent due to its fixed link with the depreciating dollar), while retaining capital controls for now.

But how far will this go to resolving the US deficit? China makes up only 10 per cent of the US Federal Reserve's exchange rate index. If China moves to current account balance, that is a change of less than $US50 billion, compared with the US deficit of $US500 billion.

The argument is that once China moves, the rest of Asia will follow, and if Asia is taken as a whole, it accounts for about one-third of the Fed's exchange rate index. However each Asian country is in a different situation. To start with, most have already appreciated by about 10 per cent against the US dollar over the past two years (Japan by significantly more).

Japan is tentatively emerging from its 15-year stagnation and is understandably reluctant to let the yen appreciate much more. Faster growth will help, but policy is not able to engineer this. Monetary policy is already holding a slack rein. On fiscal policy, who wants to tell the Japanese to increase their budget deficit when they are already overburdened with government debt? Until the corporate sector finishes restructuring, its savings will continue to drive the current account surplus.

What about the countries affected by the 1997 crisis, which forced them to adjust rapidly from major current account deficits to achieve substantial current account surpluses? Seven years after the crisis they still have surpluses.

The Koreans and the Thais, with the memory of the Asian crisis still fresh, may be reluctant to stop accumulating reserves. They certainly don't want to stimulate economies that are already growing fast. That said, there may be room for them to allow their currencies to appreciate if the yuan strengthens.

For Indonesia and the Philippines the adjustment should be in the form of a return to higher levels of investment, but their business sectors are not yet ready to do this.

The message to come out of this is that some of the counterpart adjustment to the US deficit may be found relatively painlessly in Asia, but not much. The rest will either be painful (for example, in Japan) or elsewhere.

The head of the European Central Bank talked recently of the "brutal" appreciation that has already occurred with the euro, but Germany is running a 4.4 per cent of GDP surplus in a position not dissimilar to Japan.

Part of the answer may be time — giving the Japanese corporate sector time to finish its restructuring, and giving the rise in the euro time to impact on trade volumes.

One other powerful message comes out of all this. In the face of this impending adjustment, which must impinge on all Asian countries to a greater or lesser degree, these nations find themselves in different situations, with the opportunity to use their individual exchange rates actively to help buffer the adjustment.

The case for tying themselves together in a single East Asian currency seems very weak indeed.

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