

Economic Policy Co-ordination is Needed to Re-align Global Imbalances

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The accumulation of foreign exchange reserves in East Asia has reached heights that could not have been imagined during the crisis of 1997-98, yet it continues. At the end of 2004, international reserves in seven East Asian economies – Japan, China, South Korea, Taiwan, Singapore, India and the Hong Kong Monetary Authority – stood at US \$2.3 trillion. This means that some 60% of total international reserves in the world economy were held by economies representing only about 40% of world GDP. If the current pace of reserve accumulation continues, Asian reserves would represent over 75% of global reserves within five years. Has this been caused by the economic structures of these countries and their economic policies, or is this just the inevitable counterpart of the immense United States current account deficit? Or are Asian surpluses and US deficits both the consequence of a 'world savings glut' whose main source is the major emerging market countries? The authors of the seventh publication in the series of the **ICMB/CEPR Geneva Reports on the World Economy, 'Official Reserves and Currency Management in Asia: Myth, Reality and the Future'** reach a number of controversial conclusions and make several policy recommendations to correct the current global imbalances:

- The Report argues that global coordination of expenditure-reducing/increasing policies and exchange rate adjustments between East Asia, the US and the EU will be necessary to achieve the least-cost adjustment to current account imbalance between the three. To this end the authors propose another Plaza Accord among the three regions for policy adjustments and co-ordination.
- While it is beyond doubt that the level of reserves in the region is larger than most measures of reserve adequacy, the authors dispute the idea that the reserve build up is driven by deliberately undervalued exchange rates.
- An examination of external payments data shows that the increase in reserves, particularly in China, has been due principally to FDI and speculative inflows, not only to current account surpluses.
- China is simply too small to be responsible for the US deficits or to be able to correct them. Since 1997 the US current account has deteriorated by \$529 billion. Over the same period, China's current account position improved by \$35.6, or just 7% of the deterioration in the US position. This

is small in absolute terms but also in relative terms, as China's share of world GDP minus the US is 16.7%.

- Reducing the current account deficit in the US requires the national savings rate in this country to be increased. Exchange rate adjustment is not a particularly powerful method of achieving this. Appreciation of the Chinese renminbi should not therefore be viewed as the principal solution to global current account imbalances even if it might have a useful supplementary role to play.
- The Report argues that the dominance of the US dollar assets in official reserves, compared to the effective size of the dollar area – measured as that part of the world in which the dollar exchange rate is relatively stable – was not excessive before the recent changes in the Chinese exchange rate regime.
- If the renminbi goes on to effectively join the regional tendency for currencies to be managed relative to a basket of currencies, then the ground may be laid for some more diversification of official reserves out of the dollar. The Report argues that the effects of any such diversification on US dollar exchange rates may be limited.
- Data on reserve composition shows that diversification has already taken place out of US Treasury bills into longer-dated US government and other obligations. It has been suggested that this increased demand for longer-dated securities through heavy central bank intervention may have served to hold down long-term interest rates. The authors review the evidence and find it far from conclusive.
- As a means to promote a better allocation of Asia's accumulated savings it could be useful to establish an Asian Investment Corporation which would pool a portion of Asia's reserves and manage them on commercial grounds as a national wealth fund.
- The authors argue that region-wide monetary unification, EMU style, is far off since the largest three economies – China, Japan and South Korea – are unlikely to give up their monetary independence.

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