Trans-Pacific Imbalances

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I. Facts

II. Various Views

III. Impacts of the Correction

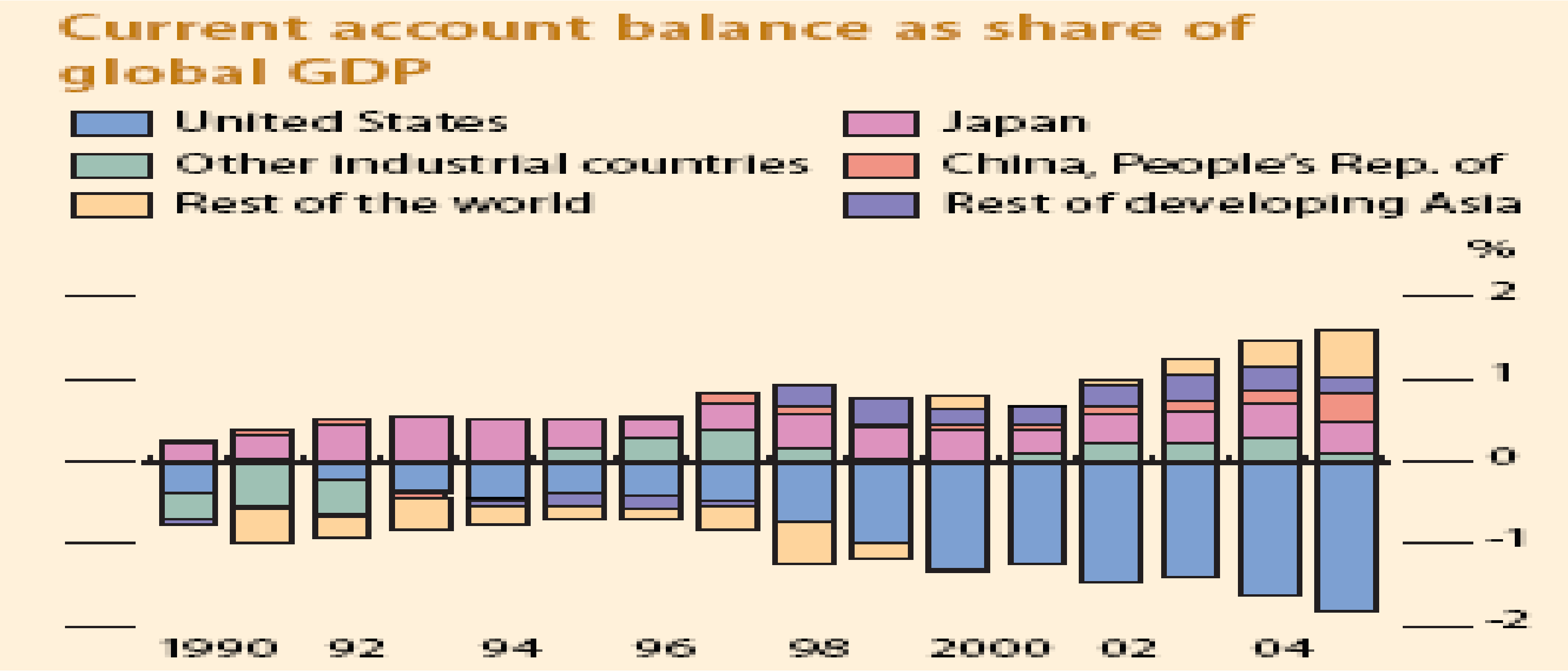
IV. Policy Reactions?

I. Facts

1. Global Imbalance: Or the U.S. imbalance?

The U.S. takes up virtually whole surplus of the world.

- While Japan is on the other side as always, the importance of China is rapidly increasing.



Source: Developing Asia and the World, ADB, 2005

2. Accumulating US foreign Debt

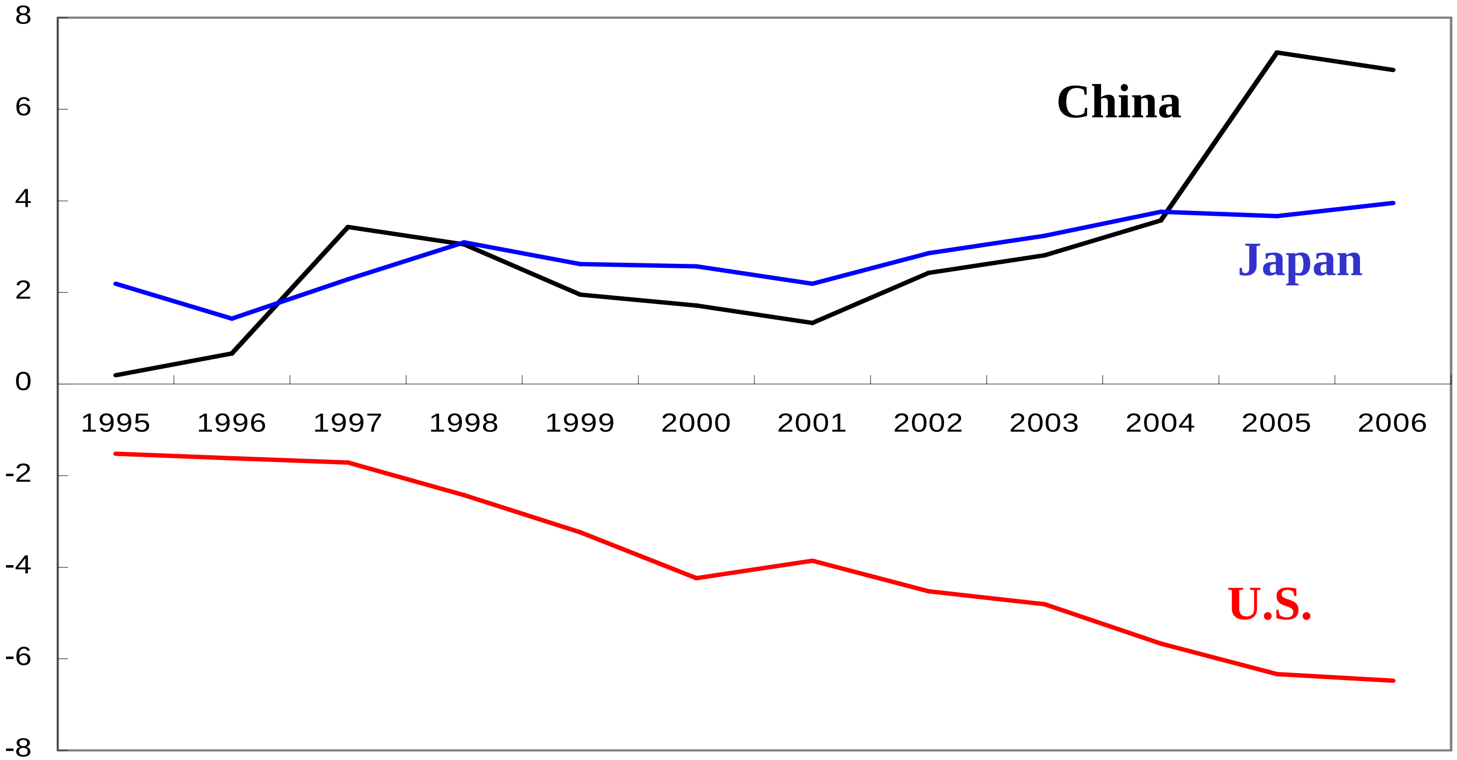
- The U.S. debt level entered into an unexplored territory.

Source: Obstfeld and Rogoff, 2005

3. More Recently…

It has been only aggravated.
→ Is the sustainability issue sustainable?

Current Account to GDP Ratio (%)

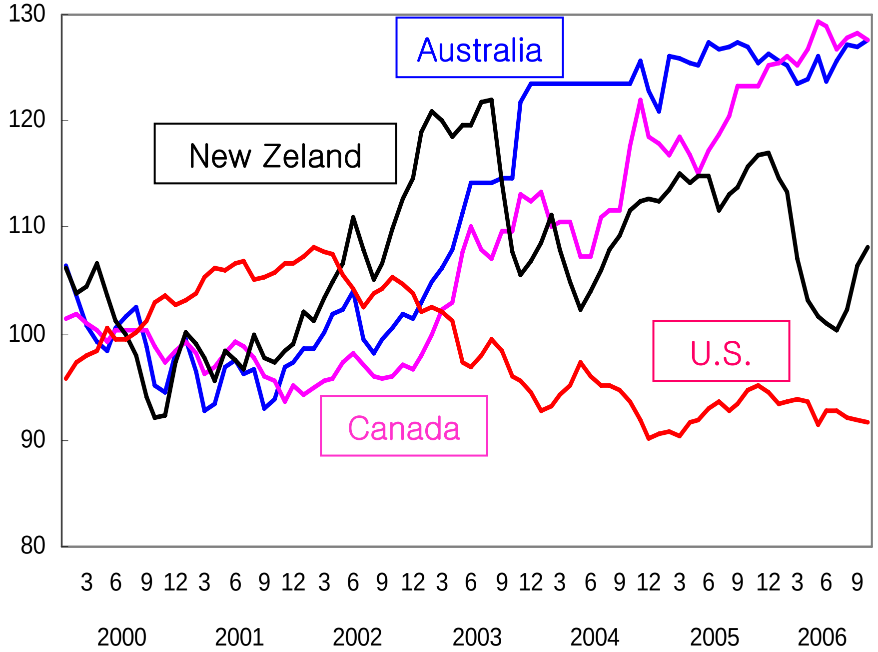


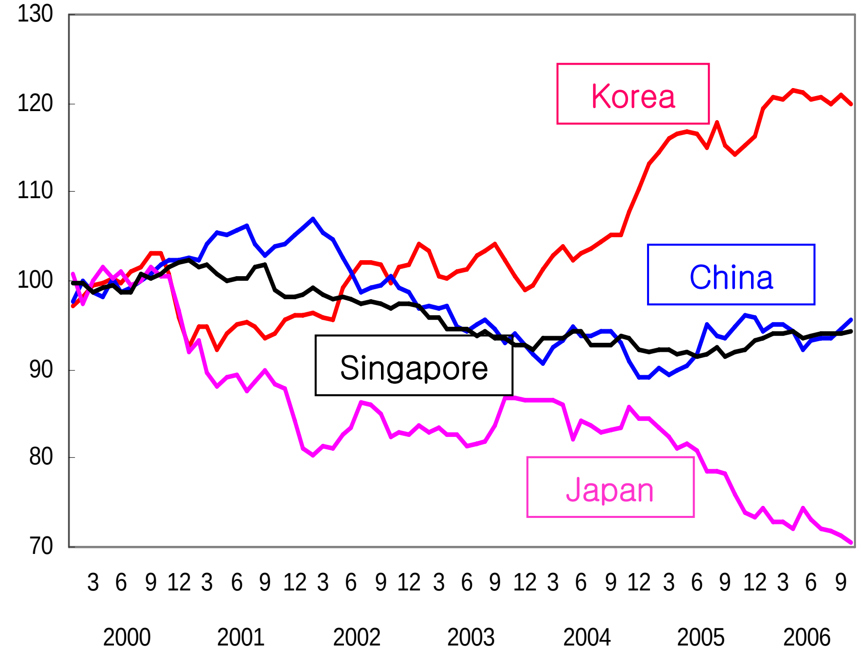
4. Exchange Rates

The dollar has been depreciated since 2003.
➔ But the appreciation degrees of other currencies differed.

- In particular, Japan and Korea in Asia are of a stark contrast. (China and Singapore are almost pegged to the US dollar.)

REER (100 in year 2000)





Source: IMF and KDI (for Korea)

II. Various Views

Various Views: Overview

	Market Integration	Exchange Rates
Optimistic	1.1 ???	1.2 Dooley, Garber (Deutche Bank)
Pessimistic	2.2 Rogoff, Obstfeld	2.1 Bergsten (IIE)

1.1 Optimistic View: Financial Integration

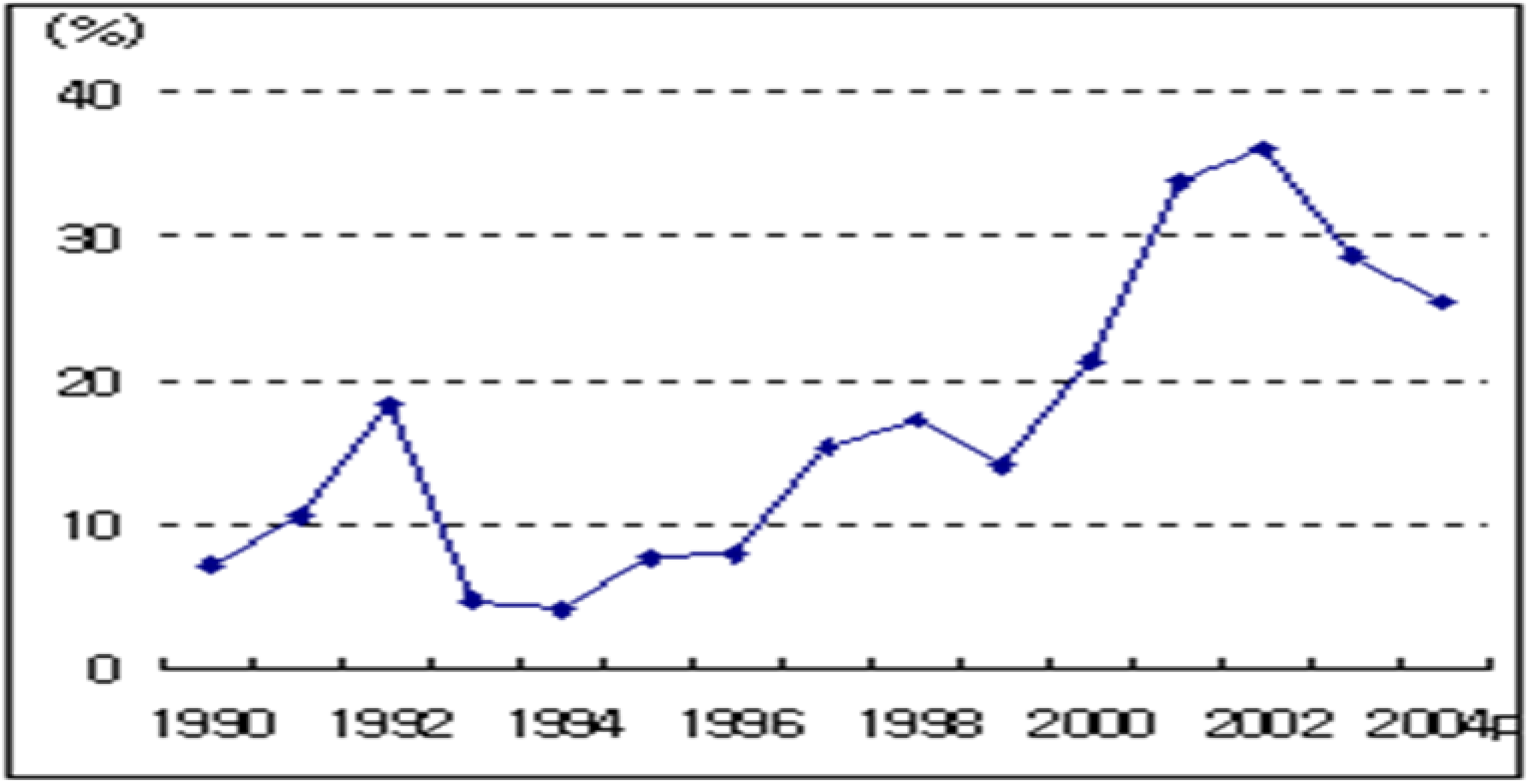
Emphasizing the capital flows into the U.S., this view interprets the global imbalance as a natural and sustainable feature.

- International capital flows into the U.S., which maintains the most sound fundamentals.
  ➔ Key currency, Financial soundness, Credible policies, Flexible market systems.
- As the international financial market is rapidly integrated, this phenomenon becomes more pronounced.
  ➔ Asian crisis awakened the attractiveness of the U.S. market.
- Therefore, not only the current account deficit but also the low savings rate and asset price hikes simply reflect good fundamentals of the U.S. economy.

1.1 Optimistic View: Financial Integration

- While the (net) external debt of the U.S. is rapidly accumulating, its external asset is accumulating more rapidly.

Ratio of Net External Debt to External Asset of the U.S.



1.2 Optimistic View: "Bretton Woods II"

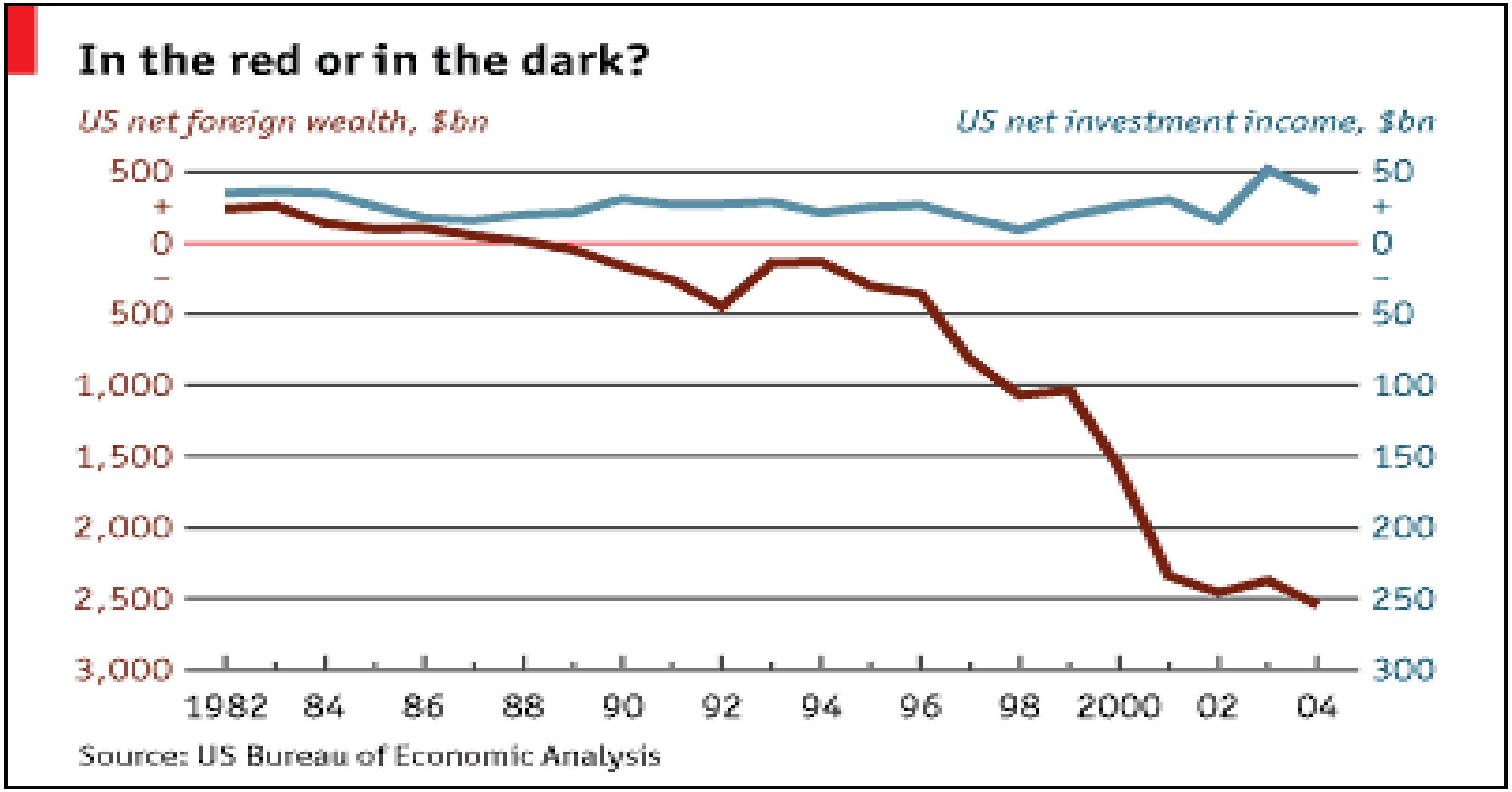
Rigid exchange rate arrangements of some countries are also natural given the current environments.

- *Periphery countries* with inefficient financial market (e.g. China) better pursue growth (or employment) by boosting exports.
- Thus, it is needed to maintain the currency value at a low level.
- Increased reserves are invested into the *center country* (U.S.), which possesses better financial capabilities. (Division of Labor?)
- As far as the current financial arrangement is mutually beneficial, there is no reason to expect the current system to break down in the near future.

  ➔ Even when China graduates from "periphery" status,
  there are sufficient reserve countries in this category (e.g. India).

1.2 Optimistic View: "Bretton Woods II"

- While net external debt of the U.S. has been rapidly increasing, its net investment income has been in steady surplus.



Source: The Economist, 2006

2.1 Pessimistic View: Rigid Exchange Rates

Emphasizing rigid exchange rate policies,
this view interprets the global imbalance is vulnerable.

- Some (Asian) governments intervene in the exchange market, maintaining low currency values under the mercantilist approach.

- This artificial valuation of the currencies, hence the global imbalance, cannot be sustained.

- When investors begin to recognize that the current situation is unsustainable, the global capital market (and real economy) will be severely disturbed.

→But this view is basically a partial equilibrium approach, taking the exchange rate as exogenous (or policy driven).

2.2 Pessimistic View: Excessive Demand of US

Emphasizing the substantial portion of non-tradables, this view interprets the global imbalance as a result of excessive demand of the U.S.

- (Relatively small) Transaction costs across countries leave a substantial portion of the world economy as non-tradables.
  ➔ Particularly in the U.S. (Exports: 10% of GDP, Imports: 16%)

- As far as goods market remains disconnected across countries, capital market cannot be as integrated as some researchers might imagine it is ("Feldstein-Horioka Puzzle", "Home Bias Puzzle").

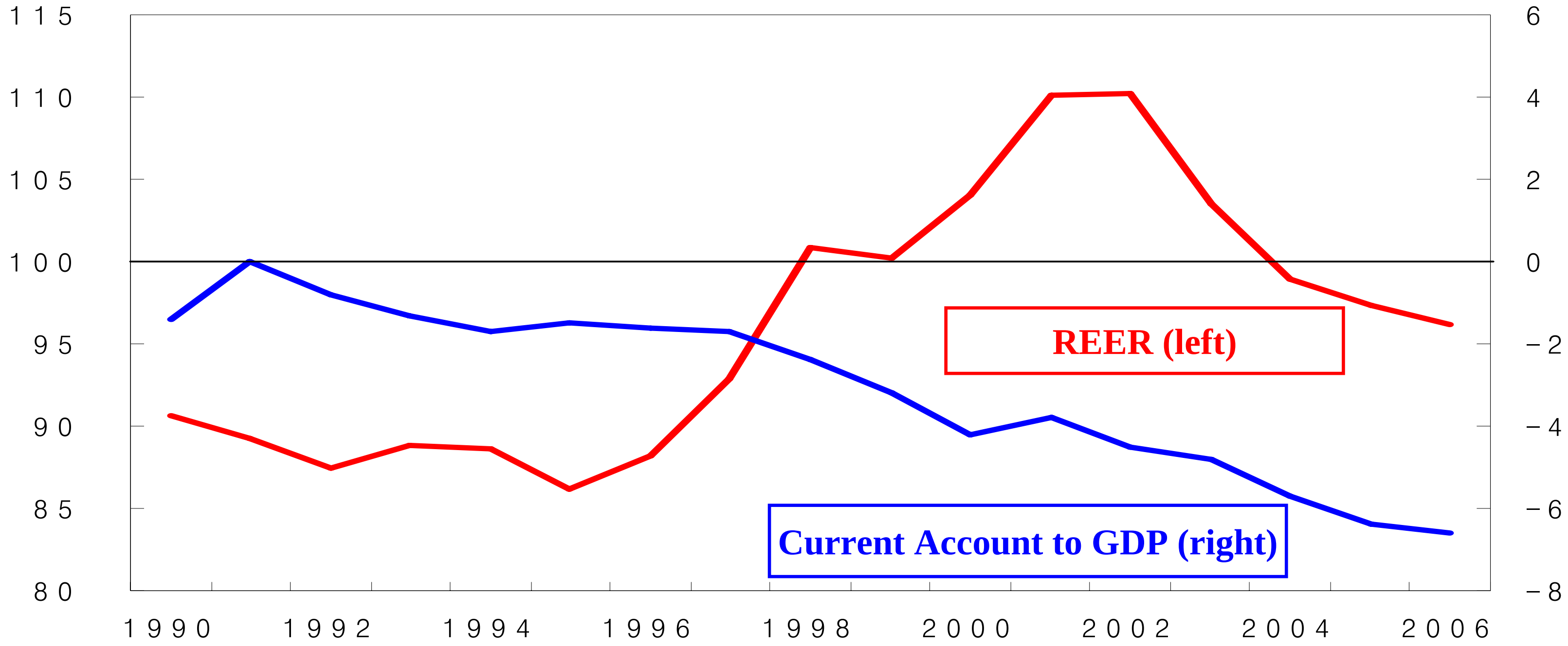
- Thus, the fact that the U.S. imports more than 150% of exports indicates that production is significantly skewed to non-tradables in response to excessive aggregate demand.

2.2 Pessimistic View: Excessive Demand of US

- In this framework, exchange rates are endogenously determined.

➔ In theory, current account can be determined irrespective of the level of the exchange rate (or relative price between tradables and non-tradables), as far as the supply side is sufficiently flexible (or in the long-run).

Current Account and Exchange Rate of the U.S.

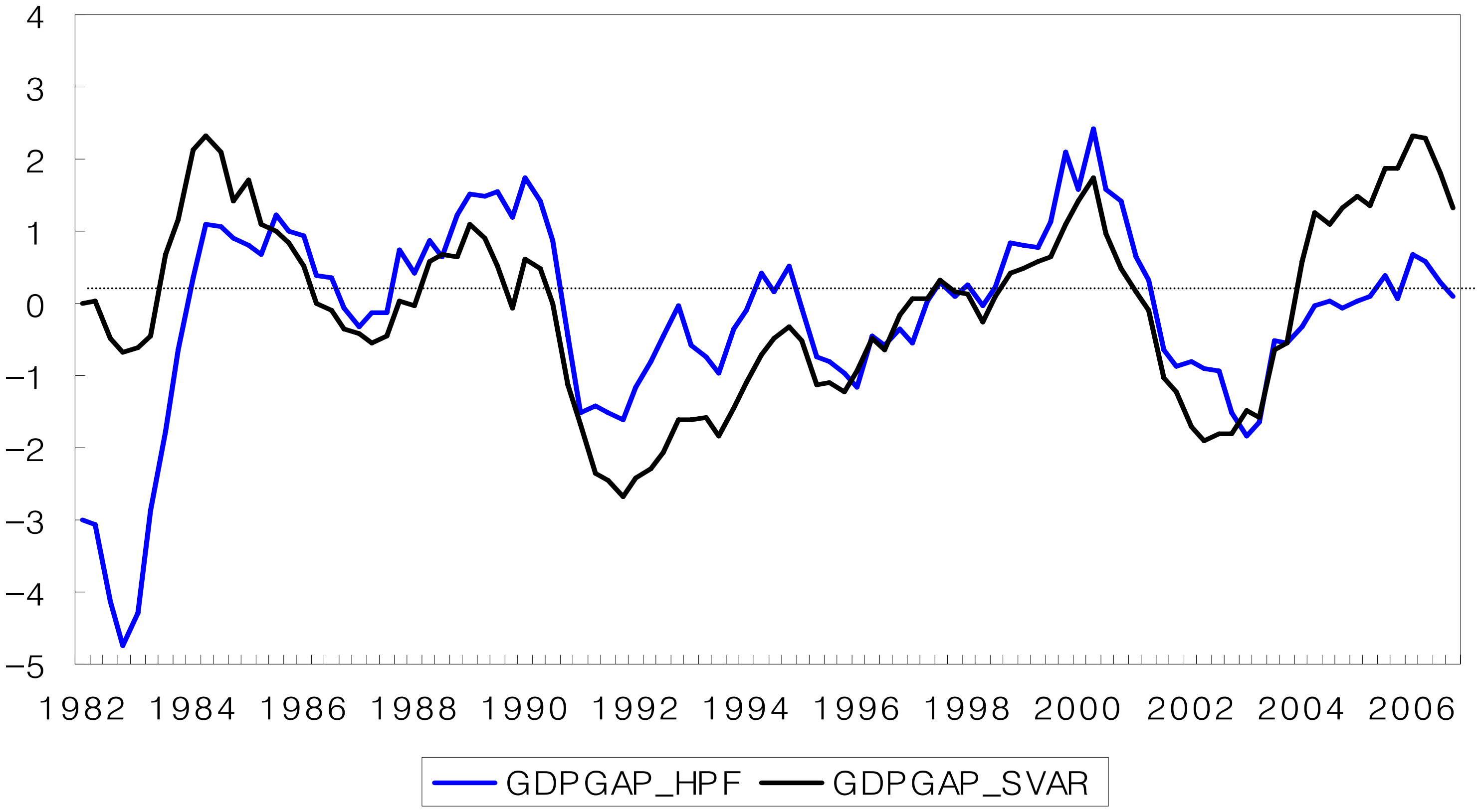


2.2 Pessimistic View: Excessive Demand of US

- Therefore, the key factor is aggregate demand of the U.S.

➔Exchange rates can be significantly affected by demand shocks (e.g. housing price shock).

GDP Gap (HP filtering) and Aggregate Demand Pressure (SVAR)



3. All in all, ...

Many seem to believe that a correction is necessary.

- But the degree of the correction may not be as large as what some commentators have estimated.

➔ For example, not many seem to believe that the long-run equilibrium level of U.S. current account is zero.

➔ Also, there seem to be other channels of correction that may not rely on the abrupt exchange rate adjustments.

III. Impacts of the Correction

1. Long-run vs. Short-run Effects

In the long-run, the adjustment of imbalances means a simple redistribution of global savings.

- Domestic absorption of the U.S. should be reduced, but domestic absorption of other countries will be increased.

Thus, the concern is a possible short-run disturbance, the degree of which will depend on two key factors.

- The magnitude of the excessive demand in the U.S.
  ➔ The higher it is, the more likely the U.S. hard-lands.

- The possibility of hysteric responses in the financial market
  ➔ With rapidly developed innovations, no one knows exactly how the risks are distributed to the global financial market.

2. Interest Rates and Exchange Rates

Responses of the U.S. interest rates would depend ...

- ... on the relative forces of the two possible factors.

➔ A correction driven by capital outflow would raise interest rates.
➔ A correction driven by demand shock would lower interest rates.

But the dollar value is likely to decline.

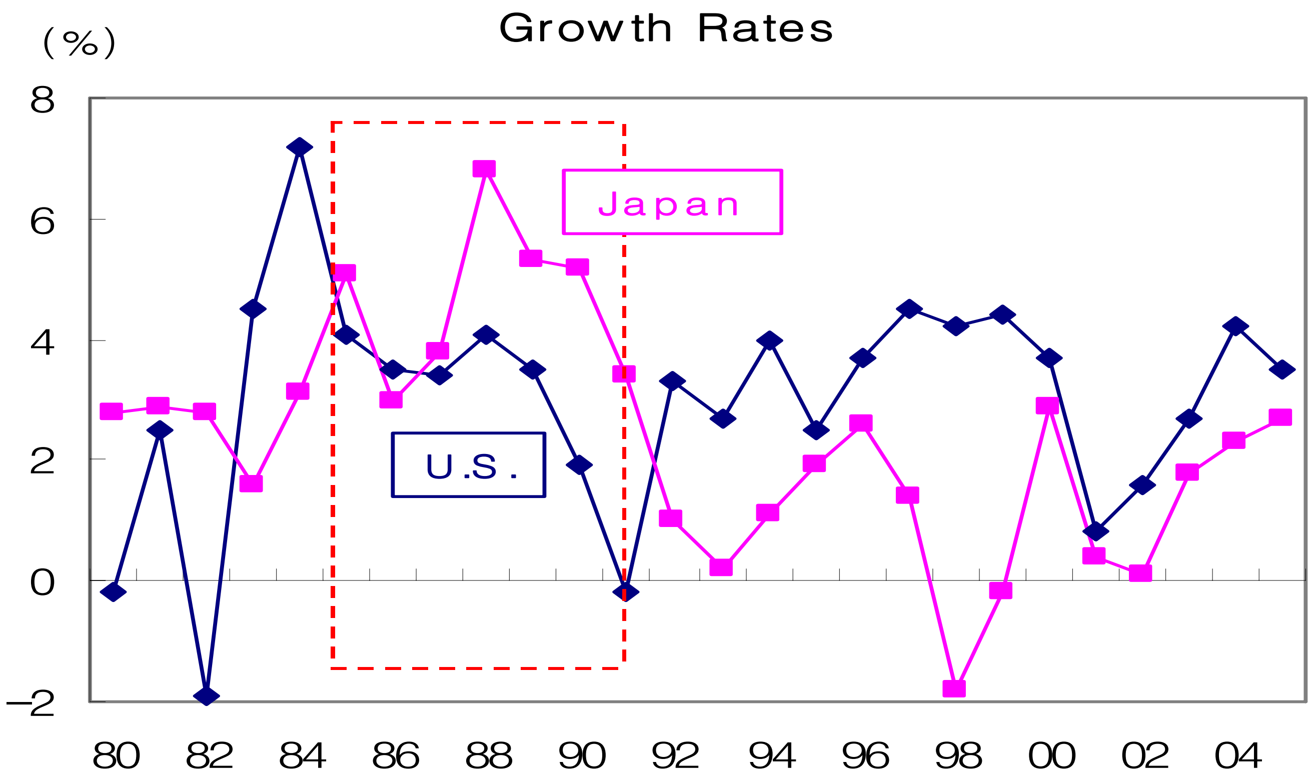
- No matter whether the correction is driven by capital outflow or demand shock, they are all the factors to depreciate the dollar.

- If an inflationary policy is taken to cope with deflationary pressures on non-tradables, it will be an additional factor to (nominally) depreciate the dollar.

3. Experience after the Plaza Accord

Impacts on the real economy may not necessarily be disastrous.

- After the Plaza Accord, while the imbalances were gradually corrected, the global growth rate was not significantly affected.



IV. Policy Reactions

1. Typical Recommendations

Reduce fiscal deficit of the U.S., and increase consumption in China.

- Logically obvious, but in practice ...

Increase the exchange rate flexibility.

- Flexible exchange rates are basically desirable.
- Given the financial market situation (particularly in China), however, the Bretton Woods view would not agree to it.

Increase “policy coordination.”

- Does this mean another Plaza Accord?
  (How effective would “coordinated intervention” be?)
- Exchanges of information about the financial market is fine.

2. Additional Recommendations

Tighten financial supervision.

- To maintain financial soundness.

Release as much information about the financial market as possible.

- Lack of information is a key factor of the financial market panic.

Enhance labor market flexibility.

- Flexible adjustment in the supply side of the economy reduces the real impacts of a drastic change in demand (and relative prices) between tradables and non-tradables.

Thank You