Asian Drivers; international financial and macro-economic implications globally and for developing countries

Stephany Griffith-Jones[1]

I Introduction

The influence of Asian drivers (and especially China and India) on the growth of the global economy and thus on growth and poverty reduction in the developing world are massive, via two main channels. The first one relates to the very rapid growth of China and India themselves, and the extremely large effects this has on trade flows, as well as on prices of tradeables (see, for example, IMF 2004 and Reisen et al, 2004). The second channel relates to the central role played by China (and other Asian economies) in helping to sustain high levels of US growth especially of consumption by continuing to fund the very large US current account deficit. This allows higher levels of growth globally, and in the rest of the developing world. It is the ability and willingness of Asian Central Banks to fund the triple US deficits, (of the current account, of public savings and of private savings), that is contributing significantly as a second engine for global growth. Therefore both directly (first channel) and indirectly (second channel) Asian drivers are playing a fundamental role in influencing global growth. Though there is quite a bit of analysis – and debate – on the impact of Asian reserves on the US economy, there is practically no analysis of the very large direct and indirect effects this, and related flows, have on the rest of the developing world.

This paper first outlines the nature and scale of the flows and stocks involved in the second channel; then it addresses the sustainability of the current situation, and possible scenarios of its unfolding; from that it raises research questions for the Asian drivers programme, which will relate both to the impact of funding of the US current account deficit by Asian official reserves, and also to other issues of capital flows within East Asia, to the rest of Asia and to the rest of the developing world.

II The current dynamic

Large and increasing current account imbalances have characterised the global economy since the beginning of the 21st century. As can be seen from Table 1 below, since the mid 1990s,

[1] I thank Shamshad Akhtar, Jacques Cailloux, Ricardo Gottschalk, Robert Griffith-Jones and Raphie Kaplinsky for insightful suggestions and valuable discussions. Research assistance by Atsuo Mori is gratefully acknowledged.

Table 1

Current account balances in major regions

In billions of US dollars

	Average 1991–2000	2001	2002	2003	2004[1]
United States	–150	–394	–481	–542	–496
European Union	9	–6	67	36	48
Japan	107	88	113	138	144
Other advanced industrial countries	4	56	46	41	44
Emerging Asia	22	90	132	148	128
Rest of the world	–72	–3	13	58	33
World[2]	*–80*	*–169*	*–110*	*–121*	*–99*

[1] IMF forecast. [2] Reflects errors, omissions and asymmetries in balance of payments statistics.

Sources: IMF, *World Economic Outlook*; national data. Table II.7

the US current account deficit has more than tripled in value, with emerging markets (particularly in Asia) representing the bulk of the corresponding increase in surpluses. In 2003, the US current account deficit reached around 5% of US G.D.P., with some (possibly over-pessimistic) projections arguing it could reach as much as 8% of G.D.P.. There are three especially worrisome features of the rising US current account deficit, which may eventually affect its sustainability. Those relate to the fact that the deficit is rising to finance consumption, rather than investment, that US investment is shifting towards non-tradeable sectors (and especially real estate) and that short-term flows are increasingly funding this deficit (Summers, 2004). We have seen that such factors have typically made current account deficits less likely to be sustained, both in developed and developing countries. Finally, the fact that though the dollar has fallen quite significantly in recent years, this deficit has continued rising is a fourth cause of concern.

An important – and growing – part of funding of this US current account deficit originates from increased official reserves of Asian countries. In a very recent paper, the New York Fed estimates that Asian central banks financed over 70% of the 2003 current account deficit, mainly via purchases of US Treasury bills, (Higgins and Klitgaard, 2004). Within Asia, the largest reserve purchases came from Japan and China (Japan purchasing $73 billion during 2003, whilst China bought $40 billion that year); Korea, Taiwan and Hong Kong have also made sizeable purchases (US Treasury, 2004).

Asian countries have been able or willing to play this role, because they have accumulated very large foreign exchange reserves in recent years. Indeed, Asian emerging markets' foreign exchange reserves have grown from under $500 billion in 1996 to $1.3 trillion in March 2004, that is by U.S. $800 billion (see Table 2). Japanese reserves also grew significantly between 1999 and 2003– by $375 billion (IMF 2004). The largest absolute increase, amongst emerging markets, is that of China, whose reserves grew by $330 billion in that period!

Table 2: Reserve Accumulation in Emerging Markets Since the Asian Crisis

Foreign exchange reserves[1]

In billions of US dollars

	1996	2000	2001	2002	2003	March 2004
Asia[2]	477.4	694.5	770.5	944.2	1,208.1	1,302.9
China	105.0	165.6	212.2	286.4	403.3	439.8
Hong Kong SAR	63.8	107.6	111.2	111.9	118.6	123.8
India	19.7	37.3	45.3	67.0	97.6	107.2
Korea	33.2	95.9	102.5	120.8	154.5	162.7
Taiwan, China	88.0	106.7	122.2	161.7	206.6	226.5
Latin America[3]	141.3	136.1	135.9	140.1	170.7	178.8
Argentina	17.7	24.4	14.5	10.4	13.1	13.5
Brazil	58.3	32.5	35.7	37.4	49.1	51.6
Mexico	19.2	35.1	44.4	49.9	57.7	60.3
Central Europe[4]	40.1	51.5	51.3	63.2	72.9	75.4
Russia	11.3	24.3	32.5	44.1	73.2	79.6
South Africa	0.9	5.8	5.8	5.6	6.2	7.9

[1] End of period; for the regions, sum of the economies listed in the footnotes. [2] China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [4] The Czech Republic, Hungary and Poland.

Sources: IMF; national data. Table III.3

Source: BIS, 74 Annual Report, 28 June 2004.

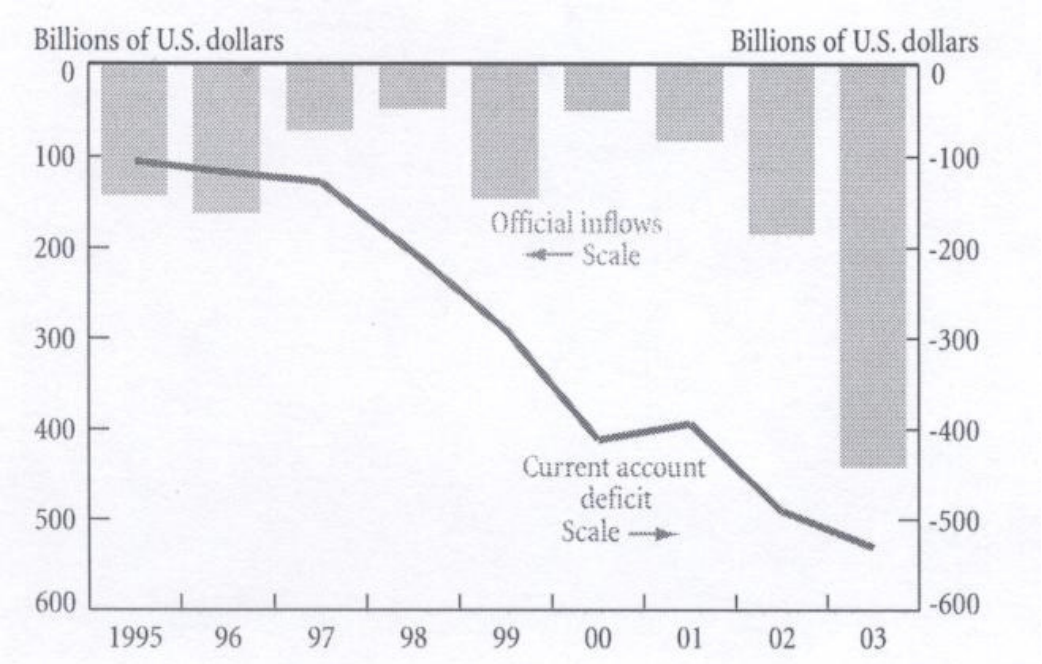
It is important to analyse the dynamic and reasons for Asian reserve accumulation, to try to estimate future trends. An interesting new point is that in 2003, there were net positive inflows from private investors into Asia. Therefore, Asian central banks were not only channelling the region's current account surpluses, but also recycling substantial net inflows of private capital.

The reasons for massive accumulation of reserves by Asian central banks are twofold (see, for example, BIS, 2004, Higgins and Klitgaard, interview material). The first reason, apparently more dominant in the 1998-2001 period, was self-insurance. After the developmentally and financially costly crises in 1997-98, many emerging Asian countries significantly increased reserves to help avoid future excessive currency volatility or crises, (see, for example, Griffith-Jones, Gottschalk and Cailloux, 2001). However, since 2002, an increasingly important motive of rapid reserve accumulation was Central Bank intervention to avoid currency overvaluation, especially in relation to the dollar. This intervention leads to foreign exchange reserve accumulation.

The costs (current and potential) of reserve accumulation are also important to consider for an analysis of likely future trends. Until the end of 2003, Japanese reserve accumulation has been largely unsterilised, whilst China sterilised approximately half of its' reserve accumulation. The reason for this policy choice was the risk of deflation. However, recently China has become concerned – on the contrary – with overheating of the economy and rising inflation. As a result, the pace of sterilisation has increased; consequently, the cost of holding increasing levels of reserves is also rising, particularly as holdings in US Treasuries have lower interest rates than paper issued for sterilisation in China. Naturally, the recent declines in the dollar (in relation to the Euro) also imply a potential cost of holding these reserves in dollars rather than Euros, if this trend is maintained.

An important trend, that has recently (in 2003) accelerated very sharply, is that since 2000, a rapidly growing share of US current account financing originates in official inflows, particularly from Asian Central Banks (see Graph 1). This implies that

Graph 1 : US Current Account Deficit and Official Inflows



Sources: Bank for International Settlements, for official inflows; U.S. Department of Commerce, Bureau of Economic Analysis, for current account deficit.

there is a sharp decline in the share of private flows that finances the US deficit, and within private flows, a decline in more long-term funding such as foreign direct investment and equity flows. As pointed out above, this makes the level of the dollar, and more broadly the sustainability of the US current account deficit, very dependent on the behaviour of Asian central banks, their willingness to continue increasing their reserves and to hold, as well as to invest them, in US assets.

There is some empirical evidence, from studies of previous experiences, (see for example BIS, 2004, for developed countries – see also for example, Griffith-Jones et al 2001 for some developing country evidence) that increases in more volatile flows (eg holdings of currency and deposits) typically increase the most before a major adjustment of the current account, and then fall the most after the current account adjustment. This could be an indicator that a significant reversal of the US current account could be more likely to happen soon.

Indeed, a careful and in-depth analysis of experience of past current account adjustments in developed countries (and especially that of the US, eg in the 1980's, also with "twin deficits") and in developing countries could be an important research component, for an analysis of sustainability (though clearly no mechanical extrapolations can be made, see below for other important factors). However, historical experience is often more likely to offer lessons than contemporary actors often wish to accept. The difficult challenge is to draw the right lessons! This should be helped by understanding the new circumstances and the motivations of the actors involved.

Differences, however, need to be considered, like the fact that in the 1980's, there was a more concerted multilateral effort to finance current account imbalances (and specifically that of the US), whereas in recent years the accumulation of reserves has been the result of unilateral intervention by Asian authorities. This may also have important political economy implications.

Differences with other countries experiences also need to be carefully assessed. For example, to what extent the dollar's role as an anchor reserve and intervention currency creates a bias in favour of US assets? Will this be changed by the growing role of the euro? How much does the large profitability of US direct investment abroad (increasingly in China in recent years) moderate the pressure on the US

current account deficit? How much do relatively low levels of US debt/G.D.P. reduce the imminent pressure of rapid adjustment?

III The issue of sustainability

a) The issues

To what extent is the existing situation sustainable, which allows the US to maintain such high levels of consumption? This is a central question for the developing world, as alternative scenarios (eg a large reduction in Asian funding of the US, leading to a sharp fall in the dollar, linked to a large increase in US interest rates) could:

a) Lead to a slowdown or even a contraction of US output (especially of consumption). By lowering world aggregate demand, this would lower growth in developing countries. To an important extent, this would be transmitted via lower demand for developing country exports (affecting both volumes and prices).

b) Furthermore, US interest rates could increase from currently low levels. This could discourage US capital flows to developing countries in general (as returns become more attractive in the US). The impact would be particularly negative for highly indebted developing countries; as their debts would be seen as less sustainable with interest rate increases, declines of new flows and falls in the value of their exports, the risk premiums (spreads) on their debt would probably increase further, making their debt even less sustainable.

Given the significance of Asian reserves in financing the US current account deficits, the incentives or disincentives for Asian Central Banks to continue accumulating such reserves and using them to help fund the US "twin deficits" is entirely central to the sustainability issue.

b) Proposed research

There are a number of future scenarios that can be explored, and proposed research would focus on them, with an emphasis on: a) looking at relevant historical precedents b) understanding trends and motivations of, as well as costs and benefits for, Asian drivers under different scenarios. This would relate especially, but not only

to, Asian Central Banks and governments, in this case) c) developing alternative scenarios and assessing their likelihood d) examining carefully the impact of alternative scenarios on growth and poverty reduction in different categories of developing countries. Careful analysis of the financial and macro-economic channels through which alternative scenarios would have impact, would be carried out.

Points c) and d) could be significantly strengthened, if modelling, which integrated financial and trade flows eg working with Sherman Robinson and David Evans, was carried out.

e) Studying the political economy implications of different scenarios, eg increased Asian leverage in global governance of IMF, increased Chinese bargaining power vis a vis the G-7, and especially the US.

Amongst the scenarios that could be analysed would be:

i) Current situation sustained for a long period; the optimists

Some analysts have argued (Folkerts-Landau, 2004, Deutsche Bank, 2004) that the current situation is in the interest of key actors involved, and will therefore continue for a fairly long period. In this scenario, the Chinese Central Bank is, for example, willing to continue lending to the US, to fund its current account deficit, so that the US keeps growing, and keeps its markets open, for a significant period. This allows China to continue expanding its exports, and growing by shifting labour to more productive activities; according to this analysis China benefits not just from access to markets, but also from receiving F.D.I. that helps it expand further, and make more efficient, its capital stock (a high proportion of Chinese exports is generated by foreign, especially US, companies). Indeed, the flow of Chinese reserves to fund the US deficit, originates not just from Chinese trade surpluses, but increasingly from capital inflows to China (especially US F.D.I.). According to this analysis, these benefits outweigh possible costs, such as the increasing cost of sterilising the reserves – necessary to avoid overheating and inflation. Also relevant are costs of reduced wealth, due to an eventual decline in the value of the dollar in relation to the remimbi. It has been estimated that for a fall of 10% of the dollar/remimbi, the cost to China would be 3% of its G.D.P., not a trivial amount! The cost of a similar 10 per cent fall of the dollar in

relation to the currencies of Taiwan is estimated at 8 per cent, and for Singapore at 10 per cent.

The US clearly benefits, as its' consumers get cheap imports, and the economy can afford higher levels of import-led growth especially of consumption than they would otherwise; its' MNCs make large profits by investing in China. However, pessimists emphasise that this implies that the dynamism of the US economy would depend on a "global Ponzi scheme". Also a potential political dependence is generated, that would give China and Japan great leverage over the US.

Continuation of current trends would imply continued high levels of growth globally, with fairly low US interest rates, with a number of positive effects. It would be necessary however to study further what the potentially problematic effects are, for example, for capital flows to other developing countries, of the fact that the US would continue to have such a low level of savings, and would absorb such a high share of the rest of the world's savings. Also, perhaps less significantly, does the fact that such large FDI flows are going to China, divert FDI to other developing countries? This would help analyse the desirability of this scenario continuing from a development perspective.

Furthermore, it seems necessary to analyse carefully the sustainability of this scenario. There are clearly possible risks that it would unravel, and that it would unravel abruptly, which could lead to a fairly sharp fall in the dollar, and decline of US – and world – growth, as well as rising US interest rates. The risks, may well increase as time passes, and relevant stocks (of US debt, Chinese and other Asian reserves) increase, augmenting problematic effects eg costs of sterilisation and other wealth effects for China.

1. At a time of downward pressure on the dollar, Asian Central Banks could reduce their exposure to dollar assets. They could for example increasingly shift either total stocks, or at least increases, of reserves into other currencies, such as the Euro or the Yen. This would further depreciate the dollar and could lead to a rise in US yields, which would increase the capital loss on dollar assets further. However, individual central banks could try to liquidate their holdings before a more generalised outflow.
2. As a result of increased domestic unemployment perceived to result from the supply of low-cost goods and services from Asia, or concern over growing

deficits, the US could become more protectionist. This would sharply reduce the benefits of current trends for China.

3. Some unexpected shock (either economic or political) could affect motivations/incentives of key Asian or US actors. This could indirectly influence behaviour of financial markets eg. accentuating downward pressure on the dollar or openness of developed countries' markets.

ii) Current situation unsustainable; abrupt adjustment of the dollar has negative effects.

The exact evolution of this alternative scenario is difficult to forecast exactly. However, its' broad features could be outlined with careful research of different options that would particularly focus on its' impact on the rest of the developing world.

The trigger would be if the Asian central banks decided either to reduce sharply either their exposure and/or their new purchases of dollar assets, especially at a time when the dollar was under pressure. This would lead to some combination of a further – and probably abrupt – fall in the dollar, lower US asset prices, higher interest rates, and probably higher US savings and lower US investment. The magnitude of and speed of the adjustment required would depend on the scale needed to persuade private investors to increase their exposure to US assets.

More broadly, the question could be posed what are the costs and benefits of different uses – and their combination – of large East Asian and Indian official reserves, both for the countries that own these reserves and for the rest of the developing world?

iii) the Asian and South-South option

The issues

At a broad level, the current development model of China, though highly successful, may be excessively biased towards export-led growth. One of the important issues for the future is the extent to which more emphasis will be placed by the Chinese authorities on development geared towards

China's domestic market.[2] This could have implications via – for example – exchange rate policy – for the type of issues discussed above, and for the pattern of trade and finance between China and the developing world.

Within the financial sphere Asian experts (Akhtar, 2004, Park and Bea 2003, Cheong and Xiao, 2003), have rightly emphasised that East Asian countries have tended to develop far stronger financial links with North America and Europe (global integration) rather than regionally, even though the Asian economies are so dynamic and are so closely integrated regionally, especially via trade and also via foreign direct flows.

As Akhtar op.cit has emphasised, East Asia has great potential for financial regional integration, given that it owns over half of the world's official reserves and a third of the world's savings. Indeed, especially since the Asian crisis, interesting steps for regional financial integration have begun to be taken by countries, regional institutions (like the ADB) and by global institutions (eg the BIS); these measures have focused for example on development of regional bond markets (in local and in foreign currency) as well as official co-operative financial arrangements, such as the Chiang Mai initiative, with the latter establishing a network of regional swap arrangements cumulatively reaching close to $40 billion, which can provide liquidity support for countries experiencing speculative attacks or other short-run balance of payment problems. Important voices in the East Asian region are urging for further development of such initiatives, and indeed for diversification of private and official flows, including the other emerging countries, outside East Asia.

Proposed Research

This opens important additional areas of research; a) How could regional bond markets be further developed? How can restrictions, for example, on liquidity, be overcome? How could the experience of other countries eg the development of institutional investors in Chile and other emerging countries – linked for example to pension reform – help deepen demand for local and regional equity, including both long-term bonds and stocks?

[2] I thank Raphie Kaplinsky for this point.

Given the clear benefits of international diversification across developing countries (Dodd and Spiegel, 2004), could baskets of local currency bonds, including bonds from other developing countries outside Asia also be developed? b) How could the Chiang Mai initiative be strengthened, to enhance for example the scale of reserves involved, the further development of peer regional surveillance, and the development of an alternative conditionality to the IMF one? What can East Asia learn from other regional integration experiences eg Europe, in this and other aspects? Indeed, what can other parts of the developing world learn from the Chiang Mai initiative, for establishing their own regional mechanisms? What limitations would they face, eg lower level of reserves?

Given the clear benefits of international diversification and higher average yields in the rest of the developing world, what instruments and mechanisms could be developed to encourage private financial flows to the rest of the developing world, as well as regionally? What explains the dynamic of East Asia FDI flows to the rest of Asia, Latin America and Africa?

Would it be in the interest of East Asian countries and India to use a small part of their reserves to enhance their quota in the IMF and World Bank, thus strengthening their voice and influence these institutions, and to increase these institutions' lending to the rest of the developing world? Would G-7 countries make such an expansion possible? How could obstacles placed by G-7 countries be best overcome? If, or rather when, the role of China and India expands in bodies like the IMF, World Bank, BIS and other international institutions, will this also increase the voice of other developing countries? Indeed, will countries like India and China pursue joint common platforms with other developing countries, on finance and even on world macro-economic co-ordination, as they have successfully done on trade? Additionally, or alternatively, should these countries raise further their share of quotas in the Asian Development Bank, or create special funds within that Bank, for example to finance greater investment in infrastructure?