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Abstract

Global current account imbalances are one of the key macroeconomic imbalances that underlie the global financial crisis. The central objective of this paper is to analyze the causes and consequences of global imbalances from the perspective of developing Asia. More specifically, we examine the root causes of the large and persistent current account surpluses that have emerged in the region since the Asian crisis. We also explore the consequences of global imbalances for the region, in terms of welfare and economic growth. Based on our analysis, we recommend a number of concrete policy directions to help Asia rebalance its demand and growth toward domestic sources.

I. Introduction

Global imbalances or, more precisely, global current account imbalances, refer to the large current account deficits and surpluses that have emerged in the world economy during the last 10 years. For the most part, the imbalances have been heavily concentrated among a small group of regions and countries, and until recently have displayed an unusually high degree of persistence. The imbalances have centered on the large current account deficits of the United States (US), which peaked at close to 6% of gross domestic product (GDP) in 2006, and the corresponding surpluses in the rest of world, in particular developing Asia, Middle East, and Russia. By definition, a current account deficit (surplus) is equal to negative (positive) net savings. Therefore, it is conceptually useful to view persistent global imbalances as the continuous financing of US consumption with the net savings of the surplus countries. Global imbalances have enabled global aggregate demand to keep pace with the rapid expansion global aggregate supply due to the integration of the People's Republic of China (PRC) and India into the world economy.

Much of the debate about global imbalances has been framed in terms of their sustainability from the US perspective. More precisely, concerns about sustainability center on whether the US can indefinitely spend more than it produces or, equivalently, rely indefinitely on borrowing from abroad. Those concerns have been amplified by the unprecedented magnitude of the US current account deficit and its growing net foreign indebtedness. Roubini and Setser (2004) gave strikingly prescient warnings of a major global financial crisis in the absence of major adjustments to global imbalances, while Bergsten and Williamson (2004) provide an excellent overview of the pessimistic view of the US current account deficit. The underlying fear was that if the US continues to run large deficits, its net foreign liabilities would eventually reach 100% of GDP, a figure widely believed to be too large. For example, in a lucid exposition of the issue, Mussa (2004, p.18) stated that "there is probably a practical upper limit for US net external liabilities at something less than 100% of US GDP and accordingly…. current account deficits of 5% or more of US GDP are not indefinitely sustainable." However, there is also a more sanguine minority view that holds that in an era of growing financial globalization and rising US productivity, it may be feasible and even desirable for the US to run very large deficits for, say, a quarter of a century. According to this view, fears about the sustainability of the US deficit are misplaced in a world of growing international portfolio diversification where foreign countries are willing to accumulate ever larger amounts of US assets in the future.[1]

Formal studies of the sustainability of the US deficit based on rigorous economic analysis remain few and far between. In fact, most of the debate about the issue has taken the form of journalistic opinion pieces. In one of the exceptions to this trend, Edwards (2005a) develops a portfolio model of the current account to analyze the issue. He finds that even under the highly optimistic assumption that foreign net demand for US assets doubles from its current level, the US current account will have to undergo a significant adjustment in the near future. Even an abrupt adjustment to the order of 3–6% of US GDP is entirely conceivable. Edwards (2005b) also analyzes the international historical evidence to draw out the consequences of such an adjustment and finds that significant current account reversals tend to have pronounced negative effects on GDP growth. Given the central importance of the US in the world economy as an import destination, the inescapable conclusion is that the world economy as a whole will slow down sharply, as is indeed happening right now. In a separate study that analyzes a massive data set that covers over 120 emerging markets during more than 25 years, Edwards (2002) finds that large current account deficits tend to increase the probability of a financial crisis.

In the context of the current global financial crisis rooted in the US subprime mortgage crisis, a school of thought holds that global imbalances are *the* underlying root cause of the crisis. Popularly known as the global savings glut theory, this view asserts that the massive flow of savings from the surplus countries to the deficit countries lowered global interest rates by encouraging reckless investment into risky housing-related assets such as subprime mortgages. Regardless of its validity, the global savings glut theory lends further support to the notion that global imbalances are unsustainable and their unwinding will necessarily be disruptive. More generally, whatever the precise nature of the relationship between global imbalances and the global financial crisis, the fact remains that global imbalances were undoubtedly one of the key macroeconomic imbalances in the world economy before the outbreak of the global financial crisis. At a purely intuitive level, given that a crisis always reflects an unwinding of imbalances, it is difficult to believe that the current financial crisis was entirely driven by imbalances other than the current account imbalances. The more relevant question to ask is the relative contribution of global imbalances, and here there is predictably and legitimately a great deal of heated debate and a wide variety of opinions.

The central objective of this chapter is to explore the causes and consequences of global imbalances from the perspective of developing Asia rather than the US. This exploration is motivated by the broader issue of whether the deterioration of the region's exports and growth prospects as a result of the ongoing global crisis calls for rebalancing demand and

[1] See, for example, Dooley, Folkerts-Landau, and Garber (2004) and Cooper (2005).

growth toward domestic sources. To the extent that the region's current account surpluses are an integral part of global imbalances, a meaningful answer to the causes of global imbalances requires uncovering the causes of those surpluses. The roots of the region's surpluses ultimately lie in the exceptional success of developing Asia's outward-looking export-oriented growth strategy, which has delivered rapid growth and higher living standards for a generation. What deviates from the norm of the region's recent trade pattern is not the high degree of economic openness. Rather it is the emergence of large and persistent current account surplus since the 1997–1998 Asian crisis. That is, although the region has long relied on exports to drive its growth, its transformation into a surplus region or, equivalently, a net exporter of capital is a much more recent, and somewhat puzzling, phenomenon. The distinction between developing Asia's export orientation and current account surplus matters, and matters a lot, because it is the latter that has contributed to global current account imbalances. Any substantive discussion about the feasibility and desirability of rebalancing Asian growth should keep this fundamental historical background—a proven history of export-led growth—in mind.

It may be tempting for developing Asia's policymakers believe that once the global crisis subsides and the world economic outlook recovers, the region can return to its precrisis strategy of exporting its way into rapid growth. The temptation is all the stronger in light of the fact that this strategy has served the region remarkably well in the past. Under this view, rebalancing is a nice catchphrase for the government's short-term efforts to limit the reduction in growth and to alleviate the hardship of the most vulnerable groups but nothing more than that. However, there are a number of inconvenient facts that stand in the way of this type of convenient thinking. For one, given the sheer severity of the global crisis, there is a great deal of uncertainty about global recovery prospects. For another, there are serious doubts whether running current account surpluses on a sustained basis serves the region's own self-interest. In theory, running a surplus over an extended period of time is perfectly consistent with maximizing growth and welfare. In particular, economic theory suggests that both rich and poor countries will benefit if capital flows from capital-abundant rich countries where the marginal returns to capital are low to capital-deficient poor countries where the returns are high. Therefore, there are solid grounds for questioning the logic or optimality of massive flood of capital flowing from developing Asia to the much richer America.

More generally, the analysis of the causes and consequences of global imbalances from the perspective of developing Asia laid out in the rest of this chapter should make it abundantly clear that *well before the outbreak of the global crisis, developing Asia may have been paying a heavy price for its excessive dependence on external demand since the Asian crisis, in terms of welfare and growth.* Therefore, *there are good reasons for why regional policymakers should view rebalancing as a serious medium- and long-term objective rather than as a convenient short-term catchphrase.* The causes and consequences are interrelated in the sense that the consequences follow directly from the causes. For example, to the extent that the surpluses are driven by suboptimally high saving rates, they entail adverse consequences for the living standards and welfare of the region's citizens. The broader finding arising from the analysis is that large and persistent surpluses have hardly been an unmixed blessing for the region.

The global crisis, as profound as its impact has been for developing Asia, did not suddenly create the need for rebalancing out of the blue. Instead, what the global crisis has done is reinforce and add a sense of urgency to a need already widely recognized within the region. For example, the PRC policymakers have been discussing the need for more balanced growth for years even though little concrete action has been taken in that direction. At a purely practical level, the potentially severe and protracted nature of the G3 and in particular the US downturn, suggests that the region may be unable to return to its precrisis excessive dependence on exports even if it wanted to. But by far the more compelling case for why rebalancing growth toward domestic demand is fundamentally in the region's own enlightened self-interest is that (i) contributing toward preventing the build-up of unsustainable global imbalances will benefit the region and, much more importantly, (ii) the region has already been paying a substantial cost for its surpluses in terms of growth and welfare. These considerations also explain why a self-interested need for rebalancing growth will remain well after the current global storm passes through the region.

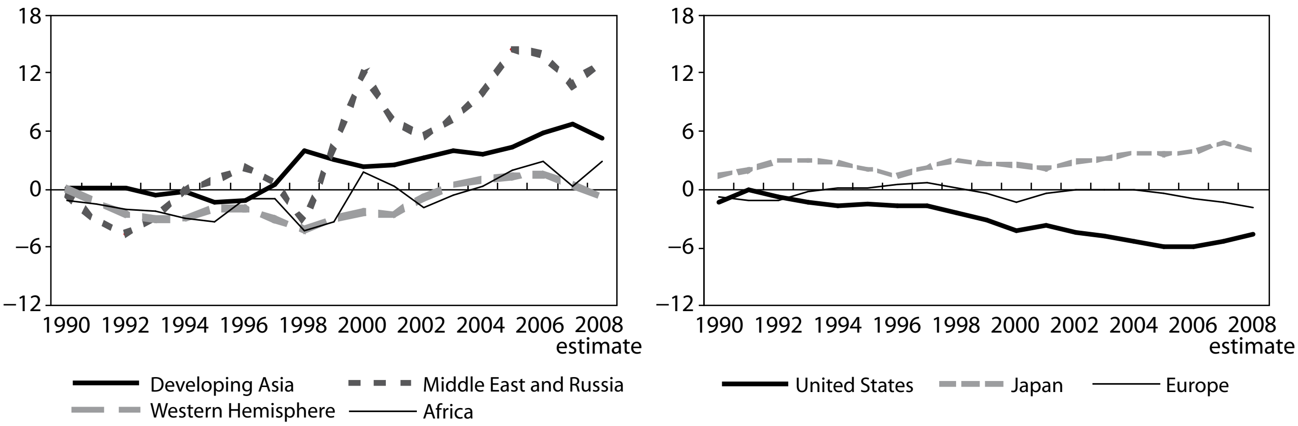
II. Profile of Global Imbalances and Current Account Positions of Asian Countries

We cannot meaningfully analyze the causes and consequences of global current account imbalances without first taking a look at the imbalances themselves. In this section, we first explore the profile of global imbalances. Developing Asia's surpluses have played a large and growing role in the formation of global imbalances. We then examine the current account positions of 11 individual economies within the region: PRC; Hong Kong, China; India; Indonesia; Republic of Korea (henceforth Korea); Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. Although developing Asia as a whole has run surpluses in the post\crisis period, there is a great deal of heterogeneity in the current account positions of countries across the region.

A. Profile of Global Imbalances

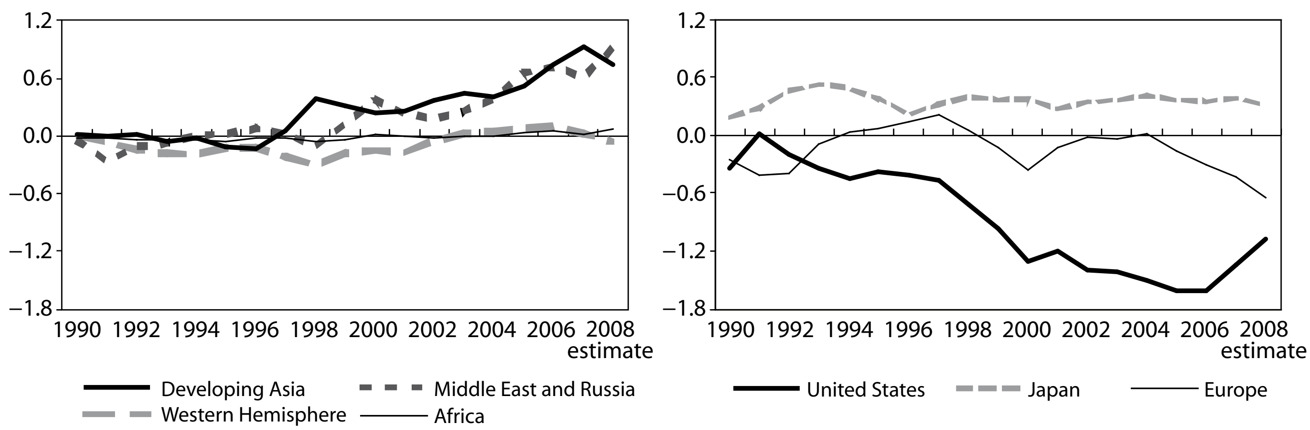
The existence of current account imbalances, per se, is not necessarily of itself a cause for concern. Given increasing financial integration across countries, there is no reason why countries should run balanced current account positions at all times. Nevertheless, the sheer size and persistence of global imbalances, as well as their concentration in a small group of countries, have raised concerns about their sustainability. There have also been questions about whether it is for optimal for low-income developing countries to use their savings to finance the consumption of high-income countries while foregoing productive investment opportunities at home. Figures 1 and 2 show the behavior of current account positions across key regions and countries over time.[2] Figures 1 and 2 show current account positions as a percentage of own GDP and as a percentage of world GDP, respectively.

Figure 1: Global Current Account Balances (percent of GDP)



Source: International Monetary Fund, World Economic Outlook Database, downloaded 10 January 2009.

Figure 2: Global Current Account Balances (percent of World GDP)



Source: International Monetary Fund, World Economic Outlook Database, downloaded 10 January 2009.

2 Data are taken from the October 2008 issue of the International Monetary Fund's (IMF) World Economic Outlook database. The various regional groupings generally follow IMF conventions with the following exceptions. As used in this chapter, developing Asia includes the newly industrializing economies of Hong Kong,China; Korea; Singapore; and Taipei,China as well as the developing Asian economies as defined by the IMF. Europe is defined to include the European Union as well as the emerging market countries of Central and Eastern Europe. The group Middle East and Russia includes all the members of the Commonwealth of Independent States in addition to Russia. Data for 2008 are IMF estimates.

A number of salient observations emerge from the two figures. First, after remaining relatively small through the early part of the 1990s, the US current account deficit widened sharply after 1997–1998 as import growth surged, and began to narrow only in 2007 and 2008. The US current account deficit at its peak accounted for as much as 1.5% of world GDP. This is by far the largest current account deficit in the world in terms of absolute size. Second, the large increase in the US current account deficit after 1997–1998 was matched almost entirely by increases in the current account surpluses of developing Asia, Middle East, and Russia. In other words, the current account imbalances that emerged during this period were heavily concentrated in a small number of countries. Third, the emergence of current account surpluses in developing Asia is a relatively recent phenomenon. As evident from both figures, the region as a whole ran current account deficits before the 1997–1998 crisis and only began to run consistent account surpluses after 1997. The region is clearly not a "serial" current account surplus region, and current account deficits used to be the norm rather than the exception in the region until the Asian crisis.

Figure 3 provides another perspective on the concentration of global imbalances. The pies in this chart use the absolute US dollar value of key current account imbalances in the years 2000, 2005, and 2007 to track the key contributors to the global imbalances. The charts include current account positions for developing Asia, Asia as a whole (developing Asia plus Japan), Middle East, and Russia. As the pie charts make clear, Asia, Middle East, and Russia have consistently accounted for the bulk of the US current account deficit, with the share of developing Asia increasing sharply since 2003. Global current account imbalances have been, and continue to be, relatively heavily concentrated among a small group of regions and countries, with developing Asia playing a large and growing role on the surplus side.

Under balance of payments accounting, the financing of current account imbalances can be broken down into net private capital flows, nonreserve related net official capital flows, and changes in international reserves. Using these breakdowns, Figure 4 displays key features of the financing of global current account imbalances in recent years.[3] One key similarity across all regions is a sharp pickup in the speed of international reserve accumulation. However, the speed and scale of developing Asia's reserve accumulation has been exceptional. The factors underlying the reserve accumulation have differed sharply across regions. In the case of developing Asia as a whole the reserve accumulation has been driven by both current account surpluses and net private capital inflows.[4] In brief, developing Asia stands out for two reasons: (i) exceptionally rapid rates of reserve accumulation; and (ii) large and growing surpluses on both the current and capital accounts, i.e., twin surpluses.

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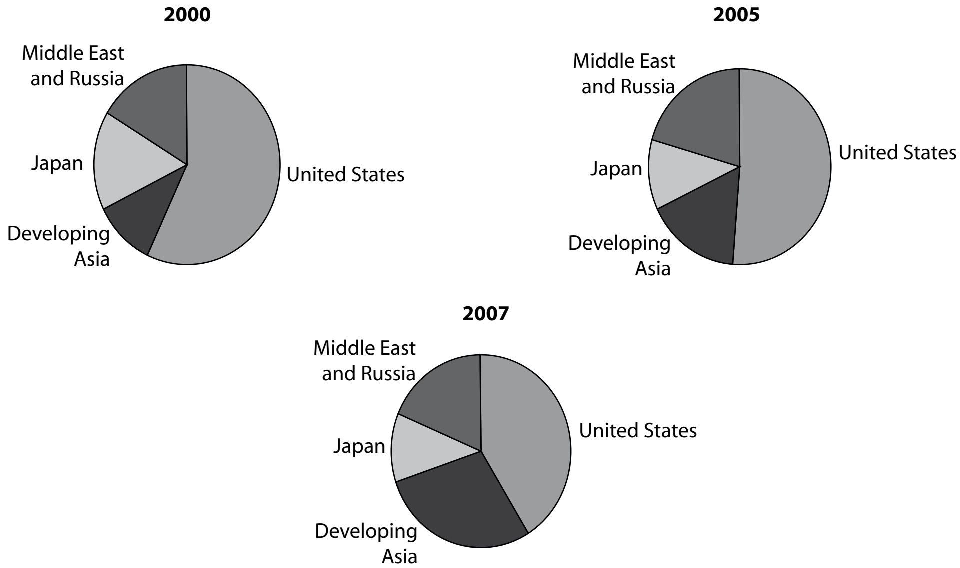
[3] We look at emerging Europe rather than Europe as a whole due to the absence of data on capital flows for the Euro area. The United Kingdom is also excluded.

[4] As noted below, the financing of current account imbalances within developing Asia has shown considerable diversity. Aggregates for developing Asia tend to be dominated by the PRC given the size of its economy and its outsized external performance.

Figure 3: Distribution of Current Account Imbalances (US dollars)



Note: Current account figures are in absolute values.
Source: International Monetary Fund, World Economic Outlook Database, downloaded 10 January 2009.

Figure 4: Current Account Financing Patterns (US dollars)

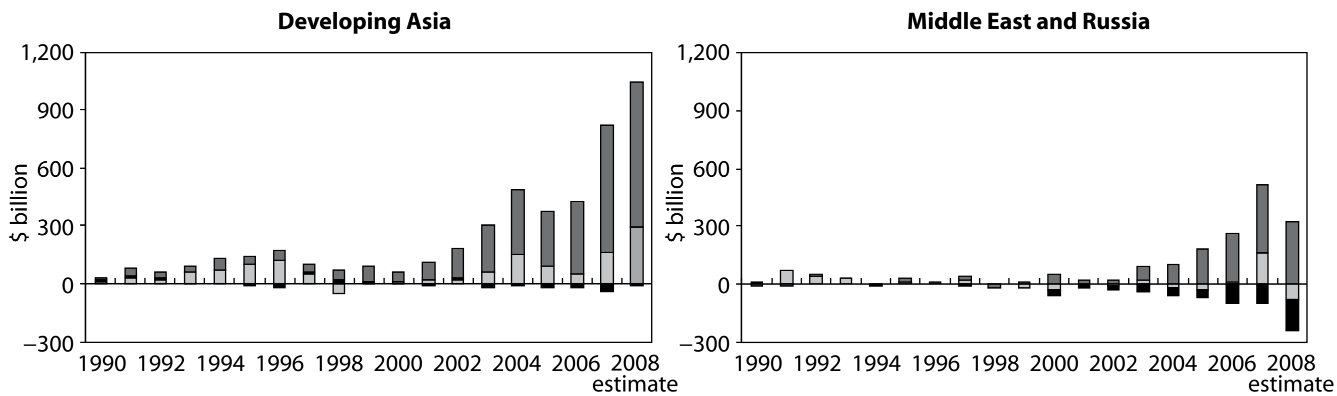


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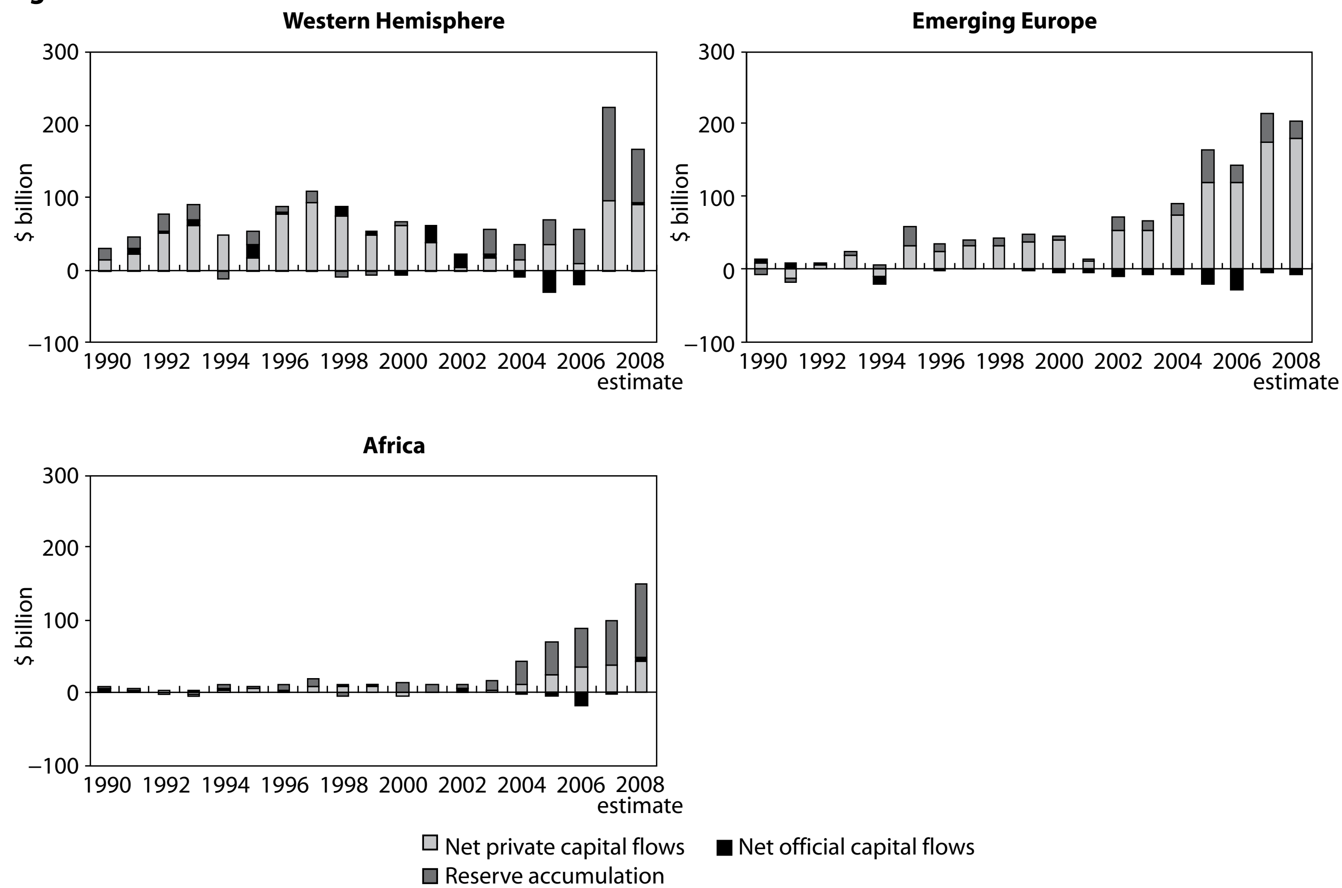
Figure 4: *continued.*



Note: Emerging Europe comprises Europe excluding the Euro area and United Kingdom.

B. Current Account Position of Eleven Economies in Developing Asia

Looking at the current account position for developing Asia as a whole provides a perspective on the region's contribution to the global current account imbalances. It also makes it abundantly clear that developing Asia has been an important and growing contributor to the recent global imbalances. However, a regionwide focus obscures important differences in the behavior of current account balances within the region. Figure 5 shows the ratio of current account balances to own GDP for the 11 largest economies in the region for which data are available. The data reinforce the earlier observation that *current account surpluses are **not** an intrinsic structural characteristic of developing Asian economies* but a recent development that has become clearly visible only since the Asian crisis. The only group of countries that seems to have a structural current account surplus is Hong Kong, China; Singapore; and Taipei,China. The 11 sample countries jointly account for over 95% of the region's GDP. The figure makes it clear that there is no single pattern of current account behavior that is common throughout the region. Instead four broad types of behavior can be identified.

(i) **Asian Crisis Affected Middle-Income Economies (Indonesia, Korea, Malaysia, Philippines, Thailand)** In these countries, the current account shifted from deficit to large surplus around the time of the Asian financial crisis and have subsequently narrowed in the last few years, except in the case of Malaysia.[5]

(ii) **Persistent High-Income Surplus Economies (Hong Kong, China; Singapore; Taipei,China)** In these cases, current accounts have been in surplus for extended periods with the surpluses increasing in recent years.

(iii) **Persistent Low-Income Current Account Deficit Economies (India, Viet Nam).** In these cases, current accounts have been in deficit on average.

(iv) **Low-Income Current Account Surplus Economies (PRC).** In this case, the current account tended to be in small surplus but the surplus has increased dramatically in recent years.

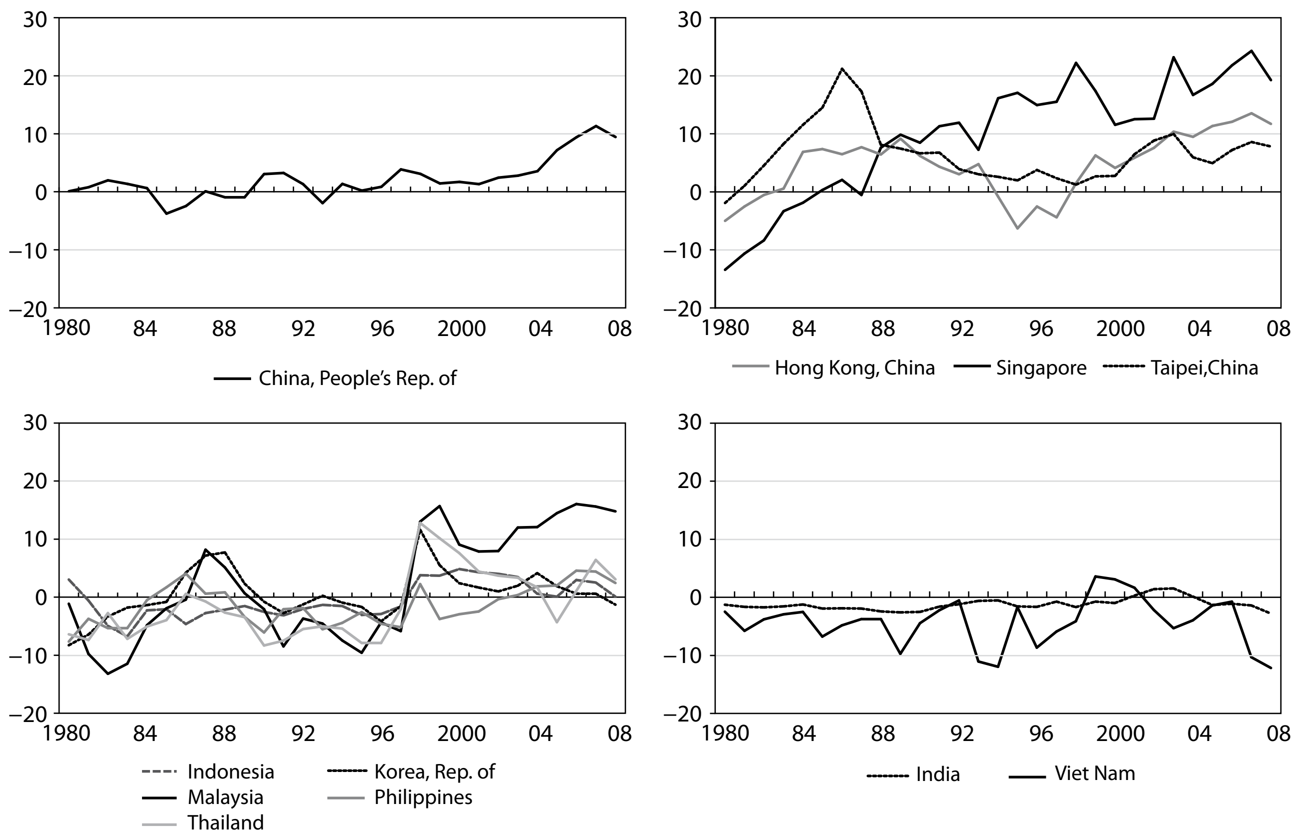
The large increase in the current account surplus for developing Asia as whole since the late 1990s occurred in two distinct phases, and different groups of countries in the region drove the current account imbalance during the two phases. In the immediate aftermath of the 1997 financial crisis, the increase in the region's surplus largely reflected swings in the current account balances of the crisis economies from positions of large deficit into large surplus.[6] Subsequently, however, and especially after 2003, the increase in the region's overall surplus has largely been the result of a surge in the PRC's surplus since the surpluses in most of the crisis economies have narrowed, while India and Viet Nam have moved into larger current account deficit. To a significant degree, developing Asia's current account surplus in recent years has been linked very closely linked to the PRC's large current account surplus.

Finally, the data in Figure 6 offer a broader perspective on the region's current account imbalances. The data display the relationship between the changes in current account balances and the changes in shares of exports in relation to GDP between the precrisis period and the postcrisis period. The data clearly point to a strong positive relationship between the increases in current account surpluses and the degree of export openness, and hence, implicitly, the share of tradables in GDP. As current account surpluses have risen in recent years, the ratio of exports to GDP has also risen. The relationship, however, is not one- to-one and export openness across the region has increased even in the face of differences in the behavior of current account positions across economies. Nevertheless, the data in Figure 6 seem to support the notion that developing Asia's current account surpluses have been driven by the region's high and growing dependence on exports as the main engine of growth.

[5] The recent widening of Malaysia's current account surplus has reflected mainly the effects of highly elevated commodity prices.

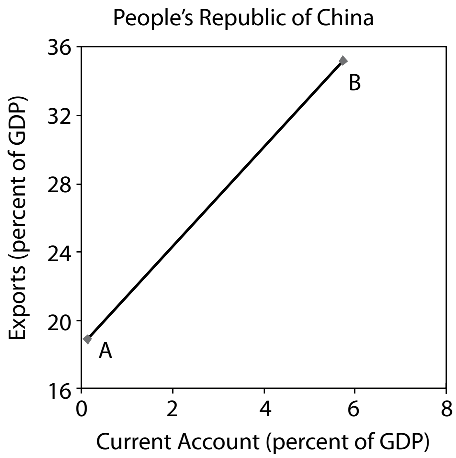
[6] These swings were the result of the large private capital flow reversals at the time of the crisis.

Figure 5: Current Account Balances of Individual Asian Economies (percent of GDP)



Source: International Monetary Fund, World Economic Outlook Database, downloaded 10 January 2009.

Figure 6: Shares of Exports in GDP and Current Account Balances of Individual Asian Economies



Newly Industrializing Economies

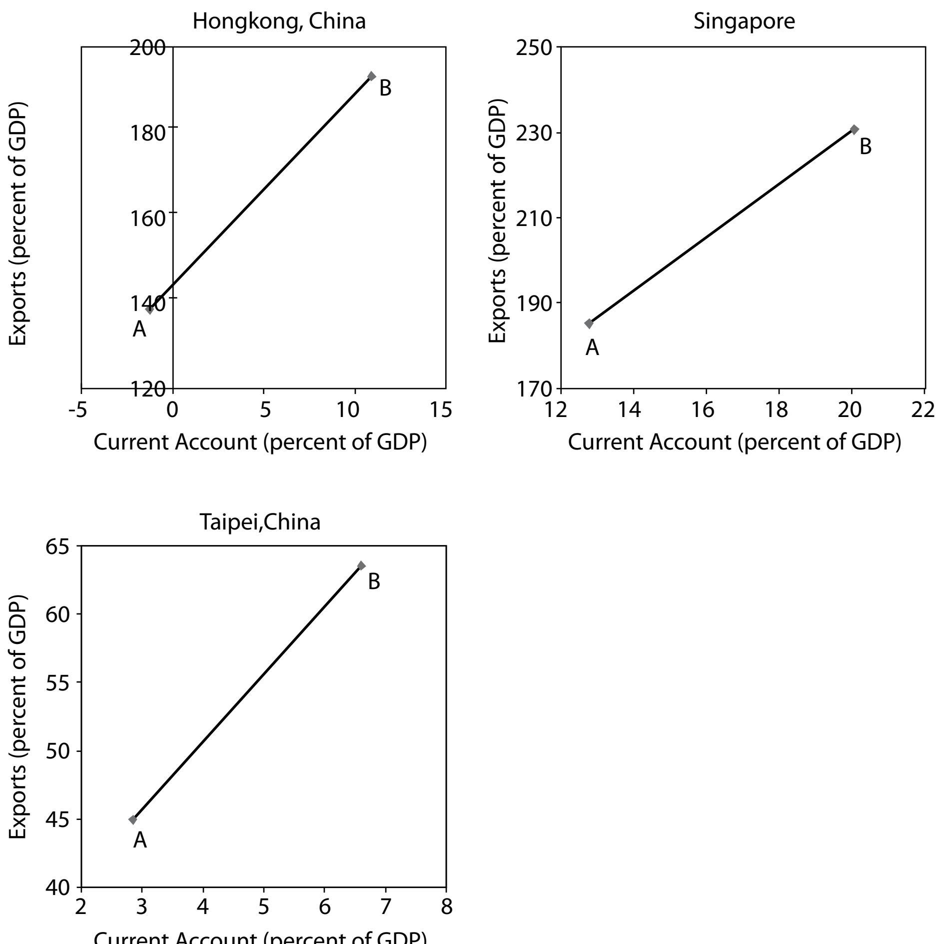


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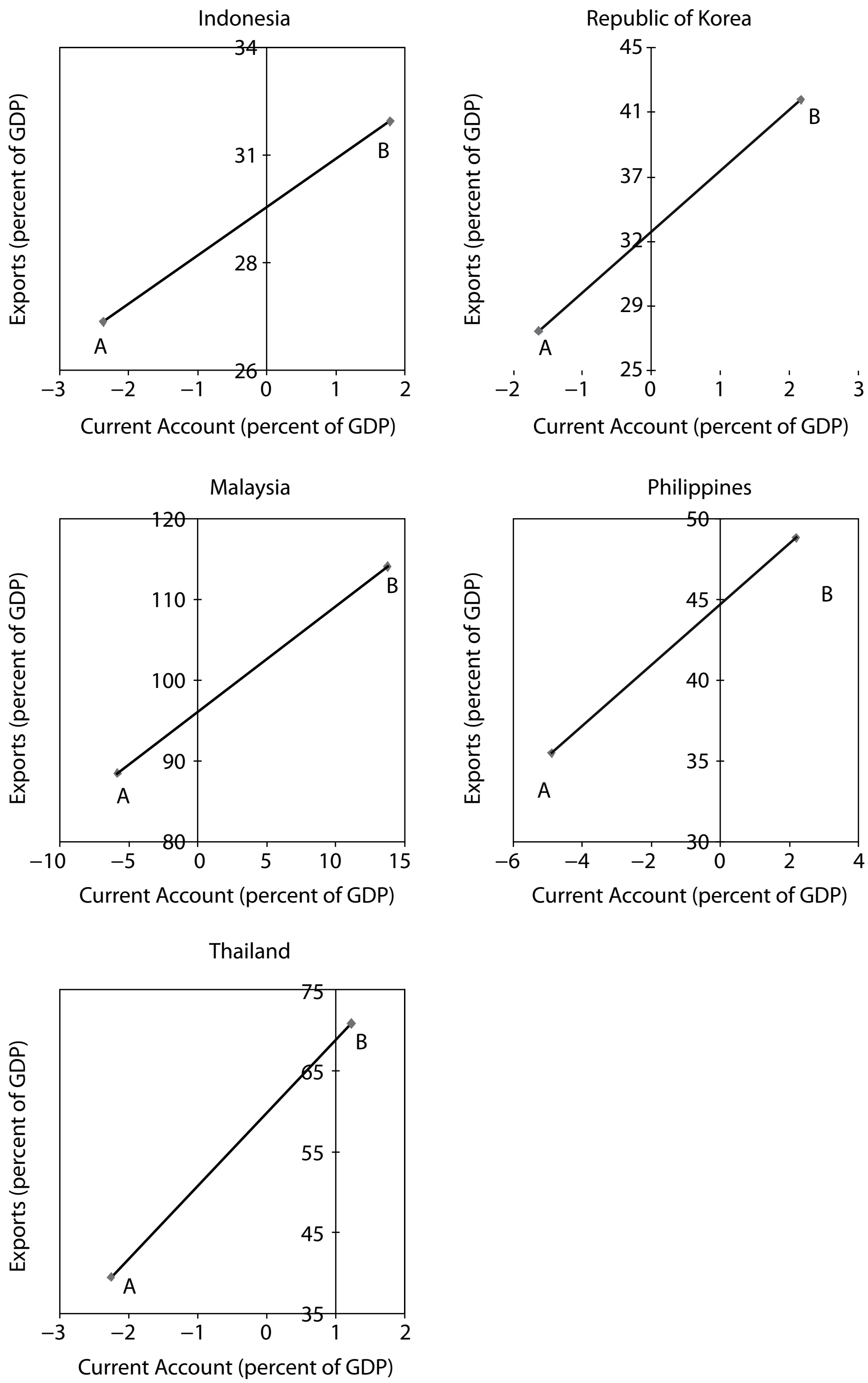
Figure 6: *Continued.*

1997/1998 Crisis Countries



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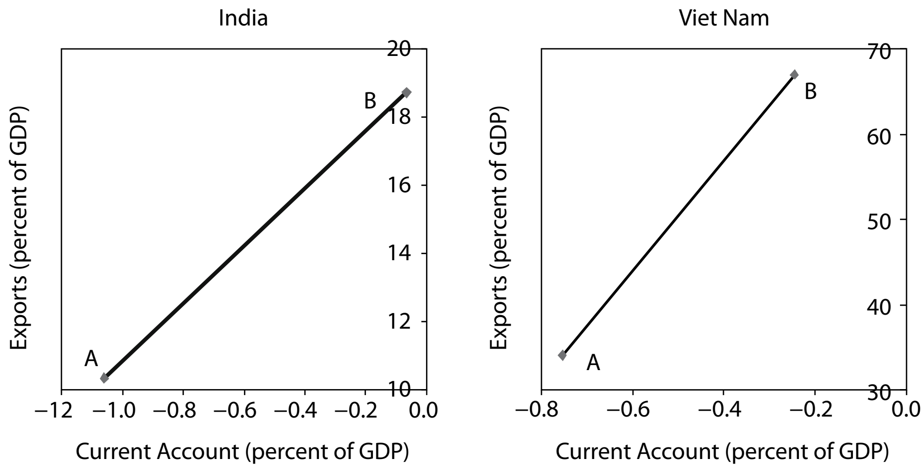

III. Causes of Developing Asia's Postcrisis Current Account Surpluses

Having reviewed the behavior of the current account in the region, we are now ready to explore the possible explanations for the emergence of surpluses in the region since the Asian crisis. By definition, the current account balance is equal to the difference between saving and investment. As such, it is possible to view a large and persistent current account surplus as arising from saving being "too high" or investment being "too low". Therefore, one set of explanations for the region's transformation into a chronic surplus region revolves around the causes of high savings rates, and the other on the causes of the decline in investment rates, especially in the crisis-hit countries. A third set of explanations, known as Bretton Woods II, takes into account the possibility that highly competitive exchange rates are the underlying driver of both current account surplus and economic growth.

A. Too Much Savings?

One broad set of explanations for developing Asia's current account surpluses focuses on the region's high saving rates. Why has saving surged in recent years in parts of the region, especially since 2003? Various explanations have been advanced for the high and rising national savings rates that the region has witnessed. Since the increase in savings rates has been largest in the PRC, much of the empirical work has focused on the PRC experience (Weimer 2008, Kujis 2005), and has centered on seeking to model the proximate factors underlying the recent surge in the PRC's saving. At the same time, however, there has also been some empirical analysis of savings in developing Asia more broadly in the context of seeking to understand the factors underlying the global current account imbalances (IMF 2006b).

Several factors have been proposed as possible contributors to the recent surge in regional private savings. These include: the region's recent rapid GDP growth, with a key finding from numerous saving studies being that rapid growth lead to surges in saving;[7] increased uncertainty in the wake of the Asian crisis experience, with a potentially positive effect on precautionary saving; demographic factors, in particular the effect of a regionwide demographic transition toward older populations; and financial development, which may in principle have either positive or negative effect on saving. As typified by IMF (2005) and Park and Shin (2009), one central finding across much of the empirical work is the key role played by the region's rapid GDP growth in explaining its high private saving rate, and the important role played by demographic factors in a number of countries. Empirical studies indicate that savings rates in the region were somewhat higher than implied by standard relationships in the period immediately after the Asian crisis, perhaps as a result of a sharp rise in uncertainty, but this effect appears to have waned in recent years (IMF 2006b, Bernanke 2005).

Based on the analysis above, a key robust finding is that much, but not all, of the recent surge in the region's saving has been the result of rapid rates of economic growth, especially in the PRC. To the extent that this is the case, a key determinant of the region's current account surpluses, especially in recent years, could be seen as its rapid rates of economic growth. In the case of the PRC, such an effect probably explains a large part of the recent increase in the saving rate on account of the fact that recent growth rates in the PRC have been exceptionally high. Elsewhere in the region, however, faster GDP growth is at best a partial explanation for any increase in savings rates insofar as average GDP growth in the last several years has tended to be below its precrisis rates in much of the region (ADB 2008).

B. Too Little Investment?

Another set of explanations for the region's current account surpluses focuses on the weakening of investment in parts of the region since the Asian crisis. Why has investment weakened since the crisis? Across the region, with the notable exceptions of PRC, India, and Viet Nam, investment as a share of GDP has been unusually low since the Asian financial crisis, with this weakness accounting for the bulk the region's shift toward current account surpluses in the period immediately after the crisis. To some degree, the investment weakness has been in the real estate sector, where there had been massive overinvestment in several countries in the run-up to the Asian crisis, and some return to lower and more sustainable investment rates was to be expected.[8] For the most part, however, the weakness has been across all the components of investment and has occurred both in countries that were at the center of the crisis and those that were not.

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7 The strong positive relationship between savings rates and GDP growth rates is found in both time series and cross sectional regressions. In principle, the relationship can be derived from either life cycle or permanent income models of consumption under the assumption that permanent income adjusts sluggishly to changes in actual income.

8 See IMF (2006a) for discussions on the role of real estate investment in Asian imbalances.

Four major explanations have been proposed for the broad-based weakness of investment in the region since the Asian crisis. According to one set of explanations, the weakness has been the result of lingering effects from the crisis (Chinn and Ito 2005 and Eichengreen (2006)]. Postcrisis restructuring and reform—along with the working off of precrisis investment excesses—contributed importantly to the weakness of investment in the crisis economies in the years immediately after the Asian crisis. A second set of explanations for the broad-based weakness of investment focus on possible competitive pressure from the PRC (IMF 2006c, Wong and Adams 2002). The argument is that if investment in the PRC increases sharply, there will be cutbacks elsewhere in Asia. A third explanation for the recent weakness of investment relates to the role of heightened regional risk in the period since the Asian crisis (ADB 2007). According to one argument, the Asian crisis served as an important "wake up" call for economic agents in the region about the risks in the investment environment. Finally, one broad view of the investment weakness is that it may reflect shortcomings in the investment climate in the region in the postcrisis period (IMF 2006c).

Overall, the weakness in investment across much of the region in the postcrisis period must be seen as a puzzle for which there is no clear explanation. Arguably, the Asian crisis played an important role in depressing investment for a period of time, but its effects have likely waned over time. Neither competition from the PRC, heightened risk, nor a deteriorating investment climate has had a clear effect. In the event, weak investment is no longer the key factor underlying the region's large overall current account surplus. Since 2003, in particular, high and rising national saving has become the key contributor to the imbalance, especially in the case of the PRC, but also in the cases of the newly industrializing economies of Hong Kong, China; Singapore; and Taipei,China.

C. Bretton Woods II View: Role of Highly Competitive Exchange Rates

The Bretton Woods II view of the imbalances seeks to explain the region's current account surplus in a more general equilibrium framework that takes into account the two-way interactions between economic growth and the surplus. The central assumption of the Bretton Woods II view is that much of developing Asia has implicitly returned to tightly managed US dollar exchange rate regimes, following a brief flirtation with floating exchange rates during the Asian crisis period.[9] The Bretton Woods II view is that the region's decision to return to relatively rigid exchange rate management has been based mainly on a desire to maintain highly competitive exchange rates so as to boost exports and thus achieve rapid growth. A key component of the Bretton Woods II view is the role of highly competitive exchange rates. Exchange rate competitiveness in turn is seen as being supported by systematic intervention in the foreign exchange market to purchase US dollars, which provides the external financing required by the US, to purchase Asian exports.

[9] Hence, the usage of the term Bretton Woods II as the intention is to draw an analogy to the Bretton Woods system of pegged but adjustable exchange rates that was in effect between 1945 and the early 1970s.

According to the Bretton Woods II view, such an arrangement benefits both developing Asia and the US. Developing Asia benefits insofar as it secures markets in which it can sell its exports, and thereby achieve rapid rates of economic growth. The US benefits because it can obtain cheap external financing via developing Asia's purchase of low-yielding US dollar reserve assets.[10] In short, the arrangement is seen as a positive-sum game for the involved countries. The Bretton Wood II view can explain how the region has simultaneously experienced rapid export and GDP growth, large current account surpluses, and rapid rates of reserve accumulation. In broad terms, these are seen as the outcome of very competitive exchange rates and the necessary accompanying monetary and exchange rate policies. However, while the Bretton Woods II provides a more comprehensive explanation, it also suffers from serious shortcomings and inconsistencies. In particular, its characterization of the region's postcrisis exchange rate to dollar pegs or quasipegs does is difficult to square with substantially greater exchange rate flexibility in countries such as Indonesia, Korea, and Thailand.

D. Summary

Putting all of the arguments together, it is clear that our understanding of the factors underlying the emergence of large and persistent current account surpluses since the Asian crisis remains limited. Clearly, there is no one single explanation for the imbalances and the relative contribution of various factors has been different over different subperiods. The broad-based weakness in investment in the immediate aftermath of the Asian crisis appears understandable, but the decade-long persistence of this weakness remains largely a puzzle. The recent surge in regional saving appear mainly to be the consequence of rapid regional growth, but such an explanation is incomplete insofar as it does not address the factors underlying the rapid growth rates. In short, both the postcrisis investment slowdown and the high and rising saving rates remain largely an unexplained puzzle.

IV. Consequences of Global Imbalances for Developing Asia

While the causes of Asia's postcrisis current account surpluses remain poorly understood, the consequences of global imbalances, which partly reflect those surpluses, are all too real and painful. In addition to the negative impact of the global financial crisis on exports and growth, global imbalances entail two types of costs for Asia. The first is the costs arising from the possibility that Asia's current account surplus may be suboptimal. The second is the costs associated with having too much foreign exchange reserves. At a

[10] Even though most economies in the region do not report the currency composition of their reserve holdings, US and IMF data suggest that the bulk of the region's reserves continue to be held in US dollar assets (Setser 2008).

broader level, since economic growth remains by far the top priority in developing Asia, what matters the most is the consequences of the global imbalances for the region's growth.

A. Benefit and Limits of Developing Asia's Export-Led Growth

Before we delve into the issues of excessive current account surplus and foreign exchange reserves, it is useful to take a step back and understand the roots of Asia's large and persistent current account surplus. Those roots ultimately reflect Asia's highly successful strategy of export-oriented industrialization. While a wide range of factors can explain why Asia was able to outperform other parts of the developing world in the postwar era, one key reason was the region's ability to produce and sell manufacturing goods abroad. Any meaningful debate about the desirability of a more balanced growth strategy should not lose sight of this historical fact. Going forward, the key question facing Asia is whether a strategy that has delivered economic growth will continue to deliver in the future. The global imbalances underlying the global financial crisis highlight the unsustainable nature of running large current account deficits forever. The global financial crisis brought to the fore the limits of a growth strategy which ultimately rests upon an ever-growing appetite for Asian goods.

B. Costs of Oversaving and Underinvestment

Asia's large and persistent current account surpluses can be viewed as a symptom of a high degree of dependence on external demand as an engine of growth. An equally valid interpretation of those surpluses is an excess of saving over investment. There are two potential types of welfare costs arising from the imbalance between saving and investment in Asia in the postcrisis period. One is oversaving and the other is underinvestment. Along with export-oriented industrialization, high saving and investment rates have long been viewed as an integral part of the East Asian growth model. Although high saving has served Asia well in the past, the key question being highlighted by the Asian crisis is whether the region now suffers from saving too much. This question is especially relevant for the PRC given the country's stunningly high saving rate relative to its income level. The welfare costs of oversaving are likely to be especially high in a poor country with low consumption levels and living standards. If the cost of oversaving is potentially large for developing Asia, so is the cost of underinvestment. The main tangible costs of a slower-than-optimal capital accumulation are a reduction of future productive capacity and growth rates. The slowdown of growth rates to suboptimal levels due to underinvestment is a huge cost indeed in light of the fact that developing Asia is still a poor region.

C. Costs of Excessive Foreign Exchange Reserves

One major consequence of persistent current account surpluses has been an explosive growth of foreign exchange reserves held by the region's central banks. There is a growing consensus that the accelerated reserve growth of developing Asian countries may have led to excess reserves, i.e., reserves in excess of optimal levels. The optimal level of reserves is determined by their marginal benefits and costs. Excess reserves are welfare-reducing by definition. According to Park (2007), both informal and formal analysis confirms the popular belief that developing Asia's reserves now exceed what is required for liquidity purposes by a wide margin, which implies correspondingly large welfare losses. One specific cost of excess reserves is the returns foregone by holding them in the form of traditional reserve assets—i.e., safe and liquid but low-yielding assets such as US government bonds—rather than higher-yielding assets. Parking excess reserves in liquid foreign currency assets that offer little additional protection against currency crisis has significant opportunity costs. Park (2008) estimates the benefits of managing excess reserves more actively and finds them to be higher than 1% of GDP in many Asian countries.

D. Costs of the Global Financial Crisis for Developing Asia

It was earlier pointed out that developing Asia will not be immune from the adverse effects of global imbalances. Most immediately, if we view the current global financial crisis as reflecting global imbalances to some extent, it is possible to interpret the current slowdown of economic activity in the region as a cost of global imbalances. The 2008 and in particular 2009 GDP growth forecasts have been sharply revised downward throughout the region. In a region as poor as Asia, a 2–3% decline will tangibly constrain the resources and capacity to reduce poverty and income inequality. A timely study from the Asian Development Bank (ADB) by James et al. (2008) explores both the financial and real impact of the global financial crisis on developing Asia in some detail. So far the crisis seems to have had only a limited impact on the region's financial systems. On the other hand, the real economies of the region are already bearing the full brunt of the global economic downturn precipitated by the crisis. The synchronized slowdown of economic activity underway in the G3 will have a pronounced impact on world trade and hence Asian exports and growth. Beyond the short term, to the extent that the US downsizes its current account deficit over an extended period of time, developing Asia will face a more permanent negative shock to its exports and growth.

E. Costs of Global Imbalances on Developing Asia's Economic Growth

In light of the fact that developing Asia remains a poor region, by far the single most important determinant of the region's economic welfare remains GDP growth. The region cannot realistically hope to reduce poverty and inequality on a meaningful scale without adequate GDP growth. As such, any discussion of the impact of global imbalances on the region has to touch upon their implications for growth. What should be of utmost concern to developing Asia's policymakers is the structural component of the ongoing deceleration of the region's exports. Achieving rapid growth by producing ever larger quantities of an ever wider range of manufactured goods is feasible as long as there are markets that can absorb those goods. However, the unfolding global crisis highlights the ultimately unsustainable nature of overproduction sustained by overconsumption. There is a widespread tendency in the region to point to rapid economic growth as the primary justification for relying on exports as an engine of growth. However, the global financial crisis rudely shatters the delusion that there are no limits to external demand and hence to export-led growth. Asia is no longer a small economy that faces an effectively infinite global market and can always export its way to high growth rates. There are also clear limits to which competitive exchange rates, emphasized in the Bretton Woods II view, can artificially promote exports in the long run.

F. Summary

Insofar as the current global financial and economic crisis reflects an unwinding of global imbalances, developing Asia is already paying a heavy price for those imbalances. In the short run, the collapse in G3 demand for the region's exports will severely dent the region's exports and growth prospects. In the medium and long run, the global crisis highlights the risks of an excessive dependence on foreign demand. An unbalanced growth based on overdependence on exports may deliver faster growth in the short run, but can contribute to the build-up of unsustainable global imbalances over a longer time horizon. Given the excellent track record of export-led growth in the region, a regional mindset that favors exports over domestic demand is all too understandable. However, the global financial crisis has rudely awakened the region that the world's demand for the region's output is neither automatic nor guaranteed. Some specific welfare costs arising from the global crisis include those associated with suboptimal levels of saving, investment, and foreign exchange reserves.

V. Concluding Observations

Global current account imbalances underlie the ongoing global financial and economic crisis. Global imbalances are as much a matter of unsustainable current account deficits as unsustainable current account surpluses. Furthermore, other parts of the developing world, most oil exporters such as the Middle East and Russia, have also contributed substantially to the surpluses. Nevertheless, the large and persistent surpluses that have emerged in developing Asia since the Asian crisis are an integral part of global imbalances. Global imbalances will also have serious adverse consequences for Asia's growth prospects insofar as the global crisis, which is crippling the region's exports, partly reflects a disorderly resolution of those imbalances. One does not have to be an adherent of the global savings glut theory to discern a connection between global imbalances and global financial crisis. At a purely intuitive level, large and persistent current account deficits financed by large and persistent current account surpluses cannot go on indefinitely and will have to unwind at some point.

It is important to distinguish between the short-term versus the medium- and long-term policy implications of the global crisis, which partly represents a disruptive resolution of global imbalances. In the short term, the undisputed priority of regional policymakers must be to manage the sharp slowdown of economic growth associated with the contraction of external demand. Such short-term management will involve both limiting the reduction of growth through expansionary fiscal and monetary policy as well as easing the hardship of those hardest hit. At the same time, it would be prudent for regional policymakers to fully recognize the medium- and long-term ramifications of the unwinding of global imbalances. Viewing the current slowdown as just another downturn of just another business cycle would be a serious mistake. For one, the sheer size of the global imbalances suggests that their unwinding may require a protracted period of adjustment in the US. At a broader level, the global crisis highlights the inherently unsustainable nature of a growth based on excessive dependence on foreign demand in the medium and long term. As such, it should serve as a wake-up call for policymakers to take concrete actions to rebalance their economies on a sustained basis.

However, it should be emphasized in the strongest possible terms that rebalancing does not imply turning back from the economic openness and integration into the world economy that has delivered enormous benefits for developing Asia in the past and will continue to do so in the future. In particular, erecting trade barriers to protect domestic firms and workers may be politically tempting under the present circumstances but will harm all countries in the region. What is hurting the region is not its traditional openness to international trade and capital flows, but unsustainable imbalance in the global structure of supply and demand. Large and persistent current account surpluses are not an intrinsic structural feature of developing Asia and, in fact, the region as a whole ran deficits until the Asian crisis. Rebalancing represents a return to the generally more balanced structure of demand and growth that prevailed in the region prior to the Asian crisis.[11]

In the postcrisis period developing Asia as a whole has been transformed into a region of chronic current account surpluses, or, equivalently, a chronic net exporter of capital. However, the behavior of the region as a whole and the existence of some common elements do not detract from the fact that there is a great deal of heterogeneity across

[11] However, in the immediate precrisis period, excessive current account deficits in some countries contributed to the outbreak of the Asian crisis.

the region's countries in terms of the size and nature of their surpluses. Unusually high saving rates that reflect unusually low consumption rates explain the imbalance between output and expenditure in the PRC. In the crisis countries, a sharp drop-off in investment rates against a backdrop of high and relatively stable saving rates explains the imbalance. Asian countries also vary widely in terms of their current account positions. For example, the ratio of current account surplus to GDP exceeds 10% in Malaysia and Singapore but Korea's account is balanced while India and Viet Nam are in fact running deficits. The lack of a one-size-fits-all explanation for the region's current account surplus rules out one-size-fits-all policy prescriptions.

Notwithstanding the heterogeneity of current account surpluses across the region, some rebalancing of growth toward domestic demand will be required for the region as a whole. In the absence of such rebalancing, the global economic crisis will have a pronounced impact on growth in highly export-dependent developing Asia. While necessary, rebalancing is bound to be a difficult, protracted, and complex structural process. Above all, mismatch between the structure of output and structure of demand in many export-oriented Asian economies will constrain the rebalancing of demand and growth. The imbalance between what the region produces and what the region consumes is partly structural, and will only be fully resolved with the recovery of the world economy. However, a key regional development that bodes well for rebalancing is the emergence of a large and rapidly growing urban middle class. The demand of this subpopulation for goods such as automobiles and household appliances is taking off, and laying the foundations for strong and sustainable domestic demand.

The intrinsically difficult and time-consuming nature of rebalancing developing Asia's economies entails a number of significant policy implications. For one, even under the most optimistic scenarios, it will be a daunting challenge for the region to achieve its exceptionally high growth rates in view of the drastically worsened global economic outlook. A more realistic and feasible goal may be to achieve growth rates that are somewhat slower than those of the period prior to the global crisis but nevertheless still high relative to other parts of the world and, more importantly, high enough to make a dent on the poverty that still afflicts wide swathes of the region. It is up to the regional policymakers to effectively communicate the reality of lower short- to medium-term growth prospects to the public as well as assist the hardest hit segments of the population to prevent social and political instability.

The fact that private domestic demand cannot be mechanically ramped up in a short period of time implies that the government must take the lead in rebalancing demand in the short run. In fact, governments around the region are already trying to pump up demand through activist fiscal policy in response to the collapse of external demand. However, the region's governments should also consider using fiscal policy for rebalancing purposes beyond the short term. In addition to becoming a "spender of last resort", using fiscal policy to stimulate domestic demand involves creating the appropriate enabling environment for the private sector. For example, investing in the education system will help to alleviate the shortage of critical skills that constrain investment in some industries. Reducing the mismatch between output and demand structures requires not only demand-side policies but also supply-side policies. In particular, removing policy distortions that favor the production of tradables over nontradables will do as much to reduce the mismatch as boosting demand.

While developing Asia has played a part in the emergence of global imbalances since the Asian crisis, an orderly unwinding of those imbalances will require a global effort. In this context, an especially significant global initiative would be the reform of the global financial architecture. There is a widespread perception in developing Asia that the International Monetary Fund (IMF) did a poor job of handling the Asian crisis of 1997–1998. Regardless of its validity, this perception has eroded confidence in the IMF throughout the region. The loss of confidence in the IMF, in turn, may have encouraged regional countries to run up current account surpluses to build up a large war chest of foreign exchange reserves to protect them from another devastating crisis in the future. Measures to restore the region's confidence in the IMF, such as governance changes that would give the region a voice proportionate with its role in the world economy, would weaken the incentives for precautionary reserve build-up and thus contribute to global rebalancing.

By far the most central message of our study is that it is fundamentally in developing Asia's own enlightened self-interest to rebalance the structure of its demand toward domestic sources. Part of the need for rebalancing is driven by short-term necessity—rebalancing will help to mitigate the sharp slowdown of exports and growth due to the synchronized slump of the G3 economies. Looking further ahead to the medium and long term, while the global crisis does nothing to diminish the benefits of an outward-looking export-oriented growth strategy, it does highlight the very real risks of an excessive reliance on external demand. It is true that Asian rebalancing would contribute to an orderly unwinding of global imbalances, which is a global public good. However, the region has the best reason of all to pursue rebalancing—its own growth and welfare. The region is in a good position to pursue rebalancing because it has much stronger fundamentals than during the Asian crisis. These include relative absence of financial sector imbalances and generally healthy fiscal positions.

A further argument for rebalancing Asia's growth is that many of the policies rebalancing requires are consistent with and in fact supportive of the broader objectives of poverty reduction and inclusive growth. For example, strengthening health care and old-age support not only helps to boost domestic demand but also reduces poverty and inequality to the extent that the poor suffer disproportionately from lack of access to such basic services. In addition to contributing to more inclusive growth, rebalancing can also give a big boost to intraregional trade. While intra-Asian trade has superficially experienced impressive growth in recent years, much of it is trade in intermediate goods geared toward exporting final goods outside the region. More robust domestic demand for final goods within regional countries will allow for more substantive intraregional trade along the lines of the European Union. As the region's incomes rise, consumers will demand more product variety and this demand will create a greater potential for intra-industry trade in differentiated products among regional countries.

Finally, the transformation of developing Asia into a surplus region is not only a relatively recent phenomenon but also a puzzling phenomenon. By definition, the current account surplus is equal to net savings, or difference between savings and investment. Therefore, the emergence of large and persistent current account surpluses is equivalent to a widening gap between savings and investment. While a number of explanations have been put forth for a well-known stylized fact—the postcrisis investment drop in the crisis countries—all of them suffer from lack of convincing theoretical and empirical support. Another well-known stylized fact that underlies the region's postcrisis surpluses (the unusually high and rising saving rates of the PRC and some newly industrializing economies) also remains a puzzle that cannot be accounted for by the fundamental determinants of savings. In short, much more research needs to be done to improve our understanding of Asia's postcrisis current account surpluses.

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About the Paper

Charles Adams and Donghyun Park examine the root causes of the large and persistent current account surpluses that have emerged in developing Asia since the Asian crisis. Those surpluses entail substantial costs for the region in terms of both welfare and growth. Therefore, reducing excessive dependence on exports and laying the foundations for a stronger domestic demand will make the region better off.

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