

The limits of Asian currency flexibility

The case for more flexible currencies should not be based on whether they help trim US current account deficit

By RAMKISHEN S RAJAN

IT would be only a slight exaggeration to suggest that many of the macroeconomic imbalances that currently plague the global economy are connected in some way to the persistent and burgeoning US current account deficit which has ballooned to about 5 per cent of GDP. This figure, which is a reflection of national dissavings, is expected to be even higher in 2004 once the projected increases in US defence-related spending and tax cuts materialise.

There are broadly two perspectives regarding the cause of this global imbalance, namely, those that focus on the current account itself, and those that deal with the financial account. As we shall see, both converge to a broadly similar judgement on its solution.

The commonly held view is that the US can improve its external competitiveness by allowing the US dollar to weaken against major trading partners, particularly those with which it runs large bilateral deficits, namely China and Japan.

The US dollar has declined significantly in recent months against many currencies but not against the Chinese yuan which is rigidly pegged to the greenback. While the Japanese yen has appreciated somewhat against the US dollar, implicit or explicit intervention in the foreign exchange markets by the Bank of Japan has limited the rise of the yen (though the yen has appreciated significantly since September's G-7 meeting in Dubai).

Thus, the bulk of the adjustment of the US dollar has hitherto largely been vis-a-vis the euro and the Australian, Canadian and New Zealand dollars. On a real trade weighted basis, the US dollar remains much higher than its recent trough in 1995, suggesting significant scope for further declines in the currency. It is in this light that many observers have advocated that the Asian currencies, particularly the Chinese yuan, be allowed to be more market driven or flexible.

Against the background of weak domestic employment (US unemployment having peaked at 6.1 per cent recently) and looming elections, many US congressmen have demanded that punitive trade sanctions be imposed on China by the US Trade Representative (USTR) or the World Trade Organization (WTO) if it fails to revalue the yuan. These overt protectionist calls are of concern, though thankfully they thus far remain a minority opinion and seem largely aimed at appeasing domestic constituencies.

A less commonly expressed - but growing - point of view regarding the US current account deficit is based on the financial account side of the ledger. The argument here goes something as follows. The deficit is nothing but a reflection of a desire by non-residents to hold US assets. A large part of this demand in turn arises from Asian central banks' holdings of foreign reserves, much of which are denominated in US

dollars. In other words, the US financial account surplus is viewed as driving the country's current account deficit rather than merely being a function of it.

Asian central banks hold about two-thirds of global reserves (amounting to about US\$2.3 trillion), about three-quarters of which are denominated in liquid US dollar assets (usually US Treasuries).

The large, and rising reserve holdings by Asian countries are presumed to be a consequence of undervalued exchange rates as their monetary authorities have attempted to keep their respective currencies stable in the face of significant buying pressure, by selling their currencies and in the process, accumulating US dollars. It is argued that if, however, these countries forsake their mercantilist currency policies and permit their currencies to be more flexible, this will reduce demand for international reserves, curb capital inflows into the US, and thus moderate the US current account.

If one accepts that capital flows are in fact driving rather than passively financing the current account, sudden offloading of US Treasuries could either lead to a sharp US dollar depreciation or necessitate a marked interest rate hike, either of which could be acutely destabilising to financial markets and the global economy. In any event, the relevant point here is that there is a convergence of opinion regarding the need for greater flexibility in Asian currencies.

Nonetheless, as long as there is no change in the US national dissavings position, inroads will not be made in reducing the country's current account deficit. One could, for instance, envisage a case where a rise in Asian currencies (particularly the yuan) could lead to a reduction in the domestic prices in China, such that real exchange rates remain more or less unchanged. In such circumstances, a yuan appreciation would simply exacerbate global deflationary pressures.

The most effective way of reducing the US current account deficit is to attack the problem head-on by reducing the US budget deficit or raising household savings. Any other proposed remedy is akin to the 'tail wagging the dog' and is destined to fail.

But where does that leave the issue of Asian currencies and reserves? Calls for greater flexibility of Asian currencies (as recently voiced by IMF as well as G-7 members after their meetings in Dubai) and consequent reduction in reserves ought not to be based on whether they help trim the US current account deficit. Rather, the most convincing case for more flexible currencies is the benefits they offer to China and other Asian economies with exchange rate pegs, such as Hong Kong and Malaysia.

Probably the most important benefit of a flexible exchange rate pertains to adjustment to adverse external shocks. In the absence of flexibility, adjustment to these shocks will have to take place domestically via changes in output and employment or costs and prices. This can be extremely long-lasting and painful, as experienced by Argentina and Hong Kong in recent years.

Nevertheless, Asian countries such as China may be resisting currency flexibility for reasons other than their desire to maintain competitiveness. Even if convinced about the virtues of more flexible exchange rates at some stage in the future, they may still want to stockpile reserves - which means there will remain a degree of currency undervaluation vis-a-vis the rest of the world. In other words, reserve accumulation by

many Asian countries may not be a consequence of an undervalued currency, but rather, a specific policy objective in and of itself.

The seemingly insatiable appetite for reserves by Asian central banks in turn appears to be a direct consequence of the risk aversion that has developed following the financial crisis of 1997-98 and thereafter, which remains fresh in the minds of policymakers.

However, stockpiling reserves can be costly as this effectively involves swapping relatively higher-yielding domestic assets for lower yielding foreign (US dollar-based) ones. There is no free lunch, but for now at least, Asian central banks seem willing to pay.

The writer is a visiting fellow at the Institute of Policy Studies. He is also Senior Lecturer at the School of Economics, University of Adelaide and Visiting Freeman Foundation Senior Lecturer at the Department of Economics, Claremont McKenna College in California