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Coping with Global Imbalances and Asian Currencies

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ERD POLICY BRIEF NO. 37

Coping with Global Imbalances and Asian Currencies

Cyn-Young Park

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Controversy surrounding currency regimes of Asian countries excluding Japan has become a subject of debate in recent years. *The Economist (*2003*),* claims that "Asian governments are creating global economic strains by tying their currencies to the dollar." Behind this is an argument that by letting their currencies appreciate, Asian countries should be able to bring about the smooth adjustment of global imbalances.

With the region's ever-growing foreign exchange reserves, the reluctance of Asian countries to allow their currencies to appreciate is often viewed as a main hurdle to the orderly resolution of the United States's (US) external imbalance. The renminbi of People's Republic of China (PRC) has become a major target of such criticism, given the PRC's substantial bilateral trade surplus against the US and large accumulation of foreign reserves over the years. This policy brief analyzes macroeconomic impacts of a "one-off" appreciation of the renminbi against the dollar using the Oxford Economic Forecasting (OEF) model to shed light on the dynamics between global imbalances and revaluation. The OEF model framework allows scenario analyses based on the global econometric structure, which will provide some quantitative results for the impacts of a revaluation on the concerned economies, such as the PRC, Japan, US, and other Asian countries.[1]

Simulation results suggest that a revaluation would have significant impacts on the PRC and its Asian neighbors, although it is unlikely to have much effect on global imbalances, and little impact on the US economy. For the PRC, a revaluation would take some of the heat off the economy and could contribute to a "soft" landing. The results, though only indicative, will help answer some key questions: the role of the PRC in adjusting global imbalances, the PRC's incentive to revalue, and implications for other Asian economies.

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[1]Nine other Asian economies are selected for the simulation: Hong Kong,China; India; Indonesia; Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand. Throughout the policy brief, Asia refers to these economies.

Impact of Revaluation

In 2004, the US current account posted another record deficit of $665.9 billion, or 5.7% of gross domestic product (GDP), following a deficit of $530.7 billion in the previous year. Reflecting growing concerns about US current account deficits, the dollar declined by 7.4% against the euro and 4.7% against the yen during 2004. This year, however, the dollar has regained some value against major international currencies such as the euro and the yen despite a widening deficit on the US trade balance. By the end of the first quarter of 2005, the dollar had appreciated from a low of 0.74 euro to 0.77.

The reversal in recent exchange rate trends has been accompanied by a shift of focus to Asian currencies and their role in restoring balance to the global economy. Pressure on Asian currencies to appreciate will likely intensify based on the region's relatively robust growth outlook, together with continuing capital inflows. In 2004, Asia accounted for more than 35% of the US's trade deficit. The PRC alone had a bilateral trade surplus with the US of $165 billion. Including Japan, about a half of the US trade deficit originated from the region.

The macroeconomic simulations explore two scenarios. First, a 10% appreciation of the nominal exchange rate of the renminbi with the dollar from the second half of 2005 and onwards (Scenario I). Second, a revaluation of the renminbi by 20% vis-à-vis the dollar (Scenario II). In comparison, the baseline scenario assumes no change in the nominal exchange rate with the dollar. For the purpose of the simulation, it is assumed that other Asian economies maintain the current exchange rate regimes, namely: (i) dollar peg for Hong Kong, China; (ii) managed floats for India, Indonesia, Philippines, Singapore, and Thailand; and (iii) free floats based on independent monetary policy with a modified Taylor rule[2] for Japan; Republic of Korea; and Taipei,China. A notable exception is Malaysia, which is assumed to revalue its currency, the ringgit, by 5 percent.

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[2]Taylor (1993) shows empirically that the US monetary policy follows a simple rule, which balances between two conflicting policy goals of price stabilization and narrowing output gap. Monetary policy pursues narrowing of the output gap without risking inflationary danger. As such, the Taylor rule calls for interest rate adjustments when (i) actual inflation deviates from the target inflation rate of monetary authority and (ii) real GDP deviates from potential GDP. The simple Taylor rule is often modified to embody complexity of practical aspects in monetary operations.

Table 1 summarizes the simulation results of Scenario I, and Table 2 describes the outcomes of Scenario II. A revaluation of the renminbi affects macroeconomic performance of the PRC and its trading partners through changes in the trade and current accounts, thereby changing aggregate demand, inflation, and real GDP. Generally, a revaluation results in a reduction of imports from the PRC, thus deteriorating the PRC's trade balance and improving the others' although various factors such as the share of bilateral trade with the PRC in total trade, price and income elasticities of demand for the PRC's exports, and changes in competitiveness will determine the net effect on the trade balance of individual countries.

In both scenarios, a revaluation has the most significant impact on the PRC economy. First, a revaluation makes the PRC's exports more expensive in the global market, thus adversely affecting its current account balance. In Scenario I, a loss of trade surplus amounts to $15 billion in 2006. In Scenario II, the trade loss is $31.8 in 2006, or a decrease in the current account as a percent of GDP by 1.7 percent. Second, the fall in exports and the resulting decrease in aggregate demand create excess supply, which dampens inflation. The result is a drop in inflation of 1.2 percentage points below baseline in Scenario I, and in case of Scenario II, the decrease is 2.4 percentage points. Third, lower inflation expectation given the level of nominal interest rates push real interest rates instantly higher, reducing investment demand, while a fall in real income lowers consumption spending. Investment decreases by 1.7% and 3.5% in Scenario I and II, respectively, and so does GDP by 1.9% and 3.9 percent. The results suggest that a revaluation of 10% could considerably stabilize the PRC's overheating economy by suppressing inflationary pressure, reducing investment and GDP growth. On the other hand, a 20% appreciation or more nearly halves GDP growth, risking a hard landing.

Of strong interest is the effect of a revaluation on the US current account balance. The US trade balance improves by $3.6 billion in Scenario I, which is a mere 0.02% change in the current account as a percent of GDP. In Scenario II with a 20% revaluation, the situation little changes, contributing to a 0.05% reduction in the current account deficit. A closer look at the US trade deficit reveals that the effect of the renminbi revaluation is unlikely to be sufficient for the necessary adjustment of the US external imbalance. First, imports from the PRC account for a relatively small share (about 13.4% in 2004) of total US imports, and exports to the PRC constitute an even smaller share (4.3%) of total US exports. Even if the revaluation were to decrease imports from the PRC by half and double exports to the PRC, it would

Table 1. **Impact of a 10% Appreciation of the Renminbi (Scenario I)**

	Exchange rate (with US$)	Trade balance (US$ million)	Current account (% of GDP)
People's Republic of China			
2005	-5.0	-3,571.9	-0.3
2006	-10.0	-14,974.6	-0.8
United States			
2005	0.0	222.9	0.0
2006	0.0	3,617.3	0.0
Japan			
2005	0.0	96.4	0.0
2006	0.0	504.3	0.0
Hong Kong, China			
2005	0.0	19.2	0.0
2006	0.0	18.8	0.1
India			
2005	0.0	-5.9	0.0
2006	-0.1	-241.2	0.0
Indonesia			
2005	0.0	56.7	0.0
2006	-0.2	32.3	0.0
Korea			
2005	0.0	378.3	0.0
2006	-0.3	1,111.5	0.1
Malaysia			
2005	-2.5	-20.3	-0.2
2006	-5.0	-339.7	-0.5
Philippines			
2005	0.0	10.6	0.0
2006	-0.2	62.1	0.1
Singapore			
2005	0.0	22.4	0.0
2006	-0.3	261.4	0.1
Taipei,China			
2005	0.0	242.2	0.1
2006	-0.4	493.9	0.1
Thailand			
2005	0.0	23.5	0.0
2006	-0.2	98.4	0.0

(continued)

Table 1. *(continuation)*

	Investment	Consumption	GDP	Inflation (in percentage points)
People's Republic of China				
2005	-0.1	-0.1	-0.3	-0.2
2006	-1.7	-0.5	-1.9	-1.2
United States				
2005	0.0	0.0	0.0	0.0
2006	0.0	0.0	0.0	0.0
Japan				
2005	0.0	0.0	0.0	0.0
2006	0.0	0.0	0.0	0.0
Hong Kong, China				
2005	0.0	0.0	0.0	0.0
2006	0.0	0.0	0.1	0.0
India				
2005	0.0	0.0	0.0	0.0
2006	0.1	0.0	0.1	0.0
Indonesia				
2005	0.0	0.0	0.0	0.0
2006	0.8	0.2	0.3	0.0
Korea				
2005	0.0	0.0	0.1	0.0
2006	0.1	0.1	0.3	0.0
Malaysia				
2005	-0.8	-0.1	-0.3	-0.3
2006	-6.0	-0.9	-2.4	-1.2
Philippines				
2005	0.0	0.0	0.0	0.0
2006	0.1	0.1	0.1	0.0
Singapore				
2005	0.0	0.0	0.0	0.0
2006	0.1	0.3	0.5	0.0
Taipei,China				
2005	0.0	0.0	0.0	0.0
2006	0.1	0.2	0.2	0.0
Thailand				
2005	0.0	0.0	0.0	0.0
2006	0.7	0.2	0.3	0.0

Note: Percentage changes from the base case unless otherwise specified. In the case of the United States, effective exchange rate is reported.
Source: Staff estimates based on OEF model.

Table 2. **Impact of a 20% Appreciation of the Renminbi (Scenario II)**

	Exchange rate (with US$)	Trade balance (US$ million)	Current account (% of GDP)
People's Republic of China			
2005	-10.0	-7,578.7	-0.6
2006	-20.0	-31,790.7	-1.7
United States			
2005	0.0	514.8	0.0
2006	0.0	7,869.7	0.1
Japan			
2005	0.0	221.7	0.0
2006	0.0	1,195.7	0.1
Hong Kong, China			
2005	0.0	46.4	0.0
2006	0.0	94.8	0.2
India			
2005	0.0	-7.7	0.0
2006	-0.1	-470.2	-0.1
Indonesia			
2005	0.0	126.1	0.0
2006	-0.3	104.4	0.0
Republic of Korea			
2005	0.0	818.7	0.1
2006	-0.7	2,412.2	0.2
Malaysia			
2005	-2.5	-3.2	-0.
2006	-5.0	-153.6	-0.4
Philippines			
2005	0.0	25.1	0.1
2006	-0.3	147.9	0.4
Singapore			
2005	0.0	65.6	0.0
2006	-0.4	531.5	0.1
Taipei,China			
2005	0.0	525.1	0.1
2006	-0.9	1,068.8	0.2
Thailand			
2005	0.0	51.6	0.0
2006	-0.5	211.4	0.1

(continued)

Table 2. *(continuation)*

	Investment	Consumption	GDP	Inflation (in percentage points)
People's Republic of China				
2005	-0.2	-0.2	-0.6	-0.4
2006	-3.5	-1.0	-3.9	-2.4
United States				
2005	0.0	0.0	0.0	0.0
2006	0.0	0.0	0.1	0.0
Japan				
2005	0.0	0.0	0.0	0.0
2006	0.1	0.0	0.1	0.0
Hong Kong, China				
2005	0.0	0.0	0.0	0.0
2006	0.0	0.0	0.2	0.1
India				
2005	0.0	0.0	0.0	0.0
2006	0.3	0.0	0.1	0.0
Indonesia				
2005	0.0	0.0	0.0	0.0
2006	1.1	0.3	0.5	0.0
Republic of Korea				
2005	0.1	0.0	0.1	0.0
2006	0.5	0.3	0.6	0.0
Malaysia				
2005	-0.8	-0.1	-0.3	-0.3
2006	-5.4	-0.8	-2.1	-1.2
Philippines				
2005	0.0	0.0	0.0	0.0
2006	0.3	0.2	0.3	0.0
Singapore				
2005	0.0	0.0	0.0	0.0
2006	0.3	0.4	0.6	-0.1
Taipei,China				
2005	0.0	0.1	0.2	0.0
2006	0.3	0.6	0.6	0.0
Thailand				
2005	0.1	0.0	0.1	0.0
2006	1.0	0.4	0.7	0.0

Note: Percentage changes from the base case unless otherwise specified. In the case of the United States, effective exchange rate is reported.
Source: Staff estimates based on OEF model.

amount to a reduction of the US trade deficit by only about $29 billion or 0.24% of GDP. Second, a reduction in imports from the PRC would likely be offset by increased imports from other Asian countries, unless other Asian currencies appreciate significantly more than the model suggested. Third, it is even more unlikely that US exports dramatically increase following a renminbi revaluation, not only because of the PRC's negligible share of US exports but also because of the negative income effect of the revaluation on the PRC economy curbing its import demand.

The impact of a revaluation is more pronounced in Asian economies. The assumed revaluation induces an appreciation of other Asian currencies.[3] However, the results show that appreciations are small: ranging from 0.1 to 0.5% in Scenario I and 0.1–0.9% in Scenario II. A relatively small-scale appreciation of other Asian currencies appears to trigger a shift of trade surplus from the PRC to some Asian countries rather than reduction of the US trade deficit, as these exporters gain competitiveness. A revaluation makes exports of Asian economies to the PRC cheaper, thus positively affecting their trade surpluses, although a reduction in the growth of the PRC's real income would partly constrain its import demand. Net effects would depend on how price-sensitive import demand is, as well as the magnitude of currency adjustments. Generally, countries with similar endowments as those of the PRC and are producing labor-intensive goods that compete with the PRC's products in third-country markets, would be expected to experience an expansion in net exports and an acceleration in the growth of their income. Conversely, other countries that have complementary endowments and strong bilateral trading links with the PRC should experience a contraction in net exports and slower income growth.

Simulation results exhibit a more diverse pattern across Asia. Trade impacts are significant in Korea; Singapore; and Taipei,China.

[3]The inclination of effective exchange rates in recent Asian currency movements suggests that a revaluation should further free up other Asian currencies. Reflecting the mounting pressure of global rebalancing, some Asian currencies, including the Thai baht, New Taiwan dollar, Singapore dollar, and the Korean won, have already significantly appreciated in the last quarter of 2004. A recent study by the Bank for International Settlements (BIS 2005) finds empirical evidence pointing to an increasing role of effective exchange rates in steering movements of these Asian currencies. In support of such tendency, the study finds that the renminbi nondeliverable forwards exert significant influence on Asian currency movements.

These economies experience improvements in their trade balances, even though their currencies rise against the dollar more than others. An increase in real income positively affects domestic consumption, especially in Singapore and Taipei,China. For Indonesia and Thailand, investment effects are particularly strong. As these countries are in direct competition with the PRC in export markets, the revaluation appears to favor their export competitiveness, hence encouraging domestic investment. Presumably, this also reflects their renewed competitiveness to divert foreign direct investment from the PRC. However, the trade impacts are muted, as strong domestic demand tends to increase imports. On the other hand, countries where domestic consumption and investment remain rather inelastic experience proportionately less increases in real income. GDP growth in Hong Kong,China and the Philippines are smaller compared to those of countries with similar income levels, although the impacts are significant on their current account balances. The effect of a revaluation is generally insignificant for India, with GDP growth decreasing only 0.1 percentage point in both Scenario I and II. The results are negative for Malaysia, which was assumed to revalue its currency by 5 percent.

To Revalue or Not to Revalue?

Contrary to popular belief, the PRC's revaluation would have little impact on the US trade deficit. On the other hand, it would be in the PRC's interest to revalue if the authorities want to cool its overheating economy. With rapidly accumulating foreign reserves and overall surpluses in both current and capital accounts, inflationary pressures and the cost of sterilization are rising. If the PRC continues to grow at the current rapid rate while attracting massive foreign capital, a fixed exchange rate will stoke inflationary pressure and cause domestic imbalance. Meanwhile, large US external imbalances require more broad-based depreciation of the dollar. That is, Asian currencies will likely further appreciate against the dollar, hence against the renminbi. Asian neighbors' generally large share of the PRC's imports implies that higher import costs may intensify inflationary pressure on the PRC economy.

An undervalued currency also motivates speculative capital inflows. The PRC already experiences greater volatility of capital inflows, as net private capital inflows continue rising. Net capital inflows to the PRC amounted to $112 billion in 2004 up from $98 billion in 2003. The proportion of short-term capital flows in the form of portfolio investment and syndicated loans is rising too. The increasing size and volatility of such capital flows compound difficulties of sterilization. Successful sterilization would stabilize domestic money supply, although sterilized reserve purchases increase fiscal burden and push domestic interest rates higher than they would be otherwise, thus eventually crowding out domestic investment and consumption. However, rising volatility of capital inflows combined with continued rapid pace of reserve accumulation has weakened the effectiveness of sterilization in the PRC economy, resulting in noticeable expansion of monetary aggregates over the past years.

Finally, reserve accumulation and growing monetary aggregates may accelerate credit growth, aggravating nonperforming loan problems of the PRC's weak banking sector. Incomplete sterilized reserve purchases by the central bank leave commercial banks with excess reserves, which become a basis for increased bank lending. Despite ongoing administrative efforts to curb excessive credit growth, broad money (M2) grew by about 14.6% in 2004—down from 19.6% in 2003 but still high. A fixed exchange rate regime constrains the autonomy of monetary policy, while creeping money supply and inflation continue to lower real interest rates, thus fuelling a credit boom.

Conclusion

The simulations confirm that a revaluation of the renminbi is no panacea for global imbalances. Resolution of global imbalances calls for more fundamental changes in both the US and the global economy. The US current account deficit is a combined result of a low private savings rate, a large fiscal deficit, and a sustained gap in growth between the US and other major industrial countries. As such, the adjustment has to come about by addressing these underlying causes. On the domestic front, the US government needs to rein in expansionary macroeconomic policies and restrain fiscal spending, while ensuring financial prudence in the private sector. At the same time, the rest of the world needs to make conscious efforts to bring down external imbalances by encouraging domestic-demand-driven growth through appropriate macroeconomic policies and structural reforms. To this end, Asia needs to accelerate comprehensive structural reforms to improve economic efficiency and competitiveness and to create a more investment-friendly environment.

Overall, the impacts of a revaluation are small but positive on other Asian economies. Asian countries appear to benefit from a shift of trade surpluses and a diversion of capital flows from the PRC. Trade effects are mostly positive, but the magnitude of the overall impacts on real incomes varies across Asia, depending on country-specific factors such as import elasticities, income effects on domestic consumption, and effects of competitiveness gains on investment.

Exchange rate policy should be considered in tandem with domestic policies for efficient aggregate demand management. Rapid expansion of the PRC economy based on strong productivity growth suggests that increasing demand pressure bring about high inflation and potentially painful adjustments of domestic imbalances. Under a fixed exchange rate, domestic prices and wages have to rise very high—thus eventually leading to appreciation of the real exchange rate—to correct internal imbalances. Meanwhile, this growing imbalance is the world's concern given the size of the PRC economy and its rising influence. Regardless of the direct impact on the US trade deficit, a modest revaluation may take some of the steam out of the PRC economy and help address emerging internal imbalances. Over the long term, a more flexible exchange rate policy would allow greater monetary autonomy and would perhaps better serve the PRC's long-term interests.

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