Global Savings–Investment Imbalances: What Role for East Asia?

Abstract
This paper examines the current path of global imbalances and the role of East Asia in addressing these issues. The roots of the problem are the exploding budget deficit and soaring current account deficit of the United States. The twin deficits are being financed by foreign savings including the placement of the massive foreign exchange reserves of East Asia in U.S. dollar–denominated debt, such as U.S. Treasury notes. Solving the imbalances will require corrections of internal and external imbalances by both the United States and its trading partners. How East Asia deploys its reserves could set off a tsunami of sales of dollar-based assets that could disrupt the U.S. and global economy. Sharp exchange rate adjustments (particularly a large fall in the U.S. dollar), and a protectionist backlash against the U.S. current account deficit, are in no one’s interest as they could trigger global shocks.

1. Introduction
The current path of global imbalances seems to be unsustainable. These imbalances originated from the United States’ exploding budget deficit and soaring current account deficit. The U.S. budget balance increased from −3.8 percent of gross domestic product (GDP) in 2002 to −4.1 in 2005, while the current account deficit rose from 4.5 percent of GDP to 6.4 percent during the same period. Solving these problems will require corrections of internal and external imbalances by both the United States and its trading partners. Sharp exchange rate adjustments, particularly a large fall in the U.S. dollar caused by a protectionist backlash against the current account deficit, are in no one’s interests because they could disrupt the global economy.

* The author acknowledges valuable comments from Renée Fry.
The paper is divided into two parts. The first part reviews various approaches to viewing the global imbalances and the responses of the Asian countries to the crisis in 1997–1998. The second part consists of policy recommendations to East Asian countries on how best to address these imbalances.

2. Five interpretations of global imbalances

Table 1 reports the global savings and investment trends in the 1990–2004 period. Drawing partly upon the recent analysis by Barry Eichengreen (2005), I see five major interpretations about the problems of global saving–investment imbalances and the persistent U.S. current account deficit, and they are:

(1) the deficient U.S. savings view
(2) the “new economy” view
(3) the global savings glut view
(4) the view of the Sino–American co-dependency
(5) the view of an overly risk-averse East Asia view

The compatibility of these five different views can be understood by using the standard textbook current account (CA) and reserve accounting identities for the United States:

\[ CA = (T - G) + (S - I), \]  

\[ (1) \]
\[ CA = (X - M), \]  
\[ \Delta R = CA + CAP. \]  

Where:  
\( T \) = government revenues  
\( G \) = government expenditures  
\( S \) = private savings  
\( I \) = investment expenditures  
\( X \) = export of goods and services  
\( M \) = import of goods and services  
\( \Delta R \) = change in external reserves, including monetary gold, foreign exchange, and securities  
\( CA \) = current account of the balance of payments which consists of exports \((X)\) and imports \((I)\) of goods and services, net factor income of labor, return from investment, and current transfer  
\( CAP \) = capital account of the balance of payments, including direct and portfolio investment

The surplus of current account of the rest of the world \((CA^*)\) must equal the deficit of the United States \((CA)\):

\[ CA = (S - I) = (I^* - S^*) = -CA^*. \]  

Shocks to any of these four variables can have different implications:

- The deficient savings view focuses on a low national savings rates in the United States \((S)\) and on a positive shock to international savings \((S^*)\).
- The “new economy” view focuses on the attractiveness of investment in the United States \((I)\).
- The global savings glut view perceives the inflows of capital to the United States as the result of high foreign savings rates, and as the cause of low interest rates in the United States.
• The Sino–American co-dependency view (or, more generally, the East Asian–American dependency view) sees China’s (East Asia’s) foreign reserves as collateral for the large amount of foreign direct investment (FDI) that is located in China (East Asia).

• The overly risk-averse view observes East Asia as being more risk averse since the economic crisis in 1997–1998. The outcome from this change in attitude is that East Asia has reduced its investment demand in order to enable a defensive accumulation of external reserves.

2.1 The deficient United States saving view
America’s national saving rate fell to −1.2 percent of national income in late 2005 and its household saving rate dropped to less than 1 percent of disposable income. As these saving rates are below the depreciation rate of the U.S. capital stock, the United States does not save enough to cover the replacement of worn-out plants and equipment. Barry Bosworth (2005) blames the decline in the U.S. savings rate mainly on fiscal policy. In his view the persistent U.S. budget deficit is due to

• tax reductions introduced since the Reagan administration
• lower tax receipts because of the stock market crash
• higher government expenditures because of increased social security payments, higher expenditures for homeland security since 11 September 2001, higher expenditures from the wars in Afghanistan and Iraq, and emergency relief for Hurricane Katrina in New Orleans in September 2005

There are two criticisms of this view:

(1) Over the long run there is only slight evidence of positive co-movements of budget and current account imbalances.
(2) Globalization, deregulation, and disinflation have enhanced price flexibility, and moderated the pressures on central banks to adopt anti-inflationary measures in response to shocks. The results are a subduing of inflation expectations, which, in turn, reduces the level of interest rates associated with any level of savings (Rogoff 2003).

2.2 The “New Economy” View
Richard Cooper (2004) and Richard Clarida (2005) argue that the capital inflows that finance the U.S.’s capital account deficit have been attracted by the high returns on investment due to the country’s high productivity and, hence, have nothing to do with U.S. fiscal and monetary policies. There are two main criticisms of this “new economy” view:
While the productivity growth in the information technology (IT) sector is faster in the United States than in Europe, the IT sector accounts for only 6 percent of the U.S. economy. Timmer, Ypma, and van Ark (2003) show that the economy-wide productivity differential between the United States and Europe in the 1995–2001 period was no more than 0.5 percent. This productivity differential is too small to attract the observed big capital inflows from Europe to the United States.

The foreign central banks play a leading role in the purchasing of U.S. assets, and their investment behavior is not motivated primarily by a differential in investment returns that reflected productivity differential.

### 2.3 The global savings glut view

Bernanke (2005) argues that demographic factors, rapid economic growth, high oil prices, and underdeveloped financial sectors are the main reasons for the high savings rates outside the United States. Eichengreen’s (2005) investigation of 53 countries during the period of 1975–2003 confirms that the difference of savings rates in Asia and the United States are mainly due to the differences in rates of economic growth, development of financial markets, and the dependency ratio between the two continents. Specifically:

- The high savings rate in Japan is encouraged by its low dependency ratio (working age individuals have relatively high savings rates).
- The rapid economic growth and corporate earnings in some economies have encouraged corporate savings and, therefore, raised national savings rates.
- The saving rates in oil producing countries have increased simply because of high oil prices.
- The underdeveloped financial sector in China has encouraged high savings rates of households to save more in order to buy homes and finance future medical expenses and pensions.

The main criticism of this view is that Table 1 shows that the fall in private (household plus corporate) savings has happened not only in the United States (a drop of 2.5 percentage points between 1991 and 2004), but also in other parts of the world—for example, Japan and Europe (a decline of 6.8 and 1.1 percentage points, respectively).

### 2.4. The Sino–United States co-dependency view

Most of China’s external reserves are invested U.S. Treasury bills and other dollar-denominated assets. A fraction of the short-term capital inflows from China are transformed in the efficient capital markets in the United States and re-exported to China in the form of long-term FDI. According to Eichengreen (2005), the external
reserves of China invested in dollar-denominated assets are being used as collateral against FDI within China. Because of this relationship, Eichengreen calls the United States the custodian of China’s savings.

2.5 An overly risk-averse Asia after the economic crisis of 1997–1998

The economic crisis of 1997–1998 was a severe blow to the emerging economies of East Asia. The simultaneous currency crisis and banking crisis scarred the national esteem of these previously high-performance countries with an unprecedented deep fall in production. The natural outcome from this calamity was an overwhelming desire by East Asian countries to prevent a future balance of payments crisis from ever inflicting such searing damage again, and the natural translation of this desire was the relentless accumulation of foreign reserves. This desire to have a large amount of foreign reserves is bolstered by two perceptions.

The first perception is that the International Monetary Fund (IMF) and international community were not able to supply enough liquidity support during the 1997–1998 crisis. The amount of IMF credits was inadequate even though they had exceeded the normal operational limit of 300 percent of a member country’s quota. Furthermore, the crisis-hit countries found that it was difficult to access bilateral assistance, which constituted the second line of defense.

The second perception of the crisis-hit countries in East Asia is that they were discriminated by the double-standard practice of the American-dominated IMF. For example, to cope with the subsequent crises in Russia, Brazil, Turkey, and Argentina, the IMF immediately provided liquidity support to defend their fixed-exchange-rate regime and then each of these exchange rates collapsed. In contrast, the IMF strongly warned the East Asian countries about the danger of the fixed-exchange-rate regime, and recommended that they shift to a floating exchange rate system, even though excessive exchange volatility was harmful for the export-led economic growth strategy of this region.

Table 2 shows the different ways countries in this region accumulate external reserves. The accumulation of external reserves in these countries was not difficult because the crisis had dampened investment growth but not savings growth in most cases. For example, in South Korea gross domestic savings increased from 33.7 percent of GDP in 1997 to 35.0 percent in 2004, whereas gross capital formation fell from 34.2 percent to 30.2 percent. The result was that most East Asian countries (Korea, Malaysia, Indonesia, The Philippines, and Thailand) quickly reversed their current account from pre-crisis deficit to post-crisis surplus. All of them, except Korea, also benefited from the recent boom in the prices of primary products.
Table 2. Gross domestic savings, capital formation, and international reserves of selected Asian countries, 1995–2004

<table>
<thead>
<tr>
<th>Year</th>
<th>Country</th>
<th>Cambodia</th>
<th>PRC</th>
<th>Hong Kong</th>
<th>Indonesia</th>
<th>Korea</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Vietnam</th>
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<td>29.8</td>
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<td>32.7</td>
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<td>34.4</td>
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<td>43.9</td>
<td>14.2</td>
<td>50.3</td>
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<td>Gross capital formation (% of GDP)</td>
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<td>1985</td>
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<td>37.8</td>
<td>21.8</td>
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<td>30</td>
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<td>42.5</td>
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<td>27.5</td>
<td>30.7</td>
<td>37.7</td>
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<td>Resource gap (% of GDP)</td>
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<td>12</td>
<td>0.5</td>
<td>-8.6</td>
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<td>-21.4</td>
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<td>-29.7</td>
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<td>Ratio of international reserves to imports (months)</td>
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<td>1985</td>
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<td>9.8</td>
<td>3.6</td>
<td>4.8</td>
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<td>2004</td>
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<td>5</td>
<td>Aggregate net resources flow from all sources (US$ million)</td>
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<tr>
<td>1985</td>
<td>—</td>
<td>41.6</td>
<td>10,466.10</td>
<td>3,516.10</td>
<td>6,304.00</td>
<td>1,455.70</td>
<td>1,308.50</td>
<td>2,179.10</td>
<td>3,213.80</td>
<td>4,921.1</td>
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<td>1990</td>
<td>534.2</td>
<td>63,037.10</td>
<td>14,592.40</td>
<td>6,686.00</td>
<td>10,016.30</td>
<td>9,770.5</td>
<td>4,509.00</td>
<td>5,051.8</td>
<td>14,177.80</td>
<td>3,353.8</td>
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<td>2004</td>
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<td>73,050.50</td>
<td>-1,362.70</td>
<td>236.2</td>
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<td>9,814.80</td>
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<td>6</td>
<td>Foreign direct investment (US$ million)</td>
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<tr>
<td>1985</td>
<td>—</td>
<td>3,487.00</td>
<td>—</td>
<td>1,093.00</td>
<td>788</td>
<td>2,333.00</td>
<td>530</td>
<td>5,574.70</td>
<td>2,444.0</td>
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<tr>
<td>1990</td>
<td>203.7</td>
<td>44,237.00</td>
<td>—</td>
<td>4,677.00</td>
<td>2,844.20</td>
<td>5,136.50</td>
<td>1,222.00</td>
<td>10,746.10</td>
<td>3,894.70</td>
<td>2,220.00</td>
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<tr>
<td>2004</td>
<td>131.4</td>
<td>54,936.50</td>
<td>-11,684.10</td>
<td>1,022.70</td>
<td>4,588.30</td>
<td>4,624.2</td>
<td>469.0</td>
<td>6307.0</td>
<td>1,412.0</td>
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</table>

China also attracted more capital inflows, particularly FDI, and hence produced large surpluses in both its current account and capital account. China’s reserve is growing by $16 billion every month and is expected to reach $1 trillion at the end of 2006. China clearly exceeds what is needed to maintain balance of payments safety as its external reserves are equivalent to 15 months of imports and are 6 times bigger than its short-term debt.

In contrast, Indonesia has been accumulating external reserves mainly from short-term capital inflows as the surplus in its current account balance has not been so high and is beginning to turn to deficit. The slow growth in exports and inflow of FDI are partly related to the deterioration in business and investment climate in Indonesia because of the difficult transition process of its socio-political system from the authoritarian and over-centralized regime of President Suharto. The transition process has had negative impacts on the business climate. For example, some local governments have misused their newly gained power by complicating the trade licensing system and the tax system.

Part of the short-term capital inflow into Indonesia is the repatriation of capital that had fled from the country during the crisis. They have been deposited in regional financial markets and re-exported back to Indonesia as foreign capital. Since 2004, the government has been issuing long-term bonds, denominated in both rupiah and U.S. dollars, to finance the budget deficit. Indonesia, like many other countries in East Asia, is paying higher rates of returns to securities held by foreign investors compared to the rates of returns from its investment in U.S. Treasury bills.

The fast accumulation of external reserves has allowed the crisis-hit countries to repay their debts to the IMF earlier than scheduled. The decisions to do so are mainly for political purposes because of the unpopularity of the IMF programs during the crisis years. The crisis-hit countries have repaid the relatively low interest rate IMF debt by floating higher-interest-rate securities in the foreign credit markets. Of course, with the debt repayment they also “lost access” to the relatively low-cost technical advice from the IMF.

3. What East Asia can do to address the global imbalances

The global imbalances require corrections by both the United States and its trading partners (particularly the other major industrial countries and the emerging economies in East Asia). The group of emerging East Asian countries is currently trapped in a low growth but high savings equilibrium. As this group of countries has high savings, it should be able to afford to borrow more in order to take advantage of
high returns on capital and to create jobs for their highly productive labor force. This group of emerging East Asian countries can make five contributions to address the global current account imbalances.

### 3.1 Investment in infrastructure

There were two basic elements of macroeconomic stabilization policy under the IMF program during the Asian crisis, namely, fiscal prudence and a floating exchange rate system. For example, fiscal prudence limited the size of Indonesia’s budget deficit to no more than 1–2 percent of annual GDP. However, the increase in budget expenditure to service domestic and external debt and to cover social programs enacted to help the victims of the economic crisis has forced governments to cut expenditures on infrastructure, health, and education. These types of budget cuts had a negative impact on both growth potential and income distribution.

The first contribution that East Asia could make to reduce the global current account imbalances is to reverse these types of budget cuts. Following the new Miyazawa plan, which provides a guarantee on yen-denominated bonds issued by the crisis-hit East Asian countries in Japanese markets, East Asian countries should exploit the current window of opportunity to mop up at least part of their accumulated savings by issuing long-term bonds and channeling the proceeds to infrastructure projects in this region. The reality is that good infrastructure, as well as healthy and highly trained workers are required to boost private sector investment and productivity.

### 3.2 Regional trade integration

The second contribution the East Asian countries can make is to expand regional trade and investment in line with the principle of open regionalism. The ASEAN Free Trade Agreement (AFTA), North American Free Trade Agreement (NAFTA), and Asian-Pacific Economic Cooperation (APEC) are examples of regional trade and investment arrangements that are compatible with open regionalism. The European experience in forming a free trade area and a currency union shows that this is a difficult task in East Asia because intra-Asian political rivalries and security tensions are currently undermining regional cooperation. In Europe, regional institutions derive their power from the governments of member countries. Such a transfer of national power to regional institutions requires political decisions in cooperative arrangements and political integration, particularly by the two biggest East Asian powers, namely, Japan and China.

### 3.3 Gradual diversification of external reserve holdings

Reducing purchases of the U.S. Treasury bills assets and diversifying portfolios away from dollar-denominated assets by East Asian central banks would put up-
ward pressure on U.S. interest rates and lead to a decline in the value of the dollar, which could force the United States to adopt more protectionist policies. All of these would cause a recession in the U.S. economy, which could rapidly spread to other parts of the world.

The third contribution that the East Asian emerging economies can make toward a soft landing of global imbalances is to keep investing in U.S. assets. However, this is not an easy task for East Asia because the rising nationalism in the United States is making it increasingly difficult for foreigners to acquire strategic U.S. companies—as shown by the strong political opposition to China’s attempted acquisition of Unocal and by the strong opposition to a Dubai company buying U.S. shipping facilities.

The fear of capital loss and dissatisfaction with low yields from U.S. securities have caused China to use part of its external reserves for other purposes. In 2004–2005 China injected about $600 billion into the state-owned banks to strengthen their capital bases. A small part of the reserve is being injected into China’s underfunded pension system. Chinese state-owned companies, such as the China National Offshore Oil Company (CNOOC) and construction firms, are now investing in natural resource–rich countries all over the world.

**3.4 Regional exchange rate coordination**

The dollar over-valuation and the large current account deficit have increased protectionist pressures in the United States. The U.S. Congress has accused China several times in recent years of keeping the renminbi (RMB) artificially weak, thereby making Chinese exports unfairly inexpensive and destroying American manufacturing jobs. The U.S. Commerce Secretary has even threatened to impose high tariffs on imports from China unless it undertakes a major RMB revaluation (McGregor and Alden 2006). His remarks came right after Chinese Premier Wen Jiabao had ruled out any further sharp adjustment in the value of the RMB in March 2006.

Adopting a flexible exchange rate mechanism is the fourth contribution that the emerging economies in East Asia could make to solve global imbalances. Currently, all countries in East Asia, including Japan, still limit the volatility of their exchange rates against the dollar by intervening in the foreign exchange markets. The stability of intra-exchange rates in Asia is assured through de facto linking to the dollar.

China and Malaysia announced their switch to an adjustable peg against undisclosed baskets of currencies on 21 July 2005. The People’s Bank of China announced a 2.1 percent revaluation of RMB against the dollar and that the RMB would be al-
lowed to fluctuate by a daily trading band of 0.3 percent around parity. In contrast, Bank Negara Malaysia, the central bank of Malaysia, has not announced the management apparatus and method of its managed exchange rate system. The revaluation of the RMB was a step in the right direction, but it is a small step because most estimates suggest the RMB was at least 15–30 percent undervalued before the July 2005 devaluation.

A number of studies, such as Dornbusch and Park (1999) and Williamson (2005), have argued that East Asian countries should adopt a common currency basket peg system to stabilize an inter-currency exchange rate in East Asia. This inter-exchange rate stability is needed to stabilize the overall export competitiveness and avoid competitive devaluation. These studies suggested the use of yen, dollar, and euro in the common basket.

### 3.5 Multilateral pooling of reserves

Reducing the incentive for building up individual reserves by establishing regional multilateral reserve pooling is the fifth contribution that emerging economies in East Asia can make to address global imbalances. Regional reserve pooling can be built through the enlargement of the ASEAN Swap Facilities and the web of bilateral swap arrangements (BSA) under the Chiang Mai Initiatives; and the elimination of rigidities in usage of funds under both sets of arrangements. The present amount of funds available from these two regional facilities is only a marginal addition to the existing IMF facility, and is inadequate for prevention and management of financial crisis or to fend off the reversal of capital flows of the magnitudes experienced during the 1997–1998 crisis. As the BSA is not centralized and multilaterally administered, its use requires approval from each lender and loan provider. In addition, only 20 percent of BSA is immediately available to the borrowers while the other 80 percent is subject to IMF conditionality.

The establishment of regional multilateral reserve pooling requires the strengthening of the regional monitoring and surveillance functions already performed by the Regional Economic Monitoring Unit (REMU) of Asian Development Bank (ADB). Drawing upon the European experience, Wyplosz (2004) points out that mutual surveillance works only when backed by clear procedures and uniform rules carried out by a supra-national sovereign to limit the extent of unavoidable politicization; up to now this has not been the case in East Asia. The "Asian value" of non-interference in domestic policies adopted in this region makes pressure groups in general less effective. Because of this, interpretations, procedures, and rules of the game, as well as a punishment and reward system, are also missing in this region.
4. Conclusion

To summarize our analysis, the East Asian countries can make the following five contributions to address the global current account imbalances:

(1) Promote growth with domestic expansion through infrastructure investment.
(2) Pursue a higher degree of regional trade and investment integration in a manner that is consistent with open regionalism.
(3) Allow the United States to adopt a gradual reform policy by continuing to invest external reserves in dollar-denominated assets.
(4) Adopt more realistic and flexible exchange rate mechanisms.
(5) Reduce the need for building up individual external reserves by establishing regional multilateral reserve pooling.

References


