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Global Trade Imbalances: Are They Sustainable? Traditional and New Remedies

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Abstract:

While there is no consensus in the literature regarding the sustainability of global (in particular, US) current account imbalances, major research in this area does focus on the need for both expenditure-changing and expenditure-switching policies. Moreover, regardless of the answer to the sustainability question in terms of economics, "political sustainability" is a major policy concern. In this paper, we argue that the literature needs to re-focus itself on the creditor-side of the equation, especially Asia, which finances most of the existing global imbalances. It has largely ignored how the creditor countries can help facilitate the adjustment process through concerted exchange-rate management. We explore the case for closer concerted action in Asia. We are able to show that a combination of macroeconomic and policy convergence processes in the region make this option easier to envision.

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I. Introduction

It sometime seems that there is little new since the post WWI Keynes-Ohlin debate over the "transfer problems".[1] For those too young to remember, the issue revolved around the ability of Germany to pay war reparations to the allied powers, mainly Britain. To accomplish this, Germany would have to develop a current account surplus while the UK would have to develop a comparable deficit. The debate centered on the question of "how can that be done?".

Keynes took a classical position. A real devaluation of the German currency is necessary to make German products more competitive in the British market, thereby developing a surplus necessary to effect the transfer. Thus Germany will sustain a double burden: the tax collected from the population to pay reparations is the primary burden, and the deterioration in its terms of trade, via real devaluation, is the secondary burden. Ohlin, in that debate, took what in later years would become a Keynesian position, although without the Keynesian tools of the marginal propensities and the multiplier. He maintained that there will be no secondary burden; that the relative income changes will suffice to affect the transfer. German income will fall as taxes are collected in the amount of the reparation and hence imports will decline. UK incomes will rise as the reparations are distributed, and correspondingly imports (hence German exports) will rise. In that fashion, Germany will develop the necessary export surplus without a secondary burden.

Since that time, both effects were refined and the theory was made into an elaborate and measurable construct. Many empirical studies were conducted to estimate the size of the parameters. Nevertheless, we are basically left with two complementary mechanisms of balance of payments (BOP) adjustment: relative income (or output) and relative prices. The later work through the real exchange rate, namely the exchange rate and domestic price movement in the deficit country relative to that in the surplus country. Every so often a scholar suggests that one of the two is sufficient; yet they should both act, or be made to act, in concert.

[1] This page draws from Kreinin (2005).

Hence, economic cooperation will be at the core of any solution to existing imbalances. In this paper, we consider how these global imbalances might be corrected from a "traditional" perspective (i.e., with respect to the price and income effects) and argue that economic cooperation will be a key to the solution. However, this economic cooperation is more complicated than one might think: it needs to include not merely the type of cooperation envisioned above (that is, between the core debtor and creditors) but also across creditor countries themselves. We use the case of the United States—i.e., the world's premier debtor country—and Asia—the greatest creditor—to demonstrate the importance and complications associated with macroeconomic cooperation across creditors.

The paper is organized as follows. First, we consider the scope of the problem, review the literature regarding its sustainability, and offer the optimal solution based on the "traditional approach" in Section II. Next, Section III considers the need for closer exchange-rate cooperation in Asia and prospects to achieve it. It suggests that via closer economic cooperation it will be possible to foster an effective solution to this global problem, and that, perhaps, such arrangements are becoming easier to envision given secular economic and policy trends. Section IV offers concluding remarks.

II. Global Imbalances and the "Traditional" Approach

The United States has been running extremely high current account deficits, at over $800 billion for the past few years, or currently at 5.7 percent of GDP.[2] Given that this deficit in absolute terms is twice that of the accumulated current account deficits of all other countries combined (Rogoff 2006), it is appropriate to focus on adjustment in the United States. In the EU as a whole, the current account is exactly balanced, but this conceals differences in current account balances of its member-states: Germany's current account surplus is running at over $190 billion (5.1 percent of GDP), while Spain and Greece each have current account deficits at almost 9 percent of GDP. At the same time, Asia has been running very high surpluses, including (as a percent of GDP): Singapore (24 percent), Malaysia (14.3 percent), Hong Kong, China (10.9 percent), China (10.7 percent), Taiwan (5.8 percent), and Japan (4.4 percent). These are extremely high by historical standards; prior to the Asian Crisis, for example, the ASEAN countries were famous for their large current account *deficits*. The flip-side of these surpluses has been a massive build-up in reserves in Asia (and other surplus regions, such as the Middle East), arguably beyond what is necessary or even healthy for these economies. Moreover, the accumulated US external debt of $2.7 trillion dollars already had profound effects on the dollar exchange value. *Vis a vis* the euro, for example, the dollar has

[2] Data in this paragraph are the most recent available as of September 15, 2007 and were complied by *The Economist* (September 15, 2007, p. 118).

depreciated by over 40 percent over the past five years, currently standing at approximately 19 percent below its estimated PPP value.[3] Such dramatic changes in the world's most important currency have pervasive financial and real-side effects.

The origins of these surpluses and deficits lie in domestic macroeconomic imbalances between aggregate savings and investment. To the extent that national savings is greater than (less than) investment, an economy will have a surplus (deficit).[4] Yet, the external imbalances themselves are important for at least two reasons. First, trade deficits are politically sensitive, most notably in the United States, especially if the bilateral deficits are concentrated on one or a few partners. Domestic political responses include threats of protectionism in various forms and other policy errors. Asian countries are particularly vulnerable to the outcome of such politics: salient examples include Japan in the late 1980s and China today.[5] As is clear from Table 1, the US bilateral deficit with China has been growing by leaps and bounds over the past 10 years, to $233 billion in 2006, a third of the US total deficit. With respect to the main ASEAN countries[6], the United States trade deficits rose to $51.3 billion in 2006 (though the 2007 figures appear to be on track to be somewhat lower). Interestingly, Singapore is the only Asian country with which the United States has a surplus.

Second, these imbalances partly reflect a weakness in certain Asian economies that emerged after the Asian Crisis: reduced level of domestic investments, which in turn explains the lower growth rates. Prior to the Crisis, investment in the major ASEAN economies and South Korea amounted to 35-45 percent of GDP, whereas in recent years (2005-06) they ranged between 14 and 24 percent. Even in South Korea (and Thailand) that rate declined from 45 to 30 percent.[7] The excess of savings over investment has provoked what (now Fed Chair) Ben Bernanke has called a "savings glut"; these savings are being parked in US Treasuries rather than in lucrative investment at home or in local securities markets. This should be an important policy concern in developing Asia. Correcting this imbalance would have salutary effects on global imbalances as well as on economic growth in Asia.

[3] According to the OECD, the PPP US dollar value of the euro in 2006 is $0.854, where as of December 26, 2007 it stood at $0.694. Source: http://www.oecd.org/dataoecd/61/54/18598754.pdf.
[4] See Salvatore (2006) for a comprehensive review of the theory of the determination of current account imbalances, in particular with respect to the chain leading from a budget deficit to the current account deficit.
[5] Hanke (2008), for example, gives an interesting critique of the relationship between the "Japan bashers" and the new political attention being paid to China.
[6] In this study, we mainly refer to the original ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore and Thailand) and Vietnam.
[7] ADB (2007)

Table 1:

US Trade Balances with Selected Partners, Years
(US$ Billions)

Country/ Region	1997	2000	2006	2007/10*
EU	-17.0	-58.7	-116.5	-89.2
NAFTA	-30.0	-76.5	-136.1	-114.9
China	-49.7	-83.8	-232.6	-213.5
Japan	-56.1	-81.6	-88.6	-69.1
OPEC	-18.5	-48.0	-105.3	-100.1
ASEAN**	-22.6	-39.4	-51.3	-40.3
TOTAL WORLD	-108.3	-379.8	.758.5	-529.9

**Through October, 2007.*
***Indonesia, Malaysia, the Philippines, Singapore, Thailand, Vietnam*
Source: http://www.census.gov/foreign-trade/balance/#O,
as of 12 December, 2007, and authors' calculations

a. Are The Imbalances Sustainable?

A large literature addresses the question of whether or not these imbalances are sustainable. On the optimistic side of the argument, McKinsey Global Institute (2007) concludes that, while the build up of US external debt is unprecedented, there is nothing to prevent the country from running comparable current account deficits in the future short- and medium-term. They even suggest that the US current account deficit could reach $2.1 trillion by 2012, and the world would still finance it. However, they do acknowledge that deficits cannot be sustained "forever". In order to bring down the current account deficit to a "sustainable level", say, 3 percent of GDP, the US dollar would have to depreciate an additional 23 percent *from the January 2007 level*. Cline (2005) estimates that a 28 percent real effective depreciation would be necessary in order to achieve the same outcome. However, Mckinnon and Schnabl (2006) strongly criticize this model because it focuses exclusively on the elasticities approach and excludes deflationary effects in foreign markets as foreign currencies appreciate.

In a much-cited article, Obstfeld and Rogoff (2005) note that the adjustment required to bring the US current account deficit to a sustainable level consists of a combination of real-income and

relative price effects. They suggest that a 20 percent or greater exchange-rate adjustment on a trade-weighted basis may be necessary under reasonable assumptions.

To sum up: (1) the literature does agree that deficits cannot be sustained indefinitely; but (2) while a US current account deficit of 3 percent is sustainable, how to get there from the present situation is highly controversial. Some authors (e.g., McKinsey Global Institute 2007 and Cline 2005) suggest that expenditure-switching policies would be sufficient, while others are concerned about income-output effects (e.g, McKinnon and Schnabl 2006). But apart from the uncertainties of economic models that generate these estimates, we need to worry about the *political* threshold to sustainability. In political terms, the problem is a serious one whether or not these imbalances can be sustained.

b. The "Ideal" Solution[8]

In addressing the U.S. deficit and the declining dollar, John Connolly, the US Treasury Secretary during the Nixon administration, is reported to have told his European counterparts: "The dollar is our currency, but it is your problem". In a similar vein it can be said today that although the "owner" of the current account deficit is the United States, the problem is global. For if the United States is to remove or lower the deficit, the rest of the world would have to sustain a huge adjustment to reduced surpluses.

Because of the role of the dollar as the main reserve and intervention currency, it cannot depreciate without other countries--primarily in Asia--permitting their currencies to appreciate. These surplus countries have two choices: first, continue to run surpluses and accumulate dollar reserves, thereby enabling the United States to live 6-7 percent beyond its means. This would carry with it an inflationary risk, as well as a risk of retaliation due to due to protectionist forces in the United States.[9] Thus, Asia is the target for a disproportionate share of US anti-dumping duties. Or second, stop supporting the dollar and allow their currencies to depreciate. Here again foreign decision-making needs to be part of the process. While the euro has appreciated considerably, it is the Chinese and Japanese currencies (precisely the countries having large surpluses) that have not

[8] This section draws from Kreinin (2006).

[9] Two comments are noteworthy here. First, in the case of China, sterilization is taking place due to the government's forcing banks to hold bonds carrying interest rates that are even lower than those of US Treasuries, but higher than what they need to pay out to depositors due to stringent financial regulation. With the opening up of financial markets in China, it is not clear that this approach can be sustained, as savers will go elsewhere and the banks' financial statements will be negatively affected. Second, following the example of Singapore, China has established a sovereign wealth fund that will pursue higher returns that those offered by US Treasuries and will allow for more rational asset management…however, these sovereign wealth funds also have problems, including the potential for government intervention and skepticism in the West.

moved much in value. And other Asian countries are hesitant to let their currencies appreciate if China and Japan do not.

Ideally, both the relative income and relative price effects should be employed to resolve or alleviate the problem of global imbalances. Public savings need to be raised in the United States via reductions in government budget deficits and private savings need to rise via reductions in consumer debt and other means. But a large rise in US savings, accompanied by nothing else, would only cause a recession. While a deep recession can reduce US imports, and hence the deficit, the cure would be worse than the disease. To avert that outcome, the resources that become unemployed need to be channelled to the export and import-competing industries. One way of achieving this is a concomitant reduction in savings in the surplus countries. And indeed some observers suggest that this relative income effect--contraction in the United States and expansion in the surplus countries—would be sufficient to overcome the problem. While attractive, this relative income solution may not be sufficient.

An "efficient" solution needs to embody both the price and the income effects. To that end, the US dollar needs to experience real depreciation relative to the rest of the world currencies (Rogoff (2006. In both cases foreign cooperation is required. While the dollar did depreciate over 2006, it moved downward mainly against the euro and British sterling, which bore the brunt of dollar depreciation. Asian currencies did appreciate over 2007 but only by 5 percent over the January-November 2007 period.[10]

In the case of China, the yuan is pegged to the dollar and its exchange rate is controlled by the central bank. And indeed its foreign currency reserves increased spectacularly; they rose from $841 billion in December 2005 to $1.44 trillion in September 2007, a 44 percent increase in less than two years.[11] Indeed, for emerging Asia (ASEAN, China, and the NIEs) as a whole, foreign exchange reserves rose from $1.7 trillion in December 2005 to $2.5 trillion in September 2007, only two-thirds the Chinese rate but still highly impressive.[12] The exchange value of the Japanese yen has certainly been influenced in a downward direction by the so called "carry trade", though

[10] *ADB Economic Monitor 2007 Regional Update*, December 2007,

http://www.aric.adb.org/pdf/aem/dec07/Dec%20AEM%20complete%20131207.pdf

[11] *ADB Economic Monitor 2007 Regional Update, December 2007*, Table 9.
[12] Ibid. and authors' calculations.

quantitatively it is impossible to estimate exactly how large the carry-trade market is. With Japanese interest rates at so close to zero, it pays to borrow in Japan (also Switzerland) at 0.5 percent interest and lend the money in the West at, say, 4.5 percent. The risk in these transactions is that the yen may appreciate by the time the loan has to be repaid. But this outflow of funds depressed the Japanese yen (it was down to ¥120 = $1 in February 2007). By March 2007 the yen rose to $1 = ¥115, reducing the carry trade, and it continued to be in this range through the rest of 2007[13].

Although there exists a measure of controversy on whether the yuan should appreciate, the US government has argued that the currency of a country with a huge trade surplus that has amassed over $1 trillion in reserves is grossly undervalued. China need not abandon its fixed exchange rate system; it can merely revalue its currency. Japan's yen should rise at the same time, thereby allowing the dollar to depreciate. As we discuss in the next section, the problem arises in getting surplus countries to adjust their exchange rates in concert. Asian currencies have been extremely slow to appreciate, with the exception of Singapore (which, in turn, is the one major Asian trading economy with a deficit with the United States).

In sum, correction of the US current account imbalances will not be easy. However, adjustment is probably inevitable; the question is whether the changes will be incremental or abrupt, and how far they will go. In fact, perhaps, the process of adjustment has already begun; the US current account deficit, for example, narrowed from $188.9 billion (5.5 percent of GDP) in the second quarter of 2007 to $178.5 billion (5.1 percent of GDP) in the third quarter of 2007.[14] But a few quarters do not a trend make.

III. The Case for Exchange-rate Cooperation in Asia

It is in the interest of Asia to make sure that the upward exchange adjustment is incremental. This will require a shift from the production of tradeables to non-tradeables. The real appreciation, in turn, will help stimulate consumption and improve the standard of living of Asian countries. But it will require concerted action through regional cooperation. Most ASEAN countries, for example, will not agree to a revaluation of their currencies if China and the NIEs do not (Singapore is an

[13] For example, on December 26, 2007, it stood at $1=Y114.45.
[14]Source: http://www.economist.com/markets/indicators/

exception; its currency has appreciated significantly *vis a vis* the US dollar in recent years). In the rest of this section, we consider the case for closer exchange-rate cooperation in Asia.[15]

a. Exchange-rate Management in Asia

Exchange-rate regimes in Asia differ widely, from various degrees of managed floats (e.g., most ASEAN countries, Japan, and South Korea) to hard pegs (e.g., China and Hong Kong).[16] However, they all have one common characteristic: the US dollar as the (explicit or implicit) reference currency or anchor. In reviewing the evolution of the roles of the US dollar, yen, and euro in East Asia, Kawai (2002) notes that the US dollar was either the *de facto* or *de jure* anchor in the region's economies prior to the 1997-98 Asia Crisis. During the Crisis the role of the US dollar diminished but in its aftermath the US dollar generally resumed its traditional role as anchor. Still, its importance diminished in certain countries (e.g., Indonesia) and there has been greater flexibility in exchange-rate management. As of early 2007, the US dollar continues to be predominant, but there are some indications of certain strains and a desire to diversify is in evidence. Weakness in the US dollar appears to have led some countries (e.g., China) to announce explicit reserve diversification strategies. Thailand in December 2006 even (briefly) imposed capital controls in order to prevent further *appreciation* of the *baht* against the dollar, reflecting problems associated with continued sterilization of foreign exchange interventions over a long period of time (at the time, Thai foreign reserve holdings were growing at an annual rate of 29 percent and had risen to $65 billion).[17]

Kawai (2007) calculates the implicit weights that East Asian countries assigned over time to the dollar, the euro, and the Japanese yen. His results for the dollar are as follows:

Three observations are noteworthy. First, while there appears to be a common belief that East Asian currencies have reduced the tightness of their pegs to the dollar in the aftermath of the Asian Crisis, no clear trend appears; the weight placed on the dollar rose for Malaysia, Vietnam, Cambodia, and Laos and displayed little or no change in the cases of the Hong Kong dollar, Chinese yuan, and the Taiwan dollar. Second, the weights themselves are becoming more similar across the region, with a coefficient range of 52-.99 pre-Crisis and .66-.99 of late.[18] Third, the focus on the analysis needs to be on the "+3" and the middle-income ASEAN countries; the CLMV

[15] This section borrow from Plummer and Wignaraja (2006).
[16] There are many excellent reviews of exchange-rate regimes in the region (see, for example, ADB 2006).
[17] ADB (2007), *op.cit*.
[18] Excluding, of course, Laos, which has a closed capital account and is an extremely small economy.

countries have a long way to go before being in a position to move forward in terms of Asian monetary integration.

Table 2: Weights Placed on US Dollar in East Asian Exchange-rate Management

	Jan. 1990/June 1991	Jan. 2005/April 2006
HK$	0.99	0.99
Skwon	1.01	0.66
Sing$	0.74	0.59
Tai$	0.89	0.80
Indo rup.	0.96	0.75
Mal$	0.91	0.97
Phil Peso	1.03	0.87
Thai Bt	0.96	0.69
CHN yuan	1.02	0.96
Cam Riel	0.52	0.86
Laos kip	0.40	0.51
VN dong	0.53	0.86

Note: All estimates are statistically significant at the 99% level of confidence.
Source: Kawai (2007), Table 2.

The private sector has taken considerable interest in the rising correlation between Asian exchange rates. For example, Deutsche Bank has launched its "Asia Convergence Indexes" to explicitly to take advantage of the rising correlations across 12 Asian markets.[19] It also appears to consider this process as the beginning of a movement toward monetary union in the region. Deutsche Bank's head of fixed income and credit research, Martin Hohensee recently stated that: "The concept of an Asian Monetary Union (AMU) has been validated by a number of economic studies and is getting serious attention among central banks and exporter groups."[20]

Numerous studies in the literature evaluate alternative exchange-rate regimes in Asia. Kwan (2001) considers the case for closer exchange-rate management in Asia from a institutional/political economy perspective, with a focus on the potential role of the Japanese yen. McKibbin (2004) evaluates the performance of several potential Asian exchange-rate arrangements with respect to their effects on output and inflation variability in the presence of various shocks. He finds that no

[19] http://www.risknews.net/public/showPage.html?page=asiarisk_risknews_story&tempPageName=637617, *Asia Risk Magazine*, 21 November, 2007.

[20] *Incisivemedia*, http://db.riskwaters.com/public/showPage.html?page=638465, 26 November, 2007.

regime dominates the others in the presence of all shocks but a regime of floating and a basket peg to the US dollar, euro and yen generally perform better than an Asian currency union or yen-zone regime.

Various forms of monetary union in Asia have been tabled by academics but these have not been considered seriously by policy makers. For them, the contagion of the Crisis effect in 1997-98 underscored the "policy externalities" associated with macroeconomic and financial policies in an increasingly-integrated region.

b. Financial/Monetary Integration

One might trace the first initiative in favor of monetary/financial cooperation in East Asia to the original "Miyazawa Plan," which was initiated by Japan during the Asian Crisis. It proposed the creation of an Asian Monetary Fund to supplement the IMF. Opposed by the IMF and the United States, it eventually led to the establishment of currency swap arrangements among East Asian countries (basically bilateral swaps between Japan and individual countries) during the annual meeting of the Asian Development Bank in May 2000 (the "Chiang Mai Agreement").

There have also been proposals to integrate capital markets in the region, ranging from coordination of existing national capital markets to the creation of supranational regional bond and stock exchanges. Yet, financial and monetary cooperation in Asia is still at a conceptual stage. Even its most successful cooperative effect, the Chiang Mai Initiative, lacks ambition if one considers that its swaps totalling $72 billion will be drawn from reserves that are currently at about $2.5 *trillion*.

C. Is Policy Cooperation Feasible?

As is well known, the Asian growth "model" is based on export orientation. As the degree of overlap of developing Asian exports is high and increasing (Plummer 2007) and there exists a serious perceived Chinese (and, increasingly, Indian) competitive "threat", developing Asian countries and Japan would be loath to allow a major realignment in their respective currencies in a vacuum. These countries seem to prefer the risks associated with higher domestic interest rates through sterilization and potential inflation due to reserve accumulation, or even controls on capital inflows (Thailand), to revaluation not done in concert with other Asian countries. China has proven singularly resistant to significant revaluation that would help engineer a soft landing, despite the

threat of inflation at home and strong pressure from its key exports markets (the United States and the EU).

The solution is some form of joint revaluation in Asia (Kawai 2007). This would require closer monetary and financial cooperation than has been in evidence in the past. However, the recent process of real-sector cooperation, as well as the limited financial cooperation reviewed above, suggest that such an approach would be consistent with the regionalism trends in Asia. Apart from exchange-rate coordination, such cooperation would have to extend to other areas of macroeconomic coordination. Some of this is already happening in Asia, e.g., through the ASEAN Surveillance Mechanism, but creating "warning bells" and constructing programs of action are more ambitious.

How likely is this prospect? In terms of economics of macroeconomic convergence, this process might not be difficult. Since the Asian Crisis, there has been a strong convergence in business cycles across Asia (Table 3), which in turn is being driven by rising intra-regional trade and investment (Rana 2007). And if the business cycles of the region are in sync, there is no reason for some countries to demand opposite approaches to expenditure-switching policies.

However, as the Europeans discovered during their process of imposing policy symmetry in the run-up to monetary union, the difficulty of exchange-rate coordination is a function of the degree of policy divergence. The famous "Maastricht Criteria," later reinforced by the Stability and Growth Pact, had four principal requirements: (1) a debt/GDP ratio of no more than 60 percent (though this indicator was downplayed given the greater than 100 percent shares in Belgium and Italy); (2) a deficit/GDP ratio of no higher than three percent; (3) the inflation rate and nominal interest rate of a country should be no more than 1.5 percent higher than the average of the lowest three countries; and (4) there should be no realignment of a country's exchange-rate peg in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) for two years prior to acceding to monetary union. Thus, the main goal was macroeconomic policy harmonization and stability.

There has been considerable debate on the economic logic of the Maastricht criteria in general, and the actual numeric criteria in particular. But if we were to subject East Asia to the same test, how would it fare?

Table 3a
Correlation of GDP Growth Rates between Individual Countries and ASEAN+3: 1980 - 2005 [1/]

	1980 to 1997	1998 - 2005
China	-0,41	0,58
Indonesia	-0,23	0.9036*
Japan	-0,14	0.8103*
Korea	0,28	0,53
Lao PDR	-0,39	0,68
Malaysia	-0,20	0.8824*
Philippines	-0,19	0.9496*
Singapore	-0,16	0,69
Thailand	0,46	0.8635*
Viet Nam	-0,24	0,70

* Significant at 5% level.

[1/] ASEAN+3 excludes Brunei, Cambodia, and Myanmar. Regional GDP growth is weighted by gross national income (atlas method, current $).

Sources: IMF World Economic Outlook Database and World Bank World Development Indicators Online (Plummer and Wignaraja 2006)

Table 3b
Correlation of GDP Growth Rates between Individual Countries and ASEAN5 +3: First Quarter 1994 to Third Quarter 2006 [1/]

	Q11994 – Q41997	Q11998 - Q32006
China	-0,16	0.5117*
Indonesia	0,33	0.7633*
Japan	-0,08	0.7690*
Korea	0,08	0.5312*
Malaysia	0,35	0,81
Philippines	0,33	0.8479*
Singapore	-0,31	0.7322*
Thailand	0,06	0.7971*

* Significant at 5% level.

[1/] Regional GDP growth is weighted by gross national income (atlas method, current $).

Sources: CEIC Database and World Bank World Development Indicators Online.
Plummer and Wignaraja (2006).

As shown in Table 4, fiscal policy would generally receive high marks, especially relative to the EU. The share of government spending in GDP in the NIEs (less than 25 percent), ASEAN (11-30 percent range, save the peculiar cases of Brunei and Myanmar), and China (18 percent) are low relative to the EU average,[21] Japan's share is somewhat higher (37 percent) but it is among the lowest in the OECD (though its debt/GDP ratio of over 165 percent is the highest in the OECD). With respect to budget deficits, Table 4 shows that there is a good deal of variability across East Asia. Deficit/GDP ratios were less than three percent for all original ASEAN countries save Malaysia (3.8 percent). (But only Vietnam among the transitional economies would meet this criterion). Singapore actually had a surplus of 8 percent of GDP. Note that the Crisis-afflicted ASEAN countries had surpluses or essentially balanced budgets on the eve of the Crisis. Since then, they have tended to have modest deficits, with the occasional exception of Thailand (which had a small surplus). The deficits of China and Taiwan (2004) came to approximately 1-2 percent of GDP, while South Korea and Hong Kong had surpluses. Only Japan, which currently has a deficit/GDP of about 5 percent and has not met the Maastricht criteria since 1993, would fail the test outright. Hence, with the exception of Japan and a few of the smaller, transitional ASEAN economies, reaching a 3 percent target would not be particularly difficult for East Asia.

By developing-country standards, East Asia has been characterized by conservative monetary policies and price stability. Inflation rates in the ASEAN countries are in the 0-10.5 percent range (with Indonesia defining the upper bound); China and the NIEs have inflation rates of less than 3 percent; and Japan continued to be in a deflationary state until recently. Thus, while inflation in the region is generally under control, there exists considerable disparity in terms of its rates.

[21] With a smaller tax base, potential fiscal burdens are less, so this is not a surprising outcome.

Table 4: Divergence in East Asian Macroeconomic Indicators (2005)

	Public Sector Debt (% of GDP) [1/]	Fiscal Balance of Central Government (% of GDP)	Inflation Rate (%)	Interest Rate (%) [2/]
Japan	…	-5,2	-0,3	0,1
China	19,2	-1,6	1,8	2,5
NIEs-3				
Hong Kong, China	…	0,3	1,1	3,2
Republic of Korea	22,0	0,8	2,7	3,7
Taiwan	30,3	-1,0	2,3	1,5
ASEAN				
Brunei Darussalam	…	…	0.9 [3/]	…
Cambodia	…	-3,1	5,8	…
Indonesia	58,3	-0,5	10,5	10,3
Lao PDR	…	-6,0	7,2	…
Malaysia	68,9	-3,8	3	2,9
Myanmar	…	-6.0 [3/]	4.5 [3/]	…
Philippines	101,3	-2,7	7,6	7,0
Singapore	…	8,0	0,4	2,3
Thailand	49,4	0,1	4,5	3,3
Viet Nam	40,8	-2,3	8,3	…

[1/] Refers to consolidated government debt except for Indonesia, S. Korea, and Taiwan which refer to central government debt while Philippines refer to nonfinancial public sector debt.
[2/] Money market rate.
[3/] As of 2004.

Sources: Asia Economic Monitor (December 2006), Asian Development Outlook (2006), and Bloomberg.

But the inflation criterion of Maastricht has been a source of major disagreement: for example, if Luxembourg, the Netherlands, and Sweden were experiencing deflation, would it make sense to use their average as a reference point, given their relative sizes and falling prices? Applying this scenario to East Asia, we see that the minimum average is 0.3 percent (Singapore, Japan, and Brunei), meaning that all countries with inflation rates above 1.8 percent would be ineligible. While this appears reasonable to the European Central Bank, whose inflation target is 2 percent or less, it means that 12 out of 15 countries in Asia would fail to meet the criterion. In any event, forcing convergence of inflation rates would be more difficult than in Europe. The same story generally applies to interest rates, though divergence is much less than for inflation.

IV. Conclusions

In sum, while there is no consensus in the literature regarding the sustainability of US current account imbalances, major research in this area focuses on the need for both expenditure-changing

and expenditure-switching policies. Moreover, regardless of the answer to the economics of the sustainability question, we have stressed that political sustainability is more constraining. It may well be that we have already crossed that political threshold in the United States (particularly in the 2008 election year).

In this paper, we argued that the literature needs to re-focus itself on the creditor-side of the equation. Asia is the most important financier of US current account imbalances and exchange-rate adjustment in the region needs to be at the core of any general solution to the problem. However, it's impossible to expect Asian countries to revalue their exchange pegs individually. Such action needs to be taken in unison. Thus, we explored the case for closer monetary cooperation in Asia, suggesting that such cooperation is within the realm of possibilities.

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