

**Staff Paper No. 86**

**GLOBAL IMBALANCES: A PRIMER**

**C.S. Lim, Vincent and Victor Pontines**



The South East Asian Central Banks (SEACEN) Research and Training Centre  
Kuala Lumpur, Malaysia

**Staff Paper No. 86**

**GLOBAL IMBALANCES: A PRIMER**

**C.S. Lim, Vincent and Victor Pontines<sup>1</sup>**

**January 2012**

---

<sup>1</sup> This Paper was prepared for the 10<sup>th</sup> EXCO Meeting in January 2012 in Colombo, Sri Lanka. C.S. Lim, Vincent and Victor Pontines are Senior Economists of the Research and Learning Department of The SEACEN Centre. Views expressed are of the authors and do not necessarily represent those of The SEACEN Centre or the SEACEN member central bank/monetary authorities.

## **Abstract**

The global imbalances (current-account of BOP) refers to the large current account deficits of developed economies such as the United States and the large surpluses of developing economies such as China and oil rich economies of the Middle East and Russia. In other words, global imbalances are inevitably viewed as the surplus net savings of the developing economies financing the consumption/investment of deficit developed economies.

Against the backdrop of the recent Global Financial Crisis (GFC), persistent large global imbalances were seen as one of the triggering factors for causing the crisis. The argument is that before the crisis, the flows of savings from emerging to developed economies eased financial constraints in deficit economies, thereby lowering global interest rates resulting in the credit boom and excessive risk taking.

While the causes of the GFC are still open to debate, it may be prudent, nonetheless, to contain global imbalances even though it may have not directly triggered the crisis. In the current situation, there is still this urgent need to address these imbalances to prevent the world economy of being stuck in “midstream”, thus threatening the sustainability of the global recovery.

The worst stage of the sub-prime crisis may have passed, but uncertainties in the global financial market still remain. Global economic recovery will be predominantly driven by the strong growths of the emerging markets in Asia. However, the recovery will be underscored by fragilities still prevailing in advanced economies such as the US and Europe. The global imbalances have remained in the aftermath of the crisis and an orderly unwinding of the said imbalances is impossible without both surplus and deficit economies committing to macroeconomic and structural reform measures.

## Table of Contents

	Page
Abstract	iii
Table of Contents	iv
1. Introduction	1
2. The Pattern of Imbalances	1
3. Causes of the Global Imbalances	3
3.1 Events in the United States	3
3.1.1 Saving-Investment Imbalances	3
3.2 Events Outside the US	5
3.2.1 Inadequate Investments and Excessive Savings in Asia	5
4. Reserve Accumulations	7
5. Possible Scenarios in the Medium-Term	9
6. Policy Implications to Surplus Economies	10
6.1 Policies to Strengthen Domestic Demand	10
6.1.1 Policies That Encourage Greater Domestic Consumption	10
6.1.2 Policies That Stimulate Domestic Investments	11
6.1.3 Policies That Promote Greater Deepening of Financial Markets	12
6.2 Efforts to Intensify Regional Cooperation and Coordination	12
6.2.1 Facilitate the Development of Local Currency Bond Market	12
6.2.2 Develop Stronger Regional Safety Net	13
6.2.3 Coordinate Collective Regional Currency Appreciation	14
7. Concluding Remarks	15
References	16

## List of Charts

Chart 1: Global Imbalances	2
Chart 2: Current Account Balance of SEACEN Economies	3
Chart 3: Gross National Savings/GDP	4
Chart 4: US Corporate Savings to GDP	4
Chart 5: US Personal Saving to Disposable Personal Income	4
Chart 6: Capital Formation /GDP	6
Chart 7: Net Capital Flows in the SEACEN Economies	8
Chart 8: Current Account/GDP (%) vs Total International Reserve/GDP	8
Chart 9: Accumulated International Reserves	9
Chart 10: Potential Scenario	10

## Appendix

Chart 11: US Trade Balance by SITC Classification, 1996 and 2011	18
Chart 12: Commodity Prices	18

# GLOBAL IMBALANCES: A PRIMER

## 1. Introduction

The global imbalances (current-account of BOP) refers to the large current account deficits of developed economies such as the United States and the large surpluses of developing economies such as China and oil rich economies of the Middle East and Russia. In other words, global imbalances are inevitably viewed as the surplus net savings of the developing economies financing the consumption/investment of deficit developed economies. However, these imbalances may not necessarily be a bad thing. It makes economic sense for savings to do what they do best- to be utilized efficiently in the most productive sector of the global economy, that is, imbalances are largely “good” for the efficient reallocation of capital (Blanchard & Milesi-Ferretti 2009).

Against the backdrop of the recent Global Financial Crisis (GFC), persistent large global imbalances were seen as one of the triggering factors for causing the crisis (Economist 2009). The argument is that before the crisis, the flows of savings from emerging to developed economies eased financial constraints in deficit economies, thereby lowering global interest rates resulting in the credit boom and excessive risk taking. This argument, according to Borio and Disyatat (2011), is flawed as they argue that the ‘saving glut’ could not fully explain the relatively low global interest rate prior to the GFC as these rates were determined by many factors such as the interplay between the policy rates set by central banks and market expectation of economic agents. Rather, according to them, the crisis was a direct result of the financial system lacking strong “anchors” to deal with and prevent unsustainable credit and asset booms. Many economists, such as Ben Bernanke, Chairman of the Federal Reserve, now recognize that the lax oversight and insufficient regulations as the lead causes of the crisis (Rampell 2010). It is interesting to note that whatever the causes of the crisis, the global imbalances did narrow significantly immediately after the GFC. However, the gap is predicted to widen further in the medium-term.

The causes of the GFC are still open to debate but it is prudent to contain global imbalances even though it may have not directly triggered the crisis (Suominen 2010). In the current situation, there is still this urgent need to address these imbalances to prevent the world economy of being stuck in “midstream”, thus threatening the sustainability of the global recovery (Blanchard and Milesi-Ferretti 2009). On one hand, the sustainability of prolonged current account deficit is questionable and on the other, there is a limitation to how long export-led growth can be sustained for the surplus economies, particularly if it is due to a liberated attempt to suppress exchange rate appreciation, resulting in potential capital misallocation, overheating and rising inflation (IMF, 2008). Apart from the size, persistent nature and sustainability, another area of great concern is the concentration of these imbalances in a small group of economies (Adams & Park 2009).

## 2. The Pattern of Imbalances

An obvious trend of the global imbalances is that the size of the US’ current account deficit is almost the mirror-image of the current account surplus of Asia (China, Japan, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Chinese Taipei, Thailand), Germany and the oil exporting economies (Chart 1).<sup>2</sup> It is worth noting that in general, SEACEN economies as a group did not run current account surpluses before the 1997 Asian

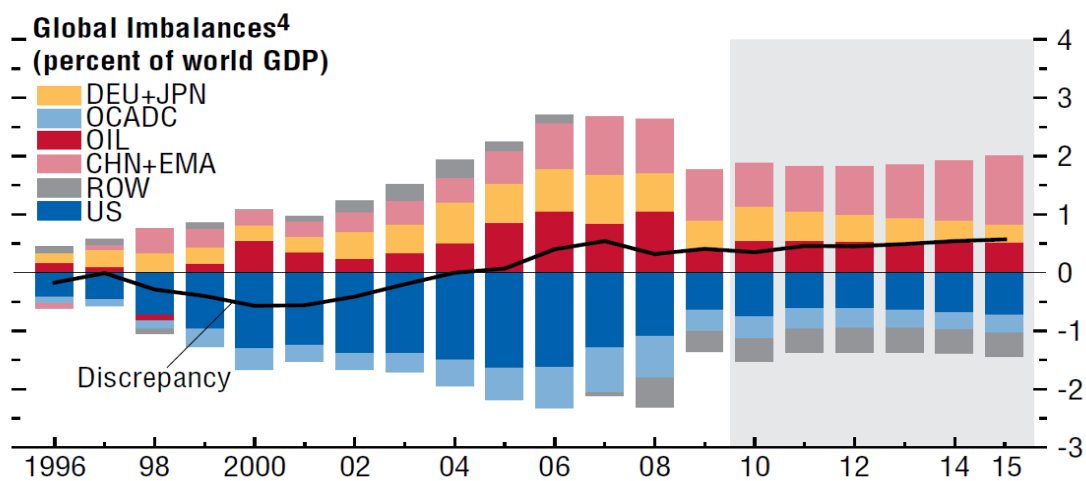
---

<sup>2</sup> Other current account deficit economies include Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, and United Kingdom

Financial Crisis (Chart 2). Meanwhile, the current account deficit of the US also started to accelerate after 1997. At its peak, the current account deficit of the US was as much as 1.5% of world GDP (Adams & Park 2009). The main components of the US trade deficit (according to the SITC classification, Jan-Sept 2011) were mineral fuels, manufacturing goods and machinery and transport (Chart 11 in the Appendix). Looking at the perspective of the surplus economies, the widening gap of the global imbalances was a direct result of the sharp rise in commodity prices and asset price booms (Chart 12 in the Appendix).

The global imbalances have narrowed immediately following the GFC due to the significant weakening of US demand. However, the absolute size of the imbalances remains large and there is indication that the imbalances are expected to remain so in the medium-term. From the perspective of the surplus economies, there have been episodes of appreciation of currencies in emerging economies since the GFC (IMF 2011). However, in general, the appreciation has been small, uneven and periodically across economies, making these episodes insufficiently significant to make an impact on global imbalances.

**Chart 1**  
**Global Imbalances**  
**(Percent of World GDP) <sup>1/</sup>**

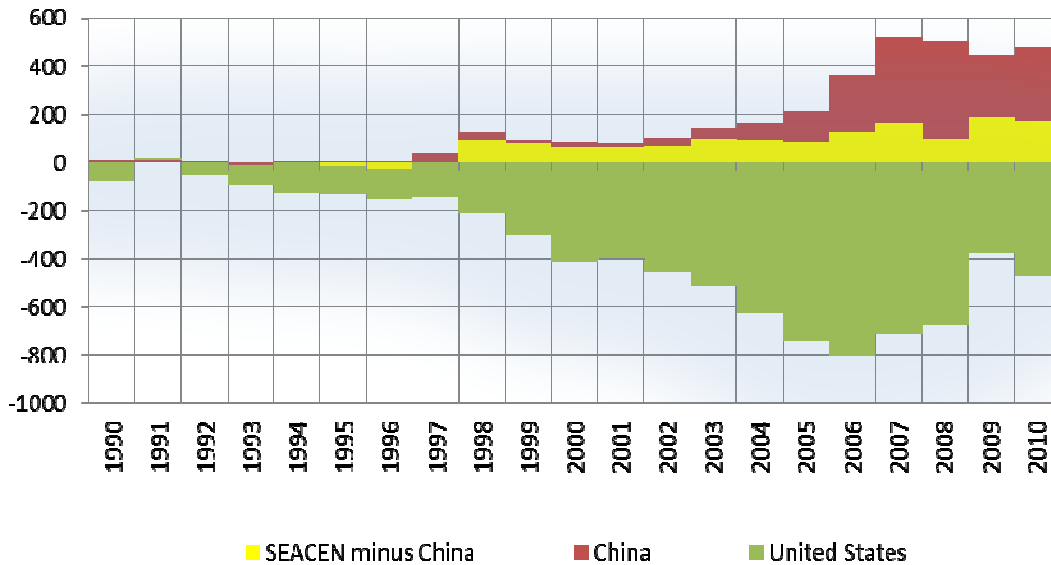


<sup>1/</sup>CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Chinese, Taipei, and Thailand; DEU+JPN: Germany and Japan; OCADC: Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, and United Kingdom;

OIL: Oil exporters; ROW: rest of the world; US: United States.

Source IMF WEO 2010

**Chart 2**  
**Current Account Balance of SEACEN Economies**  
**(Billion USD)**



Source: IMF, WEO (2011)

Furthermore, the economic growth of the surpluses (emerging) economies will continue to outperform the advanced economies. Saving surpluses in these economies will also continue to grow in the face of large capital inflows (IMF 2011). Furthermore, the US fiscal policy will not contribute to any significant lessening of the current account deficit as at this stage, there is no indication of permanent consolidation measures.

### 3. Causes of the Global Imbalances

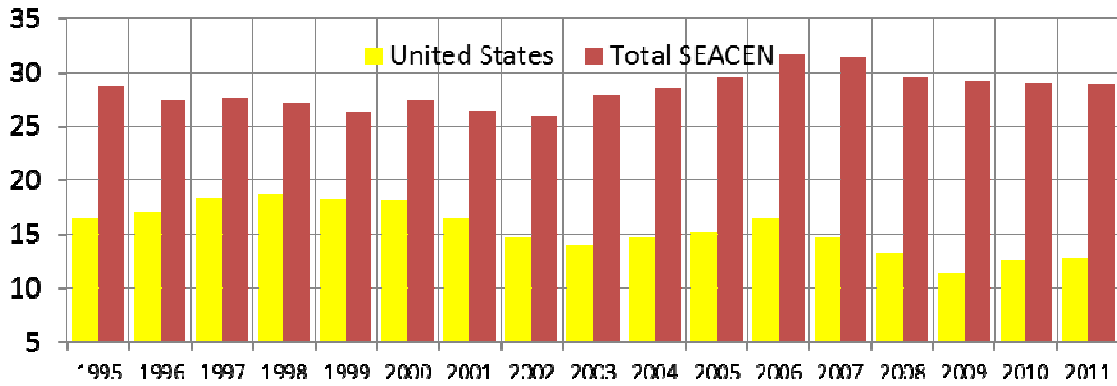
#### 3.1 Events in the United States

##### 3.1.1 Saving-Investment Imbalances<sup>3</sup>

Bernanke (2005) discusses the saving-investment imbalances from two perspectives- events in the United States and events outside of it. From the perspective of the US, it is obvious that it has been suffering from trade imbalances, with its imports exceeding US exports by a wide margin. Before March 2000, the wealth effect generated by the exceptional performance of the US stock market has induced US consumers' increased spending on imports. The wealth effect has also kept savings in the US relatively low compared to other developed economies, perpetuating the need for foreign borrowings (see Chart 3 & 5)). At the same time, spurred by profit opportunities, capital investment increased while the expectation of future income gains led to the perceived notion of the redundancy to save (Chart 4). According to (Feldstein 2008), <sup>4</sup> the increase in the savings rates of deficit economies (i.e., US) is key for addressing the global imbalances.

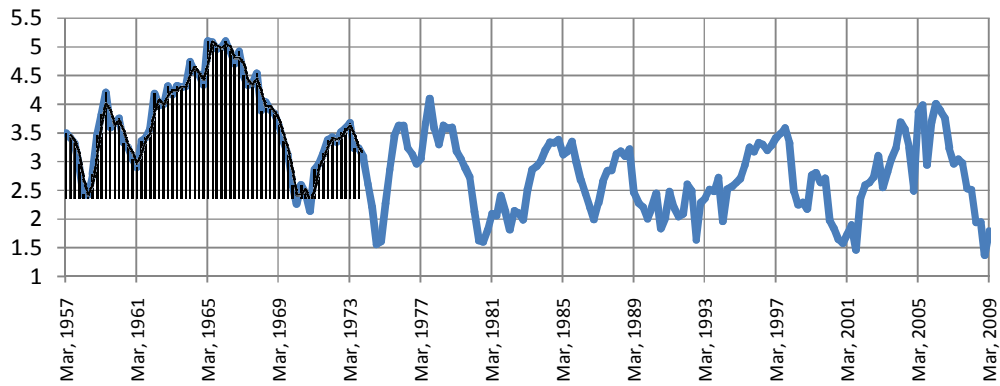
<sup>3</sup> It is obvious that there is a large savings-investment gap in emerging Asia. Emerging Asia is expected to save more than 45% of GDP in 2015 while advanced economies savings are less than half that at 20% (IMF 2011).

**Chart 3**  
**Gross National Savings/GDP**  
**(Percent)**

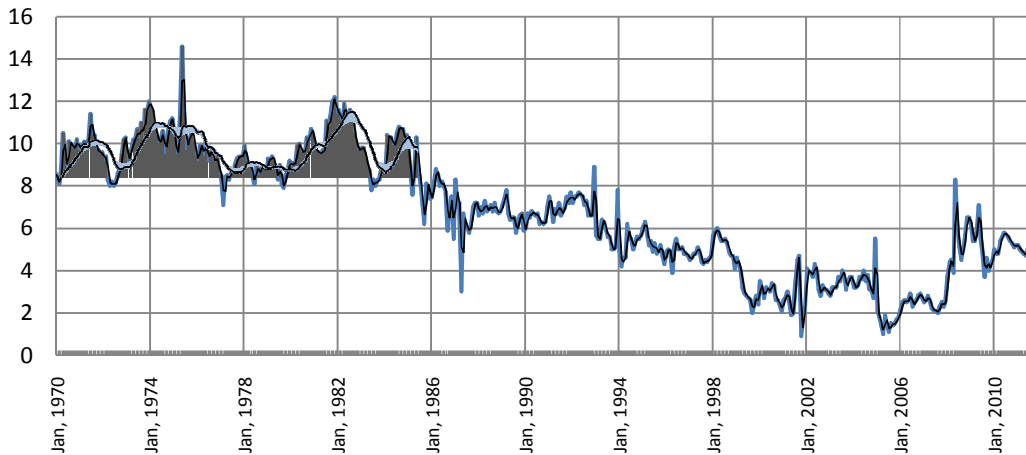


SEACEN excludes Brunei Darussalam and Fiji.  
 Source :CEIC

**Chart 4**  
**US Corporate Savings to GDP**  
**(Percent)**



**Chart 5**  
**US Personal Saving to Disposable Personal Income**  
**(Percent)**



Source: CEIC



With the downturn of the stock market in March 2000, investments in the US declined while global savings remained strong, leading to lower global interest rates. This time around, the lower interest rate caused the saving rates to remain low in the US, a phenomenon rather different from the wealth effect but nevertheless has the same impact on savings. It is clear that while corporate savings are volatile, they fluctuate around a mean but household savings have seen a declining trend since the 1980's.

The United States continue to attract capital inflows to finance the country's deficit as there is a perception that the US economy is in a constant state of innovation and hence in a perpetual state of increase in productivity (Cooper 2004). Furthermore, it is generally agreed that the large external debts of the US are sustainable because of the relatively higher yields of US foreign investment when compared to foreign investment in the US (Kitchen 2006, quoted in Eichengreen 2006).

## **3.2 Events Outside the US**

### ***3.2.1 Inadequate Investments and Excessive Savings in Asia***

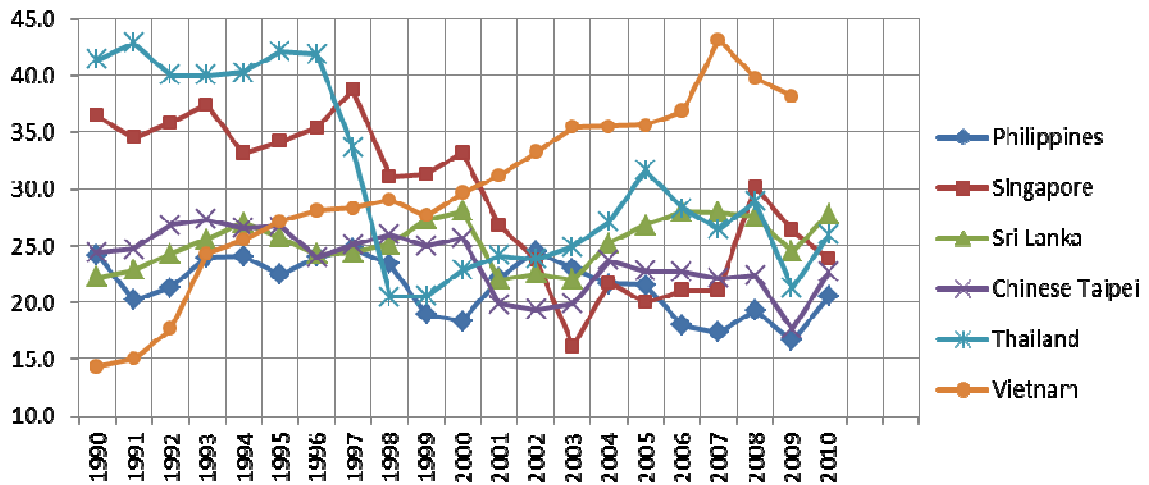
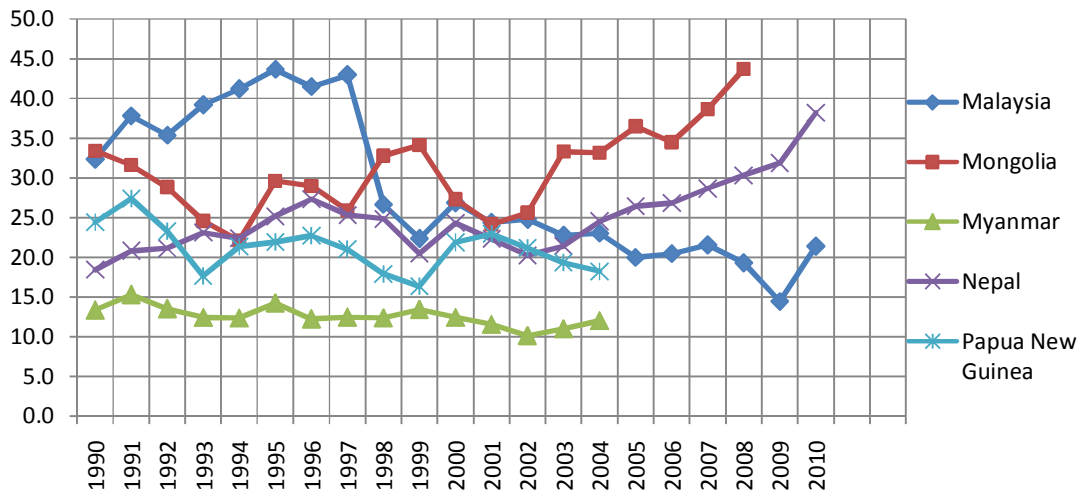
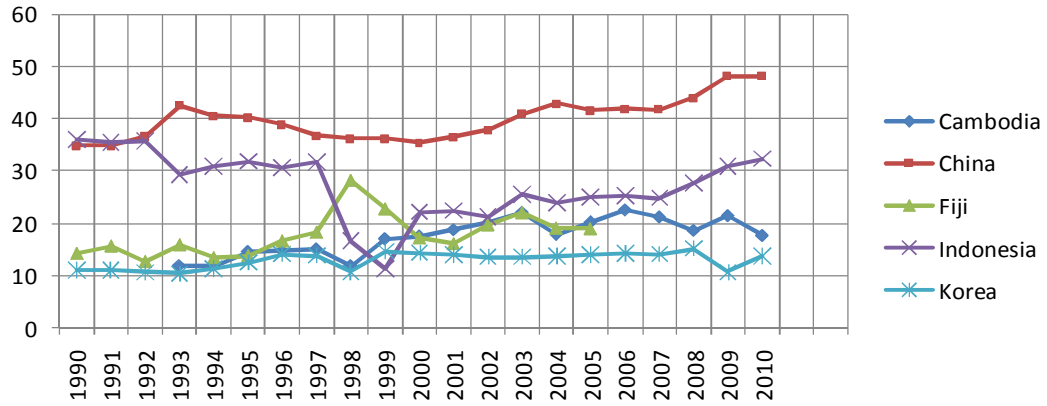
As discussed above, the global imbalances are a result of two opposite forces. On the one hand, investment opportunities were plentiful in the US, particularly during the high-tech boom and expectations of higher productivity growth. On the other hand, SEACEN economies (with the exception of Cambodia, China, Fiji, Nepal, Mongolia and Vietnam) experienced a shortage in investments in comparison to the period prior to the 1997 Asian Financial crisis.<sup>5</sup>

After a steep decline in economic growth following the 1997 Asian financial fallout, the crisis afflicted SEACEN economies experienced a remarkable V-shaped recovery. From the mid-1980s until just before the 1997 financial crisis, investment rates were relatively high. For instance, the investment ratio was well over 30% for Indonesia, Malaysia Korea, Singapore and Thailand. However, immediately prior to the crisis, the same ratio went down to between 20-25% of GDP. Even after more than fifteen years since the crisis, total investments, in particular private investments have never fully recovered to the pre-crisis level in the many SEACEN economies (e.g., in particular the 1997 Asian crisis affected economies of Indonesia, Korea, Malaysia, the Philippines and Thailand (See Chart 6).

---

<sup>5</sup> Japan has been in a protracted recession for much of the last two decades. On the other hand, China's savings rates have outpaced the strong growth in investment rates in recent years. The Chinese economy alone accounts for nearly two-thirds of gross national savings in the region (IMF, 2010).

**Chart 6**  
**Capital Formation /GDP**



Source: IMF, IFS and Website of Member Banks.

The slowdown in investment growth, however, is not a result of deficiency in savings. On the contrary, savings in most SEACEN economies, in general, have only declined slightly during the Asian financial crisis years (Chart 3). With investments at a lower level, post-crisis, the region runs successive current account surpluses (Chart 2). This, in turn, enables the SEACEN region to become capital exporters, suggesting that Asia's excessive savings glut may be partly responsible for the current global current account imbalances (Bernanke 2005).

#### **4. Reserve Accumulations**

In general, the reserve accumulation of SEACEN economies as a region is a direct result of both surpluses in the current account and capital inflows in the capital accounts (Chart 2 & 7)- termed as "twin surpluses" (Adams & Park 2009). As Chart 6 shows, current account surpluses are important sources of reserve accumulation in East Asia. In the context of the Asian economy inflicted by the 1997 Asian Financial crisis, the convention is to accumulate enough reserves to cover short-term debts in order to reduce the vulnerability of a sudden capital outflow (Chart 9), that is, holding more reserves for self-insurance (Akyüz 2008). In general, the strategy is to shift from being net importers of financial capital to being net exporters, in some cases very large net exporters. (McKinnon and Schnabl 2009)<sup>6</sup> These economies continue to do so even after the constraints imposed to manage capital inflows from global financial markets were relaxed.<sup>7</sup>

Increases in foreign-exchange reserves involve a shift toward a surplus in the country's current account, increases in gross capital inflows, reductions in gross private capital outflows, or some combination of these elements. Most of these reserves are held in US dollars given the relative safe-haven status of the dollar (Carbaugh and Hedrick, 2009). In some economies, reserve accumulation covers more than 12 months of imports.<sup>8</sup>

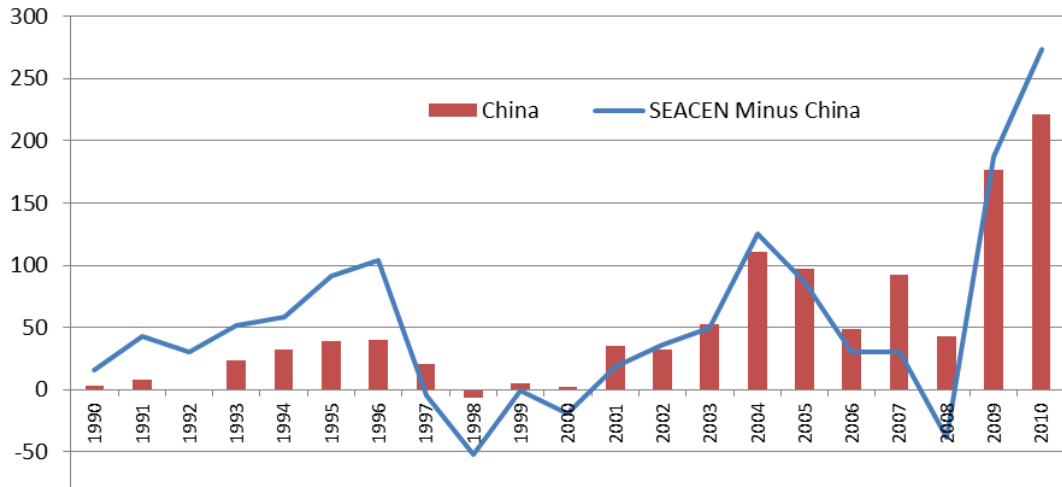
---

<sup>6</sup> For example, Mongolia, driven largely by the commodity boom, has seen its foreign exchange reserve position almost triple from January 2009 to end of 2010. With the return of political stability and security, Sri Lanka has seen its reserves triple within a period of less than 2 years.

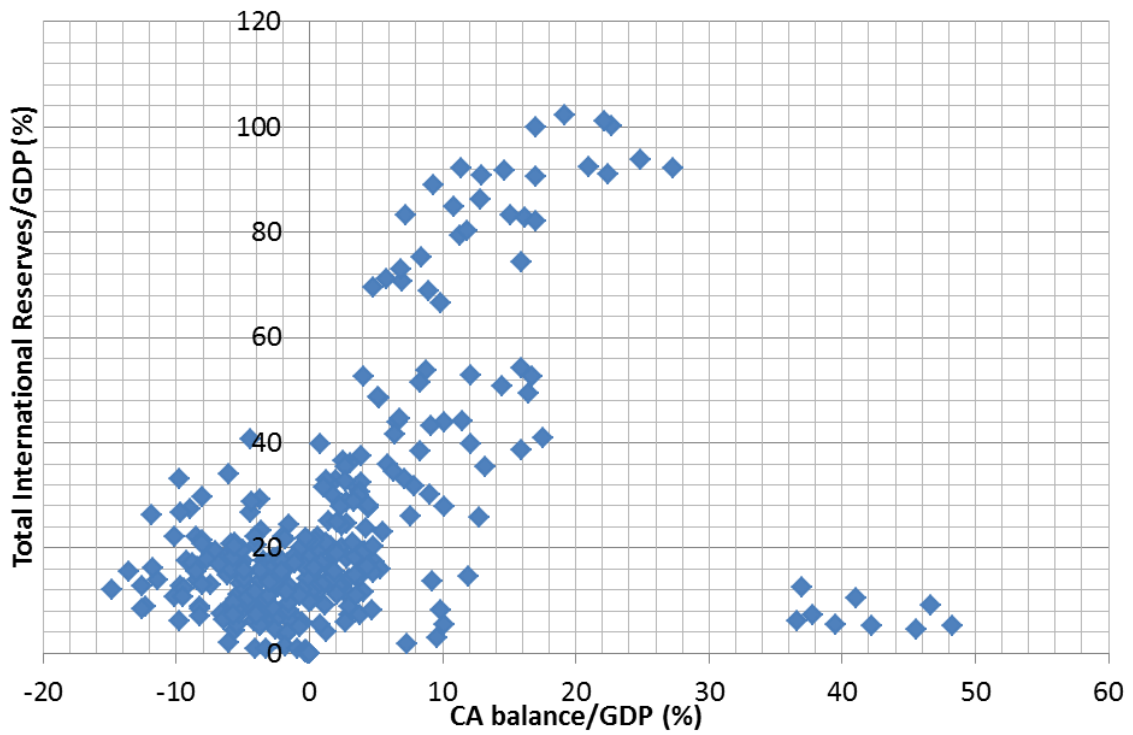
<sup>7</sup> The recent strong surges of capital to Asia (including the SEACEN economies) are expected to cause challenges to macroeconomic management policies in the region. Sterilization has, in general, been found to be fiscally very expensive as the domestic central banks/monetary authorities are forced to earn a lower interest rate on the foreign currency reserves that it purchases than it pays on the bonds of central bank securities issued in the sterilization process. These quasi-fiscal costs (roughly equal to the interest rate differential between domestic and foreign economies multiplied by the rise in foreign exchange reserves) can be quite high and damaging to the balance sheet of the central bank.

<sup>8</sup> This leads some to argue that in many surplus economies, the accumulation of foreign reserves has been excessive by any means.

**Chart 7**  
**Net Capital Flows in the SEACEN Economies**  
**(Billion USD)**

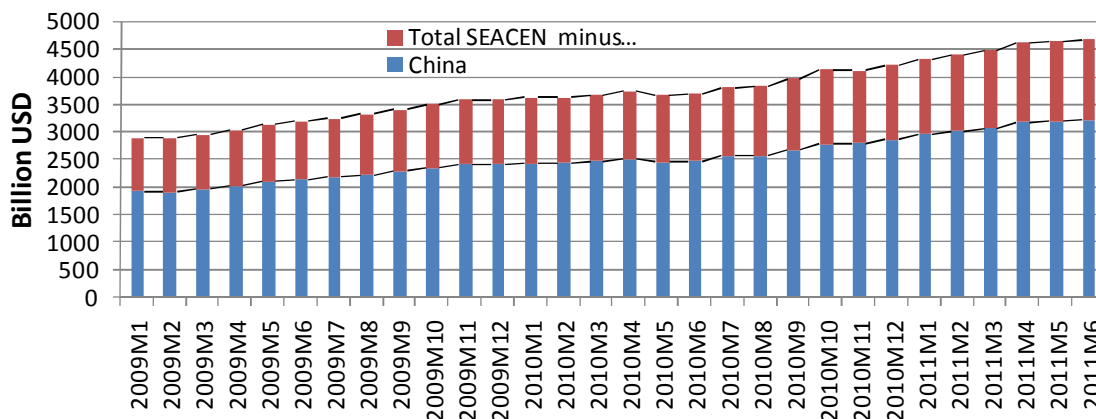


**Chart 8**  
**Current Account/GDP (%) vs Total International Reserve/GDP**  
**of SEACEN Economies**  
**(Percent)**



Data is for year 2000-2010  
 Source: IMF, IFS, CEIC

**Chart 9**  
**Accumulated International Reserves**  
**(Billion USD)**



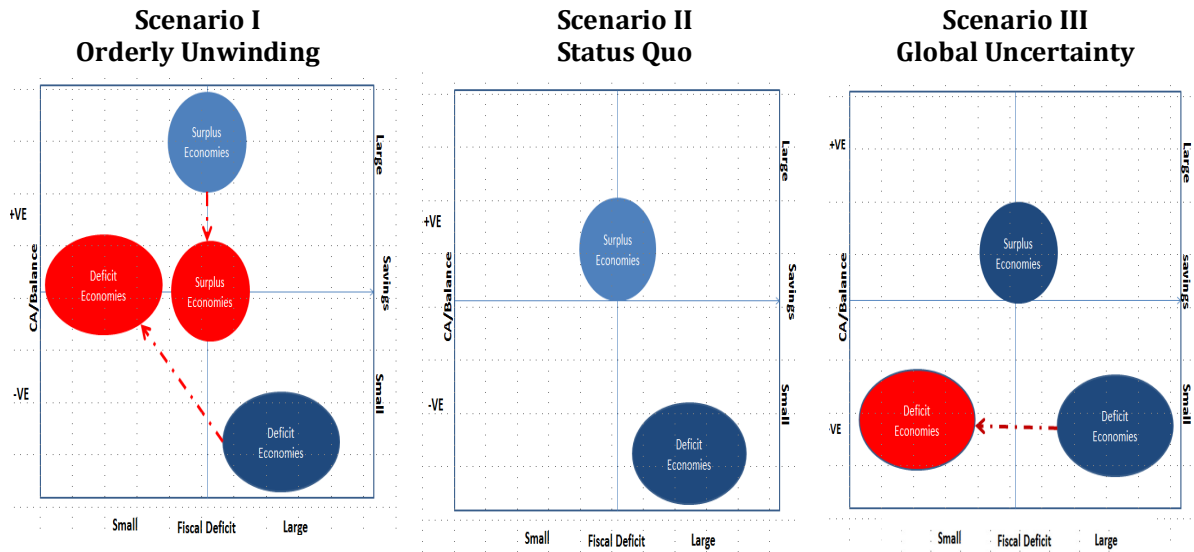
Source :IMF, IFS, CEIC.

## 5. Possible Scenarios in the Medium-Term

Blanchard and Milesi-Ferretti (2009) discuss three potential scenarios for the global imbalances. In Scenario I, there is an orderly unwinding of the global imbalances. In the current post financial subprime crisis, this would require the surplus economies to progressively reduce their current account surpluses by a gradual depreciation of their currencies while at the same time rebalancing their engine of growth for higher domestic demand. Surplus economies would also need to gradually reduce their saving rates. On the other hand, deficit countries need to consolidate their fiscal positions and eventually increase their private savings. There will be global readjustment and orderly unwinding of the global imbalances, meaning both surplus and deficit economies have to make structural changes in order to make the necessary adjustments.

Conversely in Scenario (II), the surplus economies would rebalance their growth towards domestic demand, albeit with some reluctance for the appreciation of these economies' exchange rates. Meanwhile, for deficit countries, there is some reluctance for them to decrease fiscal stimulus to continue to run fiscal deficit, given the zero bound on policy interest rates. Savings would remain low and subsequently the underlying distortion is not reduced.

**Chart 10  
Potential Scenario**



In Scenario (III), similar to Scenario (II), surplus economies would rebalance their growth towards domestic demand but there is reluctance for these economies to appreciate their exchange rates. The surplus economies, however, would phase out their fiscal stimulus. In this instance, there may be a risk of global slowdown and surplus economies that could afford to increase their internal demand would continue to do so. There may be a further distortion in economic growth.

## 6. Policy Implications to Surplus Economies

From the point of view of surplus economies, policies to directly address the risks emanating from the global imbalances challenge can be broadly divided into two – policies that strengthen domestic demand and efforts to intensify regional cooperation and coordination.

### 6.1 Policies to Strengthen Domestic Demand

Below are some of the key specific policies that can boost domestic demand. Measures that boost domestic demand can be distinctly categorized into policies that directly encourage greater domestic consumption; stimulate domestic investment and promote the development or deepening of financial markets.

#### 6.1.1 Policies That Encourage Greater Domestic Consumption

In order to encourage households to consume more, measures that aim to either increase the disposable income of households or measures to reduce the rate of savings of households should be implemented. One way to address the former is for the government to encourage the corporate sector to transfer its profits to stockholders in the form of dividend payouts rather than retaining these profits. This is in view of the present situation in most SEACEN economies where the bulk of national savings is primarily from the private sector rather the public sector. A major portion of this private sector savings in turn come primarily from corporate profits (ADB, 2009). This recommendation, of course, assumes that the majority of the household sector in SEACEN economies own shares of stocks, otherwise, it will preclude the opportunity for the corporate sector to transfer its profits to households. In such a not so remote possibility that this cannot be done in some SEACEN economies, the

state has to be ready to fill the void by implementing an effective cash-transfer program that correctly targets vulnerable sectors in the economy such as lower-income households, which typically have higher propensities to consume. Such cash-transfer schemes can be implemented on conditionality that certain requirements be met by the target recipient such as enrolling children into public schools, getting vaccinations, etc. (Morgan, 2011).

Furthermore, one important reason why consumption has fallen in Asia, especially so in the case of China, is that the share of national income that goes to households has fallen while the share of corporate profits has increased. The potential reason for this anomaly is that growth has been capital-intensive, favoring manufacturing activities over services – hence, favoring production of tradables over nontradables. In particular, interest rate controls in some economies kept the cost of capital artificially low primarily for large manufacturers that are concentrated in the export sector (ADB, 2009). Hence, corporate profits (which can be construed as the measure of the return to capital) have outpaced labor or wage income.

In addition to measures that increase the disposable income of households, the latter objective of reducing the rate of savings of households in order to increase consumption can be addressed by the government via reducing the precautionary motive of the household sector to save. The risk and uncertainty of not being able to fulfill one's consumption needs upon retirement and aging drive households to save and, thereby to self-insure. One way for the government to overcome this obstacle for greater household consumption is for it to expand its social safety net in the form of greater and better-quality provision of health care and insurance, education and pension benefits (Prasad, 2011). The extension of health care provision is very important for the elderly especially for SEACEN economies that have weak social safety nets. This is especially so in view of longer life expectancies and ever-increasing health care costs which have motivated this demographic group to save for precautionary reasons. Thus, with wider and greater social security coverage for households in SEACEN economies, it is expected that this would contribute significantly to greater consumption levels.

### ***6.1.2 Policies That Stimulate Domestic Investments***

A basic but crucial ingredient to enhance and stimulate domestic investments in SEACEN economies is to foster an investment-friendly environment that will reduce or eliminate economic uncertainty and help induce private firms to invest. Perceptions of ease in doing business in the economy plays an important role in this regard and measures that promote and enhance such perceptions, but at the same time do not require substantial expenditure outlay from the state, e.g., improvements in governance, legal and regulatory framework and a more transparent tax system, should be welcomed.

In addition to enhancing the investment climate, the financing and provision by the government of vital physical infrastructures in the form of highways, bridges, ports, telecommunications and electricity that increase connectivity across economic regions as well as across national borders can substantially reduce transport costs and make it attractive for investments by private sector firms. This is all the more relevant in view of the spectacular rise in economic growth and living standards in SEACEN economies which placed severe pressure on existing infrastructures in these economies (Kawai, 2010). Having said that, the public sector cannot do it alone - what with the strain exerted on national government budgets from the various fiscal stimulus packages that have been implemented in recent years due to the onslaught and ferocity of the global financial crisis. An alternative mechanism that will meet the infrastructure needs of SEACEN economies needs to be explored.

In response, a number of international and domestic joint ventures in the form of public-private shared partnerships for infrastructure have been initiated recently. For example, the Theun Hinboun hydropower project implemented jointly by Thailand and Lao PDR between 1994 and 1998 and the new international airport terminals in Delhi and Mumbai have been financed by such joint-venture projects. These projects offer a key lesson on how future hybrid partnerships should be designed and involve a clear and transparent delineation of risks, e.g., construction, operating and political risks, in order to facilitate optimal risk-sharing across each partners (IMF, 2011).

### ***6.1.3 Policies That Promote Greater Deepening of Financial Markets***

Deepening of financial markets in SEACEN economies serve to complement the two respective policies of encouraging greater domestic consumption as well as to stimulate domestic investments. With regard to the former, for instance, making available a larger number of financial instruments while, at the same time, providing easy access to households to these instruments, especially those located in the rural areas, reduce the incentives for households to save and self-insure (precautionary motive of savings mentioned earlier) and thus encourage greater consumption. One catalytic outcome of such so-called ‘financial-inclusion’ policy is the greater opportunity to borrow and finance the consumption of durables such as houses.

With regard to the latter, deepening financial markets provide the opportunities for savings of the private sector to be channeled into productive investments instead of low-yielding bonds from overseas (ADB, 2009). In addition, it lessens the need for the private corporate sector in SEACEN economies to rely on retained earnings to finance their investment projects since it makes available to the private sector, a broader array of financing-related vehicles, in particular, financing that can be obtained from the region’s bank-based financial system. An equally important outcome is that the greater provision of new prospects for financing can provide small-and medium scale firms, particularly those in the non-tradable sector, access to alternative and possibly cheaper sources of funds without having to create and use their own resources. As these firms predominate in the services sector, which arguably caters largely to domestic demand, not only is this particular aspect of deepening financial markets expected to boost domestic demand but will also promote entrepreneurial activity and growth in employment (ADB, 2009; Prasad, 2009).

A potential source of funding long-term investment is through the insurance sector. The nature of assets of a firm normally reflects the maturity of its liabilities and because the liabilities of insurance firms are normally long-term in nature, so are their investments (Haiss and Sümegi, 2006). Hence insurance companies, with their available funds, play an important role in financing deepening. As insurance penetration among households (especially low-income households) in Asia is still very low, concerted efforts should be made to improving insurance distribution (Lim 2011).

## **6.2 Efforts to Intensify Regional Cooperation and Coordination**

Resolving the global imbalances problem should not fall squarely on the shoulders of domestic policies that stimulate domestic demand, but also on initiatives that attempt to resolve the collective action problem by forming a regional consensus in the implementation of national economic policies that ultimately boost intra-regional demand. Some of these policies are discussed below.

### ***6.2.1 Facilitate the Development of Local Currency Bond Market***

In essence, the role of the financial sector in any economy is to channel funds from those who are saving to those who want to invest. The more efficient the financial sector



plays this very vital role, the lower is the cost of capital expected to be for the real sector in the economy. Bond markets have a crucial role to perform in this regard. Because investment projects take time to generate economic returns, while the economic risks are already immediate and profound at the onset of the project, a bond-financed investment project allows investors to share the risks with other investors and the flexibility if needed, to transfer the risks by trading the bond even before the project is completed. Thus, in view of these dual advantages of bond financing, investors are more willing to undertake bigger and lasting commitments to an investment project.

These are precisely some of the motivations underlying the establishment of the ABMI (Asian Bond Market Initiative) and the ABF (Asian Bond Fund) in the aftermath of the Asian financial crisis of 1997-98 whereby the two initiatives were designed to achieve an efficient recycling of savings in the Asian region into Asian investments with the development of bond markets denominated in local currencies (Capanelli, 2011). This comes on the back of a recent observation by the ADB (2010) that the development of local currency bond markets in East Asia is uneven in that the larger economies in the region tend to have bigger bond markets. More importantly, most observers believe that had a well-developed domestic bond market been in place at the onset of the Asian financial crisis, the crisis would not have been as severe as it turned out since the borrowing that created the so-called double-mismatch problem, i.e., long-term domestic investment projects that were being funded through short-term and foreign currency borrowing, could have easily been avoided.

While Asian bond markets have come a long way since the Asian financial crisis and had proven to be resilient during the recent global financial crisis, more still needs to be done. There is a need in the region to improve accounting standards and market infrastructures - two areas for which further regional cooperation initiatives can help significantly. For instance, the creation of the Credit Guarantee and Investment Facility (CGIF) under the aegis of the ABMI is a step in the right direction in that apart from its objective of making it easier for firms to issue local-currency bonds with longer maturities, the CGIF is also expected in the longer term to promote the harmonization of standards and practices for bond issuance. Finally, the creation of a regional rating agency in the near future can serve as a catalyst in helping to bring about harmonization and comparability in the rating process of local and domestic companies in the Asian region (ADB, 2010).

## ***6.2.2 Develop Stronger Regional Safety Net***

Starting in the 2000s, several SEACEN economies have undertaken on large-scale reserves accumulation which is primarily justified on the basis that it serves the crucial purpose of affording these economies the ability to withstand and self-protect against sudden reversals or shortages of liquidity. Indeed, there are a number of available evidence that show that economies with more stockpiled international reserves at their disposal on the eve of the global financial crisis in 2008-2009, fared better in terms of insulating themselves from the onslaught of the recent crisis.<sup>9</sup> However, this advantage of accumulating international reserves has to be counterbalanced by its costs in terms of investing in low-yielding foreign assets let alone the accounting losses each time emerging market currencies appreciate against the three tri-polar reserve currencies - US dollar, euro and the Japanese yen. More importantly, large accumulated international reserves which are also evidently demonstrated by large current account surpluses have been alleged as the culprit behind the global imbalances problem and its prospective adverse consequences to financial stability.

---

<sup>9</sup> Although evidence provided by Moghadam (2010) argues that there have been diminishing returns to reserve accumulation beyond a certain point during the recent crisis.

The crucial question then is what alternative mechanism can be put in place regionally that will reduce or eliminate the incentive of SEACEN economies to maintain large international reserves? The recent collective efforts of ASEAN+3 economies to pool a portion of their international reserves in view of the recent multilateralization of the Chiang-Mai Initiative (CMIM) in March 2010 as well as the creation of an organization, i.e., ASEAN+3 Macroeconomic Research Office (AMRO), that will conduct regional economic surveillance, is a step in the right direction towards a regional self-help liquidity mechanism. Moving forward, the success and effectiveness of the CMIM as a regional liquidity support facility will depend on how it will meet some of the following key policy challenges (Kawai, 2010):

- enlarging the size of the facility;
- introducing new instruments;
- eventual delinking of facility from IMF programs

With regard to the first challenge, the current CMIM total size of \$120 billion and the corresponding borrowing limits of the individual ASEAN+3 economies are not necessarily adequate in meeting head-on the potential liquidity requirements of these economies should another international liquidity crunch ensue. Furthermore, the above CMIM size is only approximately 2.5% of total ASEAN+3 economies' international reserves, suggesting that there is still ample room to increase the CMIM's fund size (Capannelli, 2011). As to the second challenge, the CMIM in its present form is a lending-facility for crisis situations and as such, introducing a precautionary component that involve lending during near-crisis situations is an essential step towards CMIM's reform in terms of streamlining and affording flexibility in its conditionalities.

One such model for which the precautionary component can be patterned after is the IMF's recently-introduced Flexible Credit Line (FCL) where conditionalities operate ex-ante or by prequalification, meaning that countries applying with sound fundamentals can qualify, instead of the traditional ex-post conditionality whereby countries can only apply when in the midst of a crisis. The FCL works as a renewable credit line, which at the country's discretion, can initially be for either a six-month or a twelve-month period with a review for eligibility several months down the track. Thus, access is guaranteed for a relatively short period, while future pre-qualification is not guaranteed (Jeanne, 2010). That said, it is important that conditionalities are regarded with full-credibility especially in the eyes of markets for the lack of it creates complications in terms of the following two relevant concerns: first, how to disqualify previously prequalified countries when the authorities' management of the economy does not improve without stoking the same crisis the facility was originally intended to avoid; and second, how can one convince economies in applying when along the way their application for renewal can be denied, without triggering a financial panic in their own economies (Eichengreen, 2010).

While the first two challenges are very involved, the third and final one is quite controversial. In its present form, the utilization of more than 20% of an economy's borrowing limit will trigger an economic review by the IMF and perhaps tie it to an IMF economic program. Memories of some economies in the East Asian region of relying solely on the IMF during the pinnacle days of the 1997-98 Asian financial crises are still fresh. It is for this reason that some quarters have proposed that the IMF-linked part of the liquidity facility be reduced or completely eliminated. On the other hand, one can also understand the main argument for requiring the CMIM to be linked to an IMF program since that there are no better alternatives to the moral hazard problem in such a crisis-lending liquidity facility (Kawai, 2010). In the final analysis, once all three envisaged reform measures listed above are put in place in the years ahead, the CMIM and its regional surveillance arm, AMRO, can have an expectedly strong chance to grow into a strong regional fund and institution, respectively. In the same vein, it is only at such time that the creation of a regional liquidity safety-net in the region can have a significant dent on reducing, if not, completely eliminate

the motivation of Asian economies to accumulate international reserves and, thereby contribute to a significant narrowing of global imbalances.

### **6.2.3 *Coordinate Collective Regional Currency Appreciation***

As the Asian region grows together through ever increasing intra-regional trade, investments and significantly tighter financial linkages, the greater will be the call to bolster efforts for improving existing coordination mechanisms in the region that range from softer forms of coordination such as information sharing and surveillance to stronger forms such as formal exchange rate and monetary policy coordination. The close macroeconomic interdependence of the regional economies means that they are increasingly affected by shocks that emanate from neighboring economies as well as being highly sensitive to policies adopted in these same economies. Take for instance the issue of competitiveness vis-à-vis neighboring economies in the region.

The rapid growth of intra-regional trade in the Asian region that is centered around China has brought about three policy concerns (Roubini, 2010). One is the concern that Asian economies-ex-China would lose their competitiveness relative to China in third markets such as in the United States, Japan and other developed economies, once their currencies appreciate. Second, as China produces and exports labor-intensive manufactured goods to neighboring Asian economies, a currency appreciation in these regional economies outside of China can trigger a 'competitive squeeze' that can hurt domestic and import-competing manufacturing industries in these same economies. And finally, a currency appreciation in one Asian economy that is not equivalently experienced to the same degree in other neighboring Asian economies, can also harm the former's market share relative to the latter in the Chinese market. In short, there is more economic reason among Asian economies outside of China to fear or dread a currency appreciation. Recent evidence indicate that indeed such is the case.<sup>10</sup>

A possible regional solution in this regard is for these economies to collectively appreciate against the U.S. dollar. This can be a logical and effective mechanism in promoting currency stability in the region without running the risk of altering the loss of price competitiveness for each economy as emphasized above. More importantly, this can facilitate the contribution of the Asian region to the global rebalancing process (Kawai, 2010). In order to ensure that such intra-regional exchange rate stability can be facilitated, it is critical that the existing dialogue process of finance ministries and central banks in the region should work towards a convergence of existing exchange rate regimes. In particular, they should work towards a regime that allows greater currency flexibility against the US dollar (Kawai, 2007).

## **7. Concluding Remarks**

The worst stage of the sub-prime crisis may have passed, but uncertainties in the global financial market still remain. Global economic recovery will be predominantly driven by the strong growths of the emerging markets in Asia. However, the recovery will be underscored by fragilities still prevailing in advanced economies such as the US and Europe. The global imbalances have "survived" the crisis and an orderly unwinding of the said imbalances is impossible without both surplus and deficit economies committing to macroeconomic and structural reform measures.

---

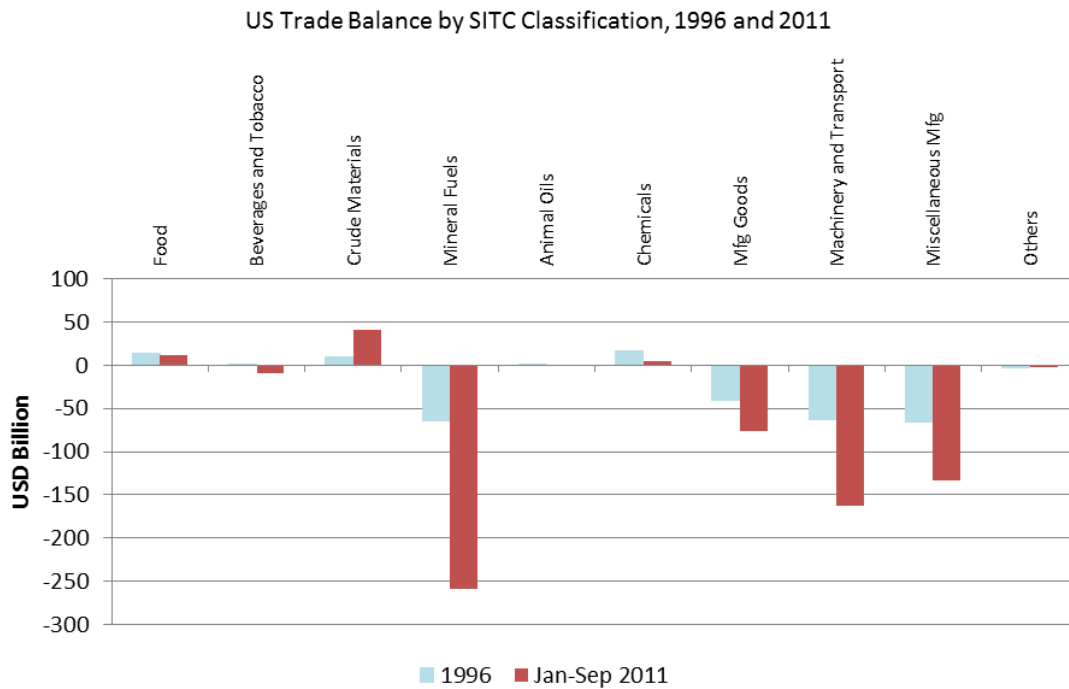
<sup>10</sup> Pontines and Siregar (2010a, 2010b).

## References

- Adams C. and Park D.H., (2009), "Causes and Consequences of Global Imbalances: Perspective from Developing Asia", *Asian Development Review*, Vol. 26, No. 1.
- Akyüz Y., (2008), *Managing Financial Instability in Emerging Markets: A Keynesian Perspective*, Third World Network.
- Asian Development Bank, (2009), *Asian Development Outlook 2009*, Manila, Philippines.
- Asian Development Bank, (2010), *Institutions for Regional Integration: Toward an Asian Economic Community*. Manila, Philippines.
- Bernanke B.S., (2005), "The Global Saving Glut and the U.S Current Account Deficit, Speech given at the Homer Jones Lecture", St. Louis, MO., April 14.
- Blanchard O. and Milesi-Ferretti G.M., (2009), "Global Imbalances: In Midstream", *IMF Staff Position Note*, International Monetary Fund, December 22.
- Borio C., and Disyatat P., (2001), "Did Global Imbalances Cause the Financial Crisis?", Research-based Policy Analysis and Commentary From Leading Economists, *VOX*, 26 July, <http://voxeu.org/index.php?q=node/6795>.
- Capanelli, G., (2011), "Institutions for Economic and Financial Integration in Asia: Trends and Prospects", *ADB Working Paper Series* No. 308, Tokyo, Japan.
- Carbaugh R.J. and Hedrick D.W., (2009), "Will the Dollar be Dethroned as the Main Reserve Currency?", *Global Economic Journal*, Vol. 9, Issue 3.
- Cooper, R., (2004), "U.S. Deficit: It is not Only Sustainable, It is Logical", *Financial Times*, 31 October.
- Eichengreen B., (2006), "Global Imbalances: The New Economy, the Dark Matter, the Savvy Investor", *The Journal of Policy Modeling*, Volume 28, Issue 6, September.
- Eichengreen, B., (2010), "The International Financial Architecture and the Role of Regional Funds", mimeo.
- Feldstein M.S., (2008), "Resolving the Global Imbalance: The Dollar and the U.S. Saving Rate", *NBER Working Paper* No.13952, April.
- International Monetary Fund, (2008), *World Economic Outlook*, October.
- International Monetary Fund, (2010), *World Economic Outlook*, April.
- International Monetary Fund, (2011), *World Economic Outlook*, October.
- International Monetary Fund, (2010), "How Did Emerging Markets Cope in the Crisis", Mimeo.
- Haiss P and Sümegi K., (2006) *The Relationship of Insurance and Economic Growth – A Theoretical and Empirical Analysis*, Paper for presentation at the 2006 EcoMod Conference, Hongkong, June 28-30, <http://www.ecomod.org/files/papers/1454.pdf>

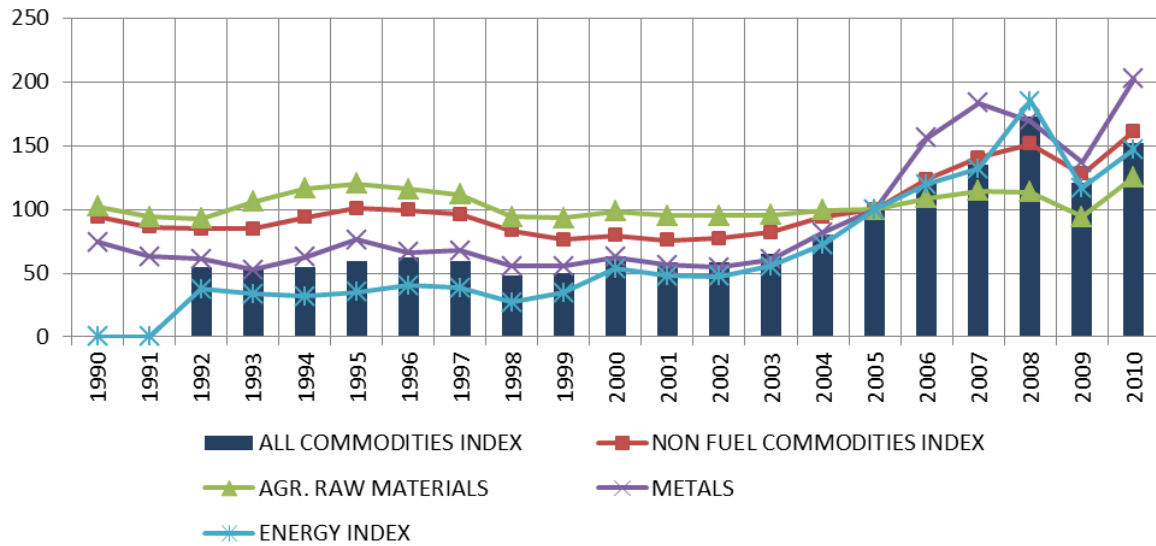
- Jeanne, O., (2010), "International Financial Safety Nets and Global Imbalances", in S. Claessens, S. Evenett and B. Hoekman (eds.), *Rebalancing the Global Economy: A Primer for Policymaking*, London: CEPR.
- Kawai, M., (2007), "Evolving Economic Architecture in East Asia", *ADB Discussion Paper* No. 84.
- Kawai, M., (2010), "Global Rebalancing: An Asian Perspective", in S. Collignon, R. Cooper, M. Kawai and Y. Zhang (eds.), *Rebalancing the Global Economy: Four Perspectives on the Future of the International Monetary System*, Berlin: Bertelsmann Stiftung.
- Lim HK (2011), Keynote Address by, Minister for Trade and Industry, and Deputy Chairman, Monetary Authority of Singapore, 25th Pacific Insurance Conference, Marina Bay Sands Convention Centre, Monday, 12 September,  
[http://www.mas.gov.sg/news\\_room/statements/2011/Keynote\\_Address\\_by\\_Mr\\_Lim\\_Hng\\_Kiang\\_Minister\\_for\\_Trade\\_and\\_Industry\\_and\\_DC\\_MAS\\_at\\_the\\_25th\\_Pacific\\_Insurance\\_Conference\\_MBS.html](http://www.mas.gov.sg/news_room/statements/2011/Keynote_Address_by_Mr_Lim_Hng_Kiang_Minister_for_Trade_and_Industry_and_DC_MAS_at_the_25th_Pacific_Insurance_Conference_MBS.html)
- McKinnon R. and Schnabl G., (2009), "China's Financial Conundrum and Global Imbalances", *BIS Working Papers*, No. 277 March.
- Morgan, P., (2011), "The Role of Macroeconomic Policy in Rebalancing Growth", *ADB Working Paper Series* No. 266, Tokyo, Japan.
- Nabar, M. and M. Syed, (2011), "The Great Rebalancing Act: Can Investment be a Lever in Asia?", *IMF Working Paper Series* WP/11/35, Washington, D.C.
- Pontines, V. and R.Y. Siregar, (2010a), "Exchange Rate Asymmetry and Flexible Exchange Rates under Inflation Targeting Regimes: Evidence from Four East and South East Asian Economies", *Review of International Economics*, Forthcoming.
- Pontines, V. and R.Y. Siregar, (2010b), "Fear of Appreciation in East and South East Asia: The Role of the Chinese Renminbi", *Journal of Asian Economics*, Forthcoming.
- Prasad, E., (2011), "Rebalancing Growth in Asia", *International Finance*, 1-40.
- Rampell C., (2010), Lax Oversight Caused Crisis, Bernanke Says, *The New York Times*, January 4.
- Suominen K., (2010), "Did Global Imbalance cause the Crisis", *VOX*, 14, June.
- The Economist, (2009), "When a Flow Becomes a Flood", 22 January.

**Chart 11**  
**US Trade Balance by SITC Classification, 1996 and 2011**



Source: CEIC

**Chart 12**  
**Commodity Prices**



Source: IMF, IFS