

The Revived Bretton Woods System: Does It Explain Developments in Non-China Developing Asia?

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It is a genuine pleasure to be here today to take part in such an interesting and important discussion, and among such a distinguished group of scholars. The comments I will offer are, of course, my own and do not necessarily reflect the views of the Federal Reserve or its staff.

I have been asked to talk about the revised Bretton Woods system in connection with the non-China Asian economies. I regard this as an exciting assignment, since, in my view, the most interesting aspect of the Dooley-Folkerts-Landau-Garber (DFG) work is their attempt to explain a key paradox in the international economic system today: that the labor-rich, capital-poor developing economies of the world are exporting substantial amounts of capital to a mature, capital-rich economy, the United States. This can be seen in Figure 1, where the industrial economies ran an estimated current account deficit of \$351 billion, whereas the developing economies ran a surplus of \$286 billion, with the global statistical discrepancy making up the rest. Accordingly, I'm going to spend most of my time referring to the non-China developing economies, and come back to Japan at the end.

¹I would like to thank Alan Ahearne, Joseph Gruber, Jane Haltmaier, David Howard, John Schindler, and Nathan Sheets for useful comments. Craig Evers provided excellent research assistance.

In Figure 1, I've identified the non-China Asian developing economies I'd like to focus on as: Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand. I've taken Hong Kong out of this group, as it is hard to separate its current account balance from China's. As may be seen, in 2004, the current account surpluses of the non-China Asian developing economies are estimated at over \$100 billion, well above the \$54 billion surplus of China and Hong Kong combined.

It seems plausible that these large current account surpluses are, at least in part, the result of official actions to keep exchange rates competitive. As indicated in Figure 2, since 2002, whereas the Federal Reserve's index of the real value of the dollar against the industrial economies (the red dashed line) has declined by some 25 percent, the value of the dollar against the currencies of non-China developing Asia (the blue line) has fallen much less. As indicated in Figure 3, the non-China developing Asian economies have intervened substantially in foreign exchange markets to keep their currencies from appreciating—in each of the last couple of years, reserves (the blue line) have risen by more than \$100 billion. Partly in consequence (Figure 4), real multilateral exchange rates in the region have remained about unchanged since 2002, even as the euro, for example, has risen considerably.

Why are relatively poor countries in developing Asia exporting capital to the United States? DFG argue that developing economies have an interest in keeping their exchange rates competitive so as to promote export-led growth supported by foreign direct investment. They argue that this export-led strategy best achieves efficient economic development, even if it forgoes the use of foreign savings. Because the need to shift vast amounts of labor into the modern sector implies that export-led growth will be needed for an extended period, DFG see

these policies as lasting for many years. Their argument appears to be focused on China. However, given that the authors appear to believe their theory is sufficiently general to characterize much of the international monetary system, and to explain a large share of the U.S. current account deficit, their theory implicitly seems to apply to the other developing economies of the region as well.

I agree with DFG that the authorities in the non-China developing economies have been acting to maintain the competitiveness of their exports. However, I disagree that these policies will be hardwired into the international monetary system for the foreseeable future. Instead, I will argue that the recent large current account surpluses in the region reflect the special, on-going effects of the Asian financial crisis of 1997-98, and once these effects wane, the surpluses will wane as well.

Figure 5 shows that relative to history, today's outsized current account surpluses are quite exceptional, and date only from the 1997-98 financial crisis. Note that the region's current account averaged out to be roughly in balance from 1980 to 1997, even though these countries have generally been pursuing export-led growth strategies for the period; export-led growth does not require running massive current account surpluses. Figure 6 plots these balances as a share of GDP—even based on this measure, the post-1997 period has been usual for both the size and sustained nature of these surpluses.

What is the cause of these large surpluses? I believe they stem from the weakness of domestic demand in the region. This weakness supports these surpluses directly, by dampening imports. This weakness also supports these surpluses indirectly, by leading the authorities to focus on keeping their exchange rates competitive to maintain growth. (To be sure, immediately

after the financial crisis, the desire to rebuild foreign exchange reserves was another reason why authorities in the region intervened in foreign exchange markets to purchase dollars, but this motive has likely diminished in importance as reserves have become very substantial). Once domestic demand revives, however, the authorities will likely be more comfortable with allowing exchange rates to appreciate and allowing the stimulus from net exports to diminish.

The weakness of demand that I have referred to is evident in Figure 7—since 1997, growth rates have averaged well below their previous pace. You can see this even more clearly in Figure 8, which indicates that the output gap has been negative, so that GDP was below its potential level, for the entire period since the financial crisis. As a consequence, inflation has remained subdued, notwithstanding the sharp runup in oil prices.² I would add that if undervalued exchange rates had led to overheating and excessive inflation, this would have been an important factor pushing the authorities to allow their currencies to appreciate, but such overheating and high inflation has not materialized. Moreover, one cannot attribute weak demand to tight policies; monetary policy has been relatively accommodative, and interest rates have been low.

So, what accounts for the weakness of demand and growth in the region? Figure 9 points to the key mover in this story—the collapse in investment spending since the 1997-98 crisis, and to levels below anything seen in the past two decades. Keeping in mind that the current account is equal to saving minus investment, it is clear that the massive swing in the region's current account from deficit to surplus mainly reflects the fall in investment. A number of factors explain this collapse:

First, investment rates were probably too high or mis-allocated before the crisis, driven by

²The runup of inflation in 1998 reflects the temporary effect of exchange rate devaluations during the crisis, particularly in Indonesia.

over-optimistic expectations of future growth, and so the region was left with considerable excess capacity after the crisis.

Second, many firms were left with excessive debt after the crisis, particularly as the domestic currency value of their dollar debt was inflated by depreciated exchange rates.

Third, in addition to the decline in the demand for investment funds, the near-collapse of domestic banking systems in the region likely contributed to a cutback in loan supply. Bank lending collapsed during the crisis (Figure 10) and remains subdued by historical standards.

Finally, one would think that export expansion in the region would have spurred greater investment in the export sector, but if this has happened, it certainly has not shown up in the aggregate investment data. I am not sure why that is the case. One possible culprit is the faltering of the global economy a few years after the Asia crisis (Figure 11), but this slowdown was short-lived. Perhaps more to the point, the downturn hit high-tech demand especially hard, and this may have had more of an impact on the Asian investment climate. As shown in Figure 12, for example, global semiconductor shipments peaked in 2000 and did not regain that level until some three years later—presumably, excess capacity during this period would have damped investment demand.

Reflecting all of these factors, it is instructive that for much of the period since the 1997 financial crisis, equity prices in the region have not kept up with those in the United States (Figure 13).

From this perspective, the action of the authorities in the non-China developing Asian economies is more understandable—they have been reluctant to weaken their export sectors, as domestic spending did not appear primed to take up the slack. Yet, it seems likely to me that at

some point—which I think will be well short of some of the periods indicated in DFG’s work—investment spending will revive, domestic demand will become more solidly established, the authorities will be more comfortable in allowing their currencies to strengthen, and current account surpluses will narrow.

I base this view on several factors. First, the share of investment in GDP is below anywhere it has previously been in the past 25 years, and hence is likely to rise, once the factors weighing on it ease. Second, the evidence of other countries suggests that financial crises have long lasting effects, but eventually those effects wane. By now, corporate balance sheets in the region have strengthened, excess capacity has likely eroded, the health of the banking sector has improved, and the recovery of the global high-tech sector promises higher returns from future investment. Third, saving rates in the region have already been edging down from their pre-crisis levels, and as a consumer credit culture continues to make inroads into the region, there is the potential for further increases in consumer demand. Finally, the fact that private international capital flows to the region are growing—attracted by the dynamic, market-oriented economies of the region—should give the authorities some comfort that investment demand could replace export stimulus as a source of growth.

One issue some observers have posed is whether the non-China developing economies of Asia would let their currencies appreciate if China did not. Some suggest that as long as China’s currency remains linked to the dollar at current valuations, other economies will not want to threaten their competitiveness by allowing their own currencies to strengthen. I agree that this issue warrants consideration, although I cannot say how important it may prove to be.

I will conclude by recalling that my brief is to talk about non-China Asia, not just non-

China *developing* Asia. Therefore, I will offer a few observations on Japan. On the one hand, as suggested by Figures 14 and 15, Japan shares much in common with its neighbors: a history of past current account surpluses that reflected declines in investment rates, and which, in turn, reflected the outcome of a past financial crisis. By the logic I used before, this might suggest that, with the effects of the financial crisis waning and growth starting to establish itself, Japan, too, may start to move away from current account surpluses.

On the other hand, the pressures for a reversal of Japan's current account surplus may be less forceful than in the case of developing Asia. First, Japan's current account surplus is no recent phenomena – it has been around for decades, suggesting that a sizeable current account surplus may be a more permanent feature of Japan's economy. Second, as a consequence of a long history of prior surpluses, Japan's net international investment position is positive and substantial—therefore, even if Japan runs balanced trade, its investment income will keep its current account in surplus. Finally, unlike developing Asia, Japan has a mature, capital-rich economy that eventually will be supporting a dwindling population. This, too, would seem to militate against a dramatic rise in investment rates and associated decline in current account surpluses. (As one caveat to that, however, another consequence of an aging population may be further declines in saving rates, and these could lead to reduced surpluses.)

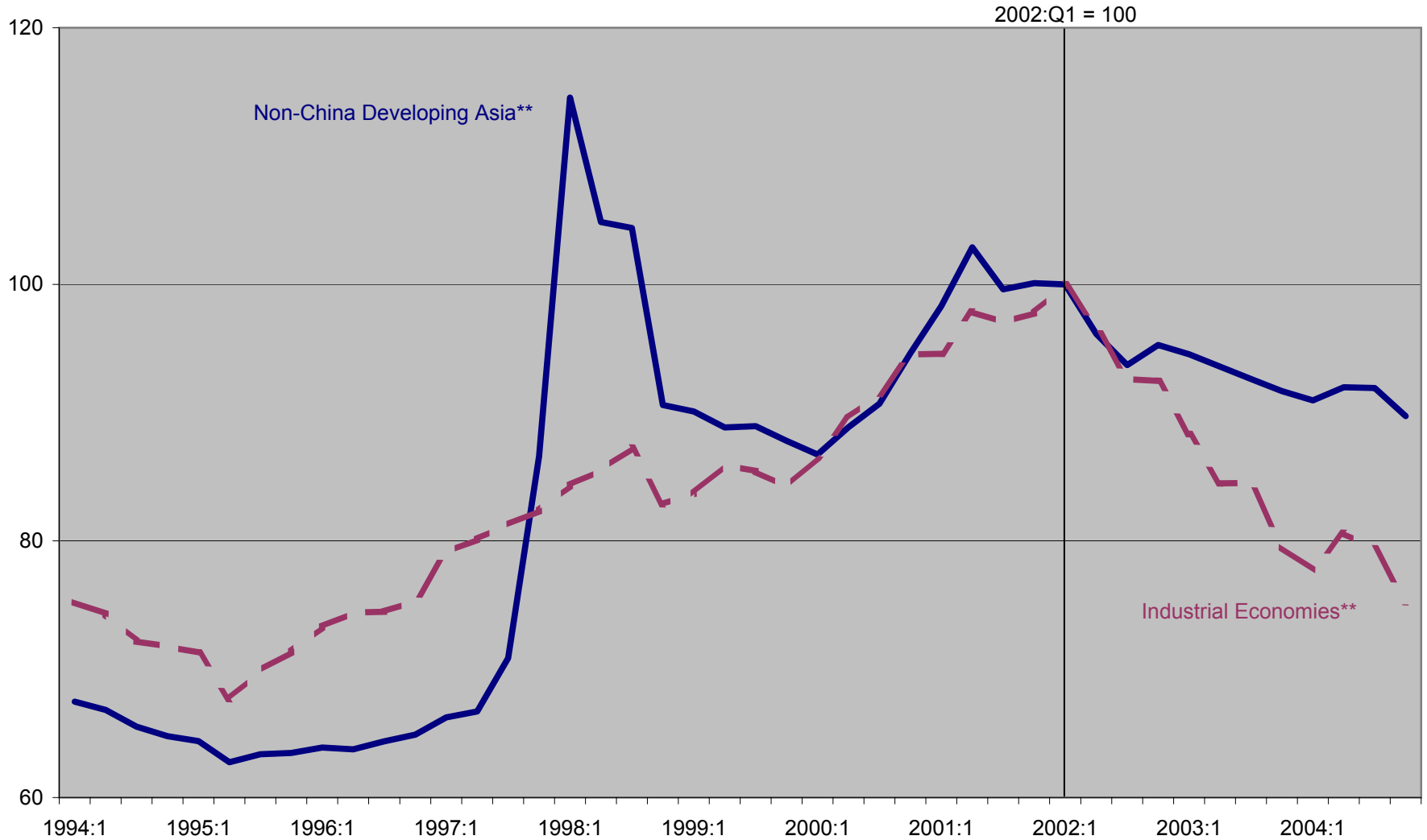
To conclude, there are several reasons why non-China developing Asia's large current account surpluses are not likely to last indefinitely. I think similar arguments can be made for Japan, too, although the counter-arguments are a bit more compelling here.

**Figure 1: Current Account Balances in 2004
(\$billions)**

<i>Industrial Economies</i>	-351
United States	-631
Japan	172
<i>Developing Economies</i>	286
China	38
Hong Kong	16
<i>Non-China Developing Asia</i>	106
Indonesia	6
Korea	28
Malaysia	14
Philippines	2
Singapore	28
Taiwan	21
Thailand	7

Source: IMF WEO Sept. 2004 Database for aggregate Industrial and Developing Economies, and economies where full-year data are not available (the United States, China, Hong Kong, Indonesia, Malaysia, Philippines, Taiwan); national sources for all else.

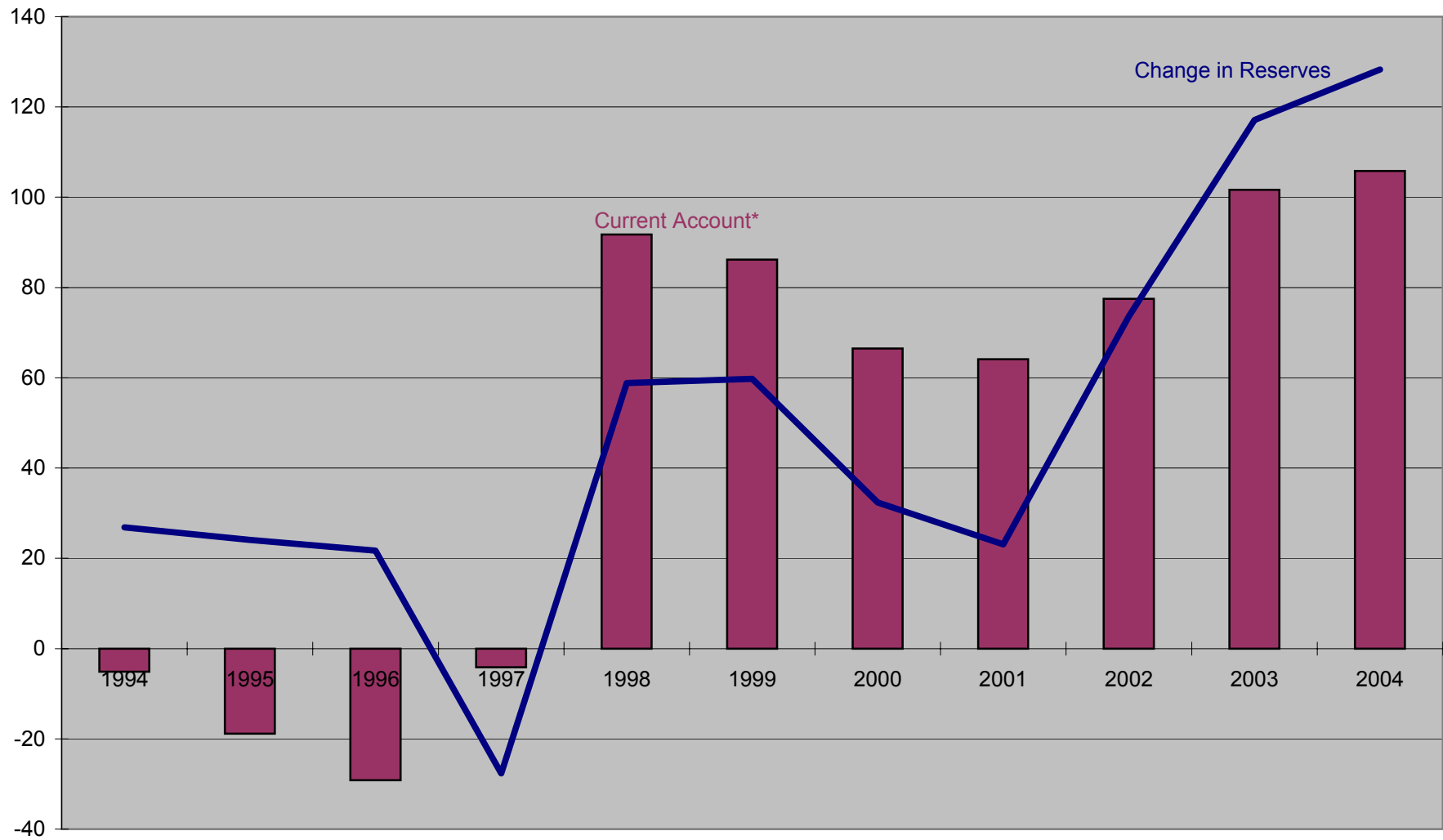
Figure 2
Real Foreign Exchange Value of Dollar*



*Weighted by country shares in \$US GDP, averaged over 1980-2004.

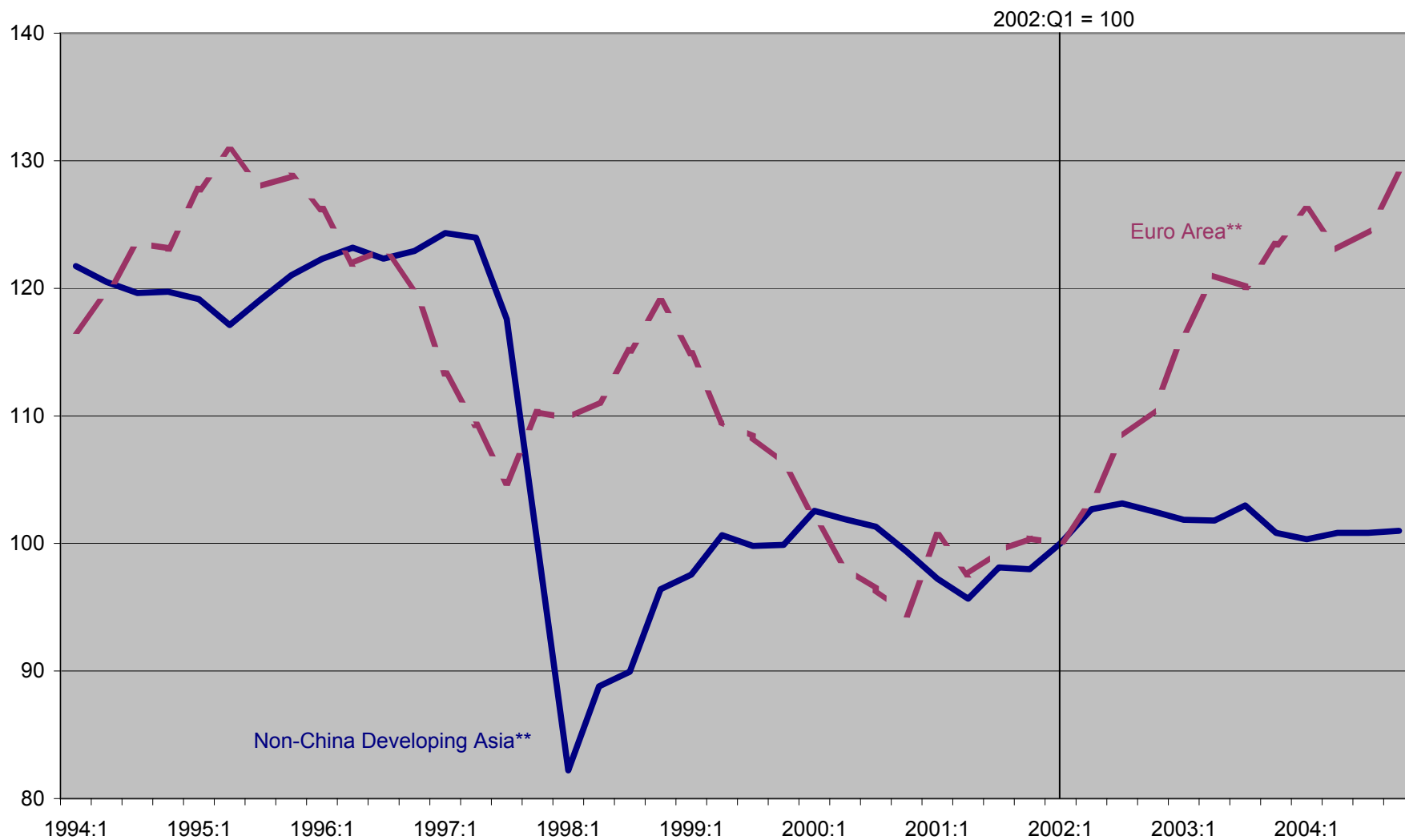
**An increase indicates dollar appreciation.

Figure 3
Non-China Developing Asia: Current Account and Reserve Accumulations (\$ billions)



*2004 is based on national sources for Korea, Singapore, and Thailand; and September 2004 IMF WEO Database for all else.

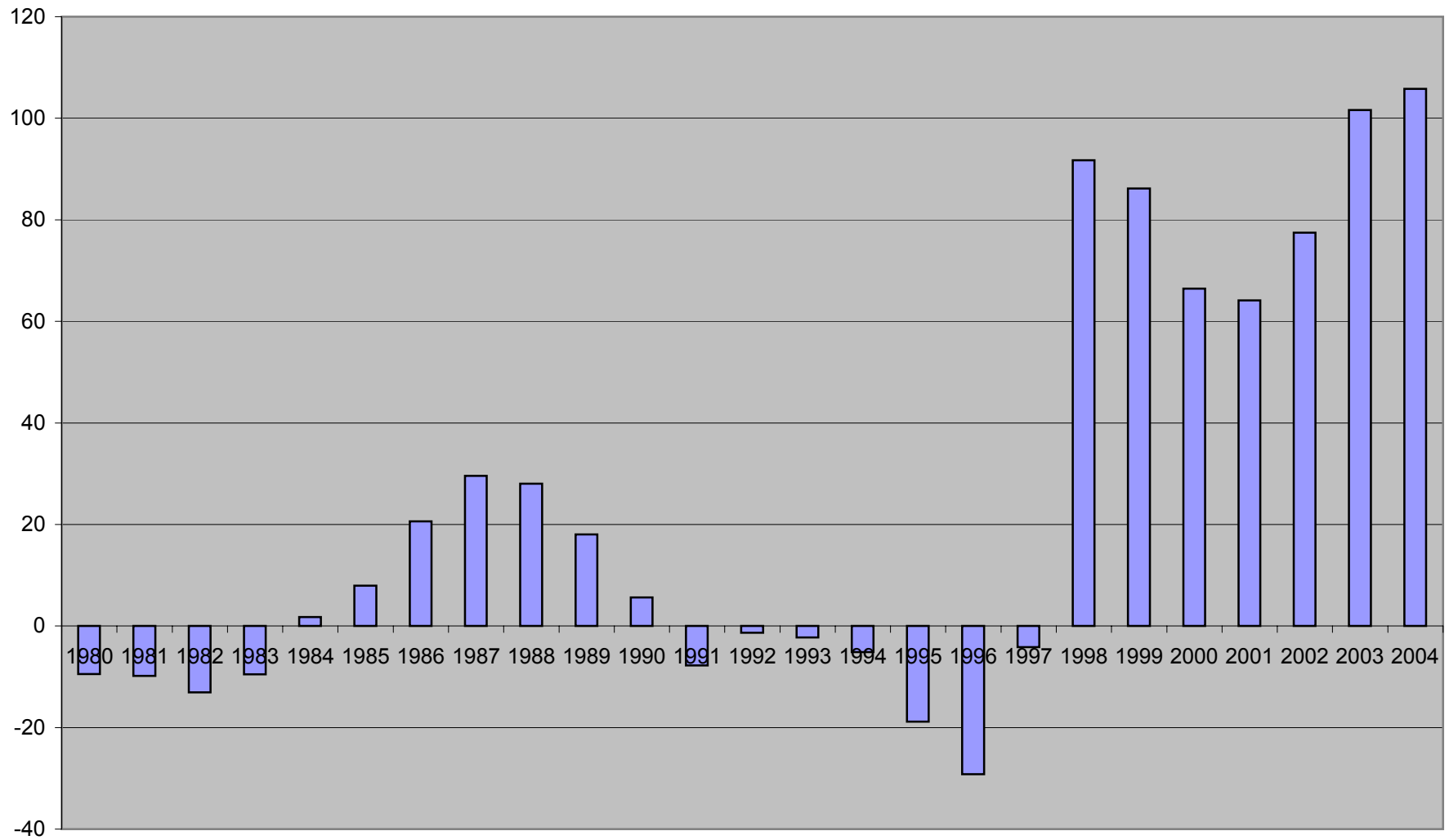
Figure 4
Real Multilateral Exchange Rate Indices*



*JP Morgan estimates. Weighted by country shares in \$US GDP, averaged over 1980-2004.

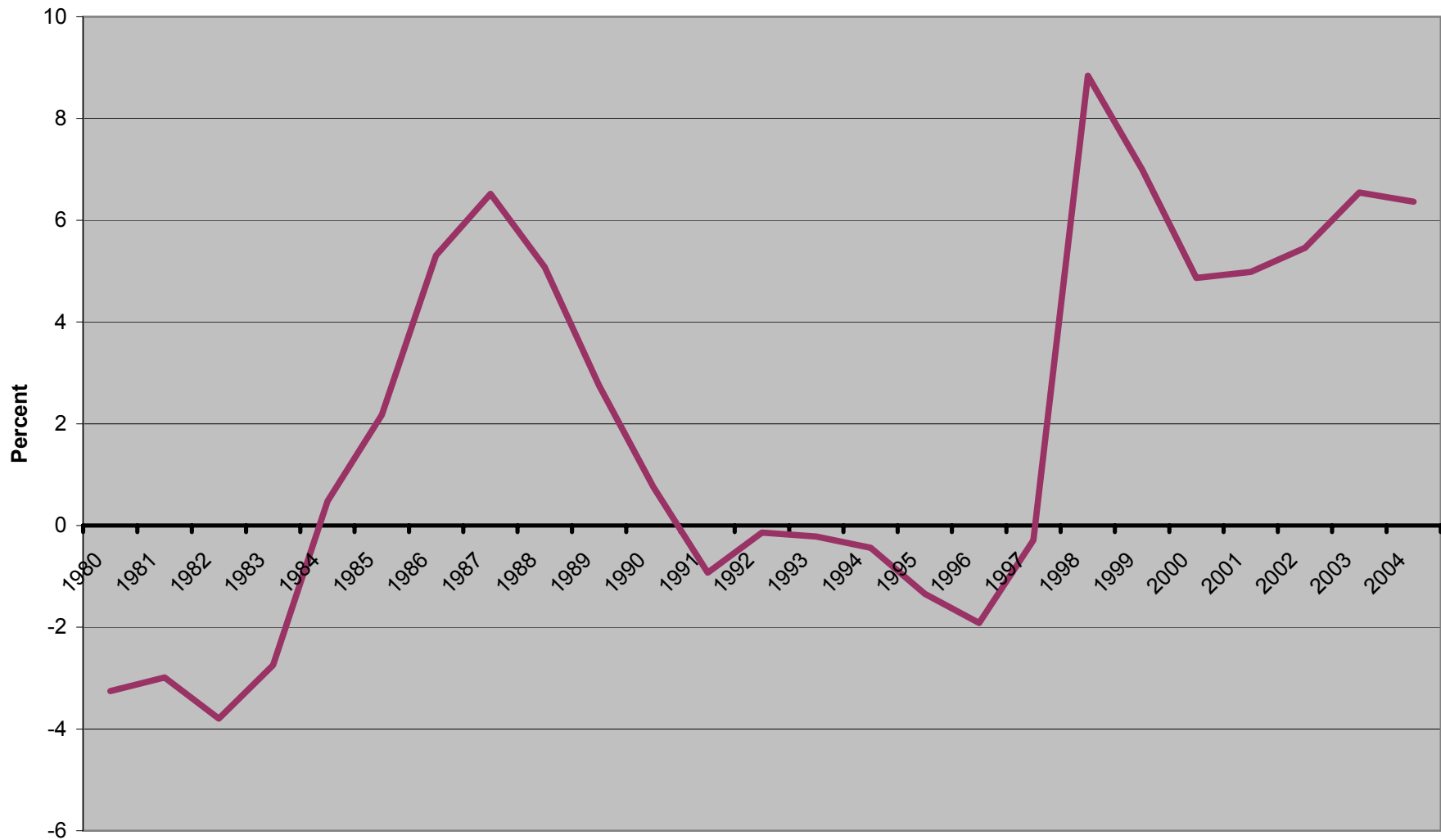
**An increase indicates domestic currency appreciation.

Figure 5
Non-China Developing Asia: Current Account (\$ billions)*



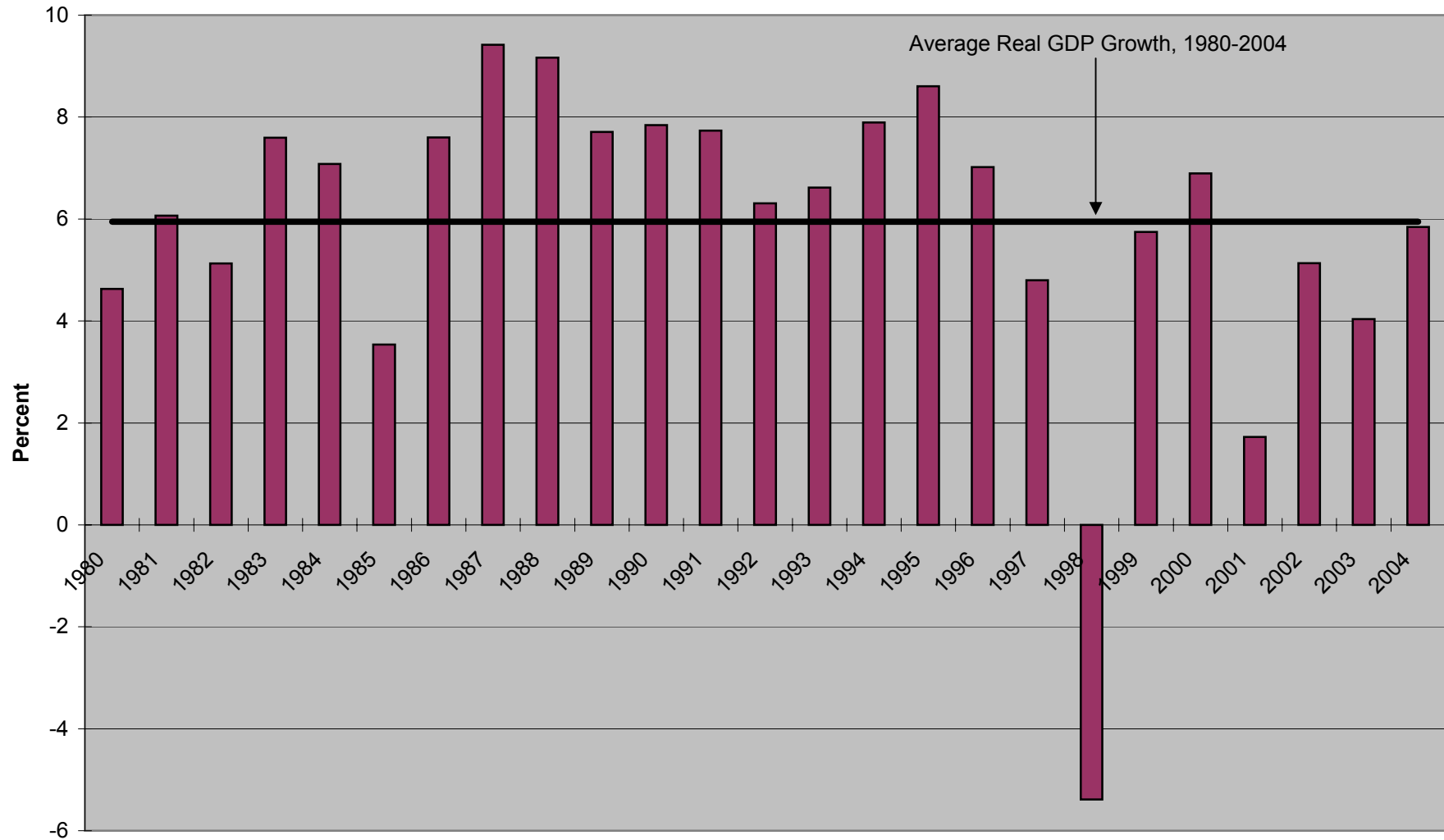
*2004 is based on national sources for Korea, Singapore, and Thailand; and September 2004 IMF WEO Database for all else.

Figure 6
Non-China Developing Asia: Current Account / GDP*



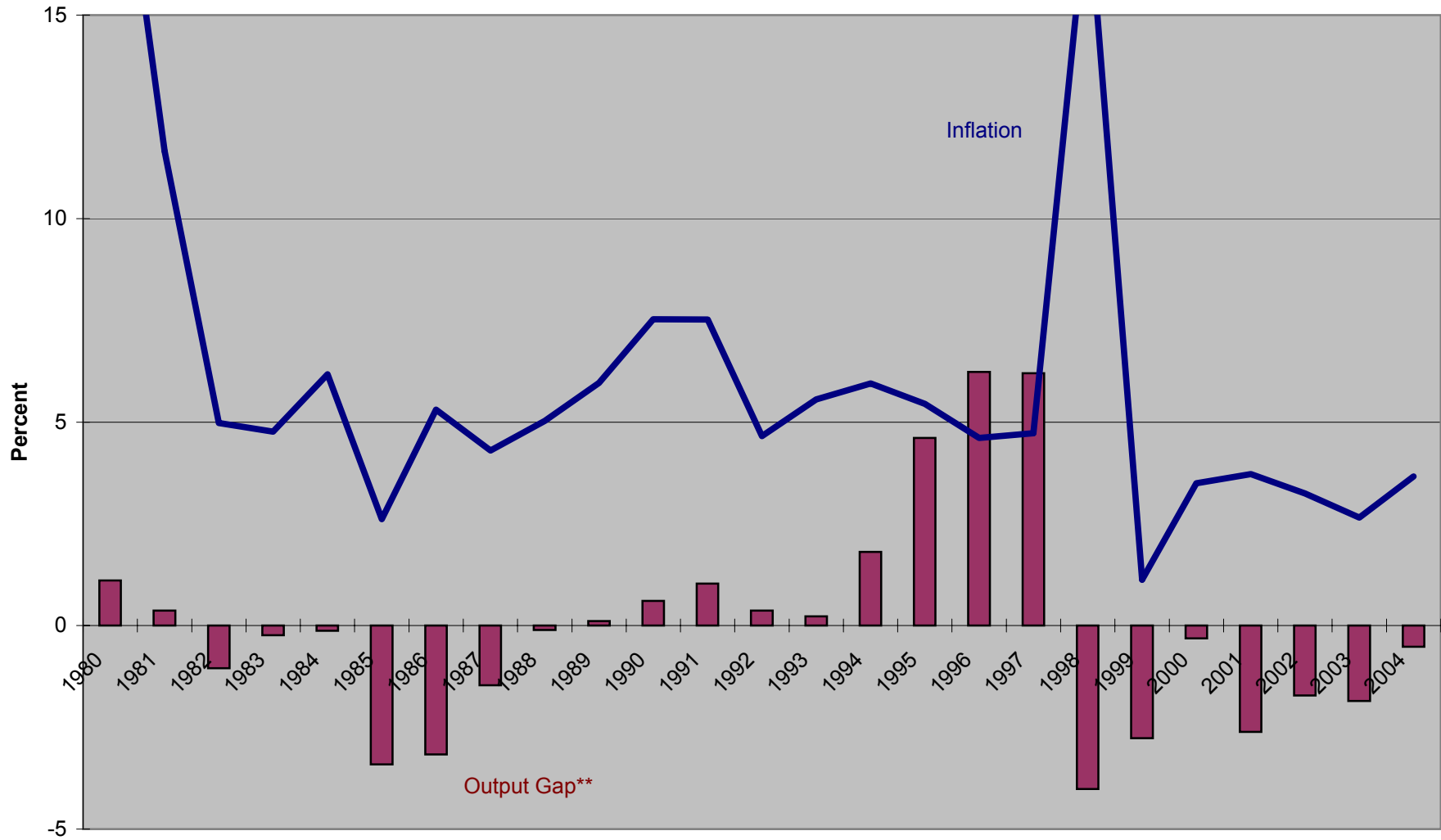
*2004 current account data is based on national sources for Korea, Singapore, and Thailand; and September 2004 IMF WEO Database for all else. 2004 \$US GDP for the region is from September 2004 IMF WEO Database.

Figure 7
Non-China Developing Asia: Real GDP Growth*



*Annual average growth; weighted by country shares in \$US GDP, averaged over 1980-2004. Korea, Malaysia, and Thailand are estimates for 2004.

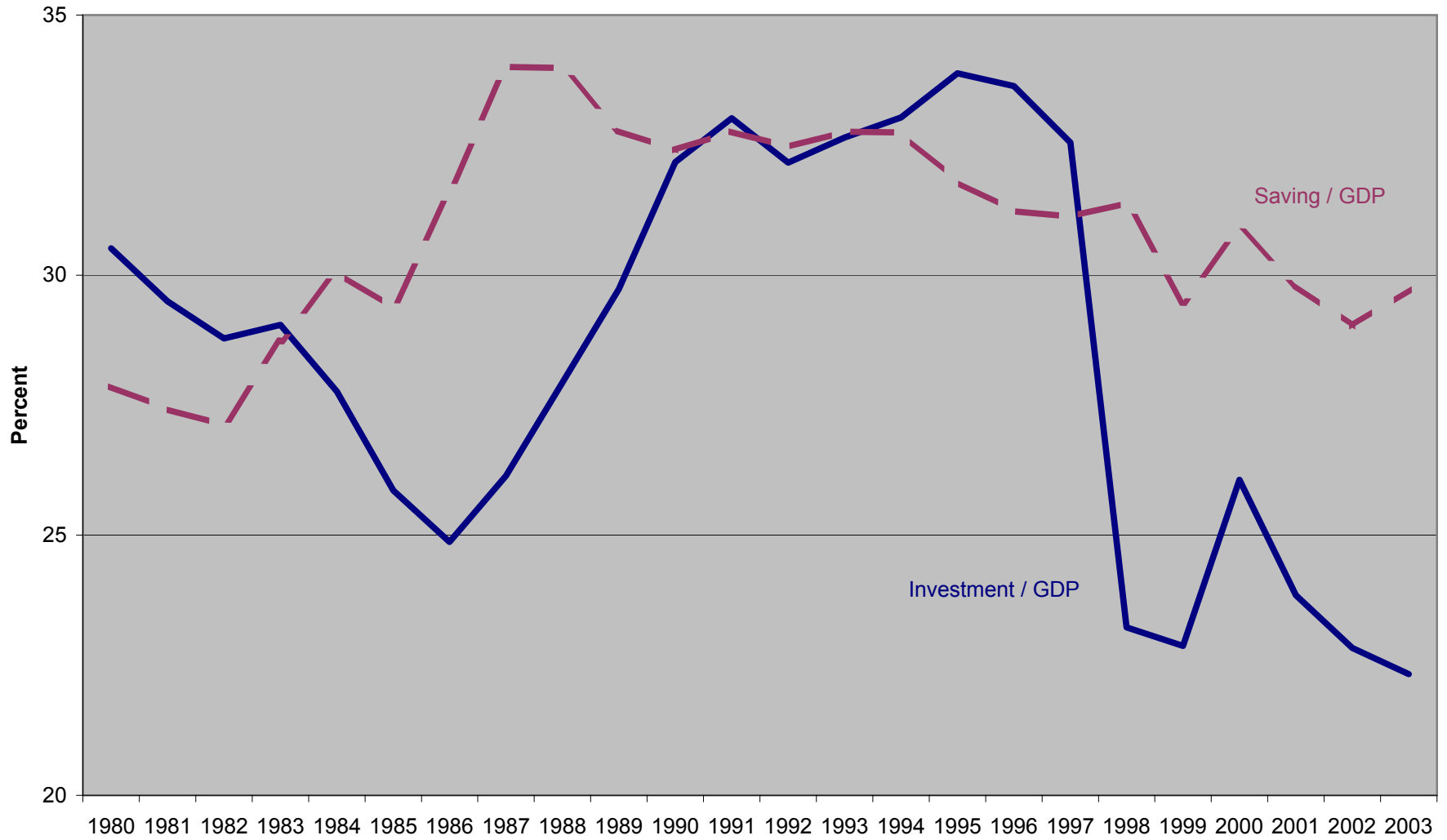
Figure 8
Non-China Developing Asia: Output Gaps and Inflation*



*Weighted by country shares in \$US GDP, averaged over 1980-2004.

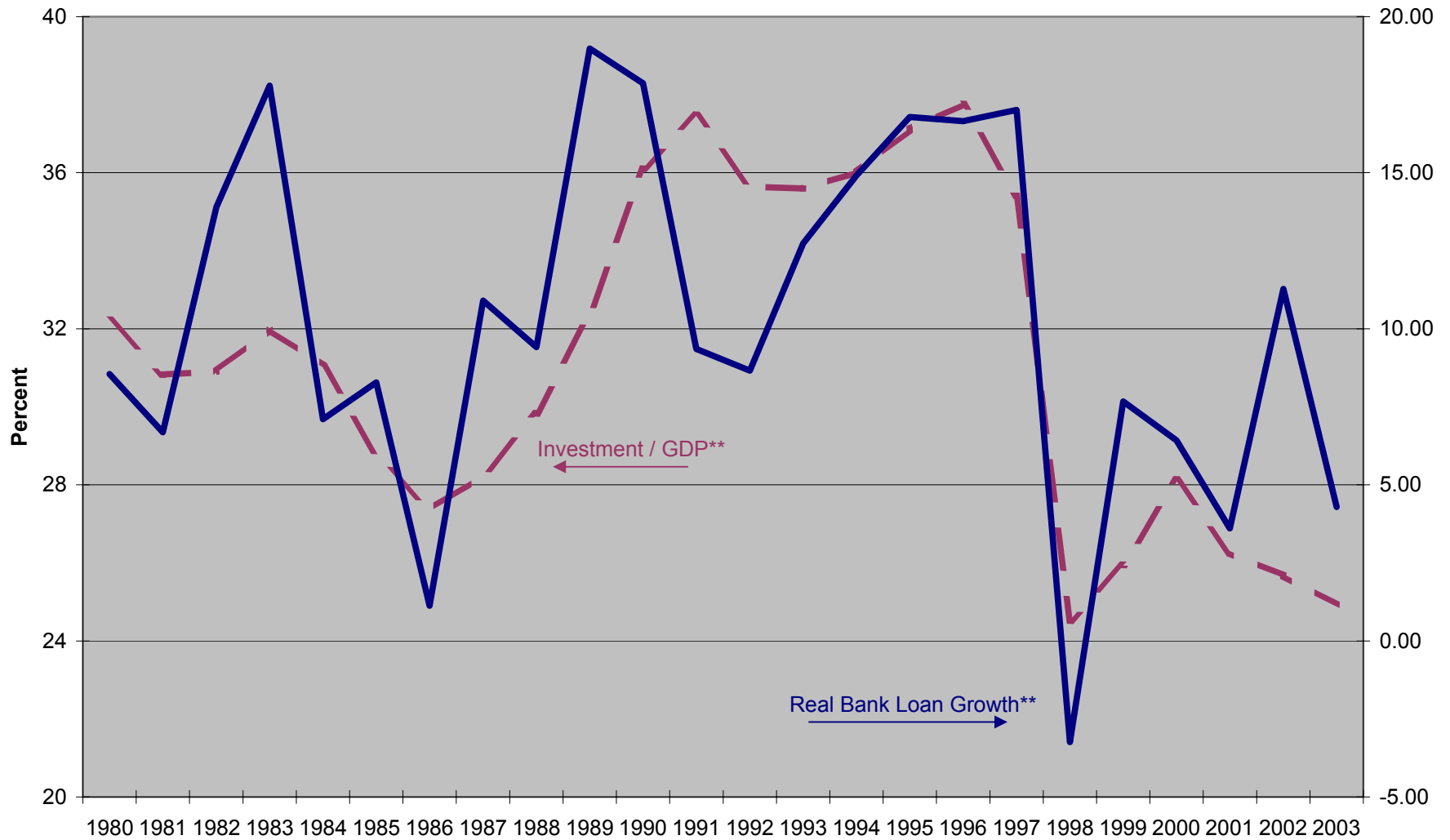
**Output gaps based on estimates of potential output derived from application of HP filter to actual output.

Figure 9
Non-China Developing Asia: Saving and Investment Rates*



*Weighted by country shares in \$US GDP, averaged over 1980-2004.

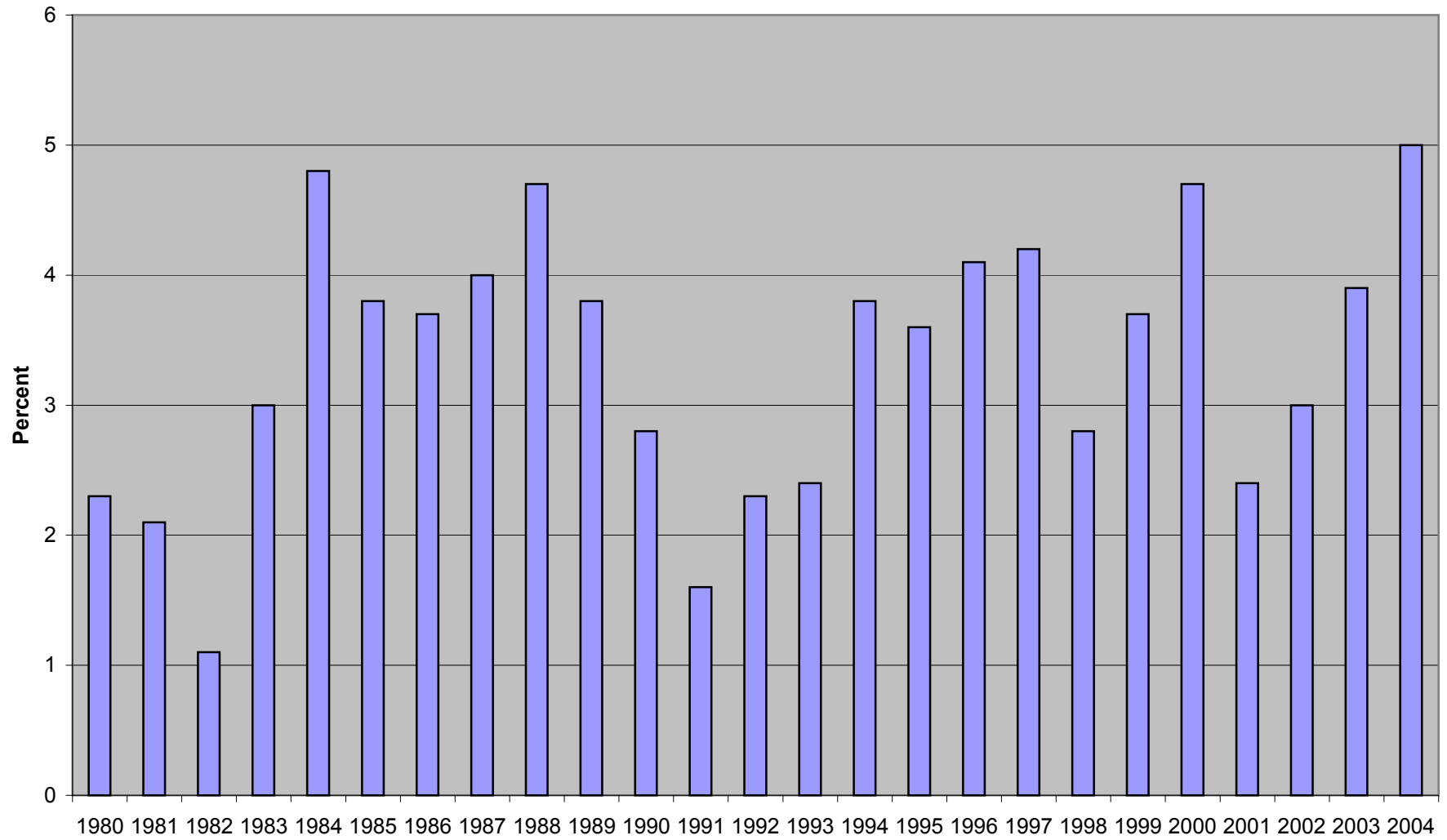
Figure 10
Non-China Developing Asia: Investment Rates and Real Bank Loan Growth*



*Weighted by country shares in \$US GDP, averaged over 1980-2004.

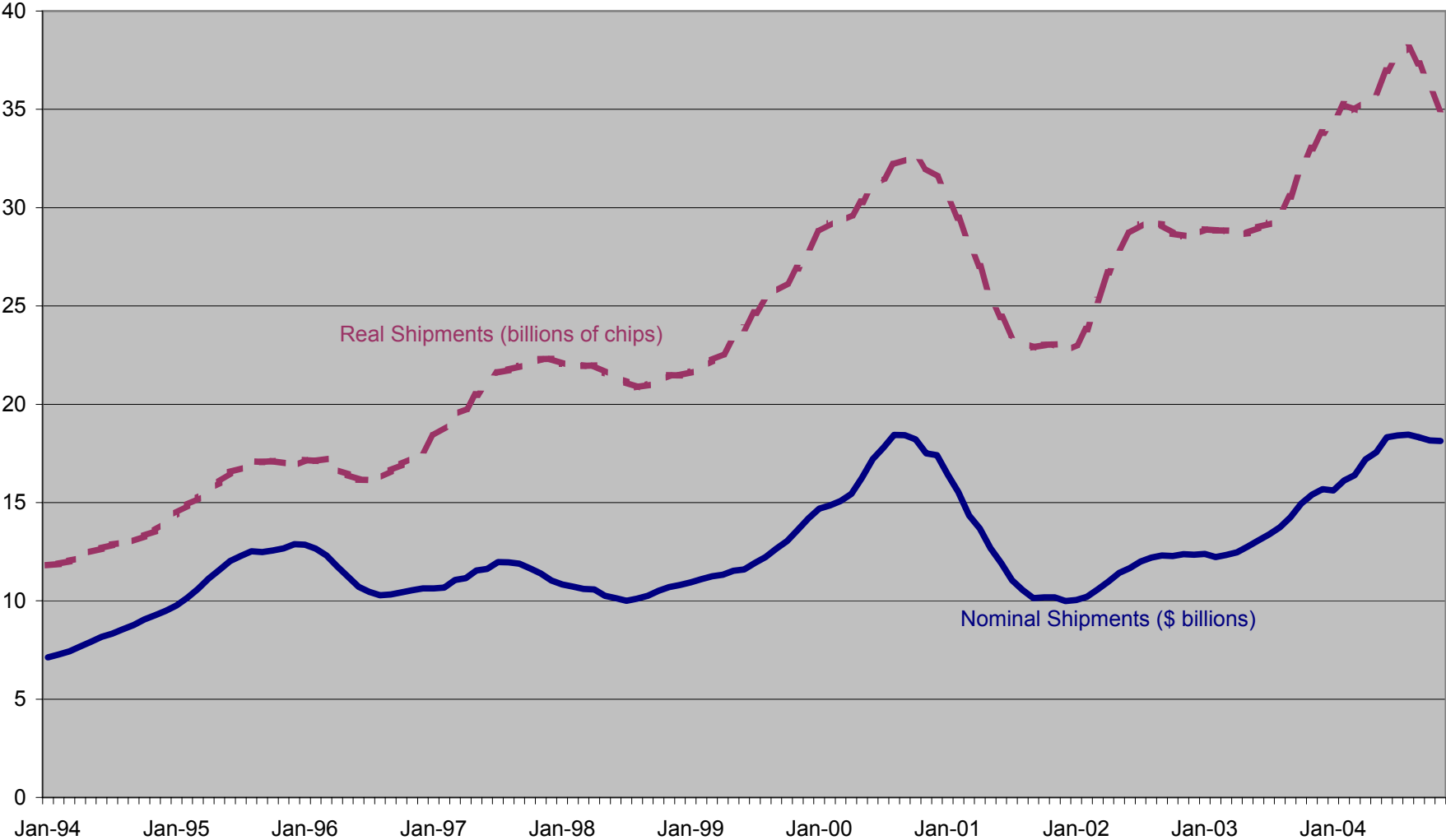
**Excludes Taiwan and Indonesia

Figure 11
World GDP Growth*



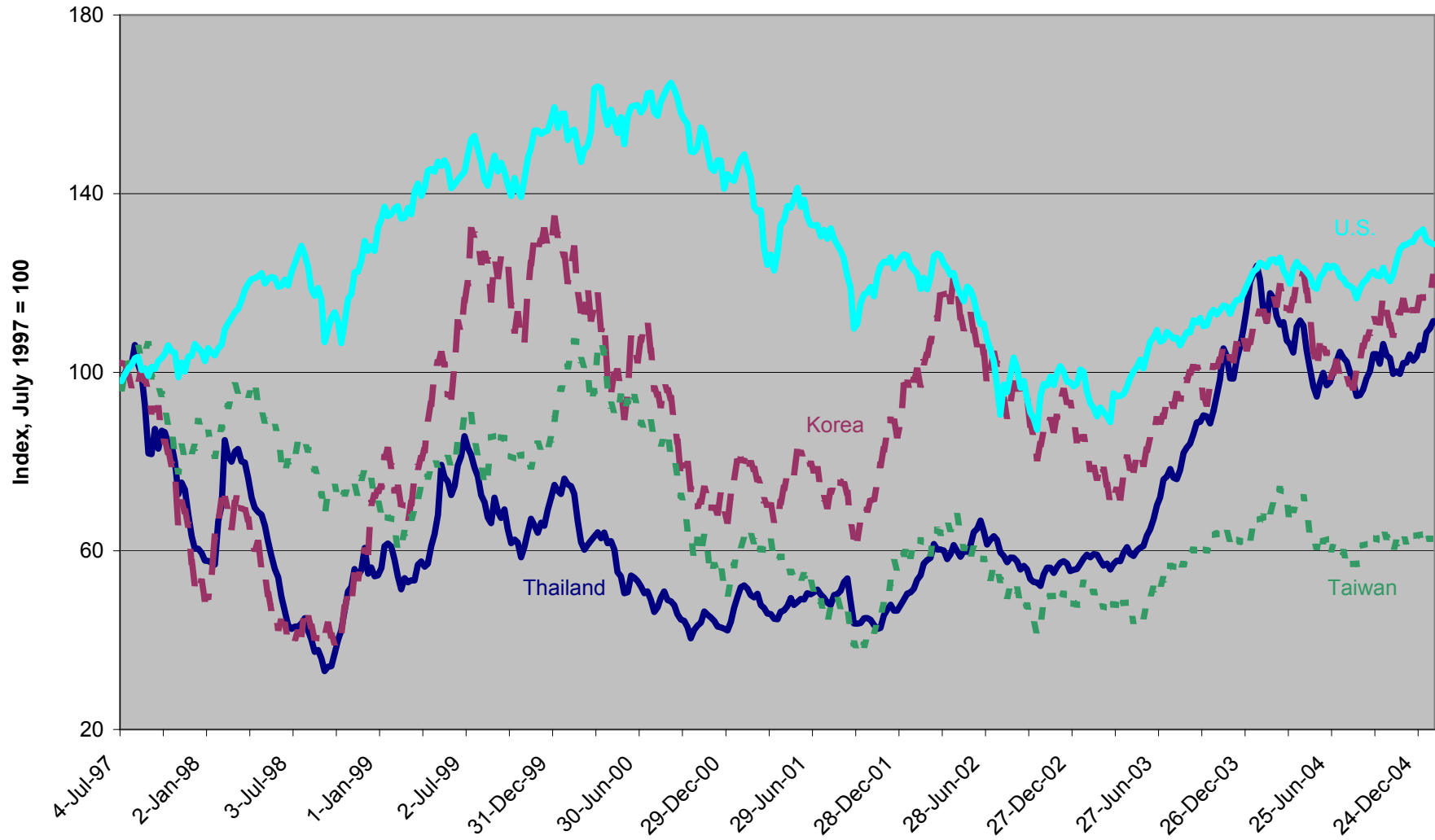
*Source: September 2004 IMF WEO Database.

Figure 12
Global Semiconductor Shipments*



*Source: Semiconductor Industry Association.

Figure 13
Equity Prices*



*Indexes based on local currencies.

Figure 14
Japan: Current Account

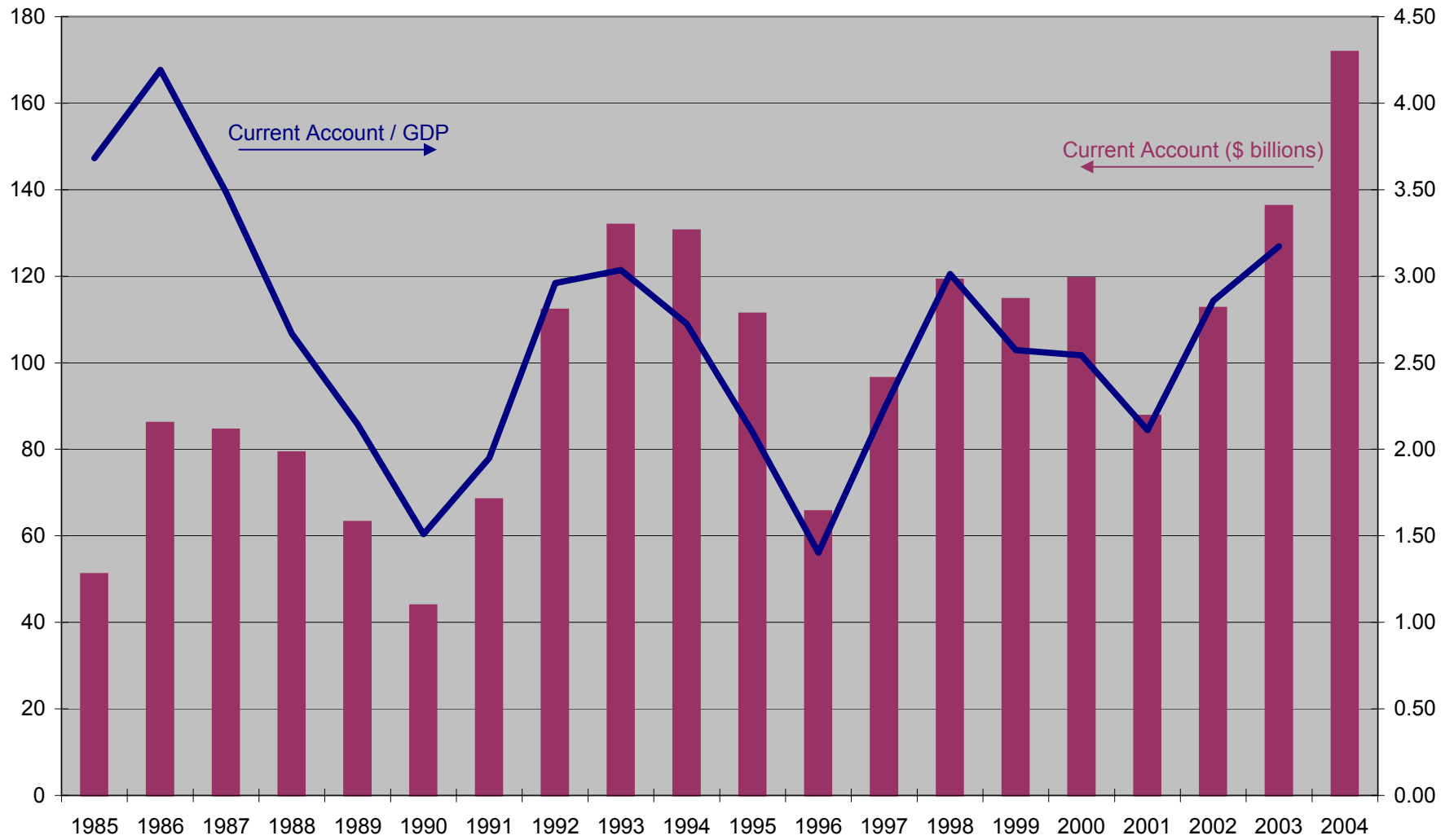


Figure 15
Japan: Saving and Investment Rates

