

Reshaping APEC for the Asian Pacific Century

priorities and strategies

Coping with Financial Imbalances

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Coping with financial imbalances

- What is the extent of financial imbalances within APEC?
- What is the cause?
- Are they a problem?
- Are they fundamental to APEC's future?
- Can an APEC framework assist in their resolution?
- Should they be prominent on the APEC 2007 agenda?

Scope of the issue

- Australia, New Zealand, the UK and Spain all have large current account deficits, but they are dwarfed by the size and rate of increase of the contemporary US current account deficit
- Compared to the Reagan-era deficits contemporary US current account deficits are larger as a share of GDP, now contain a component of servicing net liabilities (net income deficit) and those net liabilities are now significant (20% of GDP)
- OPEC, Europe, Japan all ran counterpart surpluses to the US deficit in the nineteen eighties. The contemporary difference is the growing importance of China's surplus

Causes of imbalances

- A current account imbalance will be equal to the difference between domestic saving and domestic investment
- It will also be equal to the difference between exports and imports, plus net interest and dividends on net foreign assets (themselves the accumulation of past current account balances)
- A current account deficit can be regarded as a capital account surplus

Causes of imbalances

- In the US case, the current account deficit is the outcome of a period of relatively strong domestic investment and relatively weak domestic saving. The US budget deficit has made a major contribution to weak saving.
- Though argued so by the President's advisers, it is unconvincing to argue that the current account deficit is the necessary result of a capital account surplus created by superior US equity returns.
- Much of the inflow is from non commercial sources (BoJ, PBOC) and is placed in US treasuries. US corporations are large offshore investors.

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Causes of imbalances

- Much of the increase in the US deficit is matched by the increase in Asian surpluses since the 1997 financial crisis
- Part of the accumulation of surpluses and of reserves is a policy response to the crisis
- The counterpart outcome is that savings have increased faster than investment. Other than in China, investment has lagged pre-1997 rates
- Since China has a managed exchange rate, capital controls and a financial system which allows only a modest role for price signals, it is hard to argue its surpluses are optimal market outcomes

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Are imbalances a problem?

- The US deficit permits it to run a higher level of investment than it otherwise could without lower consumption
- But it also permits the US administration to fund higher tax cuts and war spending than it otherwise could without political penalty. The cost is borne by future generations in additional federal debt partly matched by additional foreign liabilities
- The reserve is true of China, which is forgoing current household consumption to acquire a stock of foreign assets. To a lesser degree also true of Japan, Germany, Korea, Thailand etc
- Difficult to convince ourselves these are optimal market outcomes
- But it is also true that the rest of the world appears likely to continue to fund US deficit. Interest rates at the long end have remained quite low. The fall in the US dollar since 2004 has been persistent but mild.

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Resolving imbalances

- It is not possible to run surpluses without a matching deficit, and not possible for the USD to depreciate without other currencies appreciating
- If the US deficit falls so must matching surpluses
- Broadly the US could reduce its fiscal deficit faster, while surplus countries permitted faster currency appreciation, or encouraged higher consumption and/or higher investment
- US fiscal deficit is narrowing, exports are picking up and import growth slowing, current account deficit narrowing. But US will likely still have a formidable current account deficit in a decade, with matching surpluses elsewhere

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Are they fundamental to APEC's future?

- Imbalances themselves probably not but the companion pattern of trade surpluses and deficits is a central difficulty in APEC
- This is particularly so with China and US as China overtakes the US in economic weight, and with a fixed exchange rate, capital controls and arbitrary prices

Can an APEC framework help?

- Major surplus economies are not in APEC esp OPEC, Germany
- But within APEC the serious issues are presented only by the US, Japan, and China – and to a lesser extent Korea, Taiwan, Singapore, Thailand, Australia and NZ. Serious negotiations are US with China and Japan
- Wd be useful to encourage higher investment and consumption growth rates in East Asia, to diminish concerns that see large reserves, to encourage China's move towards more flexible exchange rate and open financial system
- Trade impediments play only a small role in resolving imbalances
- This is about philosophy and ideology of globalisation, which APEC can usefully articulate

Should be important in APEC 2007 agenda?

- If this is a top issue in 2007, Australia and APEC have a big problem
- No serious advance can be expected, no useful communiqué agreed
- US reluctant to acknowledge role of budget deficits, China of managed exchange rate, capital controls and excessive saving, etc
- Useful nonetheless to persistently disseminate the view that big deficits are the inevitable counterpart to big surpluses, that a cheaper US dollar requires more expensive Asian currencies, and that the China-US relationship is at risk under a less tolerant Administration more focused on economic performance.