Comments on Paola Subacchi, Macroeconomic Performance and Global Capital Flows: Is There a Role for Europe to Play?

By: Dr. Anwar Nasution, Professor of Economics, University of Indonesia.

I agree with Professor Subacchi on two counts. First, Europe would play a prominent role in avoiding a possible worldwide economic recession that could originate from a recession in the United States. A possible crash in the US economy could be caused by a large increase in interest rates and a sharp depreciation of the US dollar to narrow the present large and unsustainable US current account deficit. To reduce the deficit, national savings should be increased along with an associated reduction in domestic demand, particularly government expenditures. To offset the slowdown in the US economy, private consumption and investment have to be increased elsewhere, particularly in other large economies including Japan, the euro zone, and England. Second, I also agree with Professor Subacchi that China and other emerging economies in East Asia will also play a role in moderating any depreciation of the US dollar and any sharp increase in US interest rates, which could otherwise cause adverse implications for global growth and international financial markets.

The emerging economies in East Asia can, in my judgment, make three contributions to address global current account imbalances. First, these countries can boost their economic growth through expansion of domestic expenditures, including investment in infrastructure in China, Indonesia and the Russian Far East. This requires further deregulation and financial sector reforms to increase the quantity of investment and improve its quality and efficiency. Because the size of these emerging economies is still relatively small as compared to world GDP, domestic economic expansion can only make a marginal contribution to the world economic growth.

The second contribution the East Asian emerging economies can make is to keep investing their accumulated external reserves in US Treasury bills. Reducing their purchases of these assets and diversifying their portfolios away from dollar-denominated assets would put upward pressure on US interest rates and lead to a fall of the dollar that could cause a recession in the US economy. The growth of euro holdings grew significantly between 2001 and 2004 and then slowed down markedly due to uncertainty over the

EU integration as indicated by the French and Dutch no votes on the constitutional treaty earlier this year.

The third contribution the emerging economies in East Asia can make is to adopt a more flexible exchange rate mechanism. The exchange rate pegs in East Asia tend to offset the effect of the dollar's fall since 2001 on the current account imbalances.

Professor Subacchi rejects the standard policy recommendation that Europe and Japan speed up their structural reforms of labor, product, and financial markets to accelerate growth by improving investment efficiency and growth potential. His rejection is based on his belief that the high savings rate in Europe is mainly because of the aging population, high unemployment rate, and deficit target in the Stability and Growth Pact. In addition, the absence of financial products, such as easy mortgage and re-mortgage instruments, makes it more difficult to translate the wealth effect arising from the rise in house prices to corresponding consumption expenditures of the households.

To encourage expansion of domestic demand in the euro zone, Professor Subacchi recommends focusing on a program to expand household spending by correcting the structural excessive savings. For this he suggests an easing of household borrowing against housing equity and easier access to mortgage finance. In addition, he recommends that the public sector: "mops (up) domestic savings through issuing long-dated government-backed bonds and channels it towards domestic investment" (p.17), particularly in infrastructure projects. The proceeds from the long-term bonds will be used to fund the pensions of the retiring baby-boomers. To implement this proposal, Professor Subacchi proposes to replace the 'ad hoc' budget deficit target of the Stability Pact with "targets for deficits that take into account the population of savings cycle and the investment instruments required for meeting pension plans" (p.18). However, he himself recognizes the possibility that governments could misuse the extra funds through undesirable forms of public spending.

The emerging economies in East Asia continue to accumulate external reserves as the economic crisis in 1997-98 has only dampened their investment growth. Savings, on the other hand, did not leave the economies in this region with a current account surplus which is equal to an excess of saving over investment. Building up external reserves is needed by the countries in this region to intervene in the foreign exchange markets. Until

recently China and Malaysia pegged their currencies to US dollar. Hong Kong and Brunei adopted currency board systems. Other countries in this region use managed floating systems. The reserve accumulation is also part of their strategy to buffer themselves against the shocks emanating from international financial markets that they experienced in 1997-98. Accumulating individual external reserves is expensive. To reduce the cost, the Asian countries (ASEAN+3) established in May 2000 a web of bilateral swap arrangements (BSA) under the Chiang Mai Initiative to supplement the existing multilateral pooling of financial resources under the IMF. Unlike in Europe, political cohesiveness is still lacking in Asia. As a result, there will be no progress to replace the existing BSA with multilateral pooling of financial resources.

The public sector plays a leading role in channeling current account surpluses in East Asian emerging economies into foreign securities. There are two reasons for this. First, countries normally need large multinational corporations to invest the surpluses overseas, which these emerging economies lack. For example, the corporate sector in mature economies such as Japan and Korea invested a large part of the national current account surpluses overseas. The huge overseas corporate investment of these countries served as a source of corporate revenue to offset the losses from bubbles bursting at home during the 1990s.

The second reason for the leading role of the public sector in holding of external reserves is because of government regulations, such as the capital controls in China, that limit the ability of the private sector to hold foreign currencies. China and Malaysia deliberately limit the role of private sector in investing the capital account surplus by imposing capital controls. The socialist country of China uses outright prohibitions to essentially close the capital account of its balance of external payments. In contrast, Malaysia, between 1998 and 2005, temporarily used a more market-based control that attempt to discourage short-term capital outflows that may cause over-heating and a financial bubble that could eventually lead to currency and financial crises. The financial bubble comes about because of the dominant role of short-term capital inflows in the relatively narrow and shallow domestic financial and capital markets.

China still retains full capital control partly because of the dominant role of state-owned banks (SOBs) and state-owned enterprises (SOEs). The state-owned banks are typically inefficient users of resources as they issue loans,

mainly to SOEs, based on administrative directives of the government both at the central and local levels. Until recently, SOEs were highly leveraged as the government put only small amounts of equity investment into them. Many of the SOEs are located in remote places far away from their markets and transportation hubs due to historical fears during the Mao era of American attacks and/or a Russian invasion. When SOEs suffer from losses the government continues to shift the responsibility from the fiscal budget to the balance sheets of the SOBs by directly intervening to arrange more credits for SOEs or to allow roll-overs of the non-performing loans.

A lesson from the Asian crisis of 1997-98 is that appreciation of real effective exchange rates due to massive capital inflows would reduce the international competitiveness of some sectors of the Chinese economy, particularly SOEs with lagging technology located in remote places. Concurrently, the exchange rate appreciation encouraged inefficient use of resources in the domestic economy as it created more incentives for the tradable sector of the economy and disincentives for the non-tradable sector. The change in relative domestic prices has strong implications for income distribution and widens the already large regional gaps in the country. On the other hand, sudden and massive capital outflows had caused financial insolvency and raised liabilities following sharp currency devaluation. Unlike Japan, Singapore and other capital exporting countries, China does not have a large amount of overseas investment whose revenues could cushion losses from domestic operations in the event of another crisis.

All major countries in East Asia, except Hong Kong and Brunei, are now using a floating exchange rate system. These two countries still subscribe to the currency board system. China and Malaysia announced on July 21, 2005, the policy switch from a currency peg system to a new currency regime based on an adjustable peg against a basket of currencies. Malaysia had already revoked the partial capital controls earlier this year. China, on the other hand, maintains both capital controls and administrative directives to forbid free movement of capital so that its economic agents can still cannot hedge their portfolios with worldwide asset diversification.

In contrast to market expectations, the central bank of China (PBoC) announced a 2.1 percent revaluation of its currency, the RMB, against the dollar and will allow it to fluctuate by a very narrow daily trading band of 0.3 percent around central parity. The trading range was raised to 3 percent on September 24, 2005. Most estimates suggest the RMB was at least 15-30

percent undervalued prior to the revaluation. Bank Negara Malaysia, on the other hand, has not announced the management apparatus and modus operandi of its managed system.

Going against much of the foreign advice it has received, China is likely to avoid an abrupt and large appreciation of the RMB that could hurt its economy. The large RMB appreciation reduces the value of dollar denominated assets in RMB of the still fragile SOBs and SOEs. Recapitalization of both SOBs and SOEs, like that which occurred during 1997-98, could add to the fiscal strain. China can afford to adopt a series of gradual revaluations of the RMB because it has a large amount of external reserves to use to defend the targeted exchange rate. In addition, as indicated earlier, China's economy is still in transition and remains half closed. The role of SOBs and SOEs is still significant, and quantitative targets enforced through administrative directives are still widely used and remain powerful policies. With its large amount of external reserves, combined with a wide range of market and non-market policy tools at its disposal, the central bank of China can neutralize the impacts of changes in its net foreign assets (due to capital flows) on its monetary base.