Global current account imbalances are one of the key macroeconomic imbalances that underlie the global financial crisis. The central objective of this paper is to analyze the causes and consequences of global imbalances from the perspective of developing Asia. More specifically, the paper examines the root causes of the large and persistent current account surpluses that have emerged in the region since the Asian crisis. The paper also explores the consequences of global imbalances for the region, in terms of welfare and economic growth. Based on the analysis, a number of concrete policy directions are recommended that will help Asia rebalance its demand and growth toward domestic sources.

I. INTRODUCTION

Global imbalances or, more precisely, global current account imbalances refer to the large current account deficits and surpluses that have emerged in the world economy during the last ten years. For the most part, the imbalances have been heavily concentrated among a small group of regions and countries, and until recently have displayed an unusually high degree of persistence. The imbalances have centered on the large current account deficits of the United States (US), which peaked at close to 6 percent of gross domestic product (GDP) in 2006, and the corresponding surpluses in the rest of the world, in particular developing Asia, Middle East, and Russia. By definition, a current account deficit (surplus) is equal to negative (positive) net savings. Therefore, it is conceptually useful to view persistent global imbalances as the continuous financing of US consumption with the net savings of the surplus countries. Global imbalances have enabled global aggregate demand to keep pace with the rapid expansion of global aggregate supply due to the integration of the People’s Republic of China (PRC) and India into the world economy.

Much of the debate about global imbalances has been framed in terms of their sustainability from the US perspective. More precisely, concerns about sustainability center on whether the US can indefinitely spend more
than it produces or, equivalently, rely indefinitely on borrowing from abroad. Those concerns have been amplified by the unprecedented magnitude of the US current account deficit and its growing net foreign indebtedness. Roubini and Setser (2004) gave strikingly prescient warnings of a major global financial crisis in the absence of major adjustments to global imbalances while Bergsten and Williamson (2004) provided an excellent overview of the pessimistic view of the US current account deficit. The underlying fear was that if the US continued to run large deficits, its net foreign liabilities would eventually reach 100 percent of GDP, a figure widely believed to be too large. For example, in a lucid exposition of the issue, Mussa (2004, 114) stated that "There is probably a practical upper limit for US net external liabilities at something less than 100 percent of US GDP and accordingly…. current account deficits of 5 percent or more of US GDP are not indefinitely sustainable." However, a more sanguine minority view holds that in an era of growing financial globalization and rising US productivity, it may be feasible and even desirable for the US to run very large deficits for, say, a quarter of a century. According to this view, fears about the sustainability of the US deficit are misplaced in a world of growing international portfolio diversification where foreign countries are willing to accumulate ever larger amounts of US assets in the future.1

Formal studies of the sustainability of the US deficit based on rigorous economic analysis remain few and far between. In fact, most of the debate about the issue has taken the form of journalistic opinion pieces. In one of the exceptions to this trend, Edwards (2005a) developed a portfolio model of the current account to analyze the issue. He found that even under the highly optimistic assumption that the foreigners’ net demand for US assets would double from its current level, the US current account would have to undergo a significant adjustment in the near future. Even an abrupt adjustment to the order of 3 to 6 percent of US GDP is entirely conceivable. Edwards (2005b) also analyzed the international historical evidence to draw out the consequences of such an adjustment and found that significant current account reversals tend to have pronounced negative effects on GDP growth. Given the central importance of the US in the world economy as an import destination, the inescapable conclusion is that the world economy as a whole will slow down sharply, as is indeed happening. In a separate study that analyzed a massive data set that covers over 120 emerging markets during more than 25 years, Edwards (2002) found that large current account deficits tend to increase the probability of a financial crisis.

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1See, for example, Dooley, Folkerts-Landau, and Garber (2004) and Cooper (2005).
In the context of the current global financial crisis, rooted in the US subprime mortgage crisis, a school of thought holds that global imbalances are the underlying root cause of the crisis. Popularly known as the global savings glut theory, this view asserts that the massive flow of savings from the surplus countries to the deficit countries lowered global interest rates by encouraging reckless investment into risky housing-related assets such as subprime mortgages. Regardless of its validity, the global savings glut theory lends further support to the notion that global imbalances are unsustainable and their unwinding will necessarily be disruptive. More generally, whatever the precise nature of the relationship between global imbalances and the global financial crisis, the fact remains that global imbalances were undoubtedly one of the key macroeconomic imbalances in the world economy before the outbreak of the global financial crisis. At a purely intuitive level, given that a crisis always reflects an unwinding of imbalances, it is difficult to believe that the current financial crisis was entirely driven by imbalances other than the current account imbalances. The more relevant question is what the relative contribution of global imbalances was. Here there is predictably and legitimately a great deal of heated debate and a wide variety of opinions.

The central objective of this paper is to explore the causes and consequences of global imbalances from the perspective of developing Asia rather than the US. This exploration is motivated by the broader issue of whether the deterioration of the region’s exports and growth prospects as a result of the ongoing global crisis calls for rebalancing demand and growth toward domestic sources. To the extent that the region’s current account surpluses are an integral part of global imbalances, a meaningful answer to the causes of global imbalances requires uncovering the causes of those surpluses. The roots of the region’s surpluses ultimately lie in the exceptional success of developing Asia’s outward-looking export-oriented growth strategy, which has delivered rapid growth and higher living standards for a generation. What deviates from the norm of the region’s recent trade pattern is not the high degree of economic openness, but the emergence of a large and persistent current account surplus since the Asian crisis. That is, although the region has long relied on exports to drive its growth, its transformation into a surplus region or, equivalently, a net exporter of capital is a much more recent and somewhat puzzling phenomenon. The distinction between developing Asia’s export orientation and current account surplus matters, and matters a lot, because it is the latter that has contributed to global current account imbalances. Any substantive discussion about the feasibility and desirability of rebalancing Asian growth should keep this fundamental historical background—a proven history of export-led growth—in mind.
It may be tempting for developing Asia’s policymakers to believe that once the global crisis subsides and the world economic outlook recovers, the region can return to its pre-crisis strategy of exporting its way into rapid growth. The temptation is all the stronger because this strategy has served the region remarkably well in the past. Under this view, rebalancing is a nice catchphrase for the government’s short-term efforts to limit the reduction in growth and to alleviate the hardship of the most vulnerable groups, but is nothing more than that. However, a number of inconvenient facts stand in the way of this type of convenient thinking. For one, given the severity of the global crisis, there is a great deal of uncertainty about global recovery prospects. For another, there are serious doubts about whether running current account surpluses on a sustained basis serves the region’s own interest. In theory, running a surplus over an extended period of time is consistent with maximizing growth and welfare. Economic theory suggests that both rich and poor countries will benefit if capital flows from capital-abundant rich countries where the marginal returns to capital are low to capital-deficient poor countries where the returns are high. Therefore, there are solid grounds for questioning the logic or optimality of a massive flood of capital flowing from developing Asia to the much-richer America.

More generally, the analysis of the causes and consequences of global imbalances from the perspective of developing Asia laid out in the rest of this paper should make it abundantly clear that well before the outbreak of the global crisis, developing Asia may have been paying a heavy price for its excessive dependence on external demand since the Asian crisis, in terms of welfare and growth. Therefore, there are good reasons for why regional policymakers should view rebalancing as a serious medium- and long-term objective rather than a convenient short-term catchphrase. The causes and consequences are interrelated in the sense that the consequences follow directly from the causes. For example, to the extent that the surpluses are driven by sub-optimally high saving rates, they entail adverse consequences for the living standards and welfare of the region’s citizens. The broader finding that arises from the analysis in this paper is that large and persistent surpluses have been a mixed blessing for the region.

The global crisis, as profound as its impact has been for developing Asia, did not create a need for rebalancing out of the blue. Instead, the global crisis has reinforced and added a sense of urgency to a need that was already widely recognized within the region. For example, PRC policymakers have been discussing the need for more balanced growth for years even though little concrete action has been taken. At a practical level, the potentially severe and protracted nature of the G-3 (US, Eurozone, and Japan) and in particular
the US downturn suggests that the region may be unable to return to its pre-crisis excessive dependence on exports even if it wanted to. But by far the more compelling case for why rebalancing growth toward domestic demand is in the region’s enlightened self-interest is that (i) contributing toward preventing the buildup of unsustainable global imbalances will benefit the region and, much more importantly, (ii) the region has already been paying a substantial cost for its surpluses in terms of growth and welfare. These considerations also explain why a self-interested need for rebalancing growth will remain well after the current global storm passes through the region.

II. PROFILE OF GLOBAL IMBALANCES
AND CURRENT ACCOUNT POSITIONS OF ASIAN COUNTRIES

We cannot analyze the causes and consequences of global current account imbalances without first looking at the imbalances themselves. This section first explores the profile of global imbalances. Developing Asia’s surpluses have played a large and growing role in the formation of global imbalances. The section then examines the current account positions of eleven individual economies within the region: PRC; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; Thailand; and Viet Nam. Although developing Asia as a whole has run a surplus in the post-crisis period, there is a great deal of heterogeneity in the current account positions of countries across the region.

A. Profile of Global Imbalances

The existence of current account imbalances, per se, is not necessarily a cause for concern. Given increasing financial integration across countries, there is no reason why countries should run balanced current account positions at all times. Nevertheless, the size and persistence of global imbalances, as well as their concentration in a small group of countries, have raised concerns about their sustainability. There have also been questions about whether it is optimal for low-income developing countries to use their savings to finance the consumption of high-income countries and forgo productive investment opportunities at home. Figures 1 and 2 show the behavior of current account positions across key regions and countries over
time as a percentage of each region’s GDP and as a percentage of world GDP, respectively.\(^2\)

Figure 1. **Global Current Account Balances**  
(percent of GDP)

GDP = gross domestic product.  
Note: 2008 data are estimates.  

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\(^2\)Data are taken from the October 2008 issue of the International Monetary Fund’s (IMF’s) *World Economic Outlook* database. The various regional groupings generally follow IMF conventions with the following exceptions. As used in this paper, developing Asia includes the newly industrializing economies of Hong Kong, China; Republic of Korea; Singapore; and Taipei, China as well as the developing Asian economies as defined by the IMF. Europe is defined to include the European Union as well as the emerging market countries of Central and Eastern Europe. The group Middle East and Russia includes all the members of the Commonwealth of Independent States in addition to Russia. Data for 2008 are IMF estimates.
A number of salient observations emerge from the two figures. First, after remaining relatively small through the early part of the 1990s, the US current account deficit widened sharply after 1997–1998 as import growth surged and began to narrow only in 2007 and 2008. The US current account deficit at its peak accounted for as much as 1.5 percent of world GDP. This is by far the largest current account deficit in the world in terms of absolute size. Second, the large increase in the US current account deficit after 1997–1998 was matched almost entirely by increases in the current account surpluses of developing Asia, the Middle East, and Russia. In other words, the current account imbalances that emerged during this period were heavily concentrated in a small number of countries. Third, *the emergence of current account*...
surpluses in developing Asia is a relatively recent phenomenon. As is evident from both figures, the region as a whole ran current account deficits before the 1997–1998 crisis and only began to run consistent surpluses after 1997. The region is clearly not a “serial” current account surplus region and current account deficits used to be the norm rather than the exception in the region until the Asian crisis.

Figure 3 provides another perspective on the concentration of global imbalances. The pie charts use the absolute US dollar value of key current account imbalances in the years 2000, 2005, and 2007 to track the key contributors to the global imbalances. The charts include current account positions for developing Asia, Asia as a whole (Developing Asia plus Japan), and the Middle East and Russia. As the pie charts make clear, Asia, the Middle East, and Russia have consistently accounted for the bulk of the US current account deficit, with the share of developing Asia increasing sharply since 2005. Global current account imbalances have been, and continue to be, relatively heavily concentrated among a small group of regions and countries, with developing Asia playing a large and growing role on the surplus side.

Figure 3. Distribution of Current Account Imbalances (US dollars)

*Note: Shares were derived from current account figures, and are in absolute values. Source: International Monetary Fund, World Economic Outlook database, downloaded 10 January 2009.*
Under balance of payments accounting, the financing of current account imbalances can be broken down into net private capital flows, non-reserve-related net official capital flows, and changes in international reserves. Using this breakdown, Figure 4 displays key features of the financing of global current account imbalances in recent years. One key similarity across all regions is a sharp pickup in the speed of international reserve accumulation. In developing Asia, the speed and scale of this accumulation has been exceptional. The factors underlying the reserve accumulation have differed sharply across regions. In the case of developing Asia as a whole the reserve accumulation has been driven by both current account surpluses and net private capital inflows. In brief, developing Asia stands out for two reasons—(i) exceptionally rapid rates of reserve accumulation and (ii) large and growing surpluses on both the current and capital accounts—i.e., twin surpluses.

![Figure 4. Current Account Financing Patterns (US dollars)](image)

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3 Emerging Europe rather than Europe as a whole is examined due to the absence of data on capital flows for the euro area. The United Kingdom is also excluded.

4 As noted below, the financing of current account imbalances within developing Asia has shown considerable diversity. Aggregates for developing Asia tend to be dominated by the PRC given the size of its economy and its outsized external performance.
Figure 4—Continued

Middle East and Russia

Western Hemisphere

Emerging Europe

Net private capital flows
Net official capital flows
Reserve accumulation

Continued
B. Current Account Position of Eleven Economies in Developing Asia

Looking at the current account position for developing Asia as a whole provides a perspective on the region’s contribution to the global current account imbalances. It also shows that developing Asia has been an important and growing contributor to the recent global imbalances. However, a region-wide focus obscures important differences in the behavior of current account balances within the region. Figure 5 shows the ratio of current account balances to own GDP for the eleven largest economies in the region for which data are available. The data reinforce the earlier observation that current account surpluses are not an intrinsic structural characteristic of developing Asian economies but a recent development that has emerged since the Asian crisis. The only group of countries that seems to have a structural current account surplus is Hong Kong, China; Singapore; and Taipei, China. The eleven sample countries jointly account for over 95 percent of the region’s GDP. Figure 5 makes it clear that no single pattern of current account behavior is common throughout the region. Instead four broad types of behavior can be identified.

- **Asian Crisis–Affected Middle-Income Economies (Indonesia, Republic of Korea, Malaysia, Philippines, Thailand).** In these countries, current accounts shifted from deficit to large surplus around the time of the Asian financial crisis and have narrowed in the last few years, except in the case of Malaysia.⁵

⁵The recent widening of Malaysia’s current account surplus has reflected mainly the effects of highly elevated commodity prices.
• **Persistent High-Income Surplus Economies** (Hong Kong, China; Singapore; Taipei, China). In these cases, current accounts have been in surplus for extended periods with the surpluses increasing in recent years.

• **Persistent Low-Income Current Account Deficit Economies** (India, Viet Nam). In these cases, current accounts have been in deficit on average.

• **Low-Income Current Account Surplus Economies** (PRC). In this case, the current account tended to be in small surplus but the surplus has increased dramatically in recent years.

The large increase in the current account surplus for developing Asia as a whole since the late 1990s occurred in two distinct phases, and different groups of countries in the region drove the current account imbalance during the two phases. In the immediate aftermath of the 1997–1998 financial crisis, the increase in the region’s surplus largely reflected swings in the current account balances of the crisis economies from positions of large deficit into large surplus.⁶ Subsequently, and especially after 2003, the increase in the region’s overall surplus has largely been the result of a surge in the PRC’s surplus since the surpluses in most of the crisis economies have narrowed while India and Viet Nam have moved into larger current account deficits. To a significant degree, developing Asia’s current account surplus in recent years has been linked very closely to the PRC’s large current account surplus.
Finally, the data in Figure 6 offer a broader perspective on the region’s current account imbalances. The data display the relationship between the changes in current account balances and the changes in shares of exports in
relation to GDP between the pre-crisis period and the post-crisis period. The data clearly point to a strong positive relationship between the increases in current account surpluses and the degree of export openness—and hence, implicitly, the share of tradables in GDP. As current account surpluses have risen in recent years, the ratio of exports to GDP has also risen. The relationship, however, is not one-to-one and export openness across the region has increased even in the face of differences in the behavior of current account positions across economies. Nevertheless, the data in Figure 6 seem to support the notion that developing Asia’s current account surpluses have been driven by the region’s high and growing dependence on exports as the main engine of growth.

Figure 6. Shares of Exports in GDP and Current Account Balances of Individual Asian Economies

Newly Industrializing Economies

Continued
Figure 6—Continued

Newly Industrializing Economies—Continued

Taipei, China

1997/1998 Crisis Countries

Indonesia

Malaysia

Philippines

Korea, Rep. of

Continued
III. CAUSES OF DEVELOPING ASIA’S POST-CRISIS CURRENT ACCOUNT SURPLUSES

Having reviewed the behavior of the current account in the region, we are now ready to explore the possible explanations for the emergence of surpluses in the region since the Asian crisis. By definition, the current account balance is equal to the difference between saving and investment. As such, it is possible to view a large and persistent current account surplus as
arising from saving being “too high” or investment being “too low.” Therefore, one set of explanations for the region’s transformation into a chronic surplus region centers on the causes of high savings rates. Another revolves around the causes of the decline in investment rates, especially in the crisis-hit countries. A third set of explanations, known as Bretton Woods II, takes into account the possibility that highly competitive exchange rates are the underlying driver of both current account surplus and economic growth.

A. Too Much Saving?

One broad set of explanations for developing Asia’s current account surpluses focuses on the region’s high saving rates. Why has saving surged in recent years in parts of the region, especially since 2003? Various explanations have been advanced for the high and rising national savings rates that the region has witnessed. Since the increase in savings rates has been largest in the PRC, much of the empirical work has focused on the PRC experience (Weimer 2008, Kujis 2005), and has centered on modeling the proximate factors underlying the recent surge in PRC saving. There has also been some empirical analysis of savings in developing Asia more broadly in the context of investigating the factors underlying the global current account imbalances (IMF 2006b).

Several factors have been proposed as possible contributors to the recent surge in regional private savings. These include the region’s recent rapid GDP growth, with a key finding from numerous saving studies being that rapid growth led to surges in saving; increased uncertainty in the wake of the 1997–1998 Asian crisis experience, with a potentially positive effect on precautionary saving; demographic factors, in particular the effect of a region-wide demographic transition toward older populations; and financial development, which may in principle have a positive or negative effect on saving. As typified by IMF (2005) and Park and Shin (2009), one central finding across much of the empirical work is the key role played by the region’s rapid GDP growth in explaining its high private saving rate, and the important role played by demographic factors in a number of countries. Empirical studies indicate that savings rates in the region were somewhat higher than implied by standard relationships in the period closely following

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7 The strong positive relationship between savings rates and GDP growth rates is found in both time series and cross-sectional regressions. In principle, the relationship can be derived from either life cycle or permanent income models of consumption under the assumption that permanent income adjusts sluggishly to changes in actual income.
the crisis, perhaps as a result of a sharp rise in uncertainty, but this effect appears to have waned in recent years (IMF 2006b, Bernanke 2005).

Based on the analysis above, a key robust finding is that much, but not all, of the recent surge in the region’s saving has been the result of rapid rates of economic growth, especially in the PRC. To the extent that this is true, a key determinant of the region’s current account surpluses, especially in recent years, could be seen as its rapid rates of economic growth. In the case of the PRC, such an effect probably explains a large part of the recent increase in the savings rate because recent PRC growth rates have been exceptionally high. Elsewhere in the region, however, faster GDP growth is at best a partial explanation for any increase in savings rates insofar as average GDP growth in the last several years has tended to be below its pre-crisis rates in much of the region (ADB 2008).

B. Too Little Investment?

Another set of explanations for the region’s current account surpluses focuses on the weakening of investment in parts of the region since the Asian crisis. Why has investment weakened since the crisis? Across the region, with the notable exceptions of PRC, India, and Viet Nam, investment as a share of GDP has been unusually low since the Asian financial crisis, with this weakness accounting for the bulk of the region’s shift toward current account surpluses in the period immediately after the crisis. To some degree, the investment weakness has been in the real estate sector, where there had been massive overinvestment in several countries in the run up to the Asian crisis, and some return to lower and more sustainable investment rates was to be expected.8 For the most part, however, the weakness has been across all the components of investment and has occurred both in countries that were at the center of the crisis and those that were not.

Four major explanations have been proposed for the broad-based weakness of investment in the region since the 1997–1998 crisis. According to one set of explanations, the weakness has been the result of lingering effects from the crisis (Chinn and Ito 2005, Eichengreen 2006). Post-crisis restructuring and reform—along with the working off of pre-crisis investment excesses—contributed importantly to the weakness of investment in the crisis economies in the years immediately after the crisis. A second set of explanations for the broad-based weakness of investment focuses on possible competitive pressure from the PRC (IMF 2006c, Wong and Adams 2002).

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8See ADB (2005) and IMF (2006a) for discussions of the role of real estate investment in Asian imbalances.
The argument is that if investment in the PRC increases sharply, there will be cutbacks elsewhere in Asia. A third explanation for the recent weakness of investment relates to the role of heightened regional risk in the period since the crisis (ADB 2007). According to one argument, the crisis served as an important wake-up call for economic agents in the region about the risks in the investment environment. Finally, one broad view of the investment weakness is that it may reflect shortcomings in the region’s investment climate in the post-crisis period (IMF 2006c).

Overall, the weakness in investment across much of the region in the post-crisis period must be seen as a puzzle for which there is no clear explanation. Arguably, the 1997–1998 crisis played an important role in depressing investment for a period of time, but its effects have likely waned over time. Neither competition from the PRC, nor heightened risk, nor a deteriorating investment climate has had a clear effect. In any event, weak investment is no longer the key factor underlying the region’s large overall current account surplus. Since 2003, in particular, high and rising national saving has become the key contributor to the imbalance, especially in the case of the PRC, but also in the cases of the newly industrializing economies of Hong Kong, China; Singapore; and Taipei, China.

C. Bretton Woods II: Role of Highly Competitive Exchange Rates

The Bretton Woods II view of the imbalances seeks to explain the region’s current account surplus in a more general equilibrium framework that takes into account the two-way interactions between economic growth and the surplus. The central assumption of the Bretton Woods II view is that much of developing Asia has implicitly returned to tightly managed US dollar exchange rate regimes, following a brief flirtation with floating exchange rates during the 1997–1998 crisis period.9 The Bretton Woods II view is that the region’s decision to return to relatively rigid exchange rate management has been based mainly on a desire to maintain highly competitive exchange rates so as to boost exports and thus achieve rapid growth. Exchange rate competitiveness in turn is seen as being supported by systematic intervention in the foreign exchange market to purchase US dollars, which provides the external financing required by the US to purchase Asian exports.

According to the Bretton Woods II view, such an arrangement benefits both developing Asia and the US. Developing Asia benefits insofar as it

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9Hence, the usage of the term Bretton Woods II, as the intention is to draw an analogy to the Bretton Woods system of pegged but adjustable exchange rates that was in effect between 1945 and the early 1970s.
secures markets in which it can sell its exports and thereby achieve rapid rates of economic growth. The US benefits because it can obtain cheap external financing via developing Asia’s purchase of low-yielding US dollar reserve assets. In short, the arrangement is seen as a positive-sum game for the involved countries. The Bretton Woods II view can explain how the region has simultaneously experienced rapid export and GDP growth, large current account surpluses, and rapid rates of reserve accumulation. In broad terms, these are seen as the outcome of very competitive exchange rates and the necessary accompanying monetary and exchange rate policies. However, while Bretton Woods II provides a more comprehensive explanation, it also suffers from serious shortcomings and inconsistencies. In particular, its characterization of the region’s post-crisis exchange rate as dollar pegs or quasi-peggs is difficult to square with substantially greater exchange rate flexibility in countries such as Indonesia, Republic of Korea, and Thailand.

D. Summary

Putting all of the arguments together, it is clear that our understanding of the factors underlying the emergence of large and persistent current account surpluses since the Asian crisis remains limited. There is not one single explanation for the imbalances and the relative contribution of various factors has been different over different sub-periods. The broad-based weakness in investment in the immediate aftermath of the 1997–1998 crisis appears understandable, but the decade-long persistence of this weakness remains largely a puzzle. The recent surge in regional saving appears mainly to be the consequence of rapid regional growth, but such an explanation is incomplete because it does not address the factors underlying the rapid growth. In short, both the post-crisis investment slowdown and the high and rising savings rates remain largely unexplained.

IV. CONSEQUENCES OF GLOBAL IMBALANCES FOR DEVELOPING ASIA

While the causes of Asia’s post-crisis current account surpluses remain poorly understood, the consequences of global imbalances, which partly reflect those surpluses, are all too real and painful. In addition to the negative impact of the global financial crisis on exports and growth, global imbalances

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10 Even though most economies in the region do not report the currency composition of their reserve holdings, US and IMF data suggests that the bulk of the region’s reserves continue to be held in US dollar assets (Setser 2008).
entail two types of costs for Asia. The first is the costs arising from the possibility that Asia’s current account surplus is sub-optimal. The second is the costs associated with having excessive foreign exchange reserves. At a broader level, since economic growth remains by far the top priority in developing Asia, what matters the most is the consequences of the global imbalances for the region’s growth.

A. Benefits and Limits of Developing Asia’s Export-Led Growth

Before we delve into the issues of excessive current account surpluses and foreign exchange reserves, it is useful to take a step back and understand the roots of Asia’s large and persistent current account surplus. Those roots ultimately reflect Asia’s highly successful strategy of export-oriented industrialization. While a wide range of factors can explain why Asia was able to outperform other parts of the developing world in the postwar era, one key was the region’s ability to produce and sell manufactured goods abroad. Any debate about the desirability of a more balanced growth strategy should not lose sight of this historical fact. The key question facing Asia is whether a strategy that has delivered economic growth will continue to deliver in the future. The global imbalances underlying the global financial crisis highlight the unsustainable nature of running long-term large current account deficits. The global financial crisis brought to the fore the limits of a growth strategy that rests upon an ever-growing appetite for Asian goods.

B. Costs of Over-Saving and Under-Investment

Asia’s large and persistent current account surpluses can be viewed as a symptom of a high degree of dependence on external demand as an engine of growth. An equally valid interpretation of those surpluses is that they are due to an excess of saving over investment. Two potential types of welfare costs arise from the imbalance between saving and investment in Asia in the post-crisis period: costs associated with over-saving and those associated with under-investment. Along with export-oriented industrialization, high savings and investment rates have long been viewed as an integral part of the East Asian growth model. Although high saving rates have served Asia well, the key question highlighted by the global financial crisis is whether the region now suffers from saving too much. This question is especially relevant for the PRC given the country’s stunningly high savings rate relative to its income level. The welfare costs of over-saving are likely to be especially high in a poor country with low consumption levels and living standards. If the cost of
over-saving is potentially large for developing Asia, so is the cost of under-investment. The main tangible costs of a slower-than-optimal capital accumulation are reduced future productive capacity and reduced growth rates. The slowdown of growth rates to sub-optimal levels due to under-investment is a huge cost in light of the fact that developing Asia is still a poor region.

C. Costs of Excessive Foreign Exchange Reserves

One major consequence of persistent current account surpluses has been an explosive growth of foreign exchange reserves held by the region’s central banks. There is a growing consensus that the accelerated reserve growth of developing Asian countries may have led to reserves in excess of optimal levels. The optimal level of reserves is determined by their marginal benefits and costs. Excess reserves are welfare-reducing by definition. According to Park (2007), both informal and formal analysis confirms the popular belief that developing Asia’s reserves now exceed what is required for liquidity purposes by a wide margin, which implies correspondingly large welfare losses. One specific cost of excess reserves is the returns forgone by holding them in the form of traditional reserve assets—i.e., safe and liquid but low-yielding assets such as US government bonds—rather than higher-yielding assets. Parking excess reserves in liquid foreign currency assets that offer little additional protection against currency crisis has significant opportunity costs. Park (2008) estimated the benefits of managing excess reserves more actively and found them to be higher than 1 percent of GDP in many Asian countries.

D. Costs of the Global Financial Crisis for Developing Asia

We have already pointed out that developing Asia will not be immune to the adverse effects of global imbalances. Most immediately, if we view the current global financial crisis as reflecting global imbalances to some extent, it is possible to interpret the current slowdown of economic activity in the region as a cost of global imbalances. The 2008 and in particular 2009 GDP growth forecasts have been sharply revised downward throughout the region. In a region as poor as Asia, a two- or three-percent decline will tangibly constrain the resources and capacity to reduce poverty and income inequality. A timely study from the Asian Development Bank (ADB)—James et al. (2008)—explored the financial and real impact of the global financial crisis on developing Asia. So far the crisis seems to have had only a limited impact on the region’s financial systems. On the other hand, the real economies of the
region are already bearing the full brunt of the global economic downturn precipitated by the crisis. The synchronized slowdown of economic activity under way in the G-3 will have a pronounced impact on world trade and hence Asian exports and growth. Beyond the short term, to the extent that the US downsizes its current account deficit over an extended period of time, developing Asia will face a more lasting negative shock to its exports and growth.

E. Costs of Global Imbalances for Developing Asia’s Economic Growth

Developing Asia remains a poor region, so the most important determinant of the region’s economic welfare remains GDP growth. The region cannot hope to reduce poverty and inequality on a meaningful scale without adequate GDP growth. As such, any discussion of the impact of global imbalances on the region has to include their implications for growth. Of utmost concern to developing Asia’s policymakers should be the structural component of the ongoing deceleration of the region’s exports. Achieving rapid growth by producing ever-larger quantities of an ever-wider range of manufactured goods is feasible as long as there are markets to absorb those goods. However, the unfolding global crisis highlights the unsustainable nature of over-production sustained by over-consumption. There is a widespread tendency in the region to point to rapid economic growth as the primary justification for relying on exports as an engine of growth. However, the global financial crisis shatters the delusion that there are no limits to external demand and hence to export-led growth. Asia is no longer a small economy that faces an effectively infinite global market and can always export its way to high growth rates. There are also clear limits to which competitive exchange rates, emphasized in the Bretton Woods II view, can artificially promote exports in the long run.

F. Summary

Insofar as the current global financial and economic crisis reflects an unwinding of global imbalances, developing Asia is already paying a heavy price for those imbalances. In the short run, the collapse in G-3 demand for the region’s exports will severely dent the region’s exports and growth prospects. In the medium and long run, the global crisis highlights the risks of an excessive dependence on foreign demand. An unbalanced growth based on over-dependence on exports may deliver faster growth in the short run, but can contribute to the buildup of unsustainable global imbalances over a longer
time horizon. Given the excellent track record of export-led growth in the region, a regional mindset that favors exports over domestic demand is all too understandable. However, the global financial crisis has rudely awakened developing Asia to the reality that the world’s demand for the region’s output is neither automatic nor guaranteed. Some specific welfare costs arising from the global crisis include those associated with sub-optimal levels of saving, investment, and foreign exchange reserves.

V. CONCLUDING OBSERVATIONS

Global current account imbalances underlie the ongoing global financial and economic crisis. These imbalances are as much a matter of unsustainable current account deficits as unsustainable current account surpluses. Furthermore, other parts of the developing world, especially oil exporters such as Russia and the Middle East, have also contributed substantially to the surpluses. Nevertheless, the large and persistent surpluses that have emerged in developing Asia since the Asian crisis are an integral part of the global imbalances. These imbalances will hurt Asia’s growth prospects insofar as the global crisis, which is crippling the region’s exports, partly reflects a disorderly resolution of those imbalances. One does not have to be an adherent of the global savings glut theory to discern a connection between global imbalances and the global financial crisis. At a purely intuitive level, large and persistent current account deficits financed by large and persistent current account surpluses cannot go on indefinitely and will have to unwind at some point.

It is important to distinguish between the short-term versus the medium- and long-term policy implications of the global crisis. In the short term, the undisputed priority of regional policymakers must be to manage the sharp slowdown of economic growth associated with the contraction of external demand. Such short-term management will involve limiting the reduction of growth through expansionary fiscal and monetary policy as well as easing the hardship of those hardest hit. At the same time, it would be prudent for regional policymakers to fully recognize the medium- and long-term ramifications of the unwinding of the global imbalances. Viewing the current slowdown as just another downturn of just another business cycle would be a serious mistake. For one, the sheer size of the global imbalances suggests that their unwinding may require a protracted period of adjustment in the US. At a broader level, the global crisis highlights the inherent instability of growth based on excessive dependence on foreign demand in the medium and long
term. As such, it should serve as a wake-up call for policymakers to take concrete actions to rebalance their economies.

However, it must be emphasized that rebalancing does not imply turning back from the economic openness and integration into the world economy that has delivered enormous benefits for developing Asia and will continue to do so. In particular, erecting trade barriers to protect domestic firms and workers may be politically tempting under the present circumstances but will harm all countries in the region. What is hurting the region is not its traditional openness to international trade and capital flows, but an unsustainable imbalance in the global structure of supply and demand. Large and persistent current account surpluses are not an intrinsic structural feature of developing Asia; in fact, the region as a whole ran a deficit until the Asian crisis. Rebalancing represents a return to the generally more balanced structure of demand and growth that prevailed in the region prior to the Asian crisis.\footnote{However, in the immediate pre-crisis period, excessive current account deficits in some countries contributed to the outbreak of the Asian crisis.}

In the post-crisis period, developing Asia has been transformed into a region of chronic current account surpluses, or, equivalently, a chronic net exporter of capital. However, despite the behavior of the region as a whole and the existence of some common elements, there is a great deal of heterogeneity across the region’s countries in terms of the size and nature of their surpluses. Unusually high savings rates, which reflect unusually low consumption rates, explain the imbalance between output and expenditure in the PRC. In the crisis-affected countries, a sharp drop-off in investment rates against a backdrop of high and relatively stable savings rates explains the imbalance. Asian countries also vary widely in terms of their current account positions. For example, the ratio of current account surplus to GDP exceeds 10 percent in Malaysia and Singapore but the Republic of Korea’s account is balanced while India and Viet Nam are running deficits. The lack of a one-size-fits-all explanation for the region’s current account surplus rules out one-size-fits-all policy prescriptions.

Notwithstanding the heterogeneity of current account surpluses across the region, some rebalancing of growth toward domestic demand will be required for the region as a whole. In the absence of such rebalancing, the global economic crisis will have a pronounced impact on growth in highly export-dependent developing Asia. While necessary, rebalancing is bound to be a difficult, protracted, and complex structural process. Above all, the mismatch between the structure of output and the structure of demand in many export-oriented Asian economies will constrain the rebalancing of
demand and growth. The imbalance between what the region produces and what it consumes is partly structural, and will only be fully resolved with the recovery of the world economy. However, a key regional development that bodes well for rebalancing is the emergence of a large and rapidly growing urban middle class. The demand of this sub-population for goods such as automobiles and household appliances is taking off and laying the foundations for strong and sustainable domestic demand.

The intrinsically difficult and time-consuming task of rebalancing developing Asia’s economies entails a number of significant policy implications. For one, even under the most optimistic scenarios, it will be a daunting challenge for the region to regain its previous exceptionally high growth rates in view of the drastically worsened global economic outlook. A more feasible goal may be to achieve growth rates that are somewhat slower than those of the pre-global crisis period but still high relative to other parts of the world and, more importantly, high enough to make a dent on the poverty that still afflicts wide swaths of the region. It is up to the regional policymakers to communicate the reality of lower short- to medium-term growth prospects to the public as well as assist the hardest hit segments of the population to prevent social and political instability.

The fact that private domestic demand cannot be mechanically ramped up in a short period of time implies that the government must take the lead in rebalancing demand in the short run. In fact, governments around the region are already trying to pump up demand through active fiscal policy in response to the collapse of external demand. However, the region’s governments should also consider using fiscal policy for rebalancing beyond the short term. In addition to becoming a “spender of last resort,” governments should use fiscal policy to stimulate domestic demand by creating the appropriate enabling environment for the private sector. For example, investing in the education system will help to alleviate the shortage of critical skills that constrains investment in some industries. Reducing the mismatch between output and demand structures requires not only demand-side policies but also supply-side policies. In particular, removing policy distortions that favor the production of tradables over non-tradables will do as much to reduce the mismatch as boosting demand.

While developing Asia has played a part in the emergence of global imbalances since the Asian crisis, an orderly unwinding of those imbalances will require a global effort. In this context, an especially significant global initiative would be the reform of the global financial architecture. There is a widespread perception in developing Asia that the IMF did a poor job of handling the Asian crisis of 1997–1998. Regardless of its validity, this
perception has eroded confidence in the IMF throughout the region. The loss of confidence in the IMF, in turn, may have encouraged regional countries to run up current account surpluses to build up a large war chest of foreign exchange reserves that would protect them from another devastating crisis in the future. Measures to restore the region’s confidence in the IMF, such as governance changes that would give the region a voice proportionate with its role in the world economy, would weaken the incentives for precautionary reserve buildup and thus contribute to global rebalancing.

The central message of this study is that it is fundamentally in developing Asia’s enlightened self-interest to rebalance the structure of its demand toward domestic sources. Part of the need for rebalancing is driven by short-term necessity—rebalancing will help to mitigate the sharp slowdown of exports and growth due to the synchronized slump of the G-3 economies. Looking to the medium and long term, while the global crisis does nothing to diminish the benefits of an outward-looking export-oriented growth strategy, it does highlight the very real risks of an excessive reliance on external demand. It is true that Asian rebalancing would contribute to an orderly unwinding of global imbalances, which is a global public good. However, the region has the best reason of all to pursue rebalancing: its own growth and welfare. The region is in a good position to pursue rebalancing because it has much stronger fundamentals than it did during the Asian crisis. These include a relative absence of financial sector imbalances and generally healthy fiscal positions.

A further argument for rebalancing Asia’s growth is that many of the policies rebalancing requires are supportive of the broader objectives of poverty reduction and inclusive growth. For example, strengthening health care and old-age support not only helps to boost domestic demand but also helps to reduce poverty and inequality to the extent that the poor suffer disproportionately from lack of access to such basic services. In addition to contributing to more inclusive growth, rebalancing can also give a big boost to intraregional trade. While intra-Asian trade has superficially experienced impressive growth in recent years, much of it is trade in intermediate goods geared toward exporting final goods outside the region. More robust domestic demand for final goods within regional countries will allow for more substantive intraregional trade along the lines of the European Union. As the region’s incomes rise, consumers will demand more product variety and this demand will create a greater potential for intra-industry trade in differentiated products among regional countries.

Finally, the transformation of developing Asia into a surplus region is not only a relatively recent phenomenon but also a puzzling one. By
definition, the current account surplus is equal to net savings, or difference between savings and investment. Therefore, the emergence of large and persistent current account surpluses is equivalent to a widening gap between savings and investment. While a number of explanations have been put forth for a well-known stylized fact—the post-crisis investment drop in the crisis countries—all of them lack convincing theoretical and empirical support. Another well-known stylized fact that underlies the region’s post-crisis surpluses—the unusually high and rising savings rates of the PRC and some newly industrializing economies—also remains a puzzle that cannot be accounted for by the fundamental determinants of savings. In short, much more research needs to be done to improve the understanding of Asia’s post-crisis current account surpluses.

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