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East Asia's Role in Resolving the New Global Imbalances

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The world economy hangs in a precarious balance. The current account deficits of the United States have grown from 2 percent of GDP in 1997 to 4 percent in 2002 to 6.5 percent in 2006. It is doubtful that massive US borrowing financed by foreign monetary authorities can be sustained. If America's net external debt continues along its present trajectory, it will asymptote to 120 percent of GDP. As Obstfeld and Rogoff (2004, 2005) discuss, few countries have accumulated this much foreign debt without experiencing a crisis. If foreign central banks stop channelling resources into low-yielding US Treasury bonds, the value of the dollar would tumble. This could produce a large correction in the US trade deficit. Such a correction could destabilise the global economy, given the role that the US has played as an engine of growth.

The US deficit accounts for 70 percent of the world sum of current account deficits, implying that America absorbs 70 percent of net available global saving. In contrast, East Asian surpluses account for almost half of the world sum of current account surpluses, implying that the region provides almost half of the net global saving available to world capital markets. Thus, if the global economy is to be rebalanced, East Asia will have to play a significant part in the adjustment process.

The contours of the adjustment process for the US and East Asia are clear. First, the US should increase domestic saving (S) relative to investment (I). Second, East Asia should increase I relative to S. Third, these changes in I and S will necessarily be accompanied by exchange rate depreciations of the US dollar and appreciations of East Asian currencies in order to accommodate external adjustments and to simultaneously

help individual countries maintain external and internal balance.

For East Asia, there are several advantages to coordinated as opposed to unilateral exchange rate appreciations against the dollar. First, since about half of East Asian trade is intra-regional, a joint real appreciation against the dollar would cause effective exchange rates (EER) in the region to appreciate by less than half as much. The fact that the EER in Asia would increase by less than half as much implies that the recessionary impact would be attenuated and more able to be corrected by macroeconomic and structural policy measures. Second, the region is characterised by efficient production and distribution networks, with higher skilled workers in countries like Japan, Korea, and Taiwan producing intermediate goods and shipping them to China and ASEAN for assembly by lower skilled workers and re-export to the rest of the world. Stable exchange rates within the region would provide a steady backdrop for these regional production and distribution networks. Third, by reducing exchange rate volatility, stable intra-regional exchange rates can continuously increase FDI flows and hence encourage FDI-trade linkages. Fourth, policy coordination can prevent unpleasant outcomes such as “beggar-thy-neighbour” policies or “free-rider” problems that might arise because economies in the region are not only trading partners but also competitors in third markets.

It may thus be desirable for the region to coordinate the next round of exchange rate realignments relative to the dollar. As manifested by the East Asia Summits, countries in the region are determined to embrace further economic integration.

The purpose of this chapter is to identify the roles that both the US and East Asian countries can play in resolving the current global imbalances. To do this, we first discuss the nature (Section 1) and sustainability (Section 2) of the imbalances. We then recommend necessary external adjustment policies for the US (Section 3). Finally, we consider the role that East Asia can play, acting in her own interest, in rebalancing the global economy (Section 4) and draw conclusions (Section 5).

1 The Nature of the New Global Imbalances

The new global current account imbalances have emerged since 1997-98. Simultaneous US saving-investment deficits and East Asian saving-investment surpluses arose due to serendipitous and mirror-imaged patterns of capital flows and business cycles.

US Current Account Deficits

The US current account deficits in the late 1990s were driven by a domestic investment boom. Investment as a share of GDP averaged almost 3 percentage points higher over the 1997-2000 period as compared with the 1990-1996 period. Businesses invested heavily in information and communication technology. This in turn lowered production and management costs and increased total factor productivity (Bailey, 2003). Total factor productivity growth between 1995 and 2000 averaged 1.13 percent per year, after growing only 0.38 percent per year between 1973 and 1995. This increase in productivity growth lifted real rates of return. The NASDAQ Stock Index, for instance, rose 200 percent between January 1995 and its peak in March 2000. The Standard & Poors' 500 and the Dow Jones Industrial Average both rose more than 100 percent over this period.

Soaring stock prices in the late 1990s and soaring housing prices in the early 2000s raised spending relative to income and reduced private saving as a share of GDP. Econometric estimates indicate that a one hundred dollar increase in private wealth increases spending by about six dollars (see Belsky and Prakken, 2004). The US aggregate stock market capitalisation equaled about 100 percent of GDP in 1997 and more than doubled by 2000. As the US economy entered a recession in 2000-01, the Fed lowered the federal funds rate from over 6 percent to 1 percent. This raised housing prices. Housing wealth in 2000 equaled about 109 percent of GDP, and it increased by 48 percent over the next five years. These increases in wealth raised consumption and reduced saving. In 2006, the housing markets cooled down, but this was not reflected in consumption and investment figures.

Until 2001, fiscal policy had nothing to do with the decline in national saving in the US. Unlike in the 1980s, the initial deterioration of the trade balance in the late 1990s was associated with an improving budget balance and even with budget surpluses until the second half of 2001. Since the US recession of 2000-01, however, large US budget deficits have reappeared due to expansionary Keynesian fiscal policy and increased military expenditures. The fiscal balance shifted by nearly 6 percent of GDP between 2000 and 2004, moving from a surplus of 2 percent to a deficit of 4 percent. This deterioration in the fiscal balance was the proximate cause of the decline in national saving and the resulting further deterioration of the current account deficit after 2001.

East Asian Current Account Surpluses

While the US experienced an investment boom and a swing to current account deficits beginning in 1997, East Asia experienced the opposite. The 1997-98 Asian financial crisis can be characterised as a capital account crisis that could develop even in the presence of sound macroeconomic fundamentals. Short-term foreign bank loans that had been attracted by “miraculous” macroeconomic performance in East Asia exited rapidly and in massive quantities. In Thailand, the reversal of capital flows between 1995 and 1998 amounted to 16.8 percent of GDP and in Indonesia the change between 1996 and 1998 amounted to 13.4 percent of GDP (see Yoshitomi *et al.*, 2003).

Local banks and firms were badly exposed to these outflows. Before the crisis, they had borrowed short-term in dollars and invested long-term in domestic real estate and manufacturing projects. There was thus a double mismatch (a currency and a maturity mismatch) on their balance sheets. When the capital outflows caused local currencies to depreciate, banks' and firms' liabilities soared in domestic currency terms and their balance sheets were decimated. As domestic balance sheets deteriorated, financial intermediation was destroyed and investment spending by borrowers plummeted. This occurred not just because the intermediation system had become dysfunctional but also because the prolonged debt repayment process (including the restructuring of balance sheets and the shedding of excess capital) deprived firms of new investment opportunities.

While saving as a share of GDP has more or less remained stable in Asia, investment relative to GDP has fallen and remained low. The result has been large current account surpluses, standing in sharp contrast to current account deficits in crisis-hit economies before 1997. Real GDP growth rates fell from their “miraculous” pre-crisis levels of around 8 percent to 5 or 6 percent after the crisis subsided.

Exchange rates in emerging East Asia initially collapsed by 50 percent or so due to the massive reversals of private capital flows associated with the capital account crisis. Afterwards they remained about 20 percent on average below their pre-crisis levels. Low exchange rates have helped to keep Asian current accounts in surplus after the crisis.

The more or less similar pattern of stable saving, weaker investment, and depreciated exchange rates has also been seen in non-crisis Asian countries such as Singapore and Taiwan. Investment as a share of GDP plummeted in these countries after the crisis, causing the current account balances that were already in surplus before the crisis to improve further

after the crisis. In addition, exchange rates in these non-crisis countries are substantially lower now than before the crisis.

Under strong pressure for currency appreciation in recent years, East Asian central banks have kept exchange rates low by intervening in foreign exchange markets and purchasing US securities. Official holdings of US assets by foreign central banks between 2002 and 2005 have increased by more than \$965 billion out of a cumulative US current account deficit of \$2.46 trillion.

Emerging East Asian central banks in both the crisis-hit countries (Indonesia, Korea, Malaysia, the Philippines, and Thailand) and other countries (China, Singapore, and Taiwan) have accumulated foreign exchange reserves for the following reasons: (i) to be prepared for another capital account crisis characterised by massive reversals of short-term capital that can trigger both a currency collapse due to the drain on foreign reserves and a banking crisis due to the sharp increase in external liabilities on the balance sheets of banks and firms; and (ii) to maintain competitive exchange rates in order to sustain the export-oriented thrusts of their economies. The first objective was more important after the crisis, and the second objective has been more or less persistently important.

Japan has also accumulated reserves through foreign exchange market intervention, although for a different reason. It has sought to fight price deflation by preventing the yen from appreciating too much. It resorted to this only after having exhausted traditional Keynesian fiscal and monetary policy remedies as the public debt/GDP ratio approached 200 percent and short-term interest rates became zero after 2001.

The next section considers whether the current global arrangement, with the US running current account deficits that are financed largely by Asian central banks, will prove sustainable.

2 The Sustainability of the New Global Imbalances

The shortfall of saving relative to investment in the US has caused it to borrow trillions of dollars from private investors and Asian central banks, among others. A question of particular concern is whether the current equilibrium will remain stable, or whether the world economy will have to pass through a possibly painful adjustment process. The sustainability question can be divided into two parts: (i) the sustainability of large US deficits, and (ii) the sustainability of reserve accumulation by Asian monetary authorities.

The Sustainability of US Current Account Deficits

As the US runs current account deficits, it accumulates debt against the rest of the world. The sustainability of these deficits can be judged by considering whether foreign investors will willingly hold the amount of debt that the US must issue to finance her continued deficits. This analysis should take into account dynamic changes in interest rates and risk premia on US liabilities. Assuming that US current account deficits continue to equal 6 percent of GDP and that the underlying US nominal GDP growth rate equals 5 percent and that the net interest rate on net foreign liabilities remains negligible as it is now, net external debt will eventually reach 120 percent of GDP (6 percent/ 5 percent) in the long run.

These assumptions also imply that after 10 years net external debt will reach 65 percent of GDP, representing 18 percent of the wealth of the rest of the world. Such a level might be willingly held by international investors and thus be sustainable thanks partly to the key currency status of the dollar.

However, interest rate dynamics get progressively worse over time. Despite the fact that since 2004, US external liabilities exceed US foreign assets by more than 20 percent of GDP, until recently, net international investment income remained slightly positive for the US. This is because, up until now, investment income earned by US residents (mainly from equity investments including FDI abroad) has exceeded investment income paid by US residents (mainly on US bonds held by the rest of the world). However, recent data show that the US net international investment income became negative in 2006, suggesting that the turning point has been reached (Heath, 2007; Bergsten, 2007). Income yields on US liabilities have increased with rising US debt and rising interest rates, narrowing the difference between the yields on net debt and net equity.

Even assuming that the current rates of return on US investments abroad and foreign investments in the US remain unchanged, the massive amount of US liabilities that are projected to accumulate over the next 10 years will raise the net interest rate to almost 1 percent. In this case the long-run debt/GDP ratio would be 150 percent of GDP ($6\%/[5\%-1\%]$), equal to 40 percent of the net wealth of the rest of the world.

Notwithstanding the key currency status of the US dollar, it is implausible that foreign investors would hold such high shares (as exemplified above at 40 percent) of their total wealth in US assets without receiving a higher rate of return, especially if they feared that the dollar would depreciate. If after 10 years the required return on US

assets rose by only 1 percent, the eventual debt/GDP ratio would be greater than 300 percent of GDP ($6\% / [5\% - 3\%]$). This would exceed the total wealth of the US! Thus current borrowing levels in the US will at some point prove to be unsustainable.

If current account deficits remained below 3 percent of GDP, on the other hand, the eventual debt/GDP ratio would remain below 60 percent of GDP in the long run, which should be sustainable, particularly given the key currency status of the US dollar.

The Sustainability of Reserve Accumulation by Asian Central Banks

Foreign reserve accumulation by Asian monetary authorities increases base money and hence creates excess liquidity in the banking system. This in turn increases the money supply and exacerbates inflation. To offset this, central banks in the region have engaged in sterilisation policies. Sterilisation involves selling government bonds or central bank bills to keep the monetary base unchanged and to mop up excess liquidity in the banking system.

Sterilisation policy in East Asia has so far been largely successful in preventing money supply growth rates from accelerating. The CPI inflation rate has also remained low, between 1 to 3 percent per year.

However, there are still several difficulties associated with sterilisation operations. First, they cause commercial banks to hold more and more central bank bills, eroding bank profitability and interfering with the allocation of credit through the banking system. Second, sustained sterilisation may fail in the long run because, as the stock of central bank bills or government securities grows large, interest rates on these instruments may have to rise in order to induce investors to willingly hold them. Higher interest rates would then attract further capital inflows and defeat the purpose of sterilisation (the self-defeating hypothesis). Third, continued accumulation of US Treasury securities (external reserves) results in an increasingly inefficient allocation of resources since both private and social rates of return would be much higher for investments in the domestic economy.

3 Necessary Adjustment Policies in the US

How should the US respond to her own unsustainable external imbalances? Since the large US current account deficits originated from her

own I-S imbalances and account for three-quarters of total world deficits as already mentioned, the primary responsibility for resolving global imbalances rests on the US and her willingness to increase national saving. The importance of increasing national saving is reinforced by the fact that the dollar, after having depreciated since 2002, returned in 2005 more or less at its long-run average and thus is not greatly misaligned. Nevertheless, the current account deficit remains huge. This implies that US external imbalances are being driven by shortfalls of saving relative to investment in the US and not by overvalued exchange rates.

Increasing national saving would involve fiscal consolidation and also policies to reduce consumption in order to raise household saving rates. However, these absorption-reducing policies would be recessionary, particularly if such policies alone were assigned to external adjustment, and hence should be offset by switching policies to stimulate net exports. Therefore, a dollar depreciation, which increases net exports by changing the terms of trade between tradables and non-tradables in favour of the former, together with absorption-reducing policies, could help to both achieve and maintain external and internal equilibria (i.e. a sustainable current account balance and full employment with low inflation). If the dollar depreciated alone without any absorption-reducing policies, inflation could accelerate. Thus the optimal policy mix for the US would involve fiscal consolidation combined with a depreciation of the dollar.

If fiscal consolidation were not undertaken, however, market forces could drive the dollar down in response to the rising share of US assets in international investor portfolios (i.e. the aforementioned unsustainable US current account deficits). The weaker the fiscal consolidation initiated, the more the dollar could fall. While this depreciation process might well be benign and gradual, there is a risk that it could be sudden and precipitous.

Chinn (2005a, 2005b, 2005c) concludes based on estimates of price and income elasticities that a depreciation of the dollar, if not accompanied by a decrease in expenditures in the US or an increase in expenditures in the rest of the world, would be unlikely to substantially reduce the US trade deficit.

Obstfeld and Rogoff (2001, 2004, 2005) reach the same conclusion using a multi-country, intertemporal, general equilibrium model. They state that most theoretical and empirical models (including theirs) indicate that a 10 percent depreciation of the dollar would be associated with a reduction in the US current account deficit of around 1 percent of GDP. They

thus argue that reducing the current account imbalance to a sustainable magnitude would require not just a dollar depreciation but also a change in the level of expenditures (e.g. a decrease in consumption in the US).

There are two policy steps that the US can take to adjust domestic absorption. First, it should seek to curtail speculative excesses in the housing market. Belsky and Prakken (2004) report that the increase in housing wealth has increased consumption by a substantial amount. Alan Greenspan (2003) also underscores the importance of housing equity in explaining the recent decrease in private saving. Continued interest rate increases by the Fed could have a salutary effect by checking the currently unsustainable rise in housing prices in the US. Second, the US can reduce its budget deficit. Increases in the budget deficit were the proximate cause of the large drop in national saving relative to investment after 2001. A decrease in the budget deficit could help to close this saving-investment gap.

Such I-S rebalancing policies would be consistent with further depreciations of the dollar in order to reduce the current account imbalances. A 30 percent depreciation of the dollar accompanied with I-S adjustment policies in the US would go a long way towards reducing the presently unsustainable US current account deficit of 6 percent down to a sustainable level of about 2.5 percent of GDP. We thus take as a working hypothesis that the dollar should depreciate by 30 percent.

4 East Asia's Role in Resolving the Current Global Imbalances

Basic Rationales for Concerted Appreciations

How should East Asian countries respond to the risky scenario of a 30 percent depreciation of the dollar, as implied by the aforementioned working hypothesis? Concerted action to maintain mutual exchange rate stability in the region would be helpful for the following reasons: First, since intra-regional trade accounts for about half of total trade, concerted increases of East Asian currencies against the dollar would attenuate effective exchange rate changes in the region. This in turn would mitigate the recessionary impact if Asian currencies appreciated against the dollar. Second, exchange rate stability in the region would encourage continued FDI flows and provide a stable backdrop for regional production and distribution networks which have been the basis for the high intra-regional trade share. By allowing fragmented

production blocks to be allocated across countries based on comparative advantage, these networks have acted as an engine of growth. Of course, the comparative advantage of individual countries and thus these production networks themselves will change dynamically over time. Third, it would help overcome prisoner's dilemma problems that arise because the fear of losing competitiveness relative to Asian trading partners sometimes prevents countries in the region from allowing their currencies to appreciate.

We briefly discuss intra-regional trade patterns and prisoner's dilemma problems below before considering the appropriate policy mix for East Asia and ways of overcoming these coordination problems.

Triangular Trading Patterns in East Asia

A high degree of economic interdependence in East Asia, with intra-regional trade accounting for about half of total trade, is based upon intricate production and distribution networks in the region that have led to triangular trade patterns. FDI flows in East Asia have played an important role in strengthening the international production networks, reducing costs, and transferring technological know-how. Japan, Korea, Taiwan, and multi-national corporations in ASEAN produce sophisticated technology-intensive intermediate goods and capital goods and ship them to China for assembly by lower skilled workers. The finished products are then exported to markets throughout the world. These processed exports account for 55 percent of China's total exports. The lion's share of China's processed exports is from FDI enterprises. Trade within these networks can be classified as vertical intra-industry trade (VIIT).

VIIT differs both from the exchange of final goods emphasised by traditional trade theory for vertical inter-industry trade between the North and the South (e.g. between capital goods and apparel) and for horizontal intra-industry trade between the North and the North (e.g. between two differentiated types of automobiles). VIIT allows the production processes of an industry (e.g. the electronics industry) to be split into fragmented production blocks that can be located in different countries. Production blocks are allocated across developing, emerging, and developed economies in the region based on comparative advantage as determined by relative endowments of capital, skill, and labour and by physical and institutional infrastructure. VIIT has led to large efficiency gains and helped to make East Asia as a whole the manufacturing centre of the world.

Because of these trading networks, Chinese value added in processed exports appears small (about 20 percent) relative to the predominant costs of the intermediate goods imported from the rest of Asia. Thus a unilateral RMB revaluation would not affect much the dollar costs of processed final products and hence China's trade surplus. Furthermore, in the triangular trading patterns, China imports sophisticated intermediate goods essentially from East Asia but not from the US and exports final products all over the world, including to the US. Hence, these triangular trading patterns imply that bilateral trade imbalances between China and the US would remain large even if China's global trade surplus disappeared. One policy implication that follows is that it is totally inappropriate to demand a unilateral RMB appreciation simply because America's bilateral deficit with China is large.

Complementary and Competitive Trade Relations in East Asia

Because Asian countries compete with each other both domestically and particularly in third markets, they may not follow regional partners in exchange rate appreciations. As implied by the triangular trading patterns and by VIIT, relatively more developed East Asian countries export large amounts of technology-intensive capital and intermediate goods, while relatively less developed countries in the region export large amounts of low skill-intensive consumer goods. Therefore there is essentially a complementary relationship between China and less developed Asia on the one hand and developed Asia on the other. Furthermore, there is a complementary relationship between China and multinational corporations located in ASEAN that export sophisticated technology-intensive parts and components there for processing. In contrast, there is largely a competitive relationship between China and less developed Asian countries in labour-intensive consumer goods trade. Existing studies indicate that if one Asian country's exchange rate appreciates relative to other Asian countries' exchange rates, that country's exports (particularly of labour-intensive consumption goods) to third markets will fall.

All in all, elements of competition exist in any international trading relationship and hence fear of losing competitiveness relative to other countries may prevent individual countries from allowing their currencies to strengthen. This may explain the unwillingness of some countries in the region to allow their currencies to appreciate unilaterally. There could thus be a collective action problem or coordination failure: all

countries would be better off if their currency values increased together but individual countries sometimes resist such increases because they are suspicious of whether other countries will allow similar increases.

The Appropriate Policy Mix for the Region

In view of (i) the high ratio of intra-regional trade to total trade, (ii) the intricate production and distribution networks, and (iii) the need to overcome coordination failures, concerted action to maintain mutual exchange rate stability among Asian currencies would be beneficial. One form of concerted action would be for all countries in the region to appreciate more or less jointly against the dollar under the aforementioned working hypothesis. However, this concerted appreciation would not sufficiently take into account individual differences among economies (e.g. policy options, macroeconomic variables, trade/GDP ratios, and structural factors) and would also ignore the actual appreciations of some Asian currencies since 2002. How can the benefits of concerted action be reconciled with the need to accommodate differences in individual economic conditions?

Since concerted action is aimed at mutual exchange rate stability, currencies that have not appreciated while the dollar fell between 2002 and 2005 should catch up with currencies that have already appreciated. This catch up would be achieved more easily if countries in the region adopted more flexible exchange rate regimes.

More flexible regimes could be characterised by two elements: a multiple currency basket-based reference rate instead of a dollar-based central rate, and a wider band around the reference rate.

These two elements would provide policymakers with greater flexibility in managing the speed and magnitude of any necessary appreciation while still taking into account their own individual economic conditions.

A free float would cause exchange rates to more accurately reflect market fundamentals. However, given the shallow and narrow domestic capital markets in some East Asian economies, a free float for some countries would generate excessively volatile exchange rates and harm economies in the region that are highly exposed to fluctuations in international trade.

We thus advocate neither a free-floating regime nor a fixed dollar peg but rather greater exchange rate flexibility in the context of a multiple currency basket-based reference rate with a band. If individual

countries adopted greater flexibility in this way, a dollar depreciation under the working hypothesis would tend to produce appreciations across the region and keep mutual real effective exchange rates among Asian currencies relatively stable.

Greater flexibility would benefit China for a couple of reasons. First, China will begin to increasingly face *de facto* capital account convertibility with the free entry of foreign banks and other financial institutions for renminbi-based financial activities due to the terms of her WTO accession commitments. In this case, wider bands would enable her to maintain greater monetary policy autonomy in the face of volatile capital flows. Second, increased flexibility would provide Chinese banks and traders with experience in managing exchange rate risk and allow Chinese forward markets and related infrastructure to develop quickly. At the same time, China should purposefully build needed financial institutional infrastructure (e.g. prudential regulation, supervision, accounting, a credit culture, etc.) as quickly as possible so that she can accommodate greater flexibility in the very near future.

If Asian countries allowed their currencies to appreciate instead of accumulating reserves, it would have a recessionary impact. This could be offset by appropriate macroeconomic and structural policies. Switching policies such as exchange rate appreciations thus need to be combined with absorption-increasing policies.

Absorption-increasing policies include employing fiscal and structural policies to build both physical and human infrastructure (particularly in rural areas) and using deregulation to promote competition and productivity growth in the non-tradable sector. These policies could promote production for domestic markets and thus rely more on domestic markets rather than exports to create jobs.

Combining expenditure-increasing policies with expenditure-switching policies would thus be the appropriate policy mix for Asian countries that had previously accumulated massive reserves. On the one hand, without exchange rate appreciations, policies aimed simply at increasing domestic demand could produce overheated economies. On the other hand, without policies to increase domestic demand, exchange rate appreciations would be contractionary. Only by combining these two, namely by implementing an appropriate policy mix, could Asian economies move away from excessive reserve accumulation and simultaneously achieve external and internal equilibria in their own interests. These policies would also contribute to easing global imbalances, thus providing a harmonised way of advancing regional and international interests.

5 Conclusion

The present global imbalances cannot be sustained indefinitely. The primary step necessary to resolve them is for the US to increase domestic saving. Absent I-S imbalance corrections in the US, the dollar could depreciate substantially due to the excessive amount of dollar assets in the portfolios of international investors as explained in Section 3. This decline could be gradual and benign, but it could also be sudden and precipitous.

In the face of an incipient depreciation of the dollar as a risk scenario, Asian countries ought to engage in concerted action to keep exchange rates as stable as possible given their individual economic differences. This could be done if countries with less flexible exchange rate regimes adopted more flexible regimes characterised by a multiple currency basket-based reference rate and a reasonably wide band. The challenge for East Asian policymakers is to harmonise exchange rate policies in this way.

Policy coordination to stabilise effective exchange rates mutually in the region through selecting more flexible exchange rate regimes would provide several advantages. First, concerted exchange rate changes against even a relatively large drop in the dollar's value would reduce the magnitude of "effective" exchange rate increases in East Asia, since about half of trade is intra-regional. This in turn would minimise the deflationary effect of a rise in the value of Asian currencies against the dollar. Second, exchange rate stability would facilitate the flow of FDI and preserve production and distribution networks in the region that have exploited comparative advantage and functioned as an engine of growth. These networks will change, though, as the comparative advantage of countries change over time. Third, it should help overcome prisoner's dilemma problems that prevent individual countries from allowing their exchange rates to rise unilaterally, even when joint increases would be mutually beneficial.

Exchange rate increases should be accompanied by absorption-increasing policies. These would offset the recessionary impact of the currency appreciations and also be consistent with the new economic strategy in East Asia of encouraging domestic demand rather than relying excessively on net export expansion.

In coordinating exchange rate policy, a regional forum would be helpful. A regional forum could develop the needed surveillance mechanisms and peer pressure in the context of exchange rate coordination policies

aimed at stabilising mutual exchange rates among East Asian economies, which would in turn promote continued economic integration.

The East Asian Summits should be an appropriate venue to begin discussing policy options along the lines spelled out here, in order to advance the interests of countries in the region.

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