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External adjustments and coordinated exchange rate policy in Asia[☆]

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ABSTRACT

In this paper, we estimate structural VAR models with contemporaneous restrictions based on neo-classical and Keynesian theories to investigate whether the cause of current account surpluses for East Asian economies is a "saving glut" or undervalued currencies. Analytical results show that the major determinant of the current account is the real effective exchange rate for all East Asian countries with the exception of China for which the major determinant is domestic GDP. Accordingly, the recently requested revaluation of the Chinese yuan may not be an effective policy for reducing the Chinese current account surplus, and may affect other Asian current accounts. We also investigate whether a Chinese currency revaluation would contribute to the improvement of current account imbalances in East Asia and find that a revaluation would, indeed, improve the current accounts of Japan, Korea, Indonesia, and Thailand. Since the trade structures of major East Asian countries are substitutes with that of China, a Chinese currency revaluation might not lead to a decrease in East Asian current account surpluses. Coordination of currency policy among East Asian countries is, therefore, needed to solve the global current account imbalance.

1. Introduction

Over the last decade we have witnessed rising global imbalances that can be characterized by large current account deficits for the U.S. and large current account surpluses for most East Asian countries and oil exporting nations. Perhaps the most influential explanation for the widening U.S. current account deficits is the widening productivity gaps between the United States and the rest of the world (Chakraborty & Dekle, 2008; Engel & Rogers, 2006; Hunt & Rebucci, 2005) while a problem on sustainability of the US current account deficit is pointed out (Mann (2002)). The fact that the deficit with East Asia is the most rapidly growing component of U.S. current account deficits may indicate, however, that Asian current account surpluses are an alternative cause. Indeed, the "global saving glut" explanation expounded by Bernanke (2005) seeks the cause of current account deficits outside the United States. This argument views the excess saving of Asian countries, due to increased saving and collapsed investment in the aftermath of the financial crisis, as the cause of U.S. current account deficits.[1] Fig. 1 presents evidence that the movements in the U.S. current account deficit have been symmetrical with those in the current account surpluses of Japan and East Asia (in terms of GDP).

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[1] Chinn and Ito (2008) point out that saving *per se* is not excessive in East Asia and rather East Asia has experienced a shortfall in investment.

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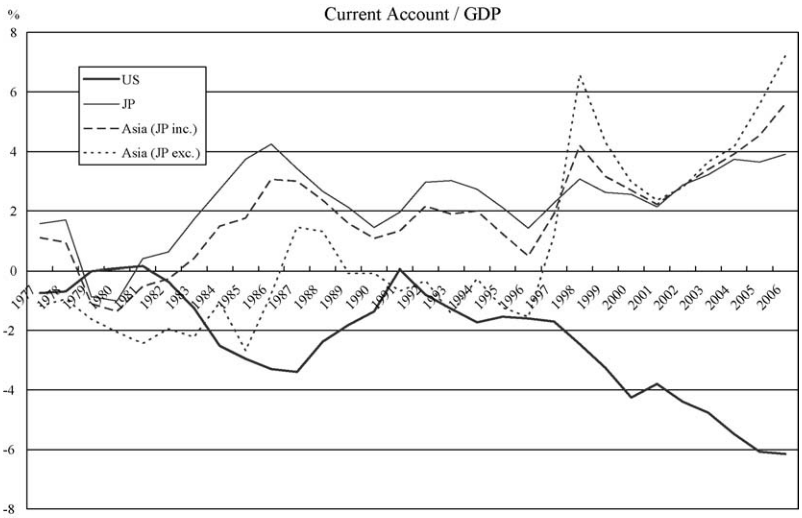

Fig. 1. Current account imbalances between the United States and Asia.

China has been accused of exchange rate manipulation by the U.S. government and requested both to revalue the Chinese yuan and to shift from a dollar peg system to a more flexible exchange rate regime.[2] In July of 2005, the Chinese government carried out a reform of its exchange rate system that included abandoning the rigid dollar peg that had been in place since 1994. The Chinese monetary authority has, however, only been revaluing its U.S. dollar rate by 3–5% per year and is still stabilizing the value of the yuan.[3] Over the last few years, the Chinese current account surplus has increased substantially and huge foreign reserves have accumulated. The widening trade deficits between the United States and China since 2001 have led the U.S. government to put even more political pressure on the Chinese government with the aim of reducing the U.S. current account deficit.[4]

The request to revalue the Chinese currency may, however, be theoretically inconsistent with the "saving glut" argument. This argument relies on neo-classical economics, in which it is not the exchange rate but rather the saving–investment balance that determines current accounts. Therefore, a revaluation of the Chinese yuan and other East Asian currencies would not help to reduce the U.S. current account deficit. In contrast, the request for a revaluation of East Asian currencies relies on Keynesian economics, in which it is not the "saving glut" but currency manipulation or undervalued East Asian currencies that would cause the U.S. current account deficit.

This paper has two objectives. The first is to investigate whether the request for a currency revaluation contributes to improvements in the U.S. current account. In doing so, we estimate structural vector autoregressive (VAR) models with contemporaneous restrictions based on neo-classical and Keynesian theories to assess whether the main determinant of the current account for each of the East Asian countries is GDP or the real effective exchange rate.

The second objective is to examine whether a revaluation of the Chinese yuan would improve current account imbalances in East Asia[5]. This link depends on whether the trade structures between China and other East Asian countries are substitutes or complements. If they are substitutes, a revaluation of the Chinese yuan will improve the current accounts of other East Asian countries. In this case other East Asian currencies should also be revalued or allowed to appreciate, in addition to the Chinese yuan, in order to reduce global current account imbalances. On the other hand, if trade structures are complementary, a revaluation of the Chinese yuan will deteriorate the current accounts of other East Asian countries. It seems fair to say that a revaluation of the Chinese yuan alone would be enough to solve global current account imbalances. We analyze the effects of the real effective exchange rate for the Chinese yuan on the current accounts of East Asian countries.

[2] Goldstein and Lardy (2003) write that China should make a medium-size (15–25%) revaluation of the yuan as the first step.

[3] See Ogawa and Sakane (2006). Goldstein (2007) stresses that even after exchange rate reform the Chinese monetary authority has maintained the undervaluation of the yuan.

[4] The effect of the Chinese currency adjustment on the U.S. current account deficits is inconclusive. Woo and Xiao (2007) point out that appreciation of the Chinese yuan will only re-configure the geographical distribution of global imbalances to other East Asian countries. It will not eliminate them. On the other hand, Bergsten (2007) stresses that a 40% appreciation of the Chinese yuan and other East Asian currencies against the US dollar would reduce the U.S. current account deficit by about $150 billion per year.

[5] Ogawa and Kudo (2007) pointed out asymmetric responses of East Asian currencies to the US dollar depreciation for reducing the current account imbalances.