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High Risks of Global Imbalances:
Role of Infrastructure Investments in Asia

Risks of Global Imbalances

A recent World Bank report *Global Development Finance: Mobilizing Finance and Managing Vulnerability* (Washington D.C. 2005) points out sharply the risks faced by the world economy due to the large global imbalances that have emerged. It notes foreign exchange reserves of developing countries which stood at $378 billion during 2004 are "excessive" for many countries and these reserves carry serious risk of capital losses and growing quasi-fiscal carrying costs. It further states the possibility of "disorderly" adjustments of external payments imbalances in the global economy poses acute risks to emerging markets.

Similar sentiments have been expressed by a large number of official bodies as well as individual experts. For example, European Central Bank said in its latest *Financial Stability Review* argues that large and growing financial imbalances continue to pose medium-term risks for the stability of foreign exchange and other financial markets. It goes on to say that a disorderly correction of the large US current account deficit and surpluses in Asia remained possible, particularly as the imbalances could increase further.

Noriel Roubini Global Economics Blog (www.roubinglobal.com/archives/2005/05/global-imbalanc.htm) provides a list of eminent economist who have warned of the high risks posed by the global imbalances in particular the high current account deficits of the US. The list includes Rubin, Sinai and Orszag, Summers, Peterson, Roach, Gross, Bergsten, Rogoff and Obstfeld, Eichengreen, and Volcker. As an illustration one can perhaps concentrate on statements of Larry Summers[1] former Secretary of Treasury of the US. He has argued eloquently how the large current account deficits of the US carry significant risks to the US as well as the rest of the world. For the United States, he emphasizes the risk of the incipient protectionist pressures that are generated by a large trade deficit, and that are connected with the current furor over outsourcing. Secondly, he notes that dependence on foreign governments for short-term financing creates vulnerabilities in both the economic and political realms. He uses the term "balance of financial terror" to refer to a situation where the US relies on the costs to others of not financing the US current account deficit as assurance that financing will continue. For the rest of the world, he notes that a great deal of money is being invested at what is almost certainly a very low rate of return. Secondly, for countries trying to avoid appreciation of their exchange rates there is the loss of domestic monetary control and the difficulty of maintaining. He notes that much of the speculative bubble in Japan during the late 1980s that had such a catastrophic long-run impact on the Japanese economy was driven by liquidity produced by a desire to avoid excessive yen appreciation.

Inadequacies of the conventional medicine

Despite the seriousness of the problem, there is a dearth of credible proposals for curing the malady. The standard recipes are three: revaluation of currencies in Asia, in particular the Chinese Yuan, reflationary policies in EU and reduction of fiscal deficits in the US. For all three of these recipes, there are doubts as to the extent to which concrete actions may be taken and the extent to which probable actions can help cure the global imbalances.

On revaluation of the Chinese Yaun an ADB Economist Cyn-Young Park in her paper on "*Coping with Global Imbalances and Asian Currencies*" has shown that a projected 10 per cent revaluation of the renminbi would only improve the US trade balance by $3.6 billion, a mere 0.02 per cent change in the

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This Policy Brief has been prepared by Dr. Ramgopal Agarwala, Senior Consultant, RIS.

current account as a per cent of gross domestic product (GDP). Even with a 20 per cent revaluation, the situation changes little, contributing only to a 0.05 per cent reduction in the current account deficit. Ms. Park argues that despite the PRC's significant trade surplus with the US, this is the case because imports from the PRC account for a relatively small share of total US imports, and exports to the PRC constitute an even smaller share of total US exports. On a broader front the Chinese authorities may well be concerned about the deflationary effects of revaluation along the lines suggested by Ron Mckinnon who has argued that exchange rate flexibility in China could lead to repetitive appreciations resulting in severe deflation throughout China's economy and a zero-interest liquidity trap—as in Japan, when forced into repeated appreciations of the yen in the 1980s into the mid 1990s. The Chinese have wisely defused the US criticism by linking Yuan to a currency basket with small band for variation in the value of Yuan. The appreciation of Yuan against the US dollar is likely to remain less than 10 per cent (as discussed above) for quite some time and it cannot be expected to have a significant impact on the current account deficits of the US.

Nor is EU ready to adopt reflationary measures in the near-term. In its recent announcement, the European Central Bank held its key interest rate steady at 2.0 per cent at its regular monthly policy-setting meeting here, refusing to bow to pressure to cut rates to inject life into the eurozone's stagnating economy. ECB fears that interest rate cuts would cause inflation.

Nor are the prospects of reducing fiscal deficits particularly bright. Again to quote Larry Summers: "There is much that one can argue about in the forecasts and the models, but I'm aware of no credible argument that without some form of discontinuity, the U.S. current account deficit will not increase from its current high level."

Perhaps in recognition of the weaknesses of the conventional remedies, World Bank's GDF report is projecting only a marginal fall in the US current account deficit over the medium-term: from 5.6 per cent in 2004 to 5.3 per cent in 2007. And that is not a reassuring prospect.

Need for a different approach

In this context there is clearly a need for some out-of-the-box thinking and one such line could be to bring in the Keynesian economics. Perhaps the focus should be shifted from demand-switching alone to demand augmentation. The point has been made forcefully by Larry Summers: "Notice that exchange rate manipulation and adjustments, even if they could be controlled or willed by policymakers, do not address the global demand-supply imbalance created by an increase in US saving. They serve simply to redistribute it from one country to another. For example, the scenario advocated by many, in which increased US global saving is associated with a depreciation in the dollar, may offset the adverse demand impact in the United States of increased saving by switching the demand for expenditure from foreign goods to American goods, but only at the cost of increasing the demand-supply imbalance abroad. A healthy global adjustment process requires a healthy US economy, which requires increased national saving, which in turn requires measures that replace the demand that is lost from increased national saving. Indeed, even with the assumption of constant US national savings, the global economy today appears to be suffering more from the deflationary pressures associated with too little demand than the inflationary pressures associated with too much demand."

It is worth remembering that it is this kind of Keynesian strategy that helped China to maintain growth in post-1997 period. Depreciations in exchange rates in Thailand, Korea, Indonesia and Japan during 1997/98 imposed strong deflationary pressure on China. Starting in March 1998, China took strong "Keynesian" measures to slow its internal deflation. Its 'New Deal' encompassed a huge expansion of government expenditure on infrastructure and on mass residential housing. Not only was fiscal deficit allowed to increase from 0.7 per cent of GDP in 1997 to 2.8 per cent in 2000 and 2.5 per cent in 2001 but there were heavy borrowing from China's state-owned banks in the form of what was called "policy loans". This was accompanied by expansionary monetary policy which included decline in China's interbank rates from 9 per cent in 1996 to 2.7 per cent by the end of 2002. The People's Bank of China also eased the austerity policy, which had been adopted in 1993, by pressuring the state banks to extend credit for the construction industry, exporters, home purchases, and infrastructure projects as well as to the struggling state-owned enterprises. Altogether the Keynesian package perhaps pumped in close to a trillion dollar stimulus in the Chinese economy during the period 1998-2002. It is this experience that is rich in lessons for Asia which needs to avoid the deflationary consequences of reducing more than $600 billion of current account deficit of the US.

Infrastructure investments in Asia can make a difference

This is where regional infrastructure investments in Asia could perhaps make a difference. It is estimated by UNESCAP that infrastructure investments needs in East Asia are alone about $200 billion per year of which only $50 billion are being financed. In addition there are large unmet infrastructure investment needs in South, Central and West Asia. These investments cover both regional and national investment needs. Among the national investment programs are those relating to roads, airports, seaports, telecommunications, metros, power generation and transmission. Among the regional investments are: investments in gas and oil pipelines and reserve facilities, development of power and power grid, broadband connectivity, regional highways, railways, shipping and airlines. Many of these investments (such as gas pipelines) seem to be viable on commercial terms and should be suitable for partnership with private investors. In global macro-economic terms, if the conventional measures on exchange rate adjustments, structural reforms in the Japan and EU and austerity in the US can be combined with measures to fill a significant part of the gap in infrastructures investments, it could be a step toward meeting the problem of "too little demand" mentioned by Larry Summers. If within a five year period, these additional investments could increase to $150 billion per year, they could through multiplier and accelerator effects contribute significantly to demand switching from the US to the Asia and to increase in global demand. They should help increase exports from developed economies of the US, Europe and Japan as well as from developing Asia and thus help in reducing global imbalances.

Where can funds come for such large investments? Fortunately, Asia is sitting on a mountain of foreign exchange reserves where the current and prospective rate of return is extremely small. And most of the Asian countries with large reserves are looking for investment opportunities better than hose provided by US Treasuries. A proper mechanism needs to be devised so that Asians can invest their surplus savings in the assets represented by regional investments. If such investment opportunities reduce the flow of funds into US treasuries, they would create a harder external budget constraint and will help the US reduce its excessive spending at a gradual and measured pace.

There are several specific proposals afloat for financing these infrastructure investments. For example, Kim Hak-Su Executive Secretary of UNESCAP has agued that "at this stage of transformation, Asia and the Pacific region requires an institution like the European Investment Bank (EIB) - an independent, government-owned Asian Investment Bank to promote regional capital markets." Such an Asian Investment bank (AIB) could provide infrastructure loans and collaborate with the banking community in both raising and investing resources. It could work with private sector by co-financing and guaranteeing private investment financing. Malaysia has proposed the setting up of an Asian Infrastructure Development Fund to finance projects in the region. In a similar vein, Datuk Seri Abdullah Ahmad Badawi, Prime Minister of Malaysia said that Asian countries could use "a fraction" of their massive foreign exchange reserves as capital for the fund, which would invest in basic economic infrastructure including super highways and super railways linking and binding the East Asian community. Even if only 50 per cent of the *incremental* surpluses in current account of Asia during the next five years are put in these assets rather than in US Treasuries, there would be ample funding for $150 billion per year investments in these regional projects.

These infrastructure investments to the tune of $150 billion per year would amount to more than 5 per cent of GDP of developing Asia and may well contribute 1 additional percentage point of growth in the region. In addition, by linking up the landlocked countries and other interior parts of the region which have been handicapped in getting the benefits of globalizations it may also increase the inclusiveness of growth in Asia.

Conclusions

The above analysis suggests that:

- On business as usual scenario there are serious risks to the global economy emanating from the current and prospective global imbalances. The conventional analysis framed in terms of structural adjustment mentality is quite inadequate to tackle the problem.
- A Keynesian approach focusing on global demand augmentation is necessary for correcting the global imbalances without a global deflation.
- National and regional infrastructure investments in Asia could provide such stimulus and the funding for such investments are available in Asia in itself.
- These investments could accelerate growth rate of developing Asia by at least one percentage point and make Asian growth more inclusive while helping to reduce the global imbalances.
- In view of these win-win opportunities presented by Asian regional co-operation programmes, they deserve full support of the international community (including that of the US and EU) which has not yet been forthcoming.

1 Lawrence H. Summers, Third Annual Stavros S. Niarchos Lecture, Institute for International Economics, Washington, DC March 23, 2004

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RIS
Research and Information System
for Developing Countries

Core IV-B, Fourth Floor
India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: dgoffice@ris.org.in
Website: http://www.ris.org.in
Website: http://www.newasiaforum.org