Asia's Slow Growth Traps

Clark Johnson

THE U.S. trade deficit currently runs at the unusually high level of 5 percent of GDP, and something like 80 percent of the net deficit has recently been funded not by private capital flows, but by foreign central bank purchases of dollars. U.S. net international indebtedness, which summed to less than 10 percent of GDP in 1998 or 1999, now exceeds 25 percent of GDP and continues to grow. In late 2004 and early 2005 it became commonplace to anticipate that the dollar would plunge and interest rates would rise. Such prestigious figures as Paul Volcker and Joseph Stiglitz have predicted that a dollar crisis is likely.

As this is written, that has not happened—the dollar has strengthened against the euro, the pound and several Asian currencies. After much American pressure, the Chinese have revalued the renminbi, but, at least initially, only by a minimal 2.1 percent. Long-term dollar interest rates remain higher than euro and yen rates, but they were boosted only slightly by the Chinese action and have continued to decline to their lowest levels in decades.

The trade balance is overrated as a driver of currency values; consequently, allowing currencies to float usually has little impact on trade deficits or surpluses. The market value of the dollar is driven also by all sorts of other factors, including supply and demand for its use as a national monetary reserve, as a short- and long-term store of value, as an investment vehicle, as circulating currency, and for facilitating trade between countries even where U.S.-produced goods are not in-

volved. By emphasizing specific national trade deficits or surpluses, we are led to propose the wrong solutions and may indeed aggravate contractionary pressure from elsewhere in the world economy—what I would term the slow-growth trap.

IN PART a consequence of the popularity of flexible exchange rates among economists, the post-World War II Bretton Woods regime of fixed exchange rates was allowed to break down in phases during the early 1970s. Yet, despite many economists' embrace of free-floating currencies, Europeans and Asians subsequently moved in the opposite direction and sought to stabilize exchange rates and re-establish currency blocs. The euro was introduced in 1999 but was preceded by European exchange rate mechanisms dating back to the 1970s. By 1980 Hong Kong, Korea, Malaysia, Singapore, Taiwan and Thailand had more or less fixed their currencies to the dollar, creating a regional dollar standard, until the "Asian crisis" of 1997 led some of them to devalue or float. The value of the Chinese renminbi hardly budged against the dollar from 1994 to 2005. Since the end of the 1997–99 crisis, a number of Asian governments and central banks have attempted to restore pre-crisis dollar pegging, this time using softer, changeable pegs. In the wake of the crisis, and facing opposition from the U.S. Treasury and the International Monetary Fund (IMF)—both of which embrace flexible exchange rates as doctrine—few would attempt a harder fix. Japan has joined the stabilizers in an effort to limit yen appreciation against the dollar.

Whatever floating-rate advocates may propose, there are a variety of reasons why developing countries often choose to peg their exchange rates, of which two stand out. First, most developing countries lack forward markets, which allow importers and exporters to hedge exchange exposure. A dollar peg provides a practical hedge, as it reduces the exchange risk in cross-border transactions. Second, many governments limit foreign exchange exposure by domestic banks, for good, prudential reasons, but doing so prevents banks from being active dealers to stabilize the exchange rate. In this circumstance, floating would likely lead to disruptive volatility.

Much of the recent discussion about U.S. trade deficits has focused on fiscal deficits and inadequate U.S. savings. But growing trade deficits and downward pressure on the dollar in part reflect contractionary pressure arising outside the United States. U.S. exports may be low because of weak demand for consumption and because of investment, and consequent oversaving, elsewhere. U.S. capital inflows may be high because other economies provide relatively few opportunities for direct or portfolio investment. We need to consider the systemic consequences—that is, the consequences for the world economy as a whole—of any measures intended to address deficits. It is in this context that allowing other currencies, including the yen, renminbi and euro, to drift upward becomes problematic. By reducing the cost of imported goods and materials, higher currency value puts relative downward pressure on domestic prices. Where systemic price inflation is modest, as has been the case for most of the past couple decades, downward price pressure in countries where currencies appreciate might generate actual deflation.

Concern that the dollar may continue to decline, or, in any event, be volatile, leads investors to expect higher interest rates on dollar assets than on assets of surplus-country currencies. Where dollar rates are themselves declining toward low single digits—that is, toward 4, 3 or 2 percent annualized—then interest levels in trade surplus countries fall to close to zero percent, too low to make lending profitable. An illiquid financial environ-

ment constrains investment in both export and home sectors and reinforces patterns of underspending and oversaving. Consequently, the U.S. trade deficit and overborrowing and oversupply of dollars are aggravated, which leads to further downward pressure on the U.S. currency.

The Case of Japan

THE NEARLY decade-and-a-half Japanese tailspin is usually assumed to have origins in some national economic malfunction—even by financial sector economists who should know better. In fact, the contractionary mechanism outlined above is most clearly at work in the case of Japan, which has in turn been a trigger for East Asian instability. The yen strengthened from 250 to the dollar in 1985 to 80 to the dollar in 1995 before weakening. Since 1985, Japan has experienced mild but persistent deflation of wholesale prices. The combination of price deflation and an often-rising yen forced interest rates down, usually to several percentage points below dollar rate levels. In a deflationary environment, firms do not want to borrow for expansion, nor do they want to owe money in a currency that has tended to gain external value. Bankers do not want to lend at interest rates too low to generate profits or to compensate for the risk of default. Investors prefer not to buy long-term bonds at very low interest rates; simple bond mathematics indicates that their principal values would collapse if interest rates were some day to rise.

But despite the sharp depreciation of the yen from 1995 to 1997, and its essentially trendless behavior since, yen interest rates typically remained 2 or 3 percent below dollar rate levels, which suggests that Japanese institutional investors now attach a large volatility premium to holding dollar-denominated paper. In the face of ongoing U.S. borrowing, dollar holdings in the portfolios of Japanese financial institutions have inevitably risen. Important empirical data indicate that the negative risk premium on yen interest rates has increased as foreign assets become a larger portion of total financial-sector balance sheets. Since liabilities are in yen—in the form of bank deposits and pension and insurance payout obligations—increased dollar holdings place at risk the solvency of many institutions and even of the financial system as a whole. Japanese borrowers are thus inclined to convert dollar holdings into yen, and, in environments of low international inflation, demand for yen keeps Japanese interest rates close to zero.

A first consequence of Japanese instability is that the floating yen has often been out of step with other currencies in East Asia, most of which have soft or hard pegs to the dollar. A decline in the exchange value of the yen during the sharp dollar recovery of 1995–97, for example, upset trade and investment patterns and helped trigger the regional financial crisis that began in 1997. It also forced several Asian countries either to devalue or to float downward against the dollar. The yen in the past was often forced upward, not for market-induced reasons, but because U.S. politicians were exerting pressure to pry open Japanese trade markets. During the past half-decade, Japanese authorities have made an effort to manage the yen so that it tracks the dollar somewhat more closely, so disruption from yen exchange rate movements has been less. Even so, the yen appreciated sharply during the fourth quarter of 2004, and concern about future appreciation and price deflation are embedded.

A second effect followed from the domestic deflation in Japan. Much of the trade advantage U.S. manufacturers would theoretically gain through yen appreciation has been offset by lower Japanese domestic prices. From 1950 through about 1977, Japanese wage levels increased far faster in nominal terms than

did wage levels in the United States—reflecting greater Japanese productivity growth. Deflationary pressure, induced by yen appreciation, then led to an abrupt reversal so that, since 1977, U.S. nominal wage growth has exceeded that in Japan in all but a few years. After decades of yen appreciation, Japan continues to run large bilateral trade surpluses with the United States, which are the flip side of ongoing capital outflow. The underlying dynamic for capital exports has gradually shifted from providing finance abroad for booming export-driven growth in Japan to (more recently) sending money abroad because of a lack of investment opportunities in Japan. But even this channel of adjustment is becoming blocked as many Japanese investors now prefer to hold yen assets; hence, a growing portion of dollars are instead bought and held by the Bank of Japan. Without the Bank of Japan's intervention, Japanese capital surpluses would be larger, and the logic of economic slowdown would again push the yen higher, and domestic prices lower, in a self-amplifying way.

A third effect of the instability has been Japanese reluctance to deregulate. In the face of rising exchange rates and shrinking demand, legislators and officials have not been willing to reduce the safety nets implicit in maintaining protected industries. Indeed, it is hard to identify important economic benefits gained by either Japan or the United States from decades of flexible exchange rates—exchange markets have driven fundamentals, rather than the other way around. The Japanese economy appears to have fallen again into recession during the fourth quarter of 2004, and the volume of bank lending has contracted every year since 1998.

The usual counter-cyclical remedies of monetary and fiscal pump-priming accomplish little as long as interest rates are stuck near zero. And against the background of financial contraction, little can be done to reduce the overhang of bad bank debt. As we recognize that the Japanese stagnation has external origins, and does not represent some peculiar, made-in-Japan policy failure, we are on the way to a systemic solution. Breaking the pattern of Japanese deflation will require breaking the expectation that the yen in the future will appreciate, fluctuate sharply, or both. Then, yen interest rates would rise to dollar rate levels, financial sector recovery could begin and the deflation trap would be sprung.

China as Stabilizer

WHILE THE Japanese economy has been a trigger of instability, the Chinese economy has helped to stabilize others in the region. Where other Asian economies have been whiplashed by yen appreciations and depreciations, most of their currencies have been pegged to the dollar and, hence, to the renminbi. By not depreciating its currency during the 1997–99 crisis, China avoided setting off a new round of competitive devaluations. More recently, a stable renminbi has been the anchor for a revived Asian dollar standard. Through a series of constitutional changes beginning in 1999, property rights have gathered much greater legal protection, and a more transparent regulatory framework has been adopted, which together have given a strong boost to private-sector-led growth. Some price controls have been lifted (although many remain), so resource allocation has become more market-driven than in the past. China is now expanding faster than the United States as a source of demand for every economy in the East Asia region.

Chinese reserves by mid-2005 exceeded $650 billion—only Japan's are higher—and grew by about $200 billion in 2004, $95 billion of it in the fourth quarter alone. Unlike the case in Japan recently, capital inflows into China have

boosted both asset prices and demand generally. They have funded lending pools to take advantage of high interest rates in the "informal sector." Inflows also reflect speculative demand for renminbi, in anticipation of its possible appreciation. Some of the new reserves are "sterilized", that is, prevented by deliberate central bank interventions from affecting the domestic money supply, aggregate demand and price level. Sterilization succeeded to the point that growth of base money actually slowed during 2004 relative to 2003, despite the extraordinary increase in the People's Bank of China's (PBC) foreign reserves.

The evidence of sterilization makes it likely that the renminbi at 8.28 or even 8.11 to the dollar is somewhat undervalued. However, it is normal practice for central banks to sterilize what they perceive as speculation-driven inflows. The Chinese current account surplus typically runs in the range of 1 to 2 percent of GDP and moved to over 3 percent during 2003 and 2004, which may suggest that domestic cost structures are somewhat low. On the other hand, most countries now run trade and current account surpluses—the inverse of huge U.S. deficits. China may produce more than it consumes because domestic savings are high; indeed, the savings habits of Chinese peasants are legendary. Alternately, savings (and the trade surplus) may be high because of a cyclical slowing of the Chinese economy—that is, the trade surplus may have little to do with the exchange rate. With inconvertibility and quantitative restrictions on capital inflows, the usual market signals are muddled.

In any event, Chinese costs may adjust through internal price inflation as well as through external appreciation of the currency. This is not hypothetical—from 1994 to 2003, money wages in manufacturing in China grew by about 13 percent annually and by only about 3 percent annually in the United States. A Morgan Stanley report calculates that domestic price changes led the renminbi to rise in real terms by 40–50 percent against both the dollar and the euro from 1993 to 2004, despite fixed nominal exchange rates. Assuming stable exchange rates, domestic prices would again increase relative to prices in the United States if the PBC sterilized less.

Notwithstanding assertions to the contrary, there is little evidence that the Chinese economy is overheated, or that it needs a chill from a rising exchange rate. While the consumer price index (CPI) increased by over 4 percent during 2004, the highest increase since 1997, the price increase for non-tradable goods was only about 2 percent. The non-food, non-energy CPI rose by less than 1 percent, after three consecutive years of decline. Labor costs have grown more slowly than sales or overall GDP. Financial sector observers now forecast that Chinese growth will slow greatly during 2006 and 2007. Stock market performance has been subdued. During 2004 and the first few months of 2005, however, higher imported commodity prices put a further squeeze on manufacturing profits.

While foreign manufacturers complain that the renminbi is too low relative to the dollar, the problem in part may be that the euro is too high relative to both the dollar and to the renminbi and that the Japanese economy is too depressed to absorb imports. Were the euro lower, Europe might export more goods and services to China, and were it also to absorb more capital inflow, it would become a larger market for imports. Were the Japanese economy more buoyant, it might absorb more imports from China, Europe and the United States, thus reducing its trade surplus and its absorption of dollars.

There is little prospect that exchange rate adjustment can generate the kind of financial shifts that would end the threat of systemic disruption; indeed, a lower

dollar might attract capital investment to the United States, which would increase U.S. indebtedness and possibly increase the trade deficit. Similarly, a rise in dollar interest rates might draw more capital to the United States, which would be offset by more imports of goods and services and would probably lead the dollar to appreciate.

The pressure on the Chinese to float their currency against the dollar seems especially misdirected. Beyond the case of Japan (above), Taiwan, Singapore and even Korea now have very low interest rates, reflecting fear of appreciation and the stagnation of financial-sector intermediation. China's dollar-linked exchange rate anchor has constrained such appreciation for much of the region, but during the last few months of 2004 several Asian countries allowed their currencies to float upward against the dollar. Were the renminbi to spiral upward, the pattern of soft-dollar pegging in East Asia would be jeopardized, and China could itself experience deflationary pressure. Reports suggest that Chinese officials are themselves concerned that ongoing anticipation of a higher renminbi could set up a Japan-style deflationary trap. Further, were China to float its currency and move it toward convertibility—floating requires market-makers and, hence, the right to freely buy and sell the currency—then its commitment to purchasing the dollar at specific levels would be lessened. The United States would find it harder to borrow from Asian countries in order to finance purchases of Asian exports. Contractionary pressure would then have spread to parts of the world that had previously avoided it.

By early summer 2005, as it appeared that China would reject pressure to appreciate its currency more than minimally, the Korean won, Thai baht, Indian rupee and Singapore dollar fell back, closer to their earlier soft-peg levels against the dollar. This is striking evidence of the stabilizing role of a steady Chinese currency in Asian trade and investment. When the Chinese proceeded to revalue slightly, early indicators were that other Asian economies would buy dollars or take other action to prevent their currencies from rising any more than the renminbi had.

As opposed to floating the renminbi, there is a good argument for a one-time revaluation—which could more easily be combined with ongoing PBC purchases of U.S. treasury securities. Because the renminbi has been fixed to the dollar, higher imported oil and commodity prices have led to a profit squeeze on manufacturing for the Chinese domestic market. Far from cooling an "overheated" Chinese economy, a revaluation could actually increase enterprise profits! Also, a one-off revaluation might be coordinated with other Asian governments to ensure that they maintained approximately stable exchange rates among themselves. But we should understand any revaluation as a paradoxical, "second-best" solution—because it might otherwise reinforce the mistaken premise that the dollar should be encouraged to drift lower. In fact, the opposite is the case: Had the dollar not depreciated since 2002, the recent upward pressure on world commodity prices would be less.

Another frequent suggestion is that the United States should reduce its international borrowing by reducing its fiscal deficit. Certainly, an improved U.S. fiscal position should be part of any pro-growth package, but taken in isolation it might bring disappointing results. If the United States reduces spending but the rest of the world does not see an offsetting increase, then growth of the world economy will slow. Fewer U.S. imports would mean less demand for producers in European and Asian economies. It is not even clear that a smaller U.S. fiscal deficit would strengthen the dollar; indeed, less borrowing by the U.S. Treasury might

lower U.S. interest rates, which would reduce capital inflow to the United States. And it might do little to allay concerns that currency volatility would continue.

TO SPRING the slow-growth trap, we need a systemic remedy. The key is not to make debtor countries (like the United States) contract, but to enable creditor countries to expand. A less volatile, growth-oriented world framework must begin with exchange rate coordination. Even better would be an effort to hammer out a long-term agreement among U.S., European, Japanese and Chinese central bankers and treasury or finance ministry officials about appropriate exchange rate levels, combined with understandings about trade, capital movements and financial sector regulation. If market participants believed dollar-yen and dollar-euro relationships would stabilize, then inflation expectations in different countries would settle at similar levels, and interest rate differentials would vanish.

Fixed exchange rate systems broke down during the 1920s and the 1960s because central bank reserves were inadequate and national macroeconomic policies were not coordinated, not because they could not have worked. The current floating-rate framework has aggravated slow-growth tendencies in Japan and in the euro bloc and could do the same in China and other parts of Asia. In an integrated world economy, there is no good alternative to monetary coordination, not if we wish to optimize welfare.

The stakes are high. Indications suggest that the United States and IMF prefer to address financial imbalances by encouraging exchange rate adjustments that will have the effect of inducing or extending the slow-growth trap in major countries. Most likely, the outcome would fall short of the deflationary depression of the early 1930s or the stagflation of the 1970s, and the situation might not be perceived as a crisis, especially not to American voters. But it would bring large-scale economic underperformance and represent serious policy failure.

There are grounds for skepticism about how much the Bush Administration might accomplish or wish to accomplish. First is the administration's obvious lack of interest in negotiations with allies and international organizations over a wide range of issues. Second is the respect still accorded to flexible exchange rate mechanisms as reflecting economic principle. Third is the tendency of those in the American "heartland", well represented in the Bush Administration, to embrace "soft" money, which, in an international context, means a willingness to let the dollar sink. This tendency has deep historical roots, as many heartland farms and businesses were often in debt to creditors in East Coast cities. But the benefits from a different approach to managing international money should be clear. □

Clark Johnson is the author of *Gold, France, and the Great Depression, 1919–1932* (1997).