EXECUTIVE SUMMARY

The studies in this volume address the major causes of the build-up of current account surpluses in the East Asian region, commonly referred to as the problem of "global imbalances". We note that the external surpluses are matched by domestic imbalances of savings and investment. There are broadly two types of policies available to the countries on the surplus side of the global imbalances – changes to the domestic economy to give different savings-investment outcomes and changes to relative prices between home-produced and foreign-produced good. Adjustment cannot and should not, however, come only from one side of the imbalance equation. We do not explicitly address the policies that might help the deficit side but look at the policies that would benefit both the Asian surplus economies themselves and help address global imbalances.

The studies in the volume look carefully at the behaviour of savings and investment during recent episodes of crisis and at the behaviour of China. Drawing on both macroeconomic and microeconomic data they make clear that the investment side of the equation is where the greatest attention is needed. Listed companies do not behave in ways that are very different from other international firms but some are finance constrained. Policy settings are not excessively favourable towards foreign or trade-engaged firms but they do currently seem to favour "outward orientation" (e.g. giving greater support to firms that have external activities as well as domestic).

There is evidence that governments resist exchange rate change for a number of reasons, not only to promote exports and these underlying motivations will need to be addressed before policies will change. There is much evidence that opening financial markets and more closely cooperating in financial activities in the region can bring benefits but the fears about increased instability have some basis and need to be addressed. Specifically the study recommends:

- Investment is the key: We recommend the main policy focus should be on improving the investment climate. Reducing savings could be counter-productive as it could bring rising interest rates globally. More investment, directed to the right industries and activities, will be growth enhancing as well as helping imbalances. Savings adjustment will come with higher household income growth, improved social safety nets and better access to more developed financial markets (including consumer financial markets) but specific policy actions are less valuable here than in investment.

- Further research on specific policies and legal environments that support investment will be valuable and ERIA could play a role in collecting better survey data on the business environment and investment climate to extend the World Bank Doing Business data.
- Exchange rate realignments play only a supporting, not the main, role. Even in China the effect of revaluation is tempered by the possible cost-reducing impact on imported components if revaluation changes relative exchange rates in the region. The exchange rate effect therefore needs to be coordinated with others in the region. They, in turn, will resist relative revaluations of their own currencies against China, so a coordinated approach is the only option. This is unlikely unless the other reasons that governments manage exchange rates and accumulate reserves are addressed.
- Improving access to the potential risk-reducing functions of the international financial system will enhance welfare and remove impediments to adopting better policies. Greater integration with external financial markets can improve welfare by reducing consumption volatility and by reducing the need to accumulate foreign exchange reserves. Working with well-chosen partners to develop safe and well-sequenced financial opening measures will achieve the largest gains. These arrangements could subsequently be extended to other partners in the region. There is less to be gained by trying to forge region-wide financial agreements from the outset if these are politically and administratively difficult.
- The region is vulnerable to external shocks but the sources are specific and can be managed if well understood. The main source of business cycle fluctuations is still the US; despite the growth of China its business cycles play a much smaller role.

- Global financial shocks are transmitted to the region by cross-border banking flows but foreign-owned banks operating on the ground within the region, and particularly other Asian-owned ones, have been a stabilising influence. Thus, opening banking markets and removing behind-the-border barriers to market entry can be helpful. These measures should be accompanied by the implementation of international standard bank regulations, which can in fact improve bank performance, and by careful management of the use of external, wholesale funding by banks. Establishing cross-border collateral arrangements and imposing a systemic-risk charge on ‘systematically important’ cross-border institutions would also help reduce volatility.
- Policies that attempt to limit or promote particular types of cross-border capital flows need to take account of the possible knock-on effects on other types of flows. These flows are not independent of each other.