

Currency Appreciation and Current Account Adjustment

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Summary

A central aspect of the recent debate on global imbalances and the US current account deficit is the role of the exchange rate peg being followed by China and other Asian economies. Does the peg prevent or delay the resolution of current account deficits? Would an appreciation of Asian currencies help to resolve the situation? While one view has stressed the need for Asian currency appreciation, another focuses on the importance of fiscal adjustment and more generally adjustment in relative savings rates in the US and Asian economies. This paper develops a simple two-region open economy macroeconomic model to analyze the alternative impacts of currency appreciation and fiscal adjustment on the current account. We note first that currency appreciation in and of itself can at best offer a short term remedy to a situation where there exists persistent current account imbalances. Moreover, we stress a number of structural features of emerging Asian economies that may make currency appreciation, even in the short-run, an ineffective means of current account adjustment relative to fiscal policy changes. In addition, we note that there may be a welfare conflict between regions on the best way to achieve adjustment.