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## 18-02-2005: Foreign reserves, Asia's problem of plenty

By Vidya Ranganathan

With high domestic borrowings and a US\$150 billion (RM570 billion) wish list for roads, railways and power projects, India's government is considering the prospects of spending some of the central bank's mountain of foreign reserves.

But the central bank is loath to let the government grab some of the US\$129 billion invested in assets overseas, reflecting a similar debate in Thailand in which central banks are defending their independence and protecting their countries' emergency reserves from compromise.

The central banks have the support of the International Monetary Fund, but some economists suggest spending the reserves on domestic projects, rather than leaving them parked idly in US debt, euros or yen, may not be a bad idea after all.

"There is a case around the region for those excess reserves to be more actively used to improve the living standards of the people," said Huw McKay, a regional economist with Westpac Bank in Sydney.

Whether the Indian government gets its hands on a proposed US\$15 billion of reserves over three years may be known at the end of the month, when the country announces its annual budget.

"For a country like India, which is very backward in terms of infrastructure, that capital could be very well used elsewhere, and perhaps targeting the exchange rate is probably not the best way to use that capital," McKay said.

Asia's reserves, including Japan, exceeded US\$2.4 trillion in January, the highest for any region in the world and a sum even the IMF reckons exceeds the optimum reserves each country needs to defend its currency in an international financial crisis.

The dilemma facing many of emerging Asia's economies over how best to use their massive stock of dollar reserves is hardly new.

China used about US\$45 billion of its reserves to recapitalise its banks in 2003. Taiwan wants to use its foreign reserves to help companies buy machinery overseas.

A Korea Investment Corporation is being set up to better manage a small portion of South Korea's pile of US\$200 billion.

Surveys show India, Indonesia and Thailand are ranked among the lowest in the region on the quality of their infrastructure, with a high cost of capital and legal uncertainties keeping the private sector from picking up the slack in investment.

Indonesia has said it needs to invest about US\$145 billion over five years in infrastructure.

Analysts at Merrill Lynch estimate Japan, China, India, Korea, Taiwan and Hong Kong may hold between them almost a trillion dollars of excess reserves.

About 70% of global reserves are invested in dollars, and markets suspect that incremental reserves are being diverted to euro assets after the dollar's decline in the past three years.

The tussle between central banks and politicians brings into focus the key question of who owns the reserves.

"Official reserves do not belong to governments, they belong to central banks," said Jonathan Anderson, regional economist at UBS.

But, "Asian cenbanks are not completely independent. The government is the ultimate owner of the central bank.

"But it is difficult for them to simply decide one day to take a lot of money out," Anderson said.

More importantly, when governments use reserves, they get to spend money that the central bank will effectively print for them, without having to borrow from markets. In other words, they monetise the deficit.

Under India's fiscal responsibility law, the government is committed to trimming the country's huge fiscal deficit each year, but it could get around that constraint by using the reserves. The federal and state deficit is running at 10 percent of gross domestic product.

Still, using reserves domestically is easier said than done.

Central banks accumulate reserves when they keep currencies from rising, so converting them back into local currency would not only put fresh upward pressure on the currency but could also stoke inflation.

The alternative -- spending the reserves abroad by using them to pay for infrastructure imports -- is not entirely painless.

Ramkishan Rajan, a professor at Singapore's Lee Kuan Yew School of Public Policy, said it would be unfair and expensive to be importing infrastructure that could be produced locally.

"If you are going to import a lot of your infrastructural needs, why don't you allow the currency to appreciate, which then allows you to import at a lower cost," said Rajan.

"What you are doing is subsidising one group of people, the manufacturers, and other agents including the fiscal authority, central bank and the economy are bearing the cost of holding reserves and an undervalued currency.

"So it seems overly complicated." - Reuters

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