

The dilemma of Asia's massive forex reserves

They are a costly form of security and more efficient uses must be found for them

By RAMKISHEN S RAJAN

IN just over six years, global international reserve holdings rose markedly from US\$1.5 trillion in 1996 to US\$2.3 trillion by mid-2003. The bulk of the reserves growth has been concentrated in Asia, much of which is invested in relatively low-yielding liquid US assets such as Treasury bills.

Part of the reserve buildup is no doubt a result of the de facto mercantilist policies pursued by some Asian countries. It would, however, be a mistake to assume that this has been the sole, or even main, reason for Asia's rapid reserve accumulation. Why?

Firstly, a country like India which has generally not been known for pursuing aggressively mercantilist exchange rate policies (compared to its East Asian neighbours), has seen an exceptionally brisk growth in reserves. India's reserves grew from about US\$30 billion in 1997-98 to US\$75 billion by 2002 (a further US\$10-15 billion rise in the first three quarters of 2003 appears to be largely due to US dollar weakness).

Secondly, the rapid reserve buildup in Asia began in earnest in 1998, when the US dollar was at its peak, many East Asian currencies had depreciated sharply (a result of the 1997-98 crisis), and there were consequently few fears of loss of export competitiveness.

Thirdly, notwithstanding some obvious exceptions, there has been a generalised move to a relatively greater degree of exchange rate flexibility in Asia. Other things being equal, one would expect that this reduced exchange rate rigidity would imply a concomitant moderation in reserve levels as payments imbalances ought to self-adjust with movements in the exchange rate.

This is the key point. The rapid reversals in capital flows and the ensuing crisis of 1997-98 appear to have led to a paradigm shift in the way many Asian policymakers perceive capital account openness and the risks associated with them. There is a general belief, partly substantiated by facts, that countries with larger reserve holdings have, by and large, been better able to shield themselves from contagious spillovers than those with smaller reserves.

In other words, reserves are viewed as a means of managing financial insecurity and as safeguards against unanticipated exogenous shocks. Seen in this light, Asia's stockpiling of reserves might be an objective in and of itself rather than merely a residual outcome of exchange rate or monetary policy.

While countries hold reserves to support a milieu of objectives, are there operational criteria by which one can judge reserve adequacy? Traditionally, the import cover ratio

has been highly popular. A rule-of-thumb emerged that reserves were insufficient unless they covered at least three to four months' worth of imports.

While the import-based criterion has been used for decades, the capital account nature of recent crises has made apparent the limitations of this benchmark of reserve adequacy. In the aftermath of the East Asian crisis, the extent of short-term external indebtedness has been found to be a key indicator of illiquidity and a robust predictor of financial crises.

While the idea of using the reserves to short-term debt ratio is not new, it has recently been popularised by former Argentine deputy minister of finance Pablo Guidotti, who proposed that countries should manage their external assets and liabilities in such a way as to be capable of living without foreign borrowing for up to one year. This implies that, at a minimum, usable foreign exchange reserves should exceed scheduled external amortisation for at least one year.

Further adjustments to this could be made on the basis of the degree of exchange rate flexibility, size of current account balance and type of capital inflows. US Federal Reserve chairman Alan Greenspan has proposed further modifications, including having a liquidity-at-risk standard to stress test a country's external financial liability position over a range of possible outcomes.

While the above capital account reserve yardsticks give an indication of the vulnerability to an external drain, they fail to capture the threat of an internal drain associated with capital flight by residents. Internal drain may be best captured by measures of broad money supply (M2). A low and declining reserves-to-M2 ratio, which captures the extent to which liabilities of the banking system are backed by international reserves, has consistently shown up as one of the leading indicators of a currency crisis.

While these financial-based reserve ratios are significant improvements over the trade-based ratios, they do not reflect the dynamics of currency crises.

Once investors lose confidence in a currency and the government is unable to restore it, reserves will tend to rapidly dissipate in the face of rapid capital outflows. Taken at face value, this leads to the conclusion that countries need to continuously pile on reserve holdings, as a prolonged decline or even stagnation might be viewed as a sign of weakness by markets.

Could this explain the current actions by Asian central banks? Quite possibly. However this policy has significant costs, as the country is effectively swapping high yielding domestic assets (or forsaking the use of these reserves for domestic development projects) for lower yielding foreign ones (US T-bills and bonds). Highly conservative estimates put this cost at anywhere between 0.5 and 2 per cent of GDP annually.

Unceasing reserve accumulation by the Asian economies implies that, at the margin, the benefits of extra reserves are perceived as exceeding the costs.

The regional governments may be willing to incur this insurance premium to reduce the chances of future crises and to retain the option of a slower speed of adjustment should the balance of payments weaken and external assistance be found wanting (as many Asian countries strongly felt to be the case in 1997-98).

In order to maximise the effectiveness of holding reserves it is important to keep in mind that the management of reserves cannot be seen in isolation. It must be seen as part of a package of macroeconomic policies, including exchange rate regimes, financial sector soundness, surveillance and debt management. In order to minimise the net costs, countries could always attempt to improve the risk-return performance of their respective reserve portfolios.

In this regard, the gradual rebalancing of reserve holdings from US dollar denominated assets to euros and higher yielding regional currencies is an important dynamic that could have significant and long-lasting impacts on the US economy, global macroeconomic imbalances and financial markets.

Beyond efficient management of reserves, is there any way in which the liquidity yield from holding reserves might be generated without the need for individual countries to continue to accumulate them at such a large scale and pace so as to reduce the insurance cost?

One possibility is for regional economies to benefit from scale economies by pooling some part of their reserves.

An obvious starting point in this regard would be to reinforce and augment the existing regional swap arrangement (Chiang Mai Initiative) as well as extend it to a broader set of countries in the region with high reserve levels. Intensive discussions are ongoing in policy circles in Asia on various possibilities along these lines.

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