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Asia has embarrassing mountain of reserves

Prudence makes nations amass reserves but often other purposes quickly take precedence

By RAMKISHEN S RAJAN

ASIA'S appetite for foreign exchange reserves seems to be unrelenting. The region's international reserves (excluding gold) rose from US$400 billion at the end of 1990 to US$2,600 billion by the end of 2004. Asia's share of global reserves correspondingly rose from about 40 per cent in 1990 to 65 per cent by 2004. While the region's reserves swelled further in the first few months of 2005, it did so at slower rates for two reasons.

One, the Bank of Japan (BOJ) took a conscious decision to abstain from intervening in the foreign exchange market since March 2004.

Two, there has been a valuation effect, as the US dollar has recently rallied against all major currencies, including the euro, thus reducing the US dollar value of that portion of Asian reserves held in non-US dollars (estimated at about 35 per cent).

The initial motivation behind the rapid stockpiling of Asian reserves was understandable - following the crisis of 1997-98 there was a belief that reserves were needed for precautionary or insurance motives. These motives encompass both crisis management and crisis prevention objectives. The former refers to the role of reserves in reducing the extent of exchange rate (and output) adjustment if a crisis does happen. This in turn could refer either to the ability to finance underlying payments imbalances, or to provide liquidity in the face of negative external shocks.

Crisis prevention refers broadly to a reduction in the incidence of a crisis. The argument here is simply that, other things being equal, high reserves may be viewed as a sign of strength or increased creditworthiness of an economy, thus reducing the chances of a run against the currency. Indeed, many studies have confirmed that low reserves to short-term debt or money supply ratios have consistently stood out as being quite robust predictors of a crisis.

How much is enough

However, the prudence rationale for amassing a war chest of reserves begets the question of how much is enough. Apart from potentially inflationary consequences of reserve buildup (or carry costs of sterilised intervention), there is a significant opportunity cost of holding reserves.

In particular, why is a developing country with relatively large domestic capital requirements (and therefore high marginal returns on domestic assets) investing its resources in low yielding assets such as US Treasury securities? One would expect that a central bank looking to balance the costs and benefits of holding reserves would desist from accumulating reserves at a point at which the costs at the margin exceed the benefits.

So does the fact that Asia is still accumulating reserves suggest that this point has not yet been attained? Not necessarily. If a country with a balance of payments surplus stops accumulating reserves, by definition it is allowing its currency to appreciate.

Apart from prudence, reserves could also be amassed as a side effect of an exchange rate policy.

Asia has attempted to maintain somewhat undervalued exchange rates with varying degrees of flexibility as an integral part of an export-led growth strategy (mercantilism). In particular, Asian central banks have intervened in the foreign exchange market to sell their currencies - and, in return, have accumulated international reserves - in an attempt to minimise the appreciation of their currencies against the US dollar.

It is extremely difficult to decipher the precautionary motives from the exchange rate and trade objectives. However, a good clue that many Asian central banks have satisfied their precautionary demand for reserves despite reserves being accumulated unabated, is offered from recent actions and policy statements.

Specifically, if the aim is to hold reserves for insurance purposes, the primary focus ought to be on ensuring that the reserves are invested in highly liquid and risk-free assets so they can be utilised immediately in the event of a crisis. However, it has become commonplace to hear Asian policy makers talk about channelling some part of their reserves to alternative higher yielding but non-liquid uses.

China was among the first country to find non-liquid uses for its reserves when it transferred US$45 million to recapitalise two of its state banks, the Bank of China and the China Construction Bank. Given the magnitude of non-performing loans (NPLs) in China's banking system, there have been indications that the Chinese may inject more of their reserves to recapitalise other state banks.

China's Director of State Administration of Foreign Exchange (Safe), Guo Shuqing, also suggested last year that the country might also use some of its huge foreign exchange reserves to finance the purchase of oil imports for a strategic reserve the country is planning.

Similarly, Korea has discussed the possibility of using some part of its reserves to help build up financial infrastructure to turn Seoul into an international financial centre. More recently, some Asian countries including India and Thailand have been actively exploring the possibility of earmarking some of their reserves for financing physical infrastructural projects. In fact, in the country's 2005-2006 Budget, the Indian Finance Minister, P Chidambaram, announced the creation of a special purpose vehicle (SPV) to channel some of its reserves to infrastructural spending on 'financially viable' projects (areas specified are roads, ports, airports and tourism).

These non-liquid uses of reserves have an important bearing on exchange rate choices and strategies. The argument some make is that Asian countries might be concerned about appreciating their currencies, not because they want to consciously increase reserves, but because of concerns about the capital losses they will suffer on their US dollar reserves in local currency terms. This is a flawed argument.

If the focus is purely on the precautionary demand for reserves, what matters is the US dollar value of reserves (the major intervention currency). Thus, capital gains or losses due to exchange rate changes ought not to be a significant issue (that is, so-called paper losses without any discernible economic consequences).

Objectives

However, if the intention is to use some of the reserves for domestic needs (bank recapitalisation or for local public works), any fall in the value of the reserve currency (that is the US dollar) relative to the domestic currency can cause significant capital losses, as the domestic purchasing power of reserves will be eroded. This is one of the many conundrums over revaluation that is currently being faced by a number of Asian countries, including China.

In other words, even if central banks are willing to eschew their mercantilist objectives, they may still be reluctant to allow their currencies to appreciate 'too sharply' because of concerns about capital losses, especially if a portion of the reserves has been earmarked for other objectives (that is, concerns about 'asset dollarisation').

Given these diverse and, in some cases, conflicting objectives, some countries seem to be eager to switch out of US dollar denominated assets in search of higher yields so as to minimise the capital losses. This strategy seems to be the one favoured by Russia and some oil-rich Middle East countries that may be shifting more of their oil revenue windfalls into euros given their fairly large trading links with Europe.

If this becomes a generalised move against the US dollar, one would expect to see a considerable decline in the share of central bank holdings in US denominated assets. This has not yet happened. Why? Part of the reason is that many Asian countries that have much stronger trading relations with the US or conduct a large part of their international transactions (trade, investments, foreign exchange intervention, and so on) in US dollars have thus far been quite circumspect about switching away from US-dollar denominated assets.

They are also fully cognizant of the fact that any such portfolio adjustments by even one of the regional economies with large reserve holdings (Japan, China, Taiwan, Korea, India, Hong Kong and Singapore - all of which hold over US$100 billion of reserves individually) could precipitate a free fall in the value of the US dollar and push US interest rates upwards, with potential negative real sector repercussions in the US and globally.

In view of this, while some countries have intermittently publicly suggested that they may be ready to diversify their assets on a large-scale basis, no Asian country has yet broken ranks from the implicit dollar-financing cartel. This said, some of the Asian countries have been channelling a greater share of their reserves into potentially higher-yielding US-denominated assets such as US equities and corporate bonds, while simultaneously moving a somewhat greater share of new reserve assets into non US-dollar assets (that is, diversification at the margin).

The enduring concern is that at some stage, one or more Asian central banks with large reserve holdings may blink and decide to diversify existing reserve stocks from US-dollar denominated assets. If this happens, it will add to the structural pressures on the US dollar as well as compromise the ability of the US to finance its yawning current account gap. In the absence of any signs of global macroeconomic coordination, all one can do is hope that the adjustments required to return the global economy to some sort of balance takes place in a smooth and calibrated manner.

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