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## Getting out of US dollars

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LAST week at the World Economic Forum in Davos (Switzerland), Prime Minister Datuk Seri Abdullah Ahmad Badawi made a remark about Malaysia's foreign exchange reserves that picqued my interest.

He stated that Malaysia has shifted some of its foreign-exchange reserves away from the US dollar. He told Bloomberg news wire: "We're concerned for the reason that the high percentage of our international trade is in US dollars."

For all intents, many see that statement prefacing a precautionary move, or as some would call it, 'buying insurance', rather than a reflection of the country's official stand on the future direction of the US dollar.

Like all other Asian countries at present, Malaysia is playing it safe by moving away from having a high concentration of US dollars in the composition of its foreign-exchange reserves. A safeguard against Malaysia being caught with its pants down when the US dollar is devalued. When that happens, Malaysia's foreign-exchange reserves, which stood at \$82.665 billion as at Jan 15, 2007, will lose substantially in value, and that can be quite disastrous. It may even be considered a case of a threat to the economic security of the country.

The composition of Malaysia's foreign-exchange reserves, like all other countries, is confidential, though many see Malaysia's composition to be very much patterned along the lines of the country's ranking of major trading partners.

Some believe that of late, the composition has included China's currency, the yuan, given its growing importance and a major trading partner of Malaysia.

In the last 10 years since the 1997-98 financial crisis, almost every Asian country has been taking a simple, basic precaution so as not to get caught by another sudden attack on its own currency: The creed is: Build up as large a foreign exchange reserve as possible, while the economy is speeding ahead.

Today, the results are staggering. Latest figures show that Asian economies have accumulated a massive total of more than \$3.1 trillion (RM11 trillion) in foreign-exchange reserves — more than 60 per cent of the world's grand total.

Much of these foreign-exchange reserves was built over the last three years. Economists are now saying that if the pace continues unabated, the foreign-exchange reserves of Asian countries in total will hit 75 per cent of the world's total — all within the next five years.

China alone has accumulated \$1.0663 trillion (RM3.8 trillion) in foreign-exchange reserves as at the end of 2006. According to Zhu Min, group executive vice-president at the Bank of China, China's foreign-exchange reserves will rise by a further \$200 billion (RM700 billion) this year.

Last year alone, Thailand, Indonesia and the Philippines together saw their foreign-exchange reserves rise by more than 20 per cent. South Korea's foreign-exchange reserves, which have been increasing for nine consecutive years, doubled between 2001 and 2004.

And Malaysia's foreign-exchange reserves of about \$82.7 billion now, are no exception, either. Compared to its foreign-exchange reserves of \$30.859 billion as of Dec 31, 1999, Malaysia has accumulated quite a fair bit with the latest figures, though by international or even Asian standards, that is no more than 'a drop in the ocean'.

And as the Singapore Business Times newspaper said in an editorial last week, that would be 'unlikely to cause US Federal Reserve Board chairman Ben Bernanke any sleepless nights'. But as the newspaper opined, 'the Fed chief might want to take some notice as Abdullah's comment is a sign of the times'.

While Malaysia's accumulation of its foreign-exchange reserves will continue unabated, so will all

other Asian countries, which will see an even higher pile of foreign-exchange reserves in the immediate years to come, as the desire to accumulate gets even more feverish.

Some have likened this to an 'arms race', but one that has nothing to do with weapons, only 'stockpiling foreign-exchange reserves'.

Indeed, Asia's foreign-exchange reserves have been piled up so high that many are now calling it 'a mountain of embarrassing riches'. It is something Asian central bankers are reluctant, or rather shy, to talk about.

Asian countries are using their huge pile of foreign-exchange reserves more as a cushion against any potential damage that massive capital flows may cause to their respective currencies and economies.

As Bank Indonesia governor Burhanuddin Abdullah rightly said at a Tokyo symposium two weeks ago to mark the 10th anniversary of the regional financial crisis: "In the aftermath of the Asian crisis, countries in the region are more conscious in protecting their national interests and strengthening their sense of security amid greater global uncertainties."

As early as 2005, Ramkishan Rajan, a visiting associate professor specialising in international economics at the Lee Kuan Yew School of Public Policy at the National University of Singapore, explained in the Singapore Business Times that the precautionary approach encompassed both crisis management and crisis prevention objectives.

He said: "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.

"The latter 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."

He added that many studies had confirmed that low foreign-exchange reserves "have consistently stood out as being quite robust predictors of a crisis."

In 1997-98, central bankers of most Asian countries then thought that they would be able to handle the massive inflows and outflows of capital. After all, their economies were speeding ahead strongly.

Furthermore, most economies adopting greater financial liberalisation of relaxed foreign-exchange rules under World Trade Organisation globalisation, most thought the financial landscape would have been one of serenity. Unfortunately, that was not the case.

For when a sudden attack from currency speculators came, some of the financial systems were shaken to the core, and their respective currencies plunged into the uncharted, frightening abyss.

In retrospect, they found that, in their zeal for greater and faster economic growth which brought about higher levels of prosperity, they forgot about their weak foreign-exchange reserves positions, and mounting external borrowings, including sovereign loans.

Their economies were getting more open, allowing free flow of massive amounts of capital, including what was known as 'hot money' — meaning, essentially money for portfolio investments that can be moved very quickly in and out of a country.

Today, exactly 10 years down the road, central bankers are still jittery about capital flows, and the effects on their financial system.

This time the situation is different — The main difference is that most of the currencies of Asian countries are under tremendous pressures to appreciate — that is, going in the opposite direction compared to the days of the 1997-98 financial crisis.

The impact and consequences of a rising value of a currency are invariably different from those of a depreciating currency. To Asian monetary authorities, this reversed trend is a new problem to grapple with; and the apprehension is in how to handle the challenge 'correctly'.

Understandably, the statements made by central bankers at the Tokyo symposium reflected this fear clearly, and gravely.

They felt it was 'the biggest challenge' they ever faced, not only because of the lack of adequate, and appropriate, preventive measures but also not knowing the full impact it would have on their respective currency and economic policies.

Bank of Japan governor Toshihiko Fukui summed it very succinctly: "It is, and will surely be, the most difficult task for any monetary authorities to maintain the stability of foreign exchange rates, the free flow of capital and the independence of monetary policy simultaneously."

Bank of Thailand governor Tarisa Watanagase was even more direct when she said: "Rapid movements of capital flows have caused exchange rates to be vastly out of line with the underlying economic fundamentals, and have negative impacts on the export or the import sectors."

But no Asian central bank governor has better experience than Watanagase, who saw turmoil in the Thai foreign exchange markets re-surface in December last year — a sudden surge in capital inflows, causing a one-way 16 per cent jump in the value of the baht relative to regional currencies.

The Bank of Thailand took immediate measures, imposing capital controls to restrain the baht's — Asia's best-performing currency in 2006 rapid rise. But the authorities made an abrupt partial reversal of their decision after the move alarmed foreign investors.

By then, the Thai stock market had already plunged about 15 per cent. Today, Thailand is still licking its financial wounds.

Ironically, it was the baht that currency speculators first attacked during the 1997-98 financial crisis. The attack resulted in a domino effect on all other Asian currencies.

This time around, when the baht took centre-stage again, none of the other Asian monetary authorities even blinked an eyelid, reflecting the strong calm that exists among the authorities, due largely to their strong foreign-exchange reserves positions.

However, the Thai situation still showed how vulnerable some of Asia's financial systems are to sudden massive capital flows.

The International Monetary Fund (IMF), in a report on Asia's economic outlook released in September last year, revealed that net private capital flows into Asia could increase to \$88 billion (RM308 billion) for 2006 from \$60 billion (RM210 billion) in 2005.

For this year, the report expects lower inflows as the IMF sees most Asian monetary authorities lessening their tight policies, possibly raising their interest rates to bring them nearer to US levels, and thus narrowing the gap.

It looks as though many Asian countries are still not fully able to handle massive capital flows in ways that would not be damaging to their respective foreign exchange and economic landscapes.

Since the 1997-98 financial crisis, most Asian countries have put their economies on sounder footing as well as strengthening their financial system so that they will be better prepared when another similar attack on their currency occurs.

Asian countries cannot help but accept that large massive capital flows are a part of the globalisation and liberalisation of the world's financial markets. And that these massive capital flows will surely have a significant impact on the respective Asian economies, which by now are more open than before.

Fukui said in summary: "In order to increase the ability to absorb external shocks from massive capital flows, the priority seems to be to strengthen the function of foreign exchange and financial markets."

Next week: A truly scary scenario.

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