Rationalizing Asia's Foreign Reserves Build-Up

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The conventional wisdom is that developing countries are endowed with plentiful labour but are usually short of capital, which is needed to finance investment in infrastructure and improvements in productive capacity that will eventually facilitate a catching up process to the developed world. The fact is, however, that some of Asia's biggest emerging economies have both a surplus of labour (mostly from India and China) and a surplus of capital. The latter is the manifestation of relatively high saving rates in the region, which amount to quite a colossal sum—especially when the more advanced countries in the region are considered. Where does all this surplus savings go? The irony is that much of it goes to the world's richest economy, the United States, to finance its current account deficit.

This paper aims to highlight the underpinnings of this situation, emphasizing how the build-up of foreign reserves in Asia fits in within the global context and tracing out the main domestic implications of large scale sterilization operations. The central message is that while the accumulation of reserves by Asian central banks is helping to support the world economy in the short term—largely by keeping interest rates in the US low and contributing to dollar stability—it is also contributing to imbalances both in their respective domestic economies, as well as the world's, that will likely have adverse economic repercussions in the medium term. The world would be a safer place if the structural adjustments required to correct current imbalances in the global economy are undertaken sooner than later.

The Current Configuration of International Balances

The current account deficit in the US has widened to over 5 percent of GDP in 2003, entailing a financing need of some 500 billion US dollars a year—an amount that exceeds the GDP of some small countries. This gap, which is equivalent to the amount by which overall consumption and investment exceed the national savings of an economy, predominantly reflects the steady decline in US saving rates—both among households, and more recently in the government sector. The importance of the latter should be underscored. The federal budget balance in the US has reversed sharply from a surplus of around 2.5 percent of GDP in FY2000 to an estimated deficit of over 4.5 percent of GDP in FY2004. Whereas the widening of the current account deficit in the 1990s was driven by the boom in business investment associated with the 'new economy', more recent deterioration is the result of the rapid increase in government spending. Normally, a sharp increase in public sector borrowing will be associated with upward pressure on interest rates but the rapid expansion in Asian central banks' reserve holdings has so far prevented this, as discussed below.

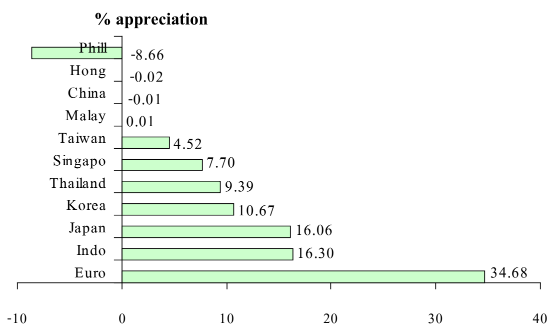
* The views expressed in this article are those of the author and do not necessarily represent those of the Bank of Thailand or Bank of Thailand policy.

By most measures, a current account deficit of the magnitude currently experienced by the US is not sustainable. Insofar as the trade deficit accounts for over 85 percent of the deficit in the current account, a major part of the adjustment can be expected to take place through a realignment of the trade balance. In general, this would involve a shift in the relative price of US exports to that of the world's, that is, a weakening of the US real exchange rate. Thus the flip side of an unsustainable US current account deficit is that the dollar is overvalued in real terms and needs to depreciate to help correct this imbalance.

A real depreciation of the US dollar can occur either through a weakening of the nominal exchange rate or a slowdown in US inflation relative to that of its main trading partners, or both. Given that price movements are generally quite sluggish and that the inflation rate in the US is already quite low—as they are across Asia—most of the adjustment in the short term has and will likely continue to come through a nominal depreciation of the dollar. This is where the accumulation of US dollar reserve assets by the Asian central banks comes into the picture.

The ongoing recovery in many Asian countries from the 1997 crisis, as well as the continued rapid growth in China, has relied heavily on the expansion of exports. Partly to safeguard the recovery process, the monetary authorities of several Asian countries have been reluctant to allow their currencies to appreciate too quickly against the dollar. At the same time, some countries—notably China, Hong Kong, and Malaysia— have continued to pursue a fixed exchange rate regime anchored solely to the dollar. The upshot, as shown in Figure 1, is that most Asian currencies have appreciated only modestly vis-à-vis the dollar since end-2001 compared to a rise in the euro of over 30 percent. A disproportionate share of the decline in the dollar has thus been falling on those countries that let their currencies float.

Figure 1: Appreciation against the dollar since end-2001 (As of end April 2004)



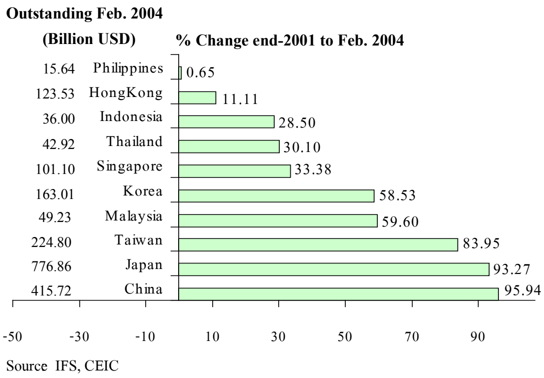
Source: CEIC

At the same time, emerging market countries, including those in Asia, have again become recipient of capital inflows from the advanced industrialized countries. A major element of renewed capital flows into these countries is the historically low interest rates in the US—yields on US treasury securities in January 2004 were negative in real terms for maturities of up to two years—as well as in most of the industrialized world (so called 'push factors').

Against the backdrop of persistent current account surpluses and renewed private capital inflows, the resistance of appreciation pressures has implied rising reserves in Asia's central banks. The share of global reserves held by emerging market countries has risen from 37 percent in 1990 to 61 percent in 2002, with emerging economies in Asia accounting for much of the increase. Figure 2 shows just how dramatic the increase in reserves held by Asian central banks has been. As of February 2004, Japan, China, Hong Kong, Taiwan and South Korea together held over 1.7 trillion US dollars in official reserves, more than half of the world total, most of them in the form of US treasury bonds. Reserves have increased sharply not only in absolute terms, but also when scaled by imports, short-term external debt, and broad money.

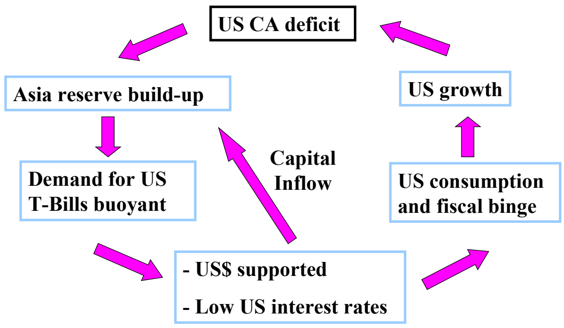
In the short term, Asian central banks' reserve accumulation is helping to support the world economy. This fact has to be clearly appreciated. By shoring up demand for dollar assets and helping to finance the US fiscal deficit, Asian central banks have not only contributed towards a more orderly decline in the dollar, but also low interest rates in the US (especially on the long-end and in the mortgage market). The latter is helping to sustain the boom in US consumer spending and mortgage borrowing which have been key in supporting the US—and thus world—economy and it's in everybody's interest that this does not stop too suddenly and that the dollar does not fall sharply (the more so given the exposure of Asia's central banks' balance sheets to the dollar, as discussed further below).[1]

Figure 2: Foreign Reserves of Asian Central Banks



With US growth supported in this way, its demand for imports is maintained and the current account deficit persists. The mechanics of this global financing cycle of the US current account deficit is illustrated in Figure 3. Importantly, the flow nature of the diagram reflects the worrying fact that the sustainability of the whole cycle rests on the willingness and ability of Asian central banks to continue accumulating US treasury bills. This is neither a viable nor desirable scenario in the long-run, both from Asia's or the US' perspective.

Figure 3: A Global Ponzi Scheme



The Lender's Curse

The build-up of reserves in Asia has meant that the dollar's fall over the last two years has been smaller and more gradual than it would have been otherwise. In effect, Asian central banks have stepped in to buoy demand for US assets at the time when private investors (whose actions are predominantly determined by expected returns) are shifting their investments elsewhere. While central banks' objective function are certainly different from those of the private sector, the potential losses that it may incur—which are ultimately born by taxpayers—should be weighed carefully against the benefits that it is perceived to be providing through its actions.

To be sure, the accumulation of foreign reserves does bestow important benefits, particularly in emerging countries. They help to guard against unexpected shocks, such as a sharp drop in exports or a sudden drying up of foreign financing, and in so doing, help to increase confidence in the country and deter speculators. In general, bigger and more open economies need more reserves to guard against such risks, while those that manage or fix their currencies

[1] Thus it is not entirely correct, for example, to argue that Asia is harming European countries. Rather, their actions are putting a disproportionate share of the adjustment on the latter while at the same time limiting the actual adjustment that is taking place.

need more reserves than those with floating exchange rates. With respect to the precautionary motive, however, there is a limit on how much reserves is needed to guard against the risks of a capital account crisis and by most measures, the level of reserves in Asian countries now substantially exceed those warranted by fundamental.[2]

In many ways, the current predicament facing many countries in the region is reminiscent of the episode of large capital inflows to emerging markets in the early 1990s. In the face of sustained capital inflows, emerging Latin American and Asian countries at the time had to contend with significant upwards pressure on the exchange rate as well as inflation. Efforts to ease the threat of currency appreciation and inflation led to significant build-up of foreign reserves as well as the imposition of other measures (including capital controls). Such sterilization of capital inflows were, in many respects, motivated by similar considerations as those that drive the actions currently being taken by many central banks in the region. One difference between these two episodes is that, in most cases, the current situation could be more usefully characterized as insufficient capital outflows rather than excessive inflows since the upward pressure on exchange rates are partly a reflection of a situation where private sector agents with surplus savings are not able/willing to acquire foreign assets at a rate fast enough to offset the current account surplus.

Resistance to rapid appreciation of the exchange rate can, to some extent, be justified for small open emerging market economies where the foreign exchange market may be relatively thin and prone to significant volatility. With underdeveloped and incomplete financial markets, hedging against exchange rate risk is more costly than in advanced industrial countries and benign neglect of the exchange rate is unlikely to be the most desirable policy. Such sterilization efforts, however, are associated with significant costs, both direct and indirect, that need to be fully appreciated and weighed up against the benefits.

Direct Costs of Sterilization

To maintain domestic interest rates, most of the reserve accumulation has to be sterilized by selling domestic bonds to soak up excess liquidity. This becomes an increasingly expensive process for central banks as their holdings of domestic bonds falls. If sterilization is not complete then reserve accumulation boosts money growth that may fuel a credit boom, as may be the case in China, which eventually adds to inflationary pressures.[3]

The most direct cost of reserve accumulation is that by investing in low-yielding US treasury bills, Asian central banks are forgoing the opportunity to invest in other assets with higher yields—such as domestic government bonds. The rapid build-up of US bonds has also significantly increased central banks' exposure to both exchange rate and interest rate risk. Given that the dollar is likely to fall further and that US interest rates will eventually rise again from

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[2] A recent study by the International Monetary Fund (2003) argues that whereas the reserve accumulation until the end of 2001 could be regarded as explainable or in line with fundamentals—namely economic size, current account and capital account vulnerability, exchange rate flexibility, and opportunity cost—the subsequent run-up in reserves is much harder to rationalize.

[3] Even if inflation does not appear to be an immediate threat, central banks should not be overly complacent since with a robust economic recovery, financial imbalances can occur in the absence of inflation.

current historical lows, Asian central banks may have to realize substantial losses from their reserve accumulation

More fundamentally, such policy can be useful only temporarily since they deal with the effect rather than the underlying forces behind the balance of payments surplus. For one, the scope for sterilization may be significantly restricted by the size of the central bank's balance sheet and the depth of the government bond market, particularly in developing countries, where financial markets are not well-developed. In particular, treasury bills or central bank bonds may be an imperfect substitute for the financial assets foreign investors actually want to hold, such as stocks and bonds. If, for example, foreign investors want equities or foreign direct investment but the central bank undertakes its sterilization operations in domestic government bonds, then the interest rate may be higher than if foreign investors wanted these bonds in the first place. The intuition here is that when assets are imperfect substitutes for one another, it takes a larger interest rate change to accommodate investor preferences than when assets are close substitutes.[4]

Viewed more broadly, sterilization is really fiscal policy since it involves no change in the stance of monetary policy but entails fiscal costs in terms of lower profit remittances from the central bank. It, however, provides no adjustment impetus and can be viewed as simply a subsidy to the export sector. Alternatively, the exchange rate could be allowed to appreciate more significantly and the cost saving from not having to sterilize spent on helping to cushion the burden borne by those most affected by the appreciation. From the government's perspective, resources are spent on facilitating economic adjustment rather than a subsidy to the export sector. Moreover, if agents come to believe that official efforts to control an exchange rate through intervention unsupported by monetary policy (ie. sterilized) are unsustainable, the large resources devoted to intervention may be viewed as a profit opportunity.

Indirect Costs of Sterilization

Broadly speaking, there are three main reasons for foreign exchange intervention: i) to maintain an external anchor for the achievement of price stability; ii) to minimize extreme exchange rate swings in the short run and minimize 'overshooting'; and iii) to correct a perceived misalignment of the exchange rate from its long-term equilibrium. Of these, the first two are typically accepted as appropriate policy while the third motive is subject to more disagreement. Strikingly though, the intervention that is taking place in many countries currently does not fall into any of these three categories. On the contrary, many central banks appear to be intervening to prevent a perceived adjustment of their real exchange rates towards long-term equilibrium values.

This possibility has to be clearly recognized since the exchange rate is but one component of a country's general economic policy and needs to be consistent with other components, most importantly with the conduct of monetary policy. Importantly, a key point that is sometimes loss in popular discussions of this topic is that an under-valued exchange rate is no more desirable than an over-valued one because the policy actions that are necessary to sustain them entail costs in the form of building up imbalances and potential risks in the future. Economic theory suggests that

[4] Although recent research using micro data on order flows cast some doubt on the conventional wisdom that sterilized intervention is not effective, their weight diminishes rapidly once the horizon under discussion moved beyond a month or so. For horizons of a year and above, the evidence on the effectiveness of sterilized intervention is much more discouraging.

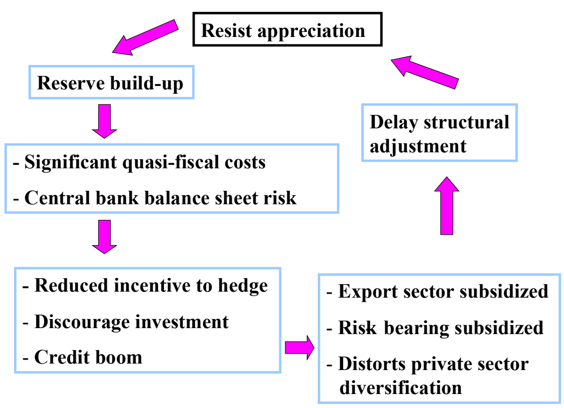
countries with relatively faster productivity improvements in the tradable sector relative to the non-traded sector should experience real exchange rate appreciations (the so-called Balassa-Samuelson effect). Many countries in the region, such as China, are experiencing such productivity gains. Shifts in preferences towards services that usually accompany economic development also imply that developing countries are typically expected to experience real appreciations over time, as the relative price of non-traded goods is driven up. In short, a case can be made that economic fundamentals dictate that there should be a trend appreciation of the real exchange rate in many Asian countries. Such appreciations can take place either through an appreciation of the nominal exchange rate, or higher inflation. Generally, it is preferable that adjustment occurs through both channels to ease the transition but Asia's pre-occupation with export-led growth currently dictates that most, if not all, of the adjustment that will eventually occur will be in the form of higher inflation.

By sustaining an undervalued exchange rate and subsidizing the export sector, economic restructuring as well as reforms that are required to unshackle domestic demand, are discouraged. For example, an undervalued exchange rate, by making imports of capital goods dearer, may act to restrain investment and limit consumption growth. While an appreciation in the exchange rate that is warranted by fundamentals may create difficulties for some industries in the short term, it also acts as a catalyst for an acceleration of reforms and initiatives that lead to the discovery of a country's true comparative advantage, which evolves over time. An appropriately valued exchange rate thus enhances a country's ability to adjust to rapid productivity growth, as well as greater trade and financial integration with the global economy. Indeed, the sooner a country embarks on this process, the better placed it will be to reap the medium to long term benefits of such economic restructuring and countries whose exchange rates are relatively flexible are getting a head-start in this respect.

Moreover, to the extent that rapid reserve accumulation contributes to exchange rate rigidity, it might actually increase vulnerability to a crisis. Just as a fixed exchange rate that is deemed to be overvalued invites speculative attacks, resistance to appreciations that results in exchange rate rigidity can boost capital inflows by reinforcing the perception of a one-way bet, the more so if a positive interest differential obtains. In conjunction with exchange rate rigidity, the accumulation of reserves can create moral hazard in the private sector by discouraging companies and households from taking out adequate insurance against the risk of exchange rate variability. Overall, the steady build-up in interest-sensitive capital inflows, and the associated increase in unhedged foreign currency exposure in the private sector, can increase the economy's vulnerability, and possibly even increase the risk of a crisis.

As summarized in Figure 4, which illustrates the domestic implications of Asia's reserve accumulation, an overly zealous resistance to exchange rate appreciation could entail significant costs and distortions to the economy. It implicitly involves a subsidy to the export sector as well as private risk-bearing, giving rise to potential moral hazard problems. Moreover, given the existence of restrictions on private capital outflows in some countries, it also implies that the central bank is effectively undertaking portfolio diversification into foreign assets on behalf of the

Figure 4: The Lender's Curse



private sector, which may not be optimal. The longer these cross subsidies, as well as central banks' own balance sheet exposure, are sustained, the more difficult it becomes to break the cycle without adverse consequences for the economy.

A Dangerous World

From the global perspective, the situation described above is neither optimal nor sustainable. The rapid accumulation of US reserve assets by Asian central banks, in many ways, allows the US to put off inevitable adjustment in the current account deficit and as the US continues to accumulate foreign debt at a faster rate, the eventual adjustment is likely to be bigger and more painful, for both the US and the world economy. Indeed, past experience suggests that less open economies, like the US, tend to require a larger exchange rate adjustment to effect the same external adjustment than a more open one.

The combination of abundant liquidity and increased risk appetite that has supported global equity prices and pushed credit spreads on both mature and especially emerging market bonds to low levels has also created the risk that asset valuations may have been pushed beyond levels justified by improvements in fundamentals. The possibility that adverse developments in currency markets associated with large global imbalances may spill over into other asset markets should not be discounted. A decline in demand for US dollar assets could trigger an increase in bond yields, undercutting the valuation of riskier assets, and lead to a significant widening of credit spreads on emerging market bonds.

Moreover, one major concern is that someday, Asian central banks may wish to diversify out of their enormous, relatively unproductive dollar reserve assets. The larger these reserves grow, the greater the impact that this eventual diversification is going to have. As echoed by Kenneth Rogoff, former Director of Research at the IMF, "...if the diversification comes too suddenly, there is the danger that Asian central bank funds, built up partly to ensure against hot money private capital flows, will themselves become the hot money of the future."[5]

Finally, and perhaps most worryingly, the maintenance of what are perceived to be undervalued exchange rates by Asian countries may provoke protectionism in the US and Europe. This is especially pertinent given the coming election year in the US. A rise in protectionist sentiment would seriously undermine the global economy and should be strongly resisted.

The Way Out

Where does the way out of this predicament that the world currently faces lie? A sharp fall in the dollar is certainly not the answer. Abrupt changes in currency values can be disruptive, as illustrated by recent episodes of international financial crises. The US economy, however, is more insulated than most through its size, the fact that most of its obligations are marketable and denominated in its own currency, and because the international role of the dollar underpins global demand for it. Unlike countries that suffered the Asian crisis in 1997, a sharp fall in the dollar would actually reduce the real level of US indebtedness to foreigners. As a result, the damage that

[5] Rogoff, K. (2003), Press Conference on the World Economic Outlook, Washington DC, September 11 (www.imf.org/external/np/tr/2003/tr030911.htm).

would occur from an abrupt fall in the dollar and the associated rise in US interest rates would be borne as much by other countries as by the US. A recent estimate by the IMF of the potential loss to holders of US assets from a 25 percent depreciation in the nominal effective value of the dollar came to about 10 percent of US GDP, of which 1.5 percent of GDP would fall on central banks' reserve holdings.[6]

A precipitous and sudden collapse in the US dollar is thus not in anybody's interest. With inflation quite low in many countries—and indeed persistent deflation in others—it is understandable that central banks in the Asian region are reluctant to let their currencies appreciate too rapidly, and rightly so. A significant fall in the dollar would exacerbate deflationary pressures in many countries in Asia and Europe, adding to the difficulties already faced by central banks in these countries as they work to ward off the threat of deflation. The exposure that central banks have accumulated in the process of slowing the appreciation of their currencies also makes them vulnerable to the dollar.

That is not to say that the US dollar should not depreciate at all, rather the key is that any adjustment in the dollar must be gradual—to allow more time for countries to adjust their production structure—and should be relatively spread out among countries with trade surpluses vis-à-vis the US. Indeed, if Asia as a whole appreciates against the US dollar—just as the 12 countries in the euro-area have done so in the last couple of years—then the effective appreciation of these countries would be limited to the relative importance of US trade in each respective countries' total trade. Asian countries would then experience some loss of price competitive vis -à-vis the US but not relative to each other, while the US would benefit from a more substantial effective depreciation.[7]

While an orderly weakening of the dollar is an important ingredient in the process of reversing the current account deficit in the US, the impetus for adjustment cannot rest on it alone. What is needed is a coherent and cooperative strategy that both facilitates the needed rebalancing of demand across countries, and at the same time help to support global growth as that adjustment takes place. Such a strategy would involve a commitment to substantial fiscal tightening and more robust household saving in the US, stronger economic growth in Asia and Europe driven by structural adjustments and higher productivity growth, as well as reduced world trade barriers. At present, however, the combination of policies across countries and regions does not appear fully consistent with an orderly adjustment of global imbalances over the medium term. Some of important considerations in this respect are discussed in more detail below.

Appropriate Policy Mix

The first question that needs to be asked is whether the equilibrium real exchange rate has changed in a way that would make real appreciation necessary. If the evidence points towards a

[6] See IMF World Economic Outlook, April 2004.

[7] The role of China is crucial in this respect. With the regions' fastest growing economy and a vast pool of cheap labour, most Asian countries are weary of losing competitiveness to China and will be reluctant to let their currencies appreciate against the reminbi. However, as argued above, *irrespective of China's decision regarding its exchange rate*, it is in each country's interest to allow some adjustment in their currencies in line with fundamentals.

need for a trend appreciation of the real exchange rate then the next step involves determining the appropriate balance between adjustments in the nominal exchange rate and the price level in order to achieve that trend. Finally, other policies, be it fiscal, structural reforms, or micro-based initiatives, that would help to facilitate adjustment of production structures to the real appreciation should be considered.

A central element in all this will, in most cases, involve a move towards greater exchange rate flexibility. While exchange rate depreciation can help support growth by boosting external demand in the aftermath of a crisis, a shift to domestic sources of growth becomes important as the recovery matures. In this regard, adjustment through the exchange rate has the added advantage of making imports cheaper and putting more of the onus of adjustment on external rather than domestic demand The removal of the one-way bet implied by excessive intervention in the exchange rate may also raise uncertainty about the expected returns from investing in the country sufficiently to reduce short-term capital inflows and offset pressures for appreciation. More generally, an exchange rate consistent with underlying fundamental trends enhances the economy's ability to adjust to rapid productivity growth and increased trade and financial integration with the global economy. Indeed, with growth picking up and signs of financial imbalances emerging in some countries in the Asian region, a gradual tightening of macroeconomic conditions can be achieved in part through nominal effective exchange rate appreciations.

At the same time, a key lesson from the experience of dealing with capital inflows in the early 1990s is that host countries that do not want to accept much appreciation in their real exchange rate must be prepared to tighten fiscal policy. This is the most reliable way to reduce aggregate demand, keep inflation in check, and limit deterioration of the current account. The major drawback to this alternative is that it involves a contraction in domestic demand since government spending is typically skewed towards domestic goods. From the US perspective, its economic potential will be brighter if the current account adjustment comes more through an increase in domestic saving rather than a reduction in domestic investment. Indeed, experience has shown that tighter fiscal policies tend to reduce the real exchange rate depreciation associated with a reversal of large current account deficits.

Structural Reforms

For the Asian countries, a key element in the orderly adjustment of the dollar is a policy environment that does not discourage a shift towards domestic-oriented growth accompanied by steady reductions in current account surpluses over the medium term. This is desirable both to help cushion these economies from a stronger currency, as well as to facilitate the unwinding of the US current account deficit. Indeed, the region should be putting its excess savings into more productive use through investment in infrastructure and projects that lead to improvements in productive capacities. Doing so will lead to tangible pay offs in terms of higher potential economic growth in the long term.

In this regard, emphasis should be placed on implementing necessary structural reforms that help to strengthen and deepen financial markets, make the economy more flexible, improve public and private sector governance, increase competition, boost potential growth, and support domestic demand. The focus in much of East Asia should be on banking and corporate reforms, as well as legal and judicial reforms that help to enhance the business and investment environment. Considerations for further liberalization of capital outflows may also be reviewed to ease the pressure on sterilization. If these reforms succeed in creating a more dynamic environment for the private sector, the likelihood of a relatively smooth rotation of demand from the US to the surplus countries in Asia is greater, mitigating potential disruptions to global growth.

A strengthening of fiscal positions throughout the region would also be an important priority since much of the necessary reforms outlined above will have significant fiscal implications. Given the low revenue to GDP ratios in many countries in the region, revenue enhancing measures, including improved tax administration, a broadening of the tax base, as well as simplification of the tax regime, should figure prominently in this respect. Existing benign financial conditions should also be seen as an opportunity to improve debt structure. By helping to reduce revenue volatility and strengthen public debt sustainability, these efforts should enhance policy credibility and endow authorities with greater flexibility in dealing with adjustment costs that may arise from an appreciation of the exchange rate.

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The current upturn in most economies provide a timely opportunity given that reform measures are easier to implement when macroeconomic conditions are favorable since rapid growth in aggregate incomes generally reduces both the pain associated with reforms and the visibility of distributional effects.

In China, a rebalancing towards domestic growth would require the implementation of tangible restructuring plans in the banking system, accelerate asset disposals by asset management companies, and restructure and diversify ownership of state-owned enterprises. Strengthening banks' balance sheets and increasing their market orientation, along with deeper capital markets, would help to improve the allocation of investment. Continued improvements in risk management, internal controls, and governance structure are key in this respect.

The reduction in real demand and disinflationary impulse associated with currency appreciation can, to some extent, be offset by monetary and/or fiscal easing. Nevertheless, the switch in demand could be lessened by greater structural flexibility. In addition, a sustained appreciation of the exchange rate would be harder to absorb in countries where room for macroeconomic manoeuvre is limited, such as Japan where interest rates are at their floor and fiscal conditions already worrisome.

While considerable progress has been made in strengthening the financial system in many countries in the region, vigilance over credit quality will continue to be necessary to limit risks from a pickup in credit growth.