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Official Reserves and Currency Management in Asia: Myth, Reality and the Future

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Executive Summary

International reserves in seven East Asian economies stood at US$2.3trn at the end of 2004. This means that some 60% of total international reserves in the world economy were held by economies representing only about 40% of world GDP. In addition to being large, the reserve levels are likely to continue to increase in the coming years.

Is this accumulation of reserves the consequence of East Asia's high saving rate, deliberate undervaluation of currencies in the region leading to large current account surpluses, or is it due to the need for the United States to finance its external imbalance, or yet again to capital inflow in the region in anticipation of currency revaluations? Will appreciation of the renminbi and other East Asian currencies in itself be a solution to the Unites States' external imbalance? If not, what other policies would be helpful? What will happen to long term interest rates and G-3 exchange rates if East Asia, the United States and the EU do not make any policy changes? Will a more flexible exchange rate system in China lead to some diversification of international reserve holdings away from the US dollar towards the euro or the yen? These are the questions addressed in this report.

While it is beyond doubt that the level of reserves in the region is larger than most measures of reserve adequacy, we dispute the notion that the reserve build-up is driven by deliberately undervalued exchange rates. In fact, an examination of external payments data shows that the increase in reserves, particularly in China, has been due principally to FDI and speculative capital inflows and not only to current account surpluses. Countries with well-developed institutional investors might be able to turn such capital inflows around in the form of offsetting private capital outflows. However, in the absence of such capacity, it can be argued that it is appropriate for the authorities to intervene in the foreign exchange market to prevent a sharp appreciation that would have the potential to cause domestic deflationary pressures.

As a means to promote a better allocation of Asia's official reserves, we support the establishment of an Asian Investment Corporation. It would pool a portion of these reserves and manage them on commercial grounds as a national wealth fund. This fund would have greater freedom than is currently the case to invest in less liquid, longer-term and, where appropriate, Asian assets.

Data also show that the current account surplus in Asia and the deficit in the United States are associated with low investment rates in the former region (ex China) and a low saving rate in the latter. Reducing the current account deficit in the United States requires the national savings rate in this country to be increased. Exchange rate adjustment is not a particularly powerful method for bringing this about. From this it follows that appreciation of East Asia's currencies, including the renminbi, should not be viewed as the principal solution to global current account imbalances even if it might have a useful ancillary role to play. Moreover, the reform of the exchange rate regime in China has the potential to give the authorities more control over China's domestic economy by preserving the independence of interest rate policy and by preventing the dollar cycle from imparting inflationary and deflationary impulses to the domestic price level.

Regarding the composition of official reserves both in terms of currency and instrument, the report documents the dominance of the US dollar assets in such reserves, well beyond the relative size of the US economy. However, the report argues that, compared to the effective size of the dollar area (measured as that part of the world which has more stability in its dollar exchange rate), it was not excessive before the recent changes in the Chinese exchange rate regime. Although it is too early to be sure how the new Chinese exchange rate regime will function, if the renminbi effectively joins the already evident regional tendency for currencies to be managed relative to a basket of currencies, then the ground may be laid for some more diversification of official reserves out of the US dollar. This is due to more balanced investment portfolios producing less variable returns in domestic currency when the currency is managed against a basket of currencies.

What consequences will such diversification have for exchange rates and interest rates? The standard answer is that the dollar will weaken and the interest rates on long-term US government securities will increase as the demand for dollar assets, and Treasury paper in particular, declines. On closer scrutiny the answer is less certain, however. At the theoretical level the report shows that the impact on exchange rates and interest rates depends on how close substitutes euro (or yen) denominated assets are for dollar denominated assets. It also shows that reserve diversification on the part of, say, the People's Bank of China is analytically equivalent to sterilized interventions in the foreign exchange market by the European Central Bank or Japan's Ministry of Finance. Since it is often argued that such interventions are of only limited effectiveness, then reserve diversification, being analytically equivalent, would not be expected to have a large influence either. The existing empirical evidence is inconclusive.

Data on reserve composition shows that diversification has already taken place out of US Treasury bills into longer-dated US government and other obligations. It has been suggested that this increased demand for longer-dated securities through heavy central bank intervention may have served to hold down long-term interest rates. We review the evidence and find that it is also far from conclusive.

Our analysis suggests that the United States, the EU and East Asia could place the global economy on three possible trajectories of adjustments depending on how the three regions manage macroeconomic policies. One scenario is that East Asia grows out of its burgeoning trade surplus, which we suggest is unlikely. Another scenario involves the adoption of non-market solutions, obviously one that should be avoided at all cost. The report favours a third scenario. We argue that global coordination of expenditure-reducing/increasing policies and exchange rate adjustments between East Asia, the United States and the EU will be necessary to achieve the least-cost adjustment to the current account imbalance between the three. To this end this report proposes another Plaza Accord among the three regions for policy adjustments and co-ordination.

Monetary policy in East Asia is already quite accommodative, so it cannot be expected to take the lead in stimulating domestic demand. Fiscal policy, for its part, is subject to long-term constraints in the largest Asian economies. Exchange rate adjustments alone will be only of limited value, however useful they may be in monetary terms.

This of course does not mean that East Asian economies should sit on the sidelines. They should step up their market oriented structural and institutional reform that will lead to more reliance on domestic demand for growth and will facilitate direct integration of the private sector into the global financial system.

Coordination of policy among East Asia, the United States and the EU may be difficult in practical terms, but efforts in this regard will help diffuse the pressure of those supporting the non-market solutions. If nothing else, this should concentrate policy-makers' minds on changes that pose difficulties form a national perspective but that help relieve the risks inherent in an ongoing widening of imbalances.

Looking further into the future, the report examines the prospects for Asian monetary integration and argues that region-wide monetary unification is far off since the three largest economies – China, Japan and South Korea – are unlikely to relinquish domestic monetary independence. However, this does not mean that countries in East Asia will retreat from their pursuit of monetary integration. They could certainly expand and consolidate the Chiang Mai Initiative as a regional liquidity support system and a regional forum for policy dialogues as they have agreed to do. This strengthening of the system may in the long run reduce the demand for reserves for self-insurance in the region and keep East Asia's initiative for regional financial and monetary integration alive.

China's and Malaysia's prospective management of their effective exchange rate will bring their practice in line with that of their neighbours and permit closer coordination of monetary and exchange rate policy in the region. With East Asian exchange rates now all reacting to each other, currency appreciation poses less risk of a loss of competitiveness or deflation to an individual economy. China has the ability, as well as an interest, to join discussions that facilitate broadly joint exchange rate moves. In the absence of comprehensive monetary cooperation, the economies, small as well as large, in the region may find it in their interest to deepen their policy dialogue to take full account of the repercussions of monetary and exchange rate policies on each other.