

Preliminary

Global Financial Imbalances: the Future Impact of
Asian and Middle East Surpluses

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The lively debate on global imbalances that has been going on for several years, and that we are engaging in at this conference, convinces me that there is surely more than one fundamental cause behind those imbalances and, indeed, more than one proximate cause. In my view, it is misguided to debate various perspectives as if they are alternatives. Rather, we should be seeking to understand how numerous market forces, policies, and truly exogenous factors have been interacting to get us to where we are today. This morning, I will be focusing my remarks on the reserve accumulation that is occurring in Asia and in oil exporting countries and related issues because that is the topic for this session. But please do not misinterpret my focus as any indication that I see this behavior as somehow the most important or determining factor within the complex set of forces underlying the global imbalances.

In assessing the implications of Asian and Middle East surpluses and reserve holdings, it is helpful to ask whether the reserve balances are themselves a problem or are they just a symptom of one or more fundamental causes. If we regard them as symptoms, what are the more fundamental factors? One is surely the choice of exchange rate regime in several Asian countries. The first slide shows the nominal bilateral exchange rate of the Chinese RMB in terms of U.S. dollars. The extended horizontal line is evidence of the implicit “peg” to the dollar that has been managed by Chinese officials since the mid-1990s. More recently, the rate has adjusted up, that is RMB appreciation, but actually not by much. This measure is of the nominal, bilateral value of the RMB. What matters for most economic behavior is the real, multilateral value of the RMB, the black line. This measure has shown much more variation over the decade and, on balance, is up about 12 percent. For comparison, the real, effective or multilateral value of the dollar is shown in

yellow. The two lines move generally together, as the nominal RMB has moved with the dollar against other currencies. Nevertheless, there are noticeable differences during the interval as a consequence of different trade weights for the two currencies and different inflation experiences. Still, the two have moved substantially together since the peak of the nominal dollar in early 2002, although the real dollar appreciated slightly less on balance since 1995.

The exchange rate regimes of other Asian currencies do not all show the same degree of managed “peg” as does the RMB. The nominal, bilateral dollar value of the Korean won moved significantly down at the time of the Asian financial crisis, but has partially retraced that decline, with a further upward shift over the past two years. The real, effective won, in black, has varied along with the nominal won, but less widely. In comparison to the real, effective dollar, the won has moved distinctly. But presently the real value of the multilateral won is appreciated relative to early 1995 to just about the same extent as is the dollar.

The Japanese yen has fluctuated in nominal terms against the dollar over much of this period even though at times Japanese officials were seeking to limit that fluctuation. The real, effective yen (in black) has moved similarly to the bilateral nominal yen and quite differently from the real effective dollar, in yellow. In contrast to the dollar, the real effective yen is on balance down, about 30 percent, over this period.

A second factor that underlies the reserve accumulation is the pace of domestic demand relative to output and the change in that gap over time. Of course, given that the United States has a large current account deficit, it follows that some other countries must have current account surpluses. But the behavior that determines which countries are in

surplus and by how much is just as much an underlying cause of the global imbalances as is U.S. behavior. The principles of national income accounting tell us that domestic demand as a share of GDP moves inversely to net exports as a share of GDP and hence in most cases to the current account balance relative to GDP.

Developing Asia in aggregate has registered an external surplus for many years. Since 2000, that surplus (the red line) has gone from 2 percent of GDP to nearly 4 percent. Within the region, the surplus of China (in yellow) as a share of GDP has shown sizable increase, reaching 7 percent last year. The rise in this ratio is indicative of the extent to which domestic demand as a share of output has fallen. Over the past six years, the current account surplus of Japan as a share of GDP (the black line) has also moved up—about 1 percentage point. In the newly industrialized Asian economies, the aggregate surplus (shown in red) has also trended up over this period. However, the surplus for Korea (in yellow) on balance has not risen, and that for Taiwan (in black) is moving back down, indicating more resilience in domestic demand recently in those economies.

For the Middle Eastern region and for emerging market fuel exporters more generally, the global price of crude oil is the critical factor driving their ability to accumulate holdings of international reserves. The price for WTI fluctuated relatively narrowly until 2003. With the sustained recovery in global activity and threatened or actual disruptions to supply, the price has since risen to more than \$60 per barrel. The higher price has generated an annual flow of oil revenue (shown in black) to fuel exporting emerging market countries that has risen from about \$300 billion in 2000 to nearly \$700 billion in 2005. These economies do import from other countries, however,

and make other payments so that their current account surpluses are about one half of their oil revenues. It should be noted that payments for oil exports are generally received directly in foreign exchange—usually dollars—and may go directly into official holdings without passing through the private sector and the foreign exchange market.

These three factors—choice of exchange rate regime, robustness of domestic demand, and the global oil price—underlie the pace at which reserve holdings have mounted in Asia and elsewhere. The exchange rate regime is at the discretion of individual governments. Global oil prices are a market phenomenon beyond the control of any one government. Nevertheless, a host of policy issues I do not have time to raise are imbedded in these more fundamental pieces of the global imbalances puzzle.

The reserve accumulations that have been recorded for Asia and for the oil exporting emerging market countries, even if a symptom of other factors, may themselves pose problems and may constitute reasons why some change in economic policy or in behavior in the countries experiencing the accumulation would be in their interest. For the Asian region, the reserve totals are large and have been rising rapidly in the most recent years. The totals shown comprise all currencies held and reported to the IMF as foreign exchange reserves by the countries listed. Although for each block shown in a different color, the total has risen over the six years, the increases in holdings are most dramatic for Japan, in white, and China, in blue. As can be seen on the slide, Japan's holdings largely stopped increasing in 2004 and were about unchanged last year. China's reserve holdings continued to expand. The total shown for this group of countries, about \$2-1/4 trillion, compares with an overall net international liability position for the United States of somewhat more than \$3 trillion at the end of 2005.

Emerging market fuel exporters have also realized rapid increases in foreign exchange reserves in the most recent years—note the difference in scale. Of the nearly \$375 billion they held at the end of 2005 (data for this year are bit incomplete), about half is held by Russia.

Not all of the reserves shown on these two slides are dollars, and many countries do not release information on the currency composition of their reserves. However, from data compiled and released by the United States, we can know portfolio inflows to the United States by country—where the figures shown on the slide are the aggregate annual flow for public and private sector holdings. These data confirm that such inflows to the United States from countries in Asia and the Middle East plus Russia have been rising over the past several years, with Japan and China important sources. The sharp drop in inflows from Japan last year, which brought the total down substantially, coincides with the leveling off in their foreign exchange reserves. It should be noted that these data do not account for dollar investments of these countries held outside of the United States.

All central banks hold some reserves, for precautionary and other reasons, but the reserve numbers just shown are large when judged by a variety of standards. And large and rising reserve holdings can pose problems that at some point raise questions about the advisability of continuing on a path of further accumulation. Unless officials take offsetting actions, increases in foreign reserve holdings feed through to render monetary policy more expansionary than it would otherwise be. This raises questions of inflationary pressures arising over time and possibly the risk of asset price bubbles. In developing Asia those pressures so far have not become alarming. In China, the acceleration in prices from 2002 to 2004 caused some to think that the inflationary

consequences of their policy regime were asserting themselves. But the return to lower inflation last year quelled those concerns. As we all know, Japan has been struggling with deflation over the past several years. And in the emerging market fuel exporters, inflation has diminished. So to date, this risk has not been pressing.

In order to prevent the unwanted easing of monetary policy that would otherwise occur, central banks “sterilize” the foreign exchange reserves they acquire when they intervene in foreign exchange markets by selling assets denominated in domestic currency to the private sector. If the central bank does not already have in its portfolio sufficient domestic assets, it can create an IOU on itself. In China, securities commonly referred to as “sterilization bonds” have been issued for this purpose. As is evident on the slide, gross issuance has trended up since 2003 and was at a very high pace in February and March.

The process of sterilization, even when it succeeds in maintaining the stance of monetary policy, poses potential problems. The stock of domestic currency assets in private hands needs to remain outstanding and, likely, grow over time. This raises questions of the maturity at which to issue the domestic bonds. If the maturity is short, then the bonds must be rolled over frequently. If the maturity is long, that may pose problems for a portion of the maturity curve where the market is not deep; other long-term borrowing may be squeezed as a result. In addition, someone in the domestic economy needs to buy these instruments. If there is demand for them by the non-bank investing public, fine. But often these instruments end up on bank balance sheets. As a result, the banks develop a smaller loan portfolio to the private sector than they would otherwise; they acquire less experience over time judging credit risk and managing loans.

More generally, the development of the financial system can be adversely affected as institutions and markets do not develop as well and as quickly as they might and as is needed to provide a market-driven, efficient system for allocating capital to domestic investment.

Sterilization also may impose a direct cost on the public balance sheet of the country engaged in it as the interest paid by the official sector to the private sector on the domestic securities exceeds the interest earned on the foreign exchange reserves, which are frequently invested in lower-return sovereign bonds of the country issuing the foreign currency. In the case of several of the Asian countries, this particular measure of cost has not been important. For example, in Japan, domestic securities could be sold to the public at very low interest rates, clearly below those on U.S. Treasuries. But the issue of “costs” associated with holding these reserves should be understood more broadly.

Reserve assets are part of national wealth. Some have suggested more sophisticated ways that officials could manage these reserves that would yield more than the rate on riskless, sovereign securities. Those ideas probably have merit, but I think they miss a larger point. Looked at from the perspective of the entire range of issues, i.e., the exchange rate regime, restrictions placed on monetary policy, distortions introduced to bank behavior, other limits put on domestic financial development, and the holding of low-yielding foreign assets, is there a better use in terms of domestic opportunities for this portion of national wealth? I suggest that the answer is almost surely yes.

Ongoing rapid accumulation of reserves is linked to a regime of managing the nominal exchange rate—a policy that by itself risks distorting aspects of the domestic economy. When the de facto outcome is to resist appreciation of the domestic currency,

there is an implicit subsidy to export industries. That subsidy constitutes a distortion of returns across sectors and, in addition, is likely to alter the allocation of domestic fixed investment and capacity expansion as domestic firms expect the exchange rate policy to continue and the excess profits thereby generated to accrue to capital invested in the export sector. If the expectation that the exchange rate policy will be maintained is widespread, then an incentive is created for additional inflow of funds from abroad that hope to gain when the appreciation of the currency finally occurs. That additional inflow will generate further intervention, further accumulation of reserves, and some intensification of the associated problems that I have already mentioned.

In sum, the very sizable and largely still-growing international reserves that we see being held in Asia and by emerging market fuel exporters are a by-product of more fundamental factors. But these reserves by themselves do have the potential to cause additional problems. The complications posed by rising foreign exchange reserves for monetary policy, the distortions they may impose on bank behavior, the limits that may result on the pace and shape of development of the financial sector, and the distortions to price signals from the managed exchange rate all suggest that it would be in the interest of individual countries not to continue to accumulate these reserves without limit.