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Love affair with FX reserves

Posted by: Christopher Swann
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The post-crisis world order is starting to look distressingly similar to the old one.

Swollen foreign-exchange holdings helped set the stage for the meltdown by suppressing interest rates and boosting mortgage lending in the United States.

Now those reserves are back on the rise. Stockpiles of hard currency recently topped their pre-crisis peak to reach $7 trillion. And China, the undisputed champion of currency hoarders, has passed the $2 trillion mark, up almost 20 percent in the last 12 months.

Reserve accumulation can be added to the list of bad habits that countries failed to wean themselves off during the crisis. Unless this trend is controlled, it will increase the risk of aftershocks.

Of course, the surge in reserves comes as a relief to rich nations — especially the United States — as they attempt to sell record volumes of government bonds to investors. For much of the past eight years, foreign central banks were the most loyal clients of the U.S. Treasury. After a brief hiatus, they are once again likely to scoop up a big share of new government bonds. Since the post-crisis low for reserves in March, central banks have bought nearly $500 billion of hard currency. Traditionally, about two thirds flows into dollars.

Developing nations, too, should be more in love with reserves than ever. Flows of capital back into emerging countries threaten to push up their currencies and undermine their exporters at the worst possible moment. Siphoning that capital to the central bank is a good way of avoiding the problem. In addition, the financial crisis offered a powerful demonstration of the value of reserves. For example, Russia’s foreign exchange arsenal allowed it to avert financial catastrophe, stabilizing financial markets and rescuing the banking system. Russia burned through a quarter of its stockpile in a matter of weeks, causing many to recognize just how big reserves need to be in a crisis.

Ultimately, however, such massive reserve building is costly and risky, both for the holder and for the financial system. At the most basic level the trend separates financial markets from economic reality.

Too many nations are still looking to the United States as a consumer of last resort. By keeping the dollar artificially high, reserve accumulation puts U.S. exporters at a disadvantage. Even if the U.S. current account deficit never returns to 6 percent of GDP, any increase in the trade gap will raise hackles in the U.S. Congress and fuel protectionism.

In addition, the financial crisis underscored how mounting reserves around the world can lead to asset bubbles in the United States by putting downward pressure on U.S. interest rates.

To reduce the allure of reserve accumulation, the first step should be to give emerging economies far more voting power at the International Monetary Fund. Because they don’t trust the IMF to hand out reserves without conditions when needed, developing nations feel the need to “self-insure” against financial turbulence by building their own reserves.

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The G20 should also consider an insurance pool, as Cornell University economist Eswar Prasad has suggested. In exchange for a modest premium, nations could get access to much larger
credit lines. (Less responsible states would pay a higher premium, creating an incentive for good behavior.)

More fundamentally, developing nations need to stop looking to U.S. demand as the preferred route to prosperity. Neglecting home markets is not only unfair on their own consumers, it is increasingly irrational, because rich nations are in no shape to consume.

Policymakers paid lip service for years to the need to reduce international imbalances and — by implication — stem the increase in reserves. Now they need to do something about it before it threatens the global economy and financial system once again.

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3:13 pm GMT

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