Bandid Nijathaworn: Reserves accumulation and global investment-savings adjustment – an Asian perspective

Speech by Dr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at the seminar on "New trends in reserve management and its meaning for the international financial system", organized by The Reinventing Bretton Woods Committee and the People's Bank of China (PBOC), Shanghai, 2 November 2007.

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First, let me thank the Reinventing Bretton Woods Committee and the PBOC for the invitation and for the excellent arrangement. Reserves accumulation and external surplus are important issues at this time, and their significance to the global financial markets deserves greater attention by all. Thailand, being a small economy with external surplus, is also a small part of this development. So, today's meeting provides a good opportunity for us to discuss this issue.

Between 1995 to September last year, global reserves rose from US$ 1.3 trillion to US$ 4.8 trillion, a large part of which was observed in Asia. The latest number now is probably much higher, and a number of important features of the recent increase in global reserves have been noted.

<u>First</u>, the size and the rapidity of the increase was not totally expected by the market and policymakers. <u>Second</u>, which is most important, is that the increase mirrors a regime shift in the external payments position between developed and developing economies, and involves a large number of countries. This is to say while the deficits, i.e. the net borrowings, lie almost entirely with the US, the surpluses or the net lenders are identified with Japan, China, East Asia, the oil exporting economies, and other emerging markets including Latin America. And the third is the financing of the deficits, as well as the reinvestment of official reserves, which are now a major component of global capital lows.

The key issues therefore are whether this process can go on? Is it a permanent or a temporary phenomenon? And what would be the implications for the global economy and financial markets.

Today, I want to comment on these issues. Specifically, I will discuss the major forces underlying external surplus and reserves accumulation from an Asian perspective. Next, I will comment on policies that are needed globally to address this problem.

To begin, reserves accumulation is essentially the mirror image of the evolution of the US external deficits. Two popular views explaining this phenomenon have been put forward. The first is the export-led development model, i.e. the new Bretton Woods, which sees reserves accumulation as a consequence of an attempt to maintain export-led development, especially in Asia. The second explanation is the global-saving glut hypothesis, of which the glut is driven by the transformation of emerging markets from net borrowers to net lenders in the international capital market.

Both interpretations I think have merits, and reserves accumulation is probably a reflection of both. But the point that really should be emphasized is that external surplus and reserves accumulation, for the most part, are a reflection of the dynamic of the adjustment in global investment and saving that has taken place since the Asian financial crisis. This dynamic has been instigated by the configuration of policies pursued by the major economies and by emerging markets, as well as by the development of financial institutions and markets around the world that has sped up and influenced the direction of global capital flows.

But why the Asian financial crisis as a starting point? To me, the Asian financial crisis marks a number of important watersheds in the global financial relationship.

First, the crisis reaffirms the dominant roles of market and globalized capital. Second, the severity of the crisis led many emerging economies to rethink their policies of relying on external help for crisis prevention and resolution. And this has led to consideration to self-insure against risk of crisis, with reserves accumulation becoming an important aspect of this consideration. And third, sharp adjustments in relative prices, especially real exchange rate and real interest rates after the crisis, brought into play the major forces that led to the adjustment in global investment and savings, as well as reserves accumulation.

Today, I want to identify three factors as the major forces contributing to external surplus and reserves accumulation. The first is the process of global investment-savings adjustment that I have noted. The second is the policy configuration in the US, especially the easing of monetary policy that plays a crucial role in promoting expenditure of US households. And the third is financial innovation and the deepening process of financial globalization, especially in the US, that facilitates risk allocation and enhances access to credit by households. The growth of credit derivatives and sub-prime mortgages are two examples of the developments that have taken place.

On the global basis, these forces have led to a widening of the US current account deficits that was matched by surpluses elsewhere. As for East Asia, in terms of the investment-savings gap, the increase in surplus essentially reflects a fall in investment as opposed to a rise in savings as is the case for China and the oil-exporting economies.

In the Thai case, a deep currency depreciation after the crisis led to a shift in profitability towards tradeables, and induced a major shift in resource allocation. Also, the damage to the banking sector compromised credit growth and the subsequent expansion of domestic demand, as the ability of the financial sector to take risk became more constrained. As a result, there was a sharp fall in domestic demand, especially private investment. And exports, by default, became the key engine for growth.

Similar adjustment was observed throughout East Asia. The adjustment led to a turnaround in the external current account, a decline in external indebtedness, and a rise in international reserves, all of which helped strengthen the region’s external position. Given the weakness in domestic demand, limiting large currency appreciation becomes a necessity for some economies to support economic recovery. And with weak domestic demand, pursuance of banking reform was an important policy to normalize lending and credit growth. On top of this, liberalization to allow more capital outflows also became an instrument of choice in managing the macroeconomic impact of rapid capital inflows.

On the demand side of global capital, policy configuration in the US was instrumental in allowing the external surplus of emerging markets to be absorbed through the US current account deficits. The key mechanism, as I noted, has been the easing of US monetary policy that has helped support global growth through the expansion of US demand. With private investment in the US still recovering from the stock-market correction in early 2000$s, lower interest rate and greater access to credit significantly increased US consumption at the expense of a fall in private savings. As a result, the US external imbalance widened while reserves accumulation by emerging markets increased.

The next question is can this go on? And is reserves accumulation a temporary or a permanent feature of the international monetary system?

To answer this question, one has to distinguish between stock and flows. On the flows side, given reserves accumulation essentially mirrors external surpluses of emerging markets, the pace of reserves increase going forward is more likely to ease. This is because the adjustment process that is now ongoing will reduce the imbalance. The more the adjustment, the less will be the additional flows, and hence the pace of reserves accumulation.

But to be successful, the adjustment will require both expenditure reduction, through higher US real interest rates, and expenditure switching through a US dollar depreciation. So far, the burden of adjustment is more on the dollar than on interest rates. Another thing to keep in mind is that the process of adjustment is likely to take time as it requires a shift in resource allocation. This point was brought out clearly by the Asian experience. But as surpluses decline, the pace of reserves accumulation will ease.

In such process, a key risk to watch is the possibility that financial adjustment, driven by the forces of market, can outpace the adjustment in the real sector, thus potentially creating a disorderly movement. Therefore, we need better coordination of policies amongst countries to ensure an orderly adjustment process.

What role can reserves accumulation play in this process? It has been pointed out that reserves accumulation can help smooth the process by limiting an abrupt US dollar decline, while enabling emerging markets to continue support the global economy by maintaining growth. This is a so-called /falling with a parachute1 scenario. In addition, the recycling of official reserves to the US market can help limit the pace of interest rates adjustment in the US, thereby supporting a smoother correction in US output.

As for emerging markets, strong reserves positions help emerging markets to be in a better position to weather the impact of market volatility that may occur during the adjustment process. A case in point is the recent experience with the US sub-prime problem.

Compared with other markets, the impact of the US sub-prime has been more limited for Asia. This is because direct exposure to subprime CDOs is relatively small compared to the overall assets of the Asian banking system.

Moreover, a number of positive developments have taken place since the Asian financial crisis that has made the region more resilient to such a downturn. First, the financial positions of banks and corporate are much stronger with reduced indebtedness and less mismatch, as well as improved balance sheets.

Second, Asian economies are much stronger in terms of external position, especially the levels of reserves that can comfortably cushion the outflows. And third, the economies overall have become more flexible both in terms of policy regime and the key prices. All these have put Asian economies in a much firmer footing to cope with the second-round effects of the sub-prime crisis.

Let me now turn to policies that are needed for an orderly process of adjustment.

In the short-term, an orderly movement in the US dollar is key for ensuring an orderly process of adjustment. The risk at this time is that market forces and expectation can lead to a disorderly movement. Hence, foreign exchange intervention remains a viable option to guide an orderly adjustment. At the same time, to ensure no disruption to the financing of the US deficits, there may be a need to consider broadening the scope of investing in US assets especially the physical assets. This is to ensure continued interest in US assets at a time when some segments of US financial assets may be less appealing than before on account of the ongoing stress in the credit market.

But in the longer-term, we need to look at this process of adjustment from a global perspective and the key to the issue would be to rebuild a stronger domestic demand growth outside the US. Doing so would require stimulating public investment in infrastructure especially in Asia, as well as continuing with the financial reform to support private investment and credit expansion. And finally, greater flexibilities in prices will also go a long way in promoting an efficient resource allocation. All these points are not new, but they are a good reminder of what needs to be done.

Since, our theme today is on the new trends in reserves management, let me end my remarks with a few points on reserves management and financial markets.

Reserves management is essentially the flip side of reserves accumulation. In terms of the stock of reserves, notwithstanding a successful adjustment in the global imbalance, the relative importance of countries, as measured by their reserves positions, is unlikely to change significantly in a foreseeable future from the position we are in today.

This is because reserves accumulation to date reflects successive years of external surpluses rather than borrowed reserves. Going forward, productivity improvement and continued careful policy management by emerging markets will help maintain this relative position. Therefore, for some or for most countries, the regime shift that we are seeing now may be more of a permanent feature.

So, the world is now different, and this change needs to be recognized more fully by the market. More importantly, the configuration of policies at the international level, especially by the Bretton Woods institutions, also need to adapt to this shift.

On reserves management, the size of reserves that we have now in emerging markets, the fiscal costs associated with reserves accumulation, and the opportunity cost of investing excess reserves, all these may induce reserves managers to explore opportunities for enhancing returns by adopting more aggressive investment policies. Such actions will undoubtedly affect financial markets. On this, it is important to remind ourselves that this style of investment can also come into conflict with the mandate of central banks in preserving stability and orderly markets. So, the challenge is to achieve a proper balance.

Thank you, Mr. Chairman.