International Reserves: The More, The Better?

By Quah Boon Huat

A large stockpile of international reserves should not be taken to mean that all is well with the domestic economy.

The world has caught a bad cold. According to the October 2008 IMF World Economic Outlook Report, the world economy, battered by the most dangerous financial shock since the 1930s and by still-high energy and commodity prices, is entering a major downturn and many advanced economies are already close to or moving into recession.

The biggest worry of almost every Malaysian right now is the resilience of the Malaysian economy. Can it ride out smoothly the global economic crisis even though half the world is already in recession?

Comments have been made that the Malaysian economy will not slide into a recession because, among other things, Malaysia's international reserves are high. As of end-September 2008, Malaysia's international reserves stood at USD107.6 billion.

What are international reserves? Is it a case of "more is better"?

Also popularly known as foreign exchange reserves, international reserves are assets a central bank holds in different reserve currencies, such as the dollar, euro and yen, and to a very much smaller extent, gold and IMF Special Drawing Rights. These assets are basically used to finance international transactions, to serve as a buffer stock to face unexpected payments difficulties, and to allow implementation of monetary and foreign exchange rate policies.

International reserves accumulation has been the favoured policy of most developing economies since the Asian Financial Crisis (1997-98). During the crisis, the scale and speed of the reversal of capital flows had resulted in sharp contractions in output and investments, credit crunches, and banking crises in several countries.

The rapid accumulation of reserves after the crisis suggests that it is a precautionary adjustment, a reflection of the desire to self-insure against exposure to future sudden stops, rather than to depend on institutions like the International Monetary Fund. For example, a country with a large stockpile of reserves will be able to lay to rest fears of potential defaults on foreign debt payments by the government or the private sector and therefore avoids being shut out of international capital markets.

In many cases, however, this precautionary motive seems to have been replaced by a strategic motive of using the reserves to manage exchange rates at a certain desired level or range.

The enormous accumulation of reserves in Asia has been so rapid that the Asian Development Bank has warned that it is now well beyond its optimal levels. Reserves

accumulation may over time entail risks and costs like inflationary pressure, over-investment, asset bubbles and complications in the management of monetary policy.

There is also the risk that the balance sheets of monetary authorities may face potentially sizeable capital losses. For example, not all risks may have been taken into account when the unprecedented increase in world reserves were partly used to fund the seemingly forever-growing U.S. deficits.

China is a case in point. With more than USD1.5 trillion in reserves denominated in U.S. dollars, it has become a hostage to its debtor, i.e. the United States. China is stuck, and any hint of it moving to shift away from the U.S. dollar in the currency composition of its reserves would be devastating. One can only guess the extent of the carnage in the financial markets and the world economy if that were to happen.

Persistent reserves accumulation suggests a strong external sector with significant trade and current account surpluses, which is certainly true for Malaysia. It has been consistently registering trade and current account surpluses for over a decade.

While a persistent trade surplus can be interpreted as a sign of export competitiveness due to rising productivity or falling costs, it is more than likely that an undervalued ringgit is the reason in Malaysia's case, and which obviously cannot go on forever.

A persistent current account surplus in the face of large reserves, on the other hand, can be interpreted as a sign of an inherently weak domestic economy, driven mainly by exports.

According to the absorption approach to interpreting balance of payments statistics, the current account balance is the difference between national income and domestic absorption, where absorption is defined as the sum of private consumption expenditure, investment and government expenditure. A current account surplus thus suggests that there is weak domestic demand, and that there is a glut of domestic savings.

As such, more international reserves do not necessarily mean better, and a large stockpile should not be mistaken as a sign of economic resilience. Besides, reserves accumulation entails risks and costs. Malaysia's stockpile of reserves should thus not lull us into a false sense of economic security, especially during the current global economic turmoil with half the world already in recession and external demand expected to shrink further.

According to Bank Negara, the optimal level of reserves for Malaysia is between USD30 billion to USD40 billion. As Malaysia's level of reserves is way above optimal level, an alternative use could be found for the excess reserves to build a more dynamic domestic sector and therefore render the economy more resilient in the face of external shocks. In Taiwan, for example, USD15 billion was allocated to banks for use in major investment projects.

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