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SHOW ME THE MONEY!

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Governments worldwide are accumulating reserves to guard against financial turmoil. Could they be contributing to it?

In the late 1990's, governments around the world held about US$2 trillion in reserves, excluding gold and foreign assets that were not recorded as assets, such as sovereign wealth funds. That figure breached US$10 trillion in 2011, and the trend shows no sign of slowing down. That prompted the International Monetary Fund (IMF) to warn its member countries that such excessive reserve accumulation could destabilise the international monetary system.

"The actual reserve accumulation is not for precautionary reasons," explains **Hans Genberg**, Assistant Director at the Independent Evaluation Office of the IMF. "Many countries end up accumulating reserves because they want to limit appreciation pressures in their currencies."

The urge to limit currency appreciation is most easily understood in trade terms, where a strong currency makes exports less competitive. Japan, in the five months since Shinzo Abe started his second stint as Prime Minister, has seen the yen weaken from 80 yen to about 100 yen to the dollar - a 25 percent fall. Japan's exporters will be cheering when exports in US dollars are filed as revenues in yen, leading to a situation which the IMF describes as "reserves (growing) as a by-product of the pursuit of policy objectives related to the exchange rate and competitiveness".

RESERVE-ING COMMENT

However, reserve accumulation for precautionary reasons is easy to understand, especially for developing countries. These economies are often the target of "hot money" investors looking to profit from interest rate differentials between low-interest developed economies and higher-interest developing ones. The surge in such investments can cause asset bubbles which cause economic misery when investors cash out, leaving local governments and financial institutions to pick up the pieces.

To help stabilise financial markets and the economy in the event of such volatility, reserve accumulation has accelerated dramatically. IMF figures show that reserves stood at 13 percent of global GDP in 2009, doubling their level in 2000. While that is high, it is peanuts compared to that of emerging economies, which in 2009 held up to 26 percent of their GDP in reserves. Add China to the mix, and you have a staggering figuring of 32 percent of GDP.

That prompted the IMF to convince member countries that, ultimately, excessive reserve accumulation was in nobody's interest. Essentially, member countries needed to agree on what was an "adequate" level of reserves for precautionary measures.

"IMF staff produced a paper where they proposed a reserve adequacy indicator, which is an elaboration of previous measures," Genberg explained to *Perspectives@SMU* during a recent SMU SKBI Seminar on the IMF report, International Reserves: IMF Concerns and Country Perspectives. "That measure is an improvement but it doesn't come to grips with the heterogeneity of countries. It's difficult to have a metric which represents all the risks that a particular country faces. Country officials say: 'Any metric must take into account the specific circumstances of our country.'."

CATCH-22

Genberg conceded that the IMF and central bankers often have contradicting views: the IMF thinks countries are holding too much reserves, while central bankers would rather incur the costs of holding extra reserves to guard against unforeseen circumstances.

However, the situation of reserves being concentrated in US dollar-denominated assets inevitably leads to excessive demand for the greenback, which makes it more difficult for governments to diversify their risks. To make matters worse, excessive selling of US dollar-based assets could spark a market panic which would lead to huge losses to the largest holders of such assets - a Catch-22 situation.

"You solve that problem by diversifying slowly. It should also be remembered that large reserve holdings must be invested primarily in large countries. It is not conceivable that a large chunk of the world's reserve would be invested in, say, the Australian dollar market, because there simply aren't enough Australian Dollar-denominated assets."

In other words, you might want to hold on to your greenback: it's not going anywhere anytime soon.