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Accounting for emerging market countries' international reserves: Are Pacific Rim countries different?

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Popular perception is that emerging market economies (EMEs), and Asian Pacific Rim countries—China, Indonesia, Korea, Malaysia, Philippines, Thailand, and Vietnam (RIMs)—in particular, have been rapidly accumulating reserves, perhaps beyond what is justified by precautionary motives. This paper compares and contrasts the determinants of the demand for international reserves in the RIM countries with other EMEs over the last three decades, based on current and capital account risks, mercantilism, and other motives. Our findings suggest that the motives for holding reserves has shifted from insurance against current account shocks (mostly in the 1980s) to insurance against capital account shocks (in the 1990s) and as the by-product of possible mercantilism (in the 2000s). We also find some differences between country groups: RIM countries tend to hold more reserves against current account vulnerabilities and fewer reserves against capital account vulnerabilities, but more reserves overall. There is also greater evidence of mercantilist motives being at play for RIM countries, though this motive accounts for only a small fraction of the rise in reserve holdings in recent years, peaking in 2004 and declining thereafter.

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1. Introduction

Over the past few decades, despite somewhat greater exchange rate flexibility, and some draw down during the global financial crisis, emerging market economies (EMEs) have been accumulating large stocks of international reserves. Reserve holdings, which averaged about 5% of GDP in the 1980s, have been doubling every decade since, reaching some 25% of GDP by 2010. While foreign exchange reserves may provide useful insurance in the face of current or capital account shocks (as part of a robust policy toolkit that includes macro policies, prudential regulations and capital controls—see Ostry et al., 2010, 2011), there is often a perception that reserves are not being accumulated for precautionary purposes but rather as the by-product of deliberate mercantilism. Beyond the possibility of unfair trade practices and exchange rate manipulation, such mercantilism may perpetuate global imbalances and ultimately undermine the stability of the international monetary system (Ghosh et al., 2010).

Asian countries, notably those on the Pacific Rim (RIM), are often singled out for purportedly pursing export-led growth strategies by keeping their currencies undervalued, in turn resulting in excessive reserve accumulation. For instance, writing in 2010, Paul Krugman claimed Today [2010], China is adding more than $30 billion a month to its $2.4 trillion hoard of reserves. This is the most distortionary exchange rate policy any major nation has ever followed.[1] And as recently as 2013, Dani Rodrik noted that: "Although China phased out many of its explicit export subsidies … mercantilism's support system remains largely in place. In particular, the government has managed the exchange rate to maintain manufacturers' profitability, resulting in a sizable trade surplus.[2]"

But does this view have any merit? In this paper, we take up that question with specific reference to the Asian Pacific Rim countries—China, Indonesia, Korea, Malaysia, Philippines, Thailand, and Vietnam.

There are potentially two approaches to addressing this question. The first is to try to establish an absolute norm for how much reserves are required for precautionary purposes, with any further accumulation that is undertaken in the context of an undervalued currency being deemed "mercantilism". The main difficulty with this approach is that "how much is enough" is an evolving standard: what was sufficient for current account shocks in the 1980s was clearly inadequate for the EME capital account crises of the 1990s. Likewise, prior to the global financial crisis, many commentators thought that Russia's US$600 billion of reserves were ample, and perhaps even excessive, yet that view was rapidly revised when the central bank spent more than one-third of its reserve stock in the space of a couple of months. Moreover, existing reserve adequacy metrics generally have wide margins—the recently developed IMF methodology for assessing reserve adequacy, for instance, suggests a range between 100% and 150% of its Reserve Adequacy Metric as being appropriate, but for the typical EME, that range translates into 10% of GDP (IMF, 2011).

In this paper, therefore, we adopt a more pragmatic tack. Rather than try to assess whether Asian RIM countries are stockpiling excessive reserves against some absolute standard, we compare the behavior of RIM countries to that of other emerging market economies. This allows for evolving notions of reserve adequacy while still assessing whether RIM countries are exceptional in their reserves accumulation behavior. Specifically, we seek to determine whether RIM countries hold more reserves than non-RIM countries, controlling for various current and capital account vulnerabilities; whether they react differently in terms of their reserve holdings to such vulnerabilities; and whether a larger proportion of their reserve accumulation over the past twenty years can be accounted for by mercantilist motives.

Building on our earlier work (Ghosh et al., 2012), henceforth GOT, we define mercantilism as reserve accumulation that is unrelated to current or capital account vulnerabilities and that takes place in the context of an undervalued currency. Our empirical strategy proceeds in three steps. We begin by estimating a reserve demand function for a large sample of (RIM and non-RIM) EMEs over

[1] Paul Krugman (14 March 2010). "Taking on China and its currency" http://www.nytimes.com/2010/03/15/opinion/15krugman.html.

[2] Dani Rodrik 2013, The New Mercantilist challenge, http://www.project-syndicate.org/commentary/the-return-of-mercantilism-by-dani-rodrik.