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Hoarding of international reserves in China: Mercantilism, domestic consumption and US monetary policy

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ABSTRACT

We develop a two-country two-period model able to reproduce the key qualitative aspects of the US-China co-dependency (and imbalances) as the result of the Chinese and American authorities pursuing different but complementary objectives. We show that a mercantilist reserve hoarding has served well the Chinese policy goals (fast GDP expansion and labor mobilization) and has been compatible with the US ones (high households' consumption). If the US authorities keep monetary policy sufficiently loose, thus reducing the real value of the US liabilities held by China, this latter finds less tempting to stop financing the US external deficit, appreciate the currency and increase consumption. On the contrary, if the policy goals in China change from the maximization of GDP growth to higher households' standards of living, a rebalancing process may be ignited. We then discuss the model and its theoretical predictions, also in light of the Five-Year Plans approved by the Chinese ruling Party.

1. Introduction

Chinese foreign exchange reserves topped $3.2 trillion in June 2011, $1 trillion above year-earlier levels and more than 7 times larger than in June 2004. Notably, most of these reserves are concentrated on US dollar denominated assets (in particular, US Treasury securities): since 2006, China alone has held on average more than 20% of all the US Treasuries in foreign hands (see Figs. 1 and 2).

Not only this fast and unusually massive accumulation of reserves has been the object of a lively debate devoted to unveil its economic rationale, but its future persistence has been repeatedly

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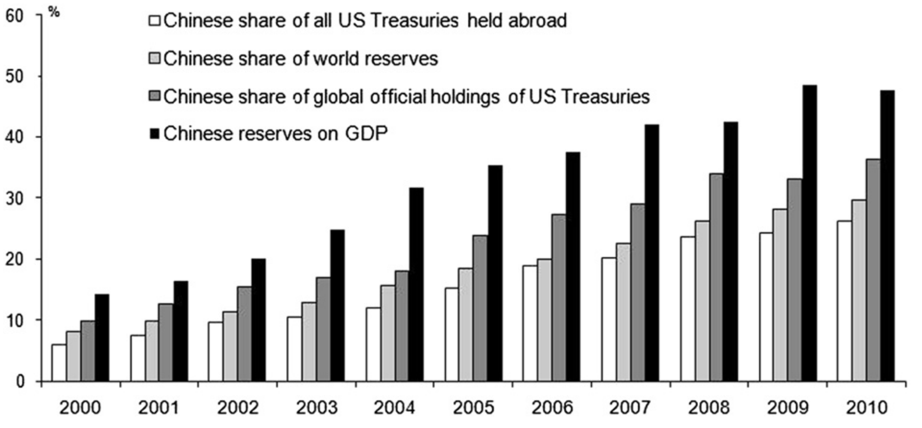

Fig. 1. Chinese reserves and holdings of US Treasuries. Sources: IMF IFS and US Treasury (TIC).

questioned in the specialized press and by distinguished economists. China, the argument went and still goes, may be tempted to stop financing the US external deficit, sell part of its reserves, increase its consumption, and move its economy away from tradables and toward nontradables.[1]

A widespread consensus in the literature has been reached on the fact that the massive accumulation of foreign reserves in most Asian countries has reflected, to a different extent in different countries, both mercantilist and self-insurance purposes. The mercantilist motive, indeed, is particularly appropriate to account for reserve accumulation in China: as the authorities have enforced tight capital controls and maintained an undervalued currency, which made the country less exposed to capital flow reversals, China has needed limited reserves for purely self-insurance purposes.[2] Delatte and Fouquau (2012) show that the observed acceleration in the accumulation of foreign reserves during the last decade is more consistent with a mercantilist motive than with a precautionary one.

Less attention and not fully satisfactory explanations, however, have been given to the reasons why this strategy has been carried on for such a long period of time despite its growing costs. Export-led growth and reserve accumulation have never been goals *per se*, but rather the outcomes of the Chinese authorities pursuing the objectives of maximizing GDP, accelerating domestic growth, and facilitating the mobilization of labor from the rural areas into the industrialized urban areas (see, for instance, Yao and Zhou (2011) on this). Nor the literature has addressed the extent to which the Chinese strategy has been compatible with the growth paradigm and the policy priorities in the US. In this work, we endeavor to show that the actual economic relationship between the US and China can be explained by referring to a stylized, but realistic, set of economic policy objectives in both countries: we model the possibility for the authorities in the two countries to choose the strategies that are conducive to better results in terms of their ultimate goals. We show that, given the Chinese objectives, the export-led paradigm has been the appropriate strategy for China once the US policy objectives are taken into account.

[1] Since mid-2000s, a number of studies have advocated a rapid rebalancing of the Chinese growth away from external demand and investment, and toward domestic demand and consumption (see, among others, Blanchard and Giavazzi (2006); Prasad (2009); Prasad and Rajan (2006); Straub and Thimann (2010); Zheng et al. (2009)), arguing that the costs associated with the maintenance of the export-led growth paradigm (such as the costs due to the difficult sterilization of the reserves, to the maintenance of tight capital controls, to overinvestment in low performing sectors, to the risks of banking loans turning bad) would be larger than those stemming from a reversal of the so-far-successful growth strategy.

[2] On the contrary, the emerging countries that liberalize the financial account tend to hoard reserves for a precautionary motive, as the policy makers grow concerned about financial stability in the face of greater financial integration. Reserves work as ammunition to fend off speculative attacks, smooth idiosyncratic shocks and manage capital reversals (see, for instance, Aizenman and Lee (2008); Cheung and Qian (2009); Durdu et al. (2009); Obstfeld et al. (2010)).