

THE ASIAN CENTRAL BANKS AND THE DOLLAR

By accumulating considerable dollar reserves in order to peg their currencies, the Asian central banks financed about two-thirds of the US current account deficit over the first three quarters of 2003. Is their behaviour likely to change? Neither the financial costs of accumulating reserves nor the economic objectives of these countries suggest they will. On the contrary, breaking currency pegs with the dollar would entail significant risks due to plummeting values of forex reserves, with the appreciation of local currencies. But the accumulation of US external deficits cannot go on forever. Adjustment will have to take place. The danger is that such adjustment may follow a speculative attack against the dollar that the Asian central banks would not be able to resist, leading to a widespread recession. Coordinated interventions by central banks in the forex markets, supported by a G7 meeting, could prevent this a scenario from unfolding. But such a concerted move could only have a sustainable impact if it were accompanied by significant changes in monetary and fiscal policies, both in the United States and in Europe.

■ The Gordian Knot of the US Deficits

The upswing of the US economy over the last year has been supported by economic policies which are leading to a rapid increase in financial imbalances. The US household savings rate is very low (2.3% during the third quarter in 2003, as opposed to a historical average of 6%), as indebtedness has been growing at twice the rate of incomes since 2001. According to the CBO (Congressional Budget Office), the federal government deficit is set to rise from 3.8% in 2003 to 4.3% in 2004. Although the financial situation of the corporate sector has improved, these internal imbalances are reflected in America's current account deficit which rose to about 5% of GDP in 2003. More worrying still than the flow is the profile of the trend that has emerged since the speculative bubble of the "New Economy" burst. The United States' net foreign debt rose from 8.5% of GDP at the end of 1999 to 25.7% at the end of September 2003, and is rising at an accelerated rate. As European companies are still far from having absorbed the capital losses they incurred on investments made during the euphoria of the late 1990s, the direct investment balance has been reversed, and must henceforth be added to the current account deficit, so that the pervasive deficit to be financed rose to \$580 billion in 2002, and to more than \$600 billion in 2003 (see Table). As a result, the supply of dollars which needs to be absorbed by

non-residents has expanded rapidly. The conditions under which the international market for dollar assets is balanced on a daily basis depend on expectations held in the foreign exchange markets.

Net portfolio investment flows and the other investments set out in the Table are rather sluggish. They show that there is no speculation either in favour of or against the dollar. Instead its value is falling mechanically as the supply of dollars generated by the needs of the US economy on any given day is not matched by sufficient demand of private foreign investors, at the exchange rate prevailing the previous day. As long as expectations do not enhance this bearish trend, the downward pressure on the dollar vis-à-vis other currencies depends mainly on the central banks. Given that the US authorities are wholly passive, the disparity in the activism of the foreign central banks largely explains the trends in the exchange rates of other currencies against the dollar. To support economic activity, numerous countries in Asia have chosen to peg their currencies against the dollar, either through fixed exchange rate regimes (China, Malaysia, Hong Kong) or through managed floating regimes (Korea, India, Taiwan and Japan). The downward pressure on the dollar is thus displaced onto freely floating currencies, such as the Canadian dollar, the pound sterling or the euro, the latter having appreciated by 23% against the US dollar in 2003, and by more than 55% since October 2000¹.

1. See "The Happy Dollar", La Lettre du CEPII, No 225, July-August 2003.

This article seeks to assess the scale of the contribution of Asian central banks in financing the US current account, and to identify possible limits to these policies. It examines the possibility of a dollar crisis and argues in favour of international cooperation.

The Financing of the US External Deficit by Central Banks

The balance of payments statistics provided by the Bureau of Economic Analysis (BEA) evaluate the direct contribution of foreign central banks to the financing of the American deficit, given under the heading “Assets held in the United States by foreign public authorities”². For the first three quarters of 2003, the rise in dollar reserves held by central banks totalled \$142 billion, thus covering 34% of American financing requirements (Table).

Table - The financing of the American current account deficit
billions of dollars and %

	1999	2000	2001	2002	2003*
American current account balance	-291	-411	-394	-481	-413
as a % of GDP	-3,1	-4,2	-3,9	-4,6	-5,0
Financial account	228	457	421	532	415
. Direct investment balance	65	162	32	-98	-37
as a % of the current balance	22	39	8	-20	-9
. Portfolio investment balance	161	258	338	425	232
as a % of the current balance	55	63	86	88	56
. Other investments (excluding monetary authorities)	-41	-1	45	110	77
as a % of the current balance	-14	0	12	23	19
. Change in assets held by the foreign public authorities	44	38	5	95	142
as a % of the current balance	15	9	1	20	34

*First three quarters of 2003.

Source: Bureau of Economic Analysis.

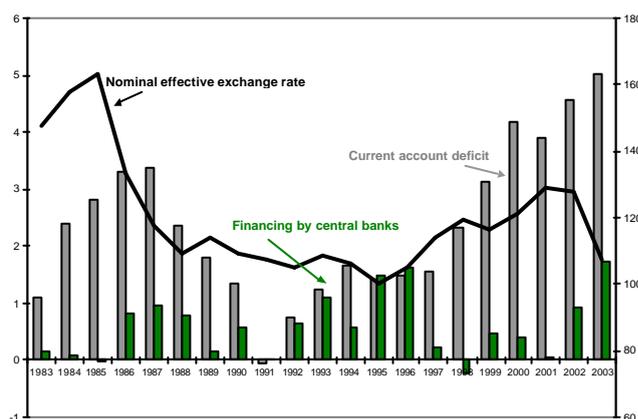
According to the IMF, however, world reserves rose by \$424 billion during the same period. Assuming that the dollar share of world reserves remained at the level estimated by the IMF for the end of 2002 (64.5%), then official reserves invested in US assets would have risen by \$274 billion. This would raise the share of central bank financing of the American deficit to approximately 66%. The difference between the two evaluations is essentially explained by the fact that a rising proportion of official dollar reserves is held in deposits outside the US banking system³. When such funds are invested in the United States by commercial banks, US balance of payments accounting records them as liabilities vis-

à-vis foreign banking and financial institutions and not vis-à-vis foreign public authorities. Part of the central banks' contribution to the financing of the American deficit may then find itself recorded under the “other investments” or under the “portfolio investments” headings of the American balance of payments.

Still, the 66% share is a rough approximation. It ignores the impact of the strong appreciation of the euro, the yen and the pound sterling on the value of the stock of world reserves: due to forex valuation effects, the reserves that have in fact been accumulated during the first three quarters of 2003 are less than the variation in stocks actually indicated. The 66% share, which is calculated on the basis of the breakdown of currencies observed at the end of 2002⁴, also ignores the fact that the main increase in reserves observed during 2003 stems from Asian central banks acquiring significant amounts of dollars to limit the appreciation of their currencies. When these factors are taken into account, it may be estimated that central banks contributed about 75% to the financing of the American current account deficit, and that the proportion of the Asian banks alone amounted to 64%⁵.

These figures may seem high. But central banks have actually provided substantial financing for the United States on several occasions, especially when the dollar has fallen to historically low levels (see Graph 1). According to data by the BEA, this proportion exceeded 100% in 1995 and 1996, reflecting massive, concerted intervention by central banks at the time, to stop the fall of the dollar.

Graph 1 - The exchange rate, the deficit and financing by central banks
The nominal effective exchange rate of the dollar 1995 = 100 (right-hand scale),
The US current account deficit and assets held by foreign public authorities
as a share of GDP



Source: Bureau of Economic Analysis.

2. The “Foreign official assets” heading covers all claims and liabilities by American residents with respect to the foreign public authorities (central banks, Treasury departments, Ministries of Finance, Stabilisation funds etc.), whatever their nature: shares, private and public bonds, Treasury bills, deposit accounts.

3. R. Cauley & B. Fung (2003), “Choosing instruments in managing dollar foreign exchange reserves”, BIS Quarterly Review, March.

4. The currency breakdown of world reserves given by the IMF for the end of 2002 is as follows: dollar: 64.5%, euro: 17.8%, yen: 4.5%, pound sterling: 4.4%, other: 8.8%.

5. This estimate is based on forex reserves held by the central banks of China, Taiwan, Hong Kong, Japan, Malaysia, the Philippines, Singapore, Korea, India and Indonesia. It is assumed that at the end of 2002, 80% of their holdings were in dollars, 10% in euros, 5% in yen and 5% in pounds sterling, whereas 90% of the reserves accumulated during the first three quarters of 2003 were in dollars.

■ The Limits on Accumulating Reserves?

Does the central banks' policy of accumulating reserves run the risk of being unsustainable? The fact that the scale of reserves accumulated is far larger than the needs linked to trade and financial operations raises questions about the costs and risks of pursuing such a policy⁶. This is especially so for Japan and China, as well as Taiwan, Korea and India. The rise in reserves accumulated by these five countries during the first three quarters of 2003 accounted for 93% of the increase in Asian reserves.

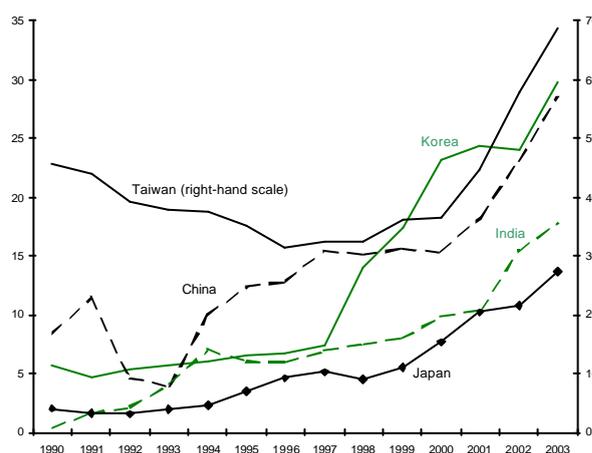
One of the risks of building up reserves lies in the fact that the induced increase in the money supply feeds the distribution of credit and hence inflationary pressures in goods and assets markets. To avoid this, central banks can sterilise the increase in reserves by selling government bonds, by cutting bank refinancing, or by issuing securities (certificates of deposit or bonds) so as to keep the supply of money constant. Such operations entail a cost to the central banks, which depends on the spread between domestic interest rates and the yield on reserves (US Treasury bonds), the quantity of reserves to be sterilised and the expected rate of appreciation of the domestic currency. For three countries which have practised such a policy (Korea, Taiwan and India), such overall costs in 2002 and 2003 were relatively minor, estimated to be in the order of 0.2% of GDP⁷.

For the two other countries –China and Japan– the injection of liquidity brought on by the inflow of foreign currencies has turned out to be positive, given a deflationary context. The goals of external and internal monetary policy have converged for Japan in particular, and there is no reason for the central bank to stop intervening in the forex markets to limit the appreciation of the yen against the dollar. In China, the central bank has used more than one tenth of its forex reserves to re-capitalise two large national banks, the Bank of China and the China Reconstruction Bank. The Chinese banking system, characterised by a large share of bad debt⁸, could still benefit from the huge amount of accumulated reserves. However, the increase in the supply of money has led to a strong rise in domestic credit and this in turn has caused accelerated house price inflation. As a result, since May 2003, the Chinese authorities have partly sterilised foreign capital inflows.

Furthermore, the Asian central banks have a strong incentive in clearly stating their commitment to pursuing currency stability against the dollar: were the credibility of their policies to be questioned by private agents, then the latter would be encouraged to convert their dollar deposits into local currency, which in turn would only lead to further increases in central bank reserves. Such deposits are approximately equivalent to half of all reserves held, especially in China and Taiwan.

Above all, far greater short and medium term risks are likely to affect these countries were they to decide to let their currencies appreciate. Insofar as forex reserves are largely held in dollar-denominated assets, a strong depreciation of the dollar would lead to significant capital losses, expressed in local currency, given the scale of reserves relative to GDP⁹ (Graph 2). Indeed, were the dollar to depreciate by about 25%, then this would lead to a capital loss of about 5.7 % of GDP in China, 6% in Korea and 13.7% in Taiwan (these estimates assume that 80% of Asian reserves are invested in dollars). The scale of such losses would exceed the amount that could be absorbed in the forex re-valuation account¹⁰ and could even exhaust the central banks' capital account. Under these circumstances, problems of solvency may arise as the value of total assets in central bank balance sheets falls below that of their liabilities. In principle, this would require a central bank to be recapitalised by government via, for example, the injection of Treasury bonds. Without such intervention, the central banks would then be exposed to a

Graph 2 – The foreign exchange reserves of Asian central banks as a % of GDP



Source: IMF and National Central Banks.

6. See IMF (2003), "Are foreign exchange reserves in Asia too high?", in World Economic Outlook, Chapter II, September.

7. Sterilisation implies either a modification in the structure of assets in favour of lower yield stocks (American Treasury bonds instead of domestic bonds), or the issuance of stocks which the central bank has to remunerate. The various costs have been estimated here on the basis of central banks' balance sheets and interest rates, provided by the IMF and the national central banks.

8. See "China's capital account liberalisation: international perspectives", BIS Paper, No 15, April 2003.

9. See the Bank of England (2003), "Foreign exchange accumulation in Non-Japan Asia" (Box 4) in "The financial stability conjuncture and outlook", Financial Stability Review, June. For example, in 2003, the appreciation of the euro against the dollar led to non-realised losses of € 500 million accruing to the ECB. These were considered as "realised" losses, given the precautionary principle.

10. Central banks have a forex re-valuation account in the liabilities of their balance sheets which allows them to smooth out the impact of exchange rate fluctuations on the valuation of their reserves expressed in local currency.

significant fall in their seignorage revenues: the income derived from their forex reserves would fall in proportion to the decline of the dollar. The situation could be especially disruptive for central banks (notably of Korea and Taiwan) which, by sterilising the inflows of foreign capital reserves, have accumulated massive liabilities in certificates of deposit and bonds that they have to remunerate. Operating losses could then occur, which governments would have to meet if they do not want the central banks to mop up such losses by creating money. In all cases, the fall of the dollar will lead to non-negligible costs for national budgets.

■ The Need for International Cooperation

It is therefore likely that Asian central banks will continue to accumulate reserves, not just to slow down the appreciation of their currencies, but also to head off the financial crisis which would be triggered by an important fall in the value of their dollar reserves. However, they cannot completely avoid the risk of downward speculation on the dollar.

Indeed, the financing of US foreign debt, which is growing faster and faster, cannot continue forever, because the debt would become insolvent. A time will come when cumulative imbalances will require adjustment. Is it possible that the fall in the dollar, limited by the behaviour of Asian central banks, can bring about such adjustment without requiring any change in economic policy? Surely not! The price elasticities of foreign trade are too low and the trade deficit too large for an adjustment to occur without there being a turnaround in the prevailing relative rates of growth between the United States and the rest of the world.

If current US economic policy is maintained, with the fall in the dollar itself not being sufficient to reverse the country's deteriorating foreign debt position, destabilising speculation against the dollar may well occur in the forex markets. The latter could challenge the capacity of Asian central banks to absorb the upward pressures on their currencies. The financial difficulties mentioned above would be likely to slow

Asian growth, while an excessive appreciation of the euro and the yen would sap their already weak economies. The Japanese and German banking systems, which still suffer from low profitability and low-quality loans, will have to absorb the losses of their debtors, brought on by exchange rate over-valuation. In turn, the adverse consequences on the growth of domestic demand in Europe and Japan would then restrict export outlets for US goods and hence prevent the trade deficit from being closed.

To avoid a fully-fledged recession from developing, central banks, supported by G7 finance ministers, would do well to engage in coordinated interventions to stabilise the forex markets and to provide an anchor for market participants' expectations. However, such measures are known not to have lasting results unless they are accompanied by significant policy changes. Such changes occurred in the wake of the stock market crash in 1987, when France and Germany adopted more expansionist monetary policies. The ECB should thus enter the ring by cutting interest rates, while the FED should raise its rates prudently. This would at least have favourable consequences for share and bond markets. But, monetary policy alone will likely be insufficient to bring about a soft landing of the dollar. European governments will have to address the urgency of the situation, by adopting new rules to allow fiscal policy to be more active, while the US government should reduce some of the permanent tax cuts it has granted. From this point of view, only a turnaround in the growth gap between the US and Europe is capable of promoting rapidly a financial situation compatible with a stable dollar.

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