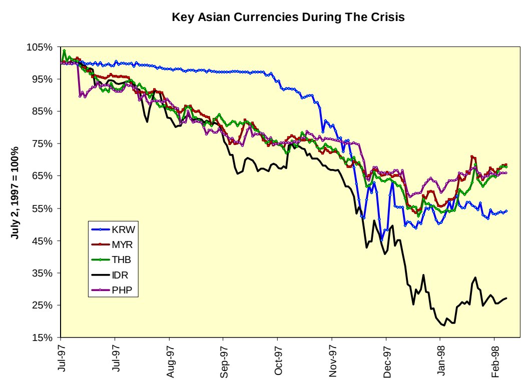
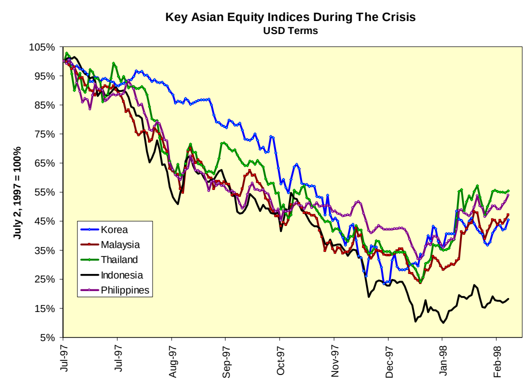
Are Asian Currency Reserves An Inverse Financial Anorexia?

A culture is a system of shared beliefs; whether they are objectively right or wrong is irrelevant. Sometimes these extend into collective economic behavior, such as the American political consensus the federal government has an affirmative responsibility to prevent a repeat of the Great Depression of the 1930s or the German fear of inflation arising from their Weimar experience. Both of these arose from negative events. Strangely, there are few parallels created from cultural agreements to repeat positive experiments. To wit, no economic experiment in human history has lifted so many people out of poverty as capitalism and yet it suffers from a bad press in many quarters.

One collective negative experience from the 1990s was the Asian financial crisis of 1997-1998, an event now more than half a trading generation ago and fading into memory outside of the region. However, it seared a lesson into citizens of Thailand, Malaysia, Indonesia, the Philippines and Korea never again to place themselves in a position where the sudden withdrawal of funds by external investors could cause a catastrophic collapses of their currency and equity markets. Anyone who lived through the financial crash in the U.S. or the multiple rolling crises in the Eurozone between 2009 and 2012 understands the human pain and suffering associated with what are otherwise lines on charts.





Reserves As Insurance

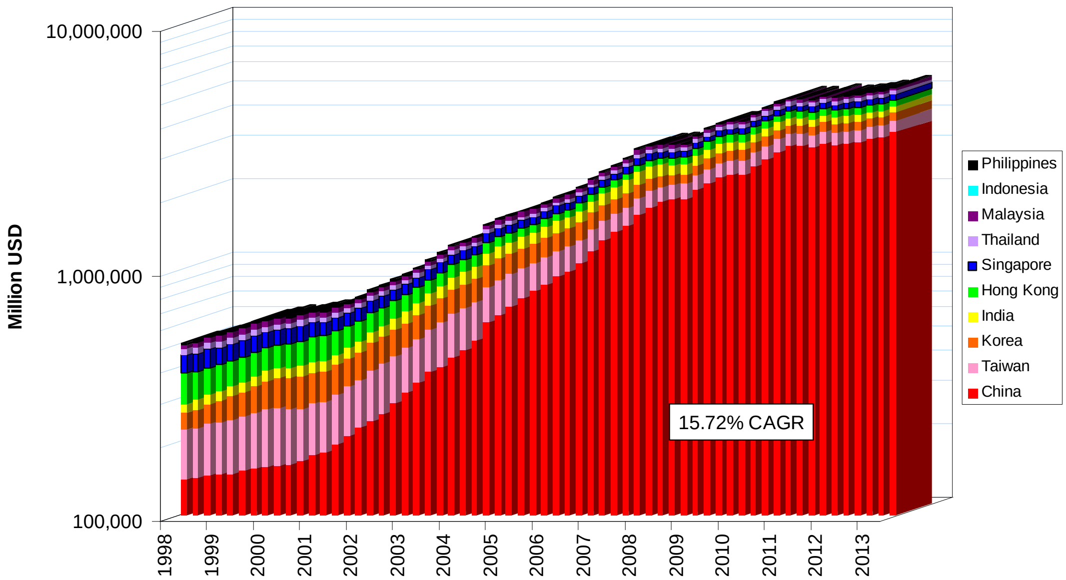
Just as generals fight the last war, so too do governments and central banks. Even though Thailand, the epicenter of the crisis, never would have been able to have stood toe-to-toe with the world's speculators to "defend" the baht via outright purchases, they and others were determined not to let the best be the enemy of the good. The collective decision was to build foreign exchange reserves to buy domestic currencies being sold by foreign investors. Like deposit insurance or even a burglar-alarm sticker on a window, the mere presence of reserves signals to sellers a cost will be involved. In addition, while piling up reserves via net exports and then selling them to buy your domestic currency is not the best use of economic resources, it is less destructive across an economy than raising short-term interest rates to absurd levels.

One of the problems associated with reserve accumulation is answering the question how much is enough? This is a problem faced by many successful individuals: Once income and wealth levels reach a certain level, the marginal utility of more money should start to decline toward zero. It does not; the very drive and ambition that led to the initial gains are not shut down and a perverse greed takes over; the more you have, the more you think you need. A similar phenomenon can be seen with corrupt officials, too; once your local kleptocrat steals the country blind, it should be enough but seemingly never is.

Post-Crisis Accumulation

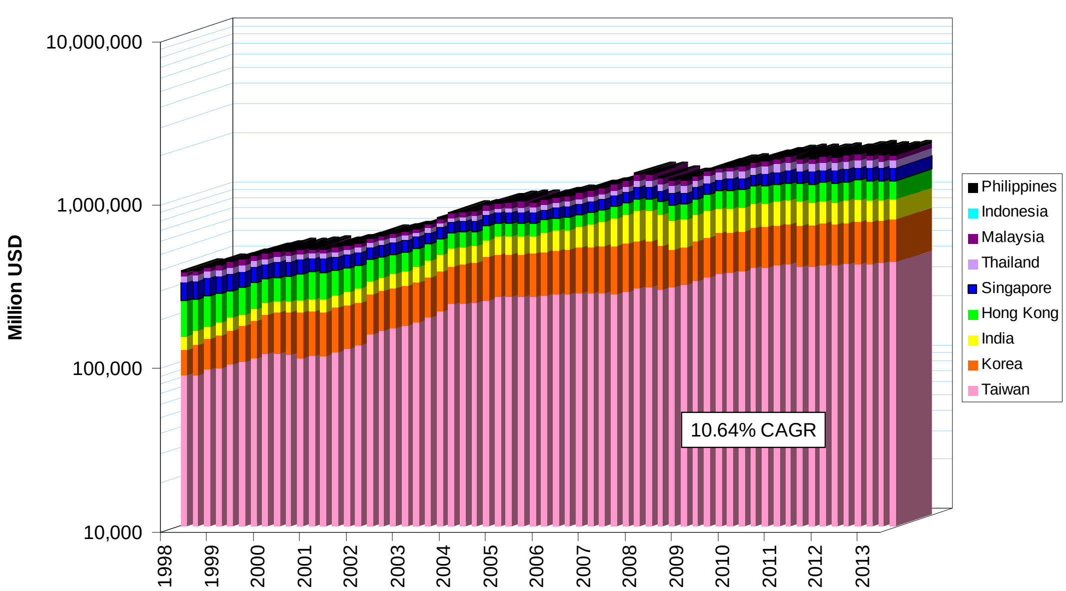
Let's take a look at the external reserve positions of the member countries of the Bloomberg-J.P. Morgan Asian dollar index (see "*Schadenfreude Is Not An Asian Schtick*," November 2012) since the first quarter of 1998. As of the first quarter of 2013, they have grown at an impressive 15.72% compound annual growth rate.

Asian Currency Index Reserves Since The Asian Crisis



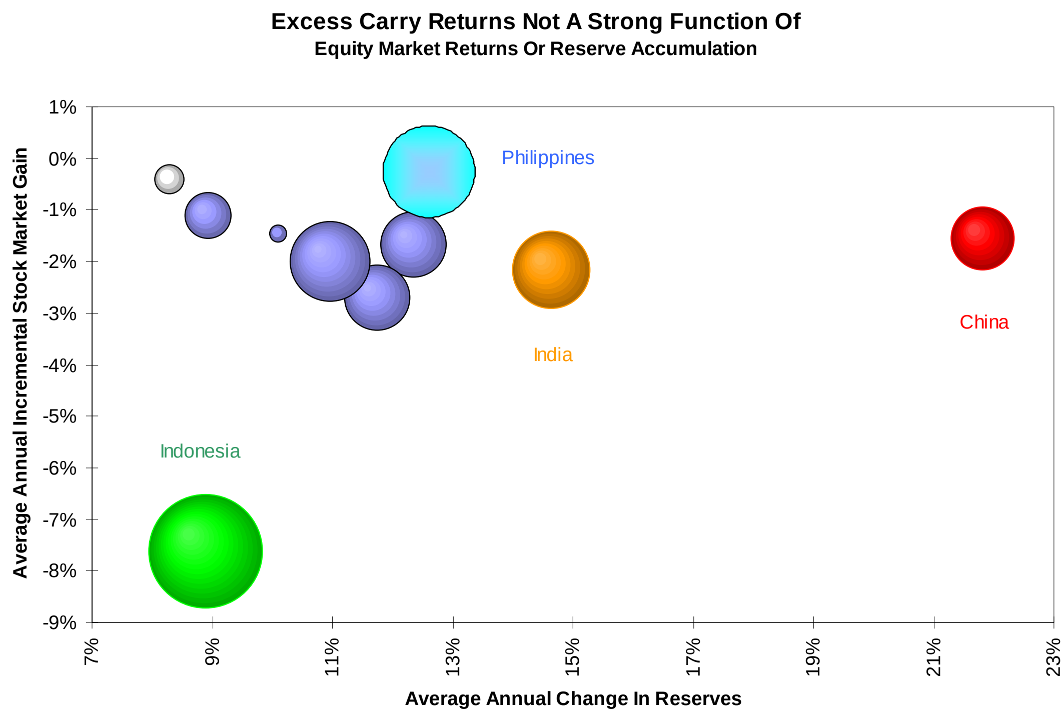
The picture above is dominated by China, although this certainly was not a given at the start of 1998 when Taiwan had one of the larger external positions. If China is stripped out of the picture, the compound annual growth rate declines, but remains at a still-impressive 10.64%.

Asian Currency Index Reserves Since The Asian Crisis
Ex-China



Market Impact

Have the accumulation of reserves or average annual equity market returns in USD terms affected the Asian currencies' excess carry returns much? Let's map each currency's average annual excess carry return from the USD as a function of average annual changes in reserves and average annual incremental stock market gains vis-à-vis the MSCI World index in USD terms. The diameters of the bubbles correspond to the currencies' excess carry returns.



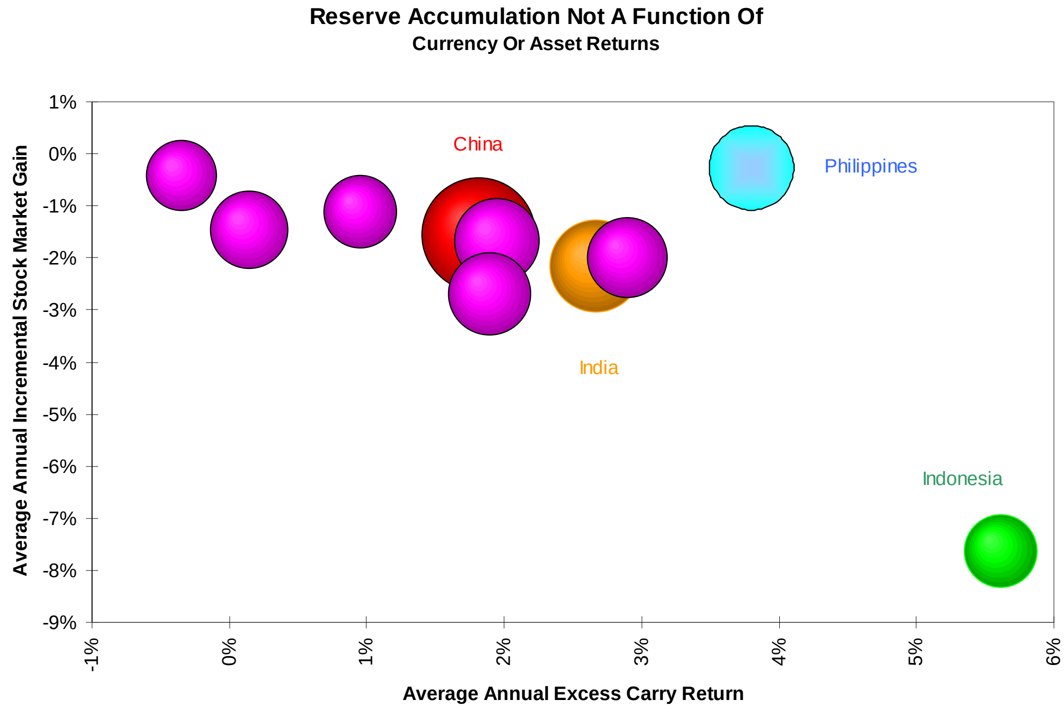
Four countries are highlighted. The excess carry return into the CNY (red bubble) has been small as a function of both Chinese stock market returns and reserve accumulation. It might be just as accurate to say China's on-again/off-again pegging of the CNY led to both large current account surpluses and accumulations of reserves as well as to small excess carry returns into the currency itself.

India's experience had been quite different through 2012 but it changed abruptly in 2013. The excess carry return into the INR declined as India's efforts to combat rising inflation via higher short-term interest rates led to capital outflows and a sharp decline in the spot INR. Its still-strong pace of reserve growth was immaterial.

Neither India nor China was a victim of the Asian crisis of pre-BRIC days. Both Indonesia and the Philippines were. The excess carry return into the IDR has been very high even as the growth in Indonesia's reserve levels has been near the bottom of the Asian pile. Finally, the PHP has had high average annual excess carry returns accompanied by both a strong equity market and rapid reserve accumulation.

On balance, a strong currency simply is not a function of rapid reserve accumulation or of high asset returns. Reserves, to the extent they affect a currency at all, do so prospectively via the deterrence mechanism.

Just for the sake of completeness, the data can be rearranged to depict average annual reserve accumulation as a function of excess carry returns and equity returns. Reserve growth itself is not a function funds flowing into either short-term currency investments or long-term equity investments but rather of national current account balances increasing over time.



To What Purpose?

Just as the original mercantilists pursued the accumulation of gold for its own sake only to discover, per Adam Smith, this was not the basis of the wealth of nations, the Asian nations will have to discover for themselves what the real purpose for their pursuit is.

Allocated global reserve holdings at the end of September 2013 were 54.1% of the totals measured by the International Monetary Fund; 61.4% of this number was held in USD and another 24.2% in EUR. As the absolute purchasing power of both currencies has been declining and real interest rates have been at or near negative levels for the past several years, the incentive of any exporter to hold either is based more on lack of suitable alternatives than anything else. Central banks' gold reserves took a beating in 2013, but as the central banks are not on marked-to-market accounting, they can proclaim themselves to be long-term holders or some other self-exculpation for poor stewardship of other peoples' money.

Exporters have been gearing their economics toward sending real goods and services to be consumed elsewhere in return for piles of paper with negative real returns. This amounts to nothing more than a wealth transfer from the productive to the unproductive and a very expensive form of vendor financing. The insurance trade of piling up someone else's currency to protect your own may have great appeal to countries torched by the 1997-1998 experience, but cultural satisfaction and good economics are two very different things.