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US$ 4 Trillion in Reserves - Whose Problem?

Speaker: Prof. Manmohan Agarwal

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The accumulation of four trillion foreign reserves by China, and consequent increasing US current account deficit has emerged as one of the most hotly debated and extensively documented issues in international relations, with many scholars even conceiving the idea of such reserve accumulation as signifying a global shift or realignment of economic power, and a perceived 'indebtedness' of the US to China.

The debate on the issue is often structured as a bilateral issue, considering the US and China as the only two actors. The talk emphasized the role of others actors and other reserve currencies, particularly the euro-zone, the developing countries, and countries like Australia which fall in neither categories, as being affected by the accumulation of huge US currency by China. In fact, the other nations will be involved if the Chinese decides either to sell these, or buy more such bonds. Two scenarios or possibilities exist – one, that China decides to sell these bonds, and two, if it decides to buy more, examining the range of possibilities that exist, thereby speculating as to how the various actors will respond in different situations.

In the first scenario, there is one possibility that nothing would happen if China decides to sell the US foreign exchange bonds. In the past years the US has issued about 1.2 trillion worth of bonds to finance their deficits, which were absorbed by the markets without any tremor. Therefore, one can infer that nothing would happen even if Chinese decide to sell these bonds. The second possibility is that the market collapses. In that case, consequences will be greatly dependent on psychological factors, which are beyond prediction. However, it is clear that if China tries to sell the bonds, the prices would fall, thereby signifying a loss for China and all other nations which also hold reserves, while the US will gain. With the raising of interest rates on US bonds, the US government can respond to the situation by buying back the bonds at the depreciated price. This will not have much impact on the US budget. The other nations, including the Chinese – who could be feeling poorer owing to depreciated prices of bonds, may respond by shifting from dollar to Euro-zone. The effect of such a move on the exchange rate is again dependent on psychological factors; however, such a move will have no impact on Yuan exchange rate. Rather, the exchange rate between Dollar and Euro will change as the Dollar will depreciate and Euro will appreciate. The depreciation of US dollar would help to reduce the US current account deficit, leading to a higher GDP for the US. Contrastingly, due to the appreciation of Euro, the exports of Euro countries will be hurt, leading to lower economic activity in the Euro-zone. The countries like Germany, which are dependent on export earnings, may respond by lowering wage rate growth, which will lead to lower inflation. This will be mirrored in much of Europe and aggravate the north-south divide between

European nations. In the second scenario, where China would continue to accumulate reserves, the reserve accumulation happens in lieu of the appreciation of Yuan, since it prevents appreciation. In the short run this retains the competitiveness of Chinese exports. Since Chinese exports compete with exports of other developing countries, a depreciated Yuan hurts the exports of other developing countries. There are two caveats in such a proposition. One is that as other developing countries are also accumulating reserves, they are all protecting their currencies from appreciating. It is impossible to predict the net effect. However, the other aspect is the size of Chinese supply that makes Chinese exports more attractive than others. The example of Walmart explains the phenomenon. It buys a lot of raw materials from China. If Walmart doesn't buy from China, it will have to scurry around to a large number of small countries to try and garner the total amount it needs. And this will also be expensive. So it's not just a question of lower prices of Chinese goods, but its lower transaction costs altogether that make it attractive.

But considering the possibility that an appreciated Yuan does actually hurt Chinese exports, it will lead to lower incomes and uncertainty in employment. Such an environment leads to high savings by the Chinese families. But, given that Chinese exports are not doing well, there will be lower investment in export industry. According to the speaker, in this scenario the investment-saving balance in China will move in wrong direction, with surpluses becoming even larger. Furthermore, lower Chinese exports would also mean lower growth in other developing countries – which supply China. The net effect of all these things – of how the world economy would adjust becomes impossible to predict.
The speaker concluded his presentation by calling the situation 'a complete black box'– because nobody has ever tried to model how the other nations will respond if the Chinese either stop accumulating reserves, or buy more. It can only be conjectured as to what could happen in the many possibilities that can be hypothesized.

The discussion following the presentation found many queries relating to the significance of China holding reserves, and what they meant in relation to the power play by the developing nations in international trade. The speaker clarified that Chinese accumulation of reserves has got nothing to do with China and it was singularly because of US policies. When Bill Clinton was the US president, the US budget was in surplus. However, the policies pursued by George W.Bush, in terms of cutting taxes and having wars, resulted in US deficit and consequently, China's surplus blossomed. Therefore, the Chinese surplus was a reflection of what the US was doing.

Commenting upon the huge quantum of Chinese reserves, the speaker again clarified that the Chinese doesn't hold the largest reserves, nor do they have fastest growing reserves. A relatively small country like Argentina had huge reserves both in terms of its GDP and imports. He further added that all over the world developing countries were accumulating reserves, as they do not wish to end up in a situation where they have to borrow from the IMF and face the conditionalties that restructured their economies. In order to prevent such a situation, they were accumulating reserves.

The speaker also explained about the impossible tri-lemma, which all countries were trying to fulfill. The three aspects-fixed exchange rate, capital mobility, and autonomy of monetary policy-cannot be all attained together, as nations have to compromise on either one of them. Since no nation wants to give up either of the three, they were constantly trying to change the weights they assign to the three objectives, and reserve accumulation is part of this game they are playing.

A significant point that emerged in the discussion was the politics behind the economics of reserve accumulation. To this the speaker elaborated on how the IMF operated over the years. Until 1977, both developed and developing nations borrowed from the IMF - because the conditions for both were highly symmetrical, and pertained only to monetary and fiscal policy. After 1977, only the developing countries were borrowing from IMF. There came a complete bifurcation of the fund – where the borrowers were the developing countries, and the conditions were from the developed. And the conditions became more and more onerous and less related to the problem. It is these lending policies that had created the problem. So now no one wants to borrow from IMF. In 2006-07, countries that had borrowed from IMF prepaid their loans causing a decline in interest payments to IMF, and for the first time IMF budget came in deficit. They were spending more money than they were earning as interest.

The constant attention being given to the rising powers, China and India in international politics, owing to the high performance of their economies was raised. However, the speaker rejected this claim and said China's influence comes due to its size. India and Brazil may be seen as big, but their GDP as a proportion of world GDP was a mere 1 percent. However, the Chinese GDP is 6 percent of World GDP, and this has been increasing. However this is unrelated to the story of reserves, because Chinese reserves are growing because of the US, and have nothing to do with the Chinese. He commented that China is rich in a very amorphous sense, as it was not like that the average citizen or peasant has become rich, who do not hold bonds. It plays very little into the domestic market.

Another participant enquired if such a scenario represented a political power shift between the developed and developing world, since the IMF could earlier dictate, but now, each developing economy had reserves. The speaker again refuted such a scenario. He made a reference to his earlier works, where a power index based on 21 indicators was made. The index was calculated for the years 1990, 2005 and 2009. And it showed no shift in the rankings of the countries. He further added that there had not been any remarkable shift in the present rankings of top 25 countries with highest GDP from 1945. Apart from Korea and Turkey whose GDP was increasing, and Canada whose was falling, there's no other change. The only country that substantially increased its share of world income was China. India only goes from 1 to 2 percent. So the so-called shift in economic power was an over blown myth.

As for the status of Yuan as an international currency, it is highly debateable whether becoming an international currency was necessarily an advantage – because Russia and Japan had in past fiercely fought to promote their currencies as international currency. And the Yuan still had a long way to go before it became an international currency. He explained that supposing India wanted to borrow 500 billion dollars, it will not be able to do so in China. But it could borrow the same in New York without much hassle.

In response to a question regarding the new emerging banks, like the Asian Development Bank, and whether these banks would come in conflict with the IMF and World Bank, the speaker clarified that the IMF only dealt with balance of payment crisis, and not developmental issues. However, the politics between the World Bank and other emerging banks, in helping developing nations has certainly been a crucial issue.