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Quid Pro Quo

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Never put all your eggs in One basket!

The total liquid foreign exchange reserves for Pakistan have witnessed significant increase in the recent years; currently recorded at US$ 12.96 billion. However, the State Bank has been widely criticized for its reserve management strategy by various economic circles. It has been accused of failing to adequately diversify its foreign reserves, over-investing in the US dollar. The criticism has gained more ground as central banks of the economies of UAE, Iran and Russia signal intentions of diversifying their holdings of foreign exchange reserves.

This issue begins with an examination of objectives of holding large foreign reserves, highlighting the emergence of dollar as the most significant reserve currency. It then moves to analyze the possibility of the impending weakness in the dollar and the subsequent need to diversify foreign exchange reserves.

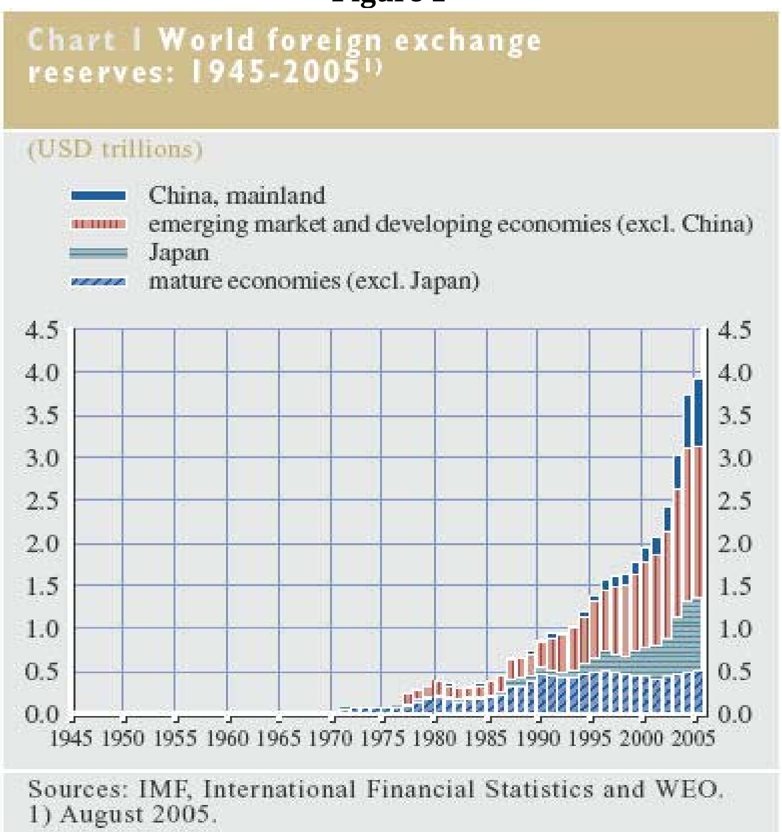
The Underlying Chemistry

The total liquid foreign exchange reserves for Pakistan are recorded at US$ 12.96 billion as of 27th Jan 2007. US$ 10.59 billion of these reserves reside with the State Bank while the remaining US$ 2.37 billion rests with the commercial banks. This presents an outstanding achievement on part of the Pakistani economy that held reserves only worth US$ 991 million by the end of 2000.

Pakistan is not the only country that has witnessed a rapid and unprecedented accumulation of foreign reserves in the recent years. In fact most Asian economies, especially China and Japan have registered significant increases in their foreign reserve holdings, causing the world foreign exchange reserves to grow almost three fold in the past decade with the rate of increase accelerating in the past few years.

Figure 1 depicts the rising trend in the world foreign exchange reserves, contributed primarily by the foreign reserve share of emerging market and developing economies.

Figure 1



As emerging economies accumulate foreign reserves, they stabilize their domestic currency. This is because reserves serve as an ideal tool to prevent the issued currency from excessive volatility, and protect the monetary system from unanticipated shocks. Hence the primary purpose of reserves is to allow central banks to intervene in the foreign exchange market in order to influence the value of the domestic currency. Central banks often claim that holding large reserves is a security measure. This is true to the extent that a central bank can prop up its own currency by spending reserves. Governments may also intervene in the foreign exchange market to keep the local currency stable relative to another currency in order to contain the exchange rate fluctuations, promoting greater foreign trade and financial flows. In Pakistan the SBP can intervene in the market to affect the rate at which the rupee trades only if it holds adequate reserves. A pro-active policy of reserve management helps Pakistan in maintaining the competitiveness of its goods and services in the world economy.

A more dramatic use of foreign reserves may occur when the domestic currency is under a speculative *attack*. Reserves can be used as a *war chest* to defend the local currency and subsequently, the domestic financial systems, in case of future runs on the currency. Following the 1997-1998 Asian financial crises, many East Asian governments moved to accumulate large amounts of reserves to serve as collateral for their domestic financial systems and prevent future currency crises.

Lastly, reserves provide funds in foreign currencies for servicing external debt and liabilities. This additionally enhances the creditworthiness of the respective country increasing inflows from foreign direct investors and portfolio investors.

Is the Greenback dieing?

Reserves were formerly held only in gold, as official gold reserves. However under the post World War II Bretton Woods System, the US dollar was pegged to the gold standard, allowing convertibility of dollars to gold while all other currencies were linked to the dollar. This effectively made dollars appear as good as gold. The US later abandoned the gold standard, but the dollar remained stable and has emerged as the most significant reserve currency as central banks over the world typically hold large amounts of dollars as reserve currency. (Table 1)

The remarkable persistence of the dollar as a reserve currency reflects several factors, including the liquidity of US financial markets. Primarily the support comes from the sustained share of global output produced by countries that we can think of as being part of a broadly defined dollar zone in the sense that their currencies tend to move in tandem with the dollar.

However if we take a closer look at Table 1, it is evident that the share of dollar in international accumulation of foreign reserve currencies has declined since 2001. Though the rate of decline has slowed, the significant decrease from 70.7% in 2001 to 65.75% in 2006 in the share of dollar in worlds foreign reserves reflects that the current debate over the death of the international role of the dollar may not be a mere exaggeration especially in the wake of the risks that the dollar currently faces.

Table 1

International Accumulation of Foreign Reserve Currencies

Currency	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
US Dollar	59.00%	62.10%	65.20%	69.30%	70.90%	70.50%	70.70%	66.50%	65.80%	65.90%	66.40%	65.70%
Euro	-	-	-	-	17.90%	18.80%	19.80%	24.20%	25.30%	24.90%	24.30%	25.20%
German Mark	15.80%	14.70%	14.50%	13.85%	-	-	-	-	-	-	-	-
Pound Sterling	2.10%	2.70%	2.60%	2.70%	2.90%	2.80%	2.70%	2.90%	2.60%	3.30%	3.60%	4.20%
Japanese yen	6.80%	6.70%	5.80%	6.20%	6.40%	6.30%	5.20%	4.50%	4.10%	3.90%	3.70%	3.20%
French Franc	2.40%	1.80%	1.40%	1.60%	-	-	-	-	-	-	-	-
Swiss Franc	0.30%	0.20%	0.40%	0.30%	0.20%	0.30%	0.30%	0.40%	0.20%	0.20%	0.10%	0.20%
Other	13.60%	11.70%	10.20%	6.10%	1.60%	1.40%	1.20%	1.40%	1.90%	1.80%	1.90%	1.50%

Source: 1995-99 & 2006 IMF, 1999-2005 ECB.

The Black Clouds casting the Greenback

The biggest risk facing the biggest economy of the world - The United States- is the persistently rising current account deficit and the federal budget deficit. None of the other major developed economies have had deficits anywhere near as large as that which the US now suffers. The current account deficit for the US stands at US$ 701 billion for Jan-Nov 2006, requiring the economy to import approximately US$ 2 billion of capital each day to finance the current deficit alone. The recent growth of the current account deficit was caused by rapid growth of imports from China and in crude oil and petroleum products. Although declining oil prices may reduce the deficit in the coming quarters, the rapid growth in Chinese imports and in interest payments to foreign holders of government debt will continue to put upward pressure on the current account deficit in the future.

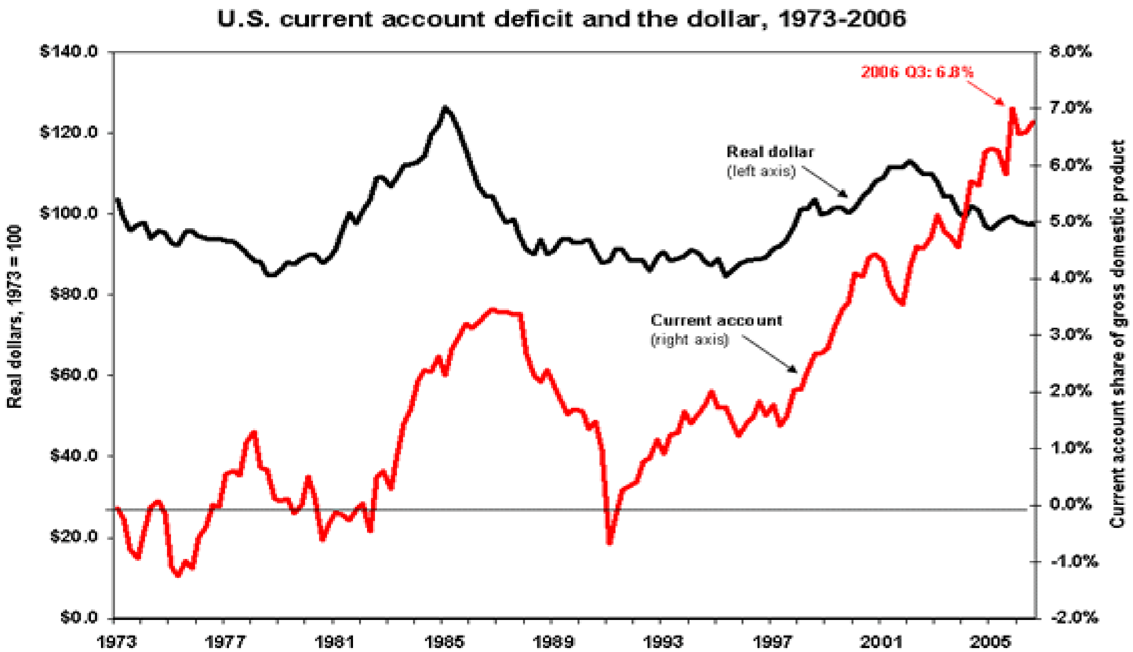
At present the current account deficit is being financed by the foreign exchange reserves of the central banks that purchase treasury bills and other government securities to suppress their currencies. For example, in the third quarter of 2006 the reserve holdings of mainly the Asian central banks financed approximately 35% of the US current account deficit. This shows that the US has come to increasingly depend on an inflow of capital from the central banks of Asia to cover its debts and the balance of payments surpluses of these economies are being used to finance the US deficit.

However the US cannot continue to run reckless budget and current account deficits and finance them with foreign exchange reserves without end. Most economists believe in a weakening dollar as the key to rebalancing the US economy, expecting that sooner or later the economy will have to tighten its belt and depreciate the dollar. This is because in the absence of a dramatic and sustained slowdown in US growth, exports can grow faster than imports only with a substantial reduction in the value of the US dollar as this shall increase exports by lowering export prices while decrease imports by increasing import prices. In contrast, when the dollar rises in value, US exports become more expensive and import prices fall.

For example, between 1995 and 2002, the dollar gained about 30% in value, as shown in Figure 2. As a result, the US trade deficit has grown as a percentage of GDP, which experts believe to be far above a sustainable level. Although the US dollar has fallen since 2002, this decline has not been sufficient to slow the growth of the trade deficit. The value of the dollar fell 29.3% against a basket of major currencies (1/31/02-2/06/07) while falling only marginally against a group of other important currencies, particularly the Chinese Yuan. This implies that a much more aggressive depreciation will be needed to substantially reduce or eliminate the deficit.

In the wake of the currently weakening dollar it is then implausible to believe that central banks with large reserve holdings are not considering if not already diversifying their foreign exchange reserves. For example if the dollar depreciates, China that approximately holds US$ 1 trillion foreign reserves shall witness a considerable capital loss as the worth of its reserves declines. Subsequently, the economies of Russia, UAE and Iran have already signaled intentions of diversifying their holdings of foreign exchange reserves.

Figure 2



Placing eggs in different baskets: Not an easy task!

In reality diversifying foreign exchange reserves is not an easy decision but one that entails critical complexities. This is because currently the world's currency reserves have reached the US$ 5 trillion mark and hence any talk of central banks moving out of dollars and into other currencies sends shivers across the foreign-exchange market.

A central bank may spark a rapid fall in the dollar's value by just declaring its intention of diversifying its reserves. When the central bank of South Korea stated its intention of diversifying its foreign reserves in 2005, the dollar plummeted to the extent that the statement had to be retracted to prevent additional decline in the value of the dollar. This essentially means that the decision of any one central bank, which holds adequate foreign reserves, to cut its exposure to the dollar significantly in favor of other currencies will threaten the strength of the dollar. This will generate fear amongst other central banks that will move quickly to follow the similar steps, to buffer themselves against any significant capital losses, putting even more pressure on the dollar. In this fashion the stability of the entire global financial system is endangered.

An important question arises at this point that presents another concern in the issue of diversification. Which Asian economy will move to diversify its foreign reserves significantly? Though it may not be clear that which economy moves to do so, we believe that it may not be China and Japan. This is because amongst all Asian central banks, those of China and Japan have the most at stake with the US economy. Both economies are heavily dependant on the US as an export market. China's GDP growth is 70% dependent on exports, and US prosperity and growth is critical to the stability and growth of these exports. Additionally China alone holds approximately US$ 1 trillion of reserves. Since the decision to diversify foreign reserves on part of either of these economies will cause the dollar to sink substantially, sparking high interest rates and pushing the American economy in a recession, the demand for Chinese and Japanese exports will shrink while the worth of their large reserves will fall, causing the Asian tigers to witness a similar slowdown. Hence this makes it a difficult proposition for these countries to diversify their reserves.

Made in Europe?

As China and Japan attempt to maintain the status quo of dollar by accumulating foreign reserves, neither has the strength to prevent the dollar from following a downtrend as the US economy continues to register rising deficits. Hence the rational decision in this ambiance is to diversify foreign reserves or at least be prepared to do so in the near future. After all economics it self argues for diversification in investment portfolios to minimize risks and maximize returns. So why not diversify foreign reserves before the crash of the dollar hits the central bank's reserve balance adversely!

It must be noted that diversification of foreign reserves by central banks does not essentially mean disinvesting from existing dollar reserves. Most currency analysts believe that central banks should rather reconsider their traditional investment strategies and allocate excess reserves which are not required for liquidity purposes to other currencies and equities from the current period onwards. By doing this they will be able to reduce their exposure to the dollar, containing the future risks that they face in the wake of a weakening dollar.

A wise decision for most central banks would be to increase the share of non dollar denominated assets, particularly the Euro. For decades the dollar has enjoyed its position as the key international trade, investment and reserve currency. Neither the D mark nor the yen, which came forward as international currencies in the 1970s and 1980s called the ascendancy of the dollar into question. However the emergence of the euro, which was introduced as the European answer to the challenges of globalization in 1999, has changed the global economic ambiance.

In terms of reserve currency though the euro is substantially behind the US dollar, it has the potential to challenge the latter in light of the fact that Euro land has the world's second largest economy as well as large and liquid financial markets. The share of the euro in the international accumulation of foreign currencies has increased to 25.2% in 2006 from 17.9% in 1999. This increase is reflective of the substantial appreciation of the euro vis-à-vis the dollar that has enhanced the euro's image before the financial markets and central banks of particularly Asia. Hence the euro has been a success story in the international arena since its emergence in 1999 as it has witnessed a considerable increase in its use as a trade, investment, and reserve currency.

Central banks can also allocate some of their reserve management to private fund managers. According to IMF estimates some 14 to 20 central banks did so in 2003; Singapore being the first. There are also rumors that China may establish a separate reserve management agency and acquire international assets. Japan too is more likely to allocate its reserves to more aggressive investments. [1]

However one has to pay heed to the fact that overt diversification is self defeating in nature as it has been seen in case of South Korea where the announcement by the central bank that it was looking to diversify its foreign reserves slipped the dollar into decline. It will be prudent then for central banks of the concerned economies to not broadcast their intention of diversifying foreign reserves even when deciding to do so; otherwise in an attempt to protect themselves against capital losses these central banks may spark capital losses for others.

"Diversification is really not a problem. It's all anxiety -- not what's real, but what the market thinks is possible."

Marc Chandler, Brown Brothers Harriman

[1] Stephen Jen: Currency Analyst, Morgan Stanley.

Economic Snapshot

Fiscal year 06														
	Units	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec
Inflation														
Headline Inflation	%	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.88	8.88
Core inflation	%	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.5	5.50
Food inflation	%	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	12.71	12.71
Non-food inflation	%	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.22	6.22
T-bill (Wgt Avg)														
3 month	%	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.64	8.64
6 month	%	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81
12 month	%	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00
External Sector														
Export	Mln US$	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1350	1383	1420	1290	1380	n.a
Import	Mln US$	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2370	2292	2450	2191	2773	n.a
Trade balance	Mln US$	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)	(1030)	(901)	(1393)	n.a
Remittances	Mln US$	336	391	339	444	401	507	464	376	435	422	410	448	475
Forex reserves	Mln US$	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960

n.a = Not Available

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