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International reserves before and after the global crisis: Is there no end to hoarding?

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ABSTRACT

We evaluate the impact of the global financial crisis (GFC) and recent structural changes in the patterns of hoarding international reserves (IR). We confirm that the determinants of IR hoarding evolve with developments in the global economy. During the pre-GFC period of 1999–2006, gross saving is associated with higher IR in developing and emerging markets. The negative impact of outward direct investment on IR accumulation is consistent with the recent trend of diverting international assets from the international reserve account into tangible foreign assets; the "Joneses' effect" lends support to the regional rivalry in hoarding IR as a motivation; and commodity price volatility induces precautionary buffer hoarding. During the 2007–2009 GFC period, previously significant variables become insignificant or display the opposite effect, probably reflecting the frantic market conditions driven by financial instability. Nevertheless, the propensity to import and gross saving continue to display strong and even larger positive effects on IR holding. The results from the 2010–2012 post-GFC period are dominated by factors that had been mostly overlooked in earlier decades. While the negative effect of swap agreements and the positive effect of gross saving on IR holdings are in line with our expectations, we find a change in the link between outward direct investment and IR in the pre- and post-crisis period. The macro-prudential policy tends to complement IR accumulation. Developed countries display different demand behaviors for IRs – higher gross saving is associated with lower IR

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holding, possibly reflecting high-income countries' tendency to deploy their savings in the global capital markets. The presence of sovereign wealth funds motivates developed countries to hold a lower level of IR. Our predictive exercise affirms that an emerging market economy with insufficient IR holdings in 2012 tends to experience exchange rate depreciation against the U.S. dollar when many emerging markets were adjusted to the news of tapering quantitative easing in 2013.

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1. Introduction and overview

The global financial crisis (GFC) has ended the "great moderation" era, bringing instability to the fore of challenges facing policymakers in the U.S., the Eurozone, and other OECD countries—that is, volatility is back. Yet, for emerging markets, volatility never disappeared, and the GFC is another crisis in the long sequence of turbulent events, this time originating from the U.S. A key lesson of emerging markets' growing financial integration has been a greater exposure to capital flight and sudden-stop crises.[2]

After the financial crises of the late 1990s, many emerging markets increased their international reserves/GDP substantially, recognizing the benefits of self-insurance against the volatility associated with financial globalization. Indeed, the growing financial integration of emerging markets during the 1990s and the ensuing crises were identified as key factors in the structural changes in the motives to hold international reserves (IR), among which the weights of financial factors as well as the past crises history increased (Aizenman and Marion, 2003, Aizenman and Lee, 2007; Cheung and Ito, 2008, 2009). The crises many emerging markets experienced in the late 1990s and early 2000s and the takeoff of reserves hoarding by China and other countries in the 2000s added new factors to the list of determinants of hoarding IR, including mercantilist motives (Aizenman and Lee, 2008), "keeping up with the Joneses," (Cheung and Qian, 2009), and self-insurance against local residents' flight from domestic assets in the context of the trilemma (Obstfeld et al., 2010; Aizenman et al., 2010).

This paper evaluates whether the GFC and recent structural changes in the global economic environment are associated with new patterns of hoarding IR. This possibility is exemplified in the recent experiences of China and South Korea, both of which have undergone large structural changes that have impacted their IR/GDP in the past decades. China became the largest IR holder in the mid-2000s, and holds $3.8 trillion dollars, about 33% of the world's total, as of April 2014 (see Fig. 1). After the GFC, however, China has experienced a sizable decline in IR/GDP, resulting in a rebalancing of its export-led growth strategy in the face of declining global demand, a liberalization of its outward foreign direct investment, and the placing of greater emphasis on its sovereign wealth fund (SWF) (Aizenman et al., 2014).

In contrast, during the GFC, South Korea found itself struggling with confidence amid its own banking crisis. Its sizable and once regarded sufficient stock of IR failed to isolate its economy from massive deleveraging. The ensuing financial panic was ultimately abated only with the help of the Fed's offer of special swap lines. Arguably, the experience of Korea illustrated the need to supplement reserves hoarding with prudential regulations dealing with balance-sheet exposure of systemic banking. Indeed, unlike the 1997–1998 Korean crisis, the crisis this time did not lead to a further increase in Korea's reserves/GDP but to prudential regulatory changes (Park, 2010, Bruno and Shin, 2014).

The experiences of China and Korea raise the possibility that the GFC may have induced structural changes in the behavior of IR holding, possibly motivating some countries to supplement their hoarding of reserves with new policies [dynamic prudential regulations including preemptive capital controls] and institutions [financial stability boards and SWFs, among others]. These developments exemplify a growing trend among emerging markets. The GFC and the resultant

[2] See Calvo et al. (2004) on the empirics of sudden stops.

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