The subject of this Panel’s discussion “New Challenges of Managing Global Foreign Exchange Reserves” is indeed timely and important. Many countries have accumulated large foreign exchange reserves in excess of their near term fiscal, monetary or financial needs. How these countries manage their reserves has important implications for global financial markets.

In part, the accumulation of sizeable foreign exchange reserves in Asia reflects the improvement in the economic fundamentals of many Asian countries after the Asian Financial Crisis of the late 1990s. That experience demonstrated the need for countries to manage debt carefully and raised the awareness that having robust foreign exchange reserves is important for maintaining currency stability and sustaining long-term fiscal health.
For well over a decade, the global economy experienced robust growth coupled with benign inflation. This was supported by rising productivity growth in the US and major emerging economies, the integration of huge labour forces in emerging markets like China and India into the global economy, and healthy increases in trade and investment flows. As inflation eased, interest rates have declined since the 1980s and stayed low the past several years. Such a favourable macroeconomic environment provided the backdrop for strong performance in financial markets. Under these circumstances, countries were able to obtain good returns on their foreign exchange reserves without taking undue risk.

In the past one year, however, the global economic environment has encountered several storms. Since 2003, the combination of low interest rates and abnormally low market volatility has resulted in financial risks in the capital markets rising to unsustainable levels. Excessive leverage in both the financial and household sectors in the US and a number of major developed economies had led to significant asset overvaluation.
Risk premiums had been driven to extremely low levels in many credit and housing markets.

The unravelling that ensued in various asset markets since the last quarter of 2007 was rapid and caused considerable disruption in the financial markets. The much sharper than expected fall in US house prices and ensuing sub-prime mortgage and credit crisis triggered a major de-leveraging of the whole US financial and banking system, leading to sharp falls in equity and credit markets.

The US credit crunch, house price deflation and energy cost inflation worsened sharply in the first quarter of 2008. This has caused business and consumer confidence and labour markets in the US to fall to recessionary levels.

The US government has applied strong fiscal stimulus to bolster the US economy. The US Federal Reserve has taken significant radical measures, including the unprecedented step of taking US$29 billion worth of credit risk onto its own balance sheet to facilitate the takeover of Bear Stearns by JP Morgan Chase.
Central banks in the US and Europe have also supplied large amounts of liquidity into their respective banking systems. This has restored a measure of stability and confidence to the financial markets.

In this difficult environment with the risk of global recession and financial crisis still a matter of concern, growth in major economies outside the US, especially in major emerging markets like China and India, has become even more important in sustaining global growth prospects. Likewise, capital flows from major Asian and Middle Eastern economies have also become more important in stabilising the global financial system by preventing a disorderly fall in the US dollar and helping to recapitalise US and European financial institutions.

A number of issues in the financial markets have still to be resolved. Inter-bank markets have not yet normalised, reflecting that liquidity needs, and potential counterparty risks remain relatively high. Financial institutions are still uncertain about how much credit losses their counterparties need to declare and their eventual capital adequacy.
They have also continued to hoard liquidity as their liabilities are increasing rapidly and short-term funding markets like the ABCP (asset-backed commercial paper) market remained seriously impaired.

Economic risks could rise further in the next 12 months due to sharper than expected falls in house prices, and a further spike in energy costs.

Steep falls in house prices in the US could deepen mortgage-related losses and dampen consumer spending.

Higher energy costs could potentially offset the positive impact of tax rebates US households receive from the fiscal stimulus package.

With these uncertainties and higher volatility in the financial markets, managing foreign exchange reserves to secure a satisfactory return within acceptable risk limits is likely to be more challenging in the coming years as compared to the past decade.

Managers of foreign exchange reserves will have to address several issues:

i) Will the US economy undergo a deep recession? Will the recession spread to major global economies?

ii) Can growth in major economies like Europe and Japan as well as the emerging economies remain resilient, if the US economy is in
recession and can no longer support the global economy? Can we avoid resurgence in trade and financial protectionism worldwide as this happens?

iii) Will financial risks reduce over the next 2-3 years as excessive leverage in the financial and banking markets return to lower and more normal levels?

iv) How persistent is the recent rise in commodity inflation and will it lead to higher core inflation? Could we be entering a world of significantly higher inflation and lower growth in the next 3-5 years? If so, how should asset allocation for a country’s reserves be adjusted to reflect this new outlook?

There are no clear answers to these questions but I hope that, by raising them, it will lay the ground for a stimulating and thoughtful discussion this afternoon.

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