

# The Declining World Foreign Exchange Reserves\*

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If one adds up the foreign exchange reserves of all the countries in the world, including under the term “reserves” what these countries hold in the form of gold, US dollars, other reserve currencies, Special Drawing Rights of the IMF, and also liquid assets such as short-term Treasury Bills of the U.S. government, then the total sum in August 2014 came to \$12.03 trillion. Nearly two-thirds of this amount is held by developing countries whose reserve accumulation started increasing after the Asian financial crisis of the late nineties. In fact, largely because of this increase, the magnitude of foreign exchange reserves increased five-fold between 2004 and 2014 for the world as a whole. Since then however there has been a decline in the total magnitude of world foreign exchange reserves. By March 2015 this magnitude had declined to \$11.6 trillion, which, though by no means a sharp drop, represents a drop nonetheless. And what is more, this drop is not some accidental occurrence, a mere happenstance; it represents a trend which has very serious implications for the world capitalist economy.

A part of the decline no doubt is because of a pure “price effect”. Since the value of the Euro and other reserve currencies is declining in terms of the US dollar, there would be some decline in the value of the total reserves when we measure everything in dollar terms. But this does not explain the entire observed decline. Besides, the fall in the value of the Euro and other reserve currencies in terms of the dollar itself turns out to be the outcome of the same factor that also explains, independent of the price effect, the decline in reserves. What is this factor?

Consider, for clarity of understanding, a very simple world where there are only two segments: a reserve currency country and the “rest”. In such a world there are two ways in which the magnitude of reserves can increase: one, if the reserve currency country has a current account deficit on the balance of payments with the “rest” which it settles by providing IOUs that are held by the latter as reserves. Now, the leading reserve currency country of the world, the U.S., has indeed been running a persistent current account deficit on its balance of payments which has contributed to the growth of the world foreign exchange reserves. But the recent decline in world foreign exchange reserves cannot be explained by this factor, since the U.S. has not suddenly developed a current account surplus. In other words, trade or current account-based explanations simply do not work in this case.

The other reason why the total foreign exchange reserves may rise or fall is because of private movements of capital across borders. In our simple case, if the wealth-holders of the reserve currency country, say instead of holding this currency at home as deposits in their own banks, decide to exchange this currency for the currency of the “rest” which the central bank of the latter provides at a fixed exchange rate, and to hold this currency of the “rest” as deposits in the latter’s banks, then the world foreign exchange reserves would have gone up. The reserve currency which was held in private banks of the reserve currency country, and hence did not count as foreign exchange reserves anywhere now gets to be held by the central bank of the “rest” and counts as foreign exchange reserves, because of private wealth-holders’ decisions. Exactly analogously, if wealth-holders, whether or not they belong to the reserve currency country, decide to shift their wealth out of the “rest” and hold instead in the form of assets in the reserve currency country, then the magnitude of world foreign exchange reserves would fall.

The sudden decline in the world foreign exchange reserves is the outcome of such an asset-choice decision on the part of the world’s wealth-holders. It is a consequence not of what

economists call “flow” decisions, relating to trade or current account deficits and surpluses, but of “stock” decisions, having to do with wealth-holders’ choice of the form in which they wish to hold their wealth.

More specifically, what is happening in the world economy today is that wealth-holders are shifting their wealth to the United States, for holding in the form of dollar-denominated assets, while earlier they were shifting to assets all over the world outside the United States. We know this well in India from the massive increase in our foreign exchange reserves which have got built up not because of any current account surpluses as in China (since we have had a deficit), but because of inflows of finance into the Indian economy by Foreign Institutional Investors (FIIs) lured by the high returns (inclusive of capital gains) that the Indian economy has been offering.

We are having in short a shift in the pattern of autonomous capital flows, with wealth-holders flocking back to the United States. All the phenomena that we observe at present, viz. a decline in the magnitude of world foreign exchange reserves; an appreciation in the value of the dollar relative to other major world currencies (to a point where the Governor of the Reserve Bank of India can take consolation from the fact that the rupee has not done as “badly” as some other currencies); the “price effect” on exchange reserves that we mentioned earlier which brings them down still further when everything is measured in dollar terms; the travails of the Euro which is losing out heavily to the dollar; the collapse of asset price bubbles in China, India and elsewhere; are all explicable in terms of this asset-choice on the part of the world’s wealth-holders, namely that they are flocking back to the United States. But the question arises: why are they flocking back to the United States?

An obvious reason is the end to “quantitative easing” by the U.S. Federal Reserve that is in sight. The Fed was pumping in huge amounts of dollars to the U.S. economy to keep, not just the short-term, but even the long-term interest rates in the U.S. at near zero levels, so that the economy could get stimulated. And these dollars were going all over the world in quest of lucrative “investment” opportunities. Now the Fed has decided to bring this “quantitative easing” to an end and has even suggested that the interest rates in the U.S. would be increasing in the coming days, which makes the flocking back of investors to the U.S. easy to understand.

Added to this is a factor that is both a cause and a consequence of such a flocking back. In the case of asset price bubbles, as they get built up, this build-up itself contributes to their further build-up, which is why they are “bubbles”. Likewise, if they collapse for any reason then this collapse itself becomes further self-reinforcing. An expected rise in the U.S. interest rates for instance, by stimulating some initial outflows of funds from, say, the Indian stock market, causes a setback to the increase in stock prices. And this in turn stimulates a further withdrawal of funds from the stock market for investment in the U.S. which then causes a further setback to stock prices, and so on. The collapse of the asset price bubbles in India and China are both a cause of, and also caused inter alia by, the shift of wealth-holders to assets in the U.S.

This shift however will further aggravate the world capitalist crisis. It may be thought that since other currencies are declining vis-à-vis the dollar, this would help these countries to expand their exports; even if this were true, since this export expansion would be at the expense of the U.S., there would be no necessary increase in the world demand as a whole and hence no alleviation of the crisis for the capitalist world taken as a whole. Additionally however long before the effects of any such currency depreciation have made themselves felt, the outflow of speculative funds stimulated by such depreciation (and in anticipation of further depreciation) can become a torrent, bringing these countries to acute financial crisis. To stem the prospects of such an eventuality, countries then adopt contractionary measures, not just in the fiscal sphere, where “austerity” is rampant anyway, but even in the monetary sphere where interest rates are jacked up to prevent the outflow of funds. An

exchange rate depreciation paradoxically then brings forth a policy response of inducing a contraction of the economy. And if this happens over the rest of the world as a whole, then there will be an overall contraction in this segment because of the wealth-holders' flocking back to the U.S.

At the same time, within the U.S. itself the increase in the interest rate that the Fed is promising to effect, will nip whatever little recovery there has been. Taking the world as a whole therefore the prospect is one of a deepening of the crisis. Put differently, the rise in U.S. interest rates will necessarily cause an increase in interest rates all around the world, which would only compound the world recession. Since fiscal means for stimulating the world economy are out in the current era of "austerity" there are no offsetting factors against this compounding of recession.

But then the question will be asked: why is such a policy stance being adopted? American radicals tend to blame the Republican Party for it, attributing this stance to the stupidities and prejudices of that Party. And it is true that the increase in interest rate that the Fed has announced that it would effect as a means of preventing inflation, is quite unwarranted at present because inflation in the U.S. is far below the Fed's own "inflation target" of 2 percent. There is undoubtedly therefore an element of ideological conservatism underlying the current moves to push the world economy towards a deeper recession.

At the same time however it simply would not do to put the blame solely on ideological conservatism. The fact is that with the enormous build up of finance, which some authors have called "financialization", the strength of the rentier interests has increased to an extent unprecedented in the entire history of capitalism, and with it also the power of the fear of inflation, which brings down the "real" value of money and of all financial assets that are denominated in terms of money. "Inflation targeting" itself is a reflection of this. And the truncation of a recovery that has barely got going, for fear that it would cause inflation, is also a reflection of this.

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