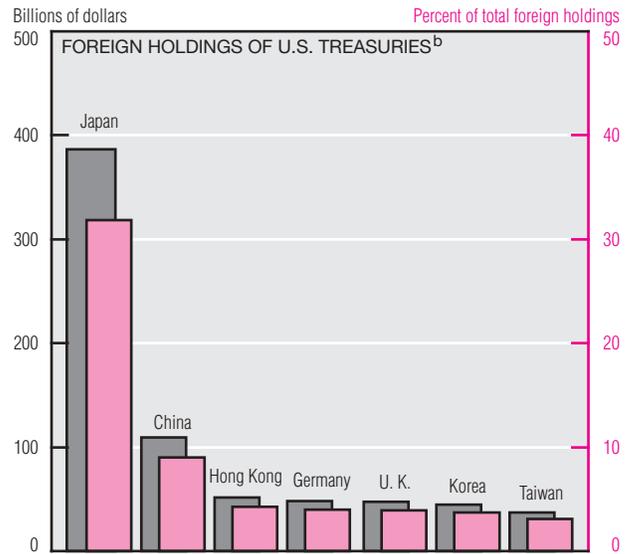
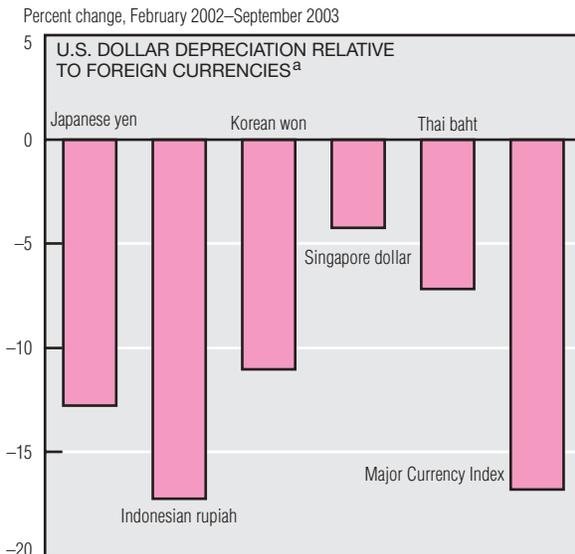
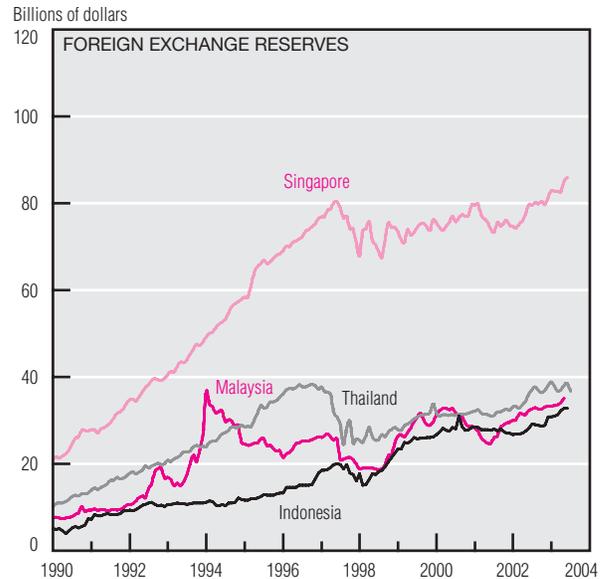
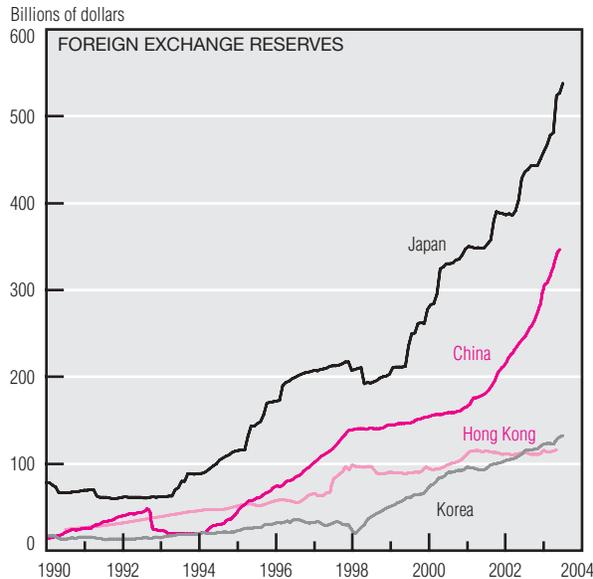


International Reserves: Expensive Insurance



a. China and Hong Kong peg their exchange rate to the dollar.

b. Includes both private and official holdings.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, July 2003; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.10; International Monetary Fund, *International Financial Statistics*; and Bloomberg Financial Information Services.

Since the 1997–98 financial crisis, many East Asian countries have greatly increased their holdings of foreign exchange reserves as insurance against exchange rate fluctuations and international crises. Foreign-exchange reserves are highly liquid, interest-bearing instruments denominated in one of the world's key currencies—U.S. dollars, Japanese yen, or euros. The exact currency compositions of countries' reserve portfolios are confidential, but the lion's share seems to be in dollars. Japan, China, Taiwan, Hong Kong, South Korea, and Singapore are now

the world's largest holders of foreign exchange reserves.

Some of these countries have acquired foreign exchange to keep their own currencies from appreciating. At its current exchange rate peg, the People's Bank of China must continuously buy dollars to satisfy an excess demand for renminbi. Similarly, in recent years, the Japanese Ministry of Finance has frequently purchased dollars to prevent the yen from appreciating against the dollar.

Once a country holds a foreign exchange portfolio, it can sell it to defend its currency's exchange value,

an important ability in an international financial crisis. The debt of most emerging market economies is denominated in foreign currencies, not in their own. The depreciation that typically accompanies a financial crisis causes the local currency value of foreign debts to soar, making debt servicing costs even more onerous.

Holding substantial international reserves seems expensive. The return typically earned, though safe, is small compared to the interest costs of the holder nation's debt and relative to the return on investment in domestic development projects.