Development Viewpoint
No. 18 October, 2008

Centre for Development Policy and Research
School of Oriental and African Studies

The Role of Developing-Country Reserve Accumulation in the Current Financial Crisis

by Juan Pablo Painceira, Department of Economics, SOAS

The epicentre of the current global financial crisis is the United States, where lending in the subprime mortgage market has triggered the alarming spread of financial instability. While the roots of this crisis lie in the rapid growth of unregulated global finance in the last three decades, there has been little recognition of the new role that emerging and developing countries have played in this process.

Since roughly the turn of the century, many of these countries have run sizeable current account surpluses in addition to receiving significant increases in private capital inflows. The result has been their impressive accumulation of foreign-exchange reserves. Promoted by multilateral institutions, such as the IMF and the World Bank, such a reserve build-up has helped defend the stability of exchange rates and protect against sudden capital outflows.

During the string of crises of the 1990s, such as in East Asia, Russia, Brazil and Turkey, many emerging and developing countries were extremely vulnerable because they ran large current account deficits that were unprotected by reserves. When crisis erupted, first in East Asia, private capital fled their economies and their currencies collapsed.

While one might assume that these countries are now benefitting from their accumulation of reserves, the truth is that the benefits have accrued mainly to the advanced capitalist countries and, in particular, the United States. The reserve build-up has facilitated the flow of global capital 'uphill', namely, from developing to developed countries, and has contributed significantly to the current financial crisis.

The Growth of Finance Capital

As a ratio to GDP, global financial assets have grown rapidly in recent decades, rising from 109 per cent in 1980 to 201 per cent in 1990 and then to 346 per cent in 2006. Just between 1995 and 2006, the financial assets of emerging and developing countries rose from US$ 3.9 trillion to US$ 23.6 trillion, or from six per cent to 14 per cent of total financial assets.

Most of these developing-country assets have been funnelled into foreign-exchange reserves, with close to two-thirds of recorded flows invested in US dollar assets. The Table shows the growth in the stock of international reserves of selected regions and countries. Developing Asia is the dominant region, with China's reserves alone totalling over US$ 1.5 trillion in 2007.

Russia, a big energy exporter, accounted for US$ 445 billion reserves in that same year. Latin American countries, such as Brazil and Mexico, also held sizeable stocks of reserves. And even the Africa region, which is the poorest in the world, held over US$ 280 billion.

Concomitantly to piling up reserves, emerging and developing countries have been rapidly increasing their domestic public-sector debt. In 1995 such debt was just about nine per cent of that of developed countries but in 2005 it had shot up to about 35 per cent. In other words, these countries have become more heavily indebted domestically while depositing increasingly more capital abroad in the advanced capitalist economies.

International Reserves for Selected Countries (US$ Billion)

	2000	2003	2007
Developing Asia	320.7	669.0	2,108.4
China	168.9	409.2	1,531.4
India	38.4	99.5	256.8
Other Asia	113.4	161.1	320.2
Russia	24.8	73.8	445.3
Brazil	31.5	49.1	180.1
Mexico	35.5	59.0	86.6
Africa	54.0	90.2	282.7

Source: IMF, *World Economic Outlook* 2008.

The Role of Reserves

Why? These countries have been obliged to 'sterilise' the monetary impact of their foreign-exchange earnings and capital inflows in order to maintain low inflation targets. So they have sold government securities in order to mop up any excess money supply in their domestic economies.

In other words, developing-country governments have borrowed domestic funds not in order to boost domestic investment but in order to keep inflation at very low levels. At the same time, the purchase of foreign-exchange reserves by their central banks has had a significant monetary impact in the US.

While the stock of US Treasury securities rose from about US$ 2.5 trillion in March 2000 to about US$ 3.5 trillion in June 2007, the holdings of central banks in such securities rose from US$ 0.5 trillion to US$ 1.5 trillion (to represent over 40 per cent of the total). Such a flood of investment helped lower the long-term yields on US debt securities, encouraging the environment of low interest rates that laid the basis for the US housing bubble, and ensuing financial crisis.

At the same time, developing countries have received a low rate of return on their holdings of US dollar-denominated reserves. According to some analysts, the opportunity cost of investing in such low-yielding assets has been significant—for instance, as much as one per cent of developing-countries GDP.

Hence, the increasing net national savings of emerging and developing countries have helped to tremendously expand the global circuits of finance capital, from which advanced capitalist countries, such as the US, have benefited. And such a reckless expansion lies at the heart of the severe financial crisis that is now wreaking havoc on the real economies of both developing and developed countries.

Reference:
Juan Pablo Painceira (2008). 'Developing Countries in the Era of Financialisation: From Deficit Accumulation to Reserve Accumulation'. Paper prepared for the international conference 'A Crisis of Financialisation', SOAS/University of London, 30 May 2008.

Centre for Development Policy and Research
SOAS, University of London
Thornhaugh Street, Russell Square, London WC1H
www. soas.ac.uk/cdpr
Telephone: +44 (0)207 898 4496