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Unsafe havens are a new fact of life

By John Plender

Emerging market countries have piled up $6,400bn worth of official reserves in supposedly safe assets. But what is safe these days? The traditional answer is sovereign debt in advanced countries. Yet the sovereign debt crisis in Europe and the dogfight over the debt ceiling in the US mean that the perception of sovereign debt as risk free looks increasingly questionable. Maybe policymakers in emerging markets – and indeed the rest of us – should rethink strategy.

The driving forces behind this oversized nest egg are, first, mercantilist exchange rate policies aimed at keeping exports super-competitive; and second, a precautionary motive. Countries want to insure against volatile capital flows of the kind that precipitated the Asian crisis of 2007-8 and to be able to smooth fluctuations in the domestic economy. Since the value of emerging market reserves was hit by the more recent financial crisis, the urge to self-insure has increased.

The result has been an extraordinary case of role reversal in the financial positions of the developed and developing world. The International Monetary Fund estimates that by 2016, emerging markets will account for a mere 14 per cent of world debt, compared with 17 per cent in 2007. By contrast the four main reserve currency areas – the US, Japan, the eurozone and the UK – currently account for 81 per cent of global debt. Looked at it another way, the emerging markets accounted for 9 per cent of the increase in global debt levels from 2007 to 2011 and are expected to account for 13 per cent of the rise from 2011 to 2016.

The implication is that emerging markets have considerably reduced their vulnerability to currency crises. Yet the process of reserve accumulation is potentially self-defeating. In a paper to the recent central bankers' meeting at Jackson Hole, Eswar Prasad of Cornell University argues that the remarkable paradox in international finance is that the emerging markets' desire for self insurance has, if anything, increased global risks while pushing the major risks on these countries' balance sheets from the liability side to the asset side. The idea that the flow of official capital from emerging markets represents a search for “safe” assets looks tenuous, he adds, if one examines the public debt trajectories of the advanced economies.

The debt path is indeed awesome. In round numbers the total debt of advanced economies will increase from $18,000bn in 2007 to $30,000bn in 2011 and is expected to rise to $41,000bn, equivalent to 80 per cent of their GDP. Further ahead, adverse demographics could cause these numbers to balloon. Compare and contrast with the emerging markets where the corresponding numbers are $4,000bn, $5,000bn and $7,000bn respectively. In the case of the US, around half the central government debt stock is in foreign hands. That serves as a reminder that reserve accumulation can be morally hazardous: it encourages the advanced countries into debt financed over-consumption, which contributes to global imbalances and increases the risk of future crises.

At the same time, rising public debt levels are associated with poor productivity growth because private sector investment is crowded out. This, together with the de-leveraging that is taking place in the advanced countries’ household and financial sectors, suggests that the emerging market economies’ currencies will appreciate over the long run. The resulting loss on the official reserves will, as Mr Prasad remarks, lead to a large wealth transfer from poorer to richer economies. And, very paradoxically, reserves will become less valuable in a global financial crisis.

The interesting question is why anyone still regards government bonds in the US, Germany, Japan and the UK as safe havens. In reality, they are unsafe havens, offering liquidity, but with escalating risk. So should investors conclude that the true havens are really in the emerging market world? Certainly there is a powerful case for saying that emerging markets would do better to deploy resources in capital investment at home than in advanced economy bonds. Mr Prasad argues that their precautionary motive could be better satisfied by setting up a global insurance pool against financial crises rather than pumping ever larger sums into advanced country debt. Developed world investors, on the other hand, have to recognise that the emerging markets’ ability to offer safe havens is constrained by inadequate property rights, poor institutional structures and under-developed financial markets. So what does that leave in the way of safe assets? There is always gold, which is an investment in collective despair over politicians’ and central banks’ ability to manage economies and currencies. But since the total stock is worth just $8,000bn, it would be hard for reserve managers to gain significant exposure without pushing the price up against themselves. And gold is no great store of value when people regain confidence. In the 20 years after the gold price peaked in the early 1980s, the yellow metal lost 80 per cent of its real value. Too bad the world is full of unsafe havens.

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