THE WALL STREET JOURNAL.
WSJ.com

OPINION ASIA | MARCH 31, 2010, 3:07 A.M. ET

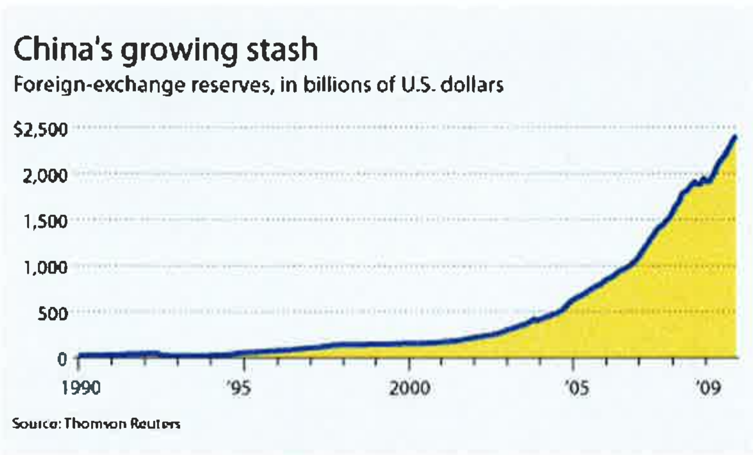
The Moral Hazard of Foreign-Exchange Reserves

China isn't the only country tempted to dip into the piggy bank.

By CATHY HOLCOMBE

There are many ways to view China's remarkable $2.4 trillion in foreign-exchange reserves—as a symbol of currency manipulation, as a form of leverage over the United States, as a high-risk exposure to the declining American empire. Increasingly, however, the country's massive cache of reserves should come to be seen as a moral hazard issue.

Like other Asian mercantilist economies, China's reserves are far and above recommended levels for protecting against liquidity crises. As they grow bigger, the temptation for the state to spend them for "strategic national interests" will similarly expand. Moreover, special interests will start clamoring for a piece of the pie.



The problem is that unlike taxpayers' money or shareholders' funds, foreign exchange reserves can seem like "free money" conjured out of a hat by central bankers. There was hardly an eyelash batted, for instance, when China spent $45 billion of foreign-exchange reserves in the early 2000s to mop up nonperforming loans in the banking sector; this despite the fact that the NPLs had basically accumulated because state-owned banks were forced to lend liberally to incompetent state-owned companies. To Beijing's credit, this exercise coincided with a financial reform drive that vastly improved risk-management systems in banks. But a precedent was set.

China's state planners now have a cushion to fall back on—other than taxpayers who might raise a fuss—if some of their policies go awry. Note that it was mostly state-owned banks which distributed funds related to China's stimulus program, and it is widely expected that the 10 trillion yuan ($1.5 trillion) in new credit created last year will lead to a surge in nonperforming loans. While in the West citizens are angry over bank bailouts, if China's recent lending bonanza goes bad, Beijing can take another dip into the foreign-exchange reserves pool to clean up the problem without much threat of a political backlash.

The same is true for China's increasing budget for overseas resources investments. Last year China's nonfinancial overseas direct investment rose some 50%, to roughly $42 billion. Much of this increase was resource- and energy-related; Chinese companies have signed contracts for long-term fuel supply deals worth more $100 billion in the past year. These investments are being made primarily by state-owned enterprises with "natural strategic interests" in mind. They are also in some cases being made in very unstable countries—but if some of these deals blow up, then why not set up a reserves-funded asset management firm to bail them out? After all, these companies are acting on behalf of the nation. It is not a stretch to imagine how $2.4 trillion in foreign-exchange reserves could raise the nation's risk appetite. China's sovereign wealth fund, the China Investment Corporation, has been funded with $300 billion in foreign-exchange reserves and mandated, among other things, to invest in overseas resources.

There is a demonstration effect on other nations, too. India's oil minister is lobbying for the country to set aside a portion of its $255 billion in foreign-exchange reserves for overseas petroleum purchases. South Korea's finance minister said earlier this month the country would set up a fund to buy resources and thus to protect companies from jumps in input prices. While he did not say how this effort would be funded, ultimately this move is probably part of the domino effect of reserves-recycling into commodities. South Korea has $270 billion in foreign-exchange reserves. Not only is this more than enough to have paid for 10 months of imports last year, but during the post-Lehman run on the Korean won, the country lost only $60 billion in foreign-exchange reserves—and that was a rare, extreme event.

The problem for China in particular is that spending reserves is not a cost-free strategy. State spending is generally less efficient than private-sector spending. Wasteful spending can also be inflationary, and in this case the result would be to drive up commodity prices for other developing nations, causing another source of political resentment against Beijing. After all, on the one hand China's fellow exporting nations are dealing with the competitive pressures of an undervalued yuan—and then on the other hand, China's state is driving up the prices of everyone's inputs with their increasingly aggressive commodities policy.

Supporters might argue that many nations have an excellent history of managing foreign-exchange reserves in a neutral manner—Finland, for example—so why pick on China or other Asian nations? But Finland has large reserves because it is blessed with natural resources. The mercantilist nations in Asia have built up reserves as a means of supporting their export markets. Like any choice, there are winners and losers, upsides and downsides. A competitive currency acts as a subsidy to producers, but it is a tax on consumers. If China did not heavily manage its exchange rate, then the currency would almost certainly be worth more—some say it would be worth 20% to 50% more than it is now. Would these individuals be using their increased purchasing power to bail out Chinese lenders or stockpile energy investments?

Mercantilist strategies have undoubtedly brought sweeping benefits to Asian nations. But they cannot go on forever. In the past few years, there has been growing discussion over the downsides of such policies—the unnatural effect on U.S. interest rates, the overdependence on exports, the trade tensions, the handicap to domestic consumption. Less apparent is the moral-hazard risk, but it is no less a danger. This is especially true in the case of China. With such a huge pile of "free money," bureaucrats and special interests will increasingly clamor for allocations to spend in ways that could ultimately obstruct its goal to reform its banking system and professionalize its corporate culture.

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