Making Sense of China’s Excessive Foreign Reserves*

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Abstract

Large uninsured risk, severe borrowing constraints, and rapid income growth can imply excessively high household saving rates. Therefore, the global saving glut and massive foreign reserves accumulated by emerging economies are not necessarily the intended outcome of any government policies or undervalued home currency, but instead a natural consequence of the inefficient financial system (or lack of timely financial reform) in these countries. Since financial development is a much more complicated task and harder goal to achieve than GDP growth, even if the Chinese government appreciate RMB dramatically, trade imbalances between China and the United States will remain, as was the case between Japan and the U.S. in the last century. Worse still, without a well developed domestic financial market, the RMB may significantly depreciate, instead of appreciate, once the government in China abandons the linked exchange rate and the massive amount of precautionary savings of Chinese households unleashed toward the world financial markets in seeking for better returns. In other words, the gigantic asset demand caused by precautionary savings may completely dominate the Balassa-Samuelson effect on the exchange rate.

Keywords: Exchange Rate Determination, Borrowing Constraints, Buffer Stock Saving, Global Imbalance, Foreign Reserves, Trade Deficit, Incomplete Markets, Uninsured Risk.

JEL Codes: ??.

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