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Comparative Study: Factors That Affect Foreign Currency Reserves in China and India

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COMPARATIVE STUDY: FACTORS THAT AFFECT FOREIGN CURRENCY RESERVES IN CHINA AND INDIA

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Foreign currency reserves in Asia are at an all-time high since the Asian crisis in 1997, despite experts predictions that increased capital mobility and funds from financial institutions like the International Monetary Fund would decrease the need for foreign reserves. It is speculated that this hoarding of reserves is a by-product of a country s exchange rate regime. To test whether the exchange rate regime significantly affects a country s level of reserve holdings, China and India were selected as comparison countries in this study. China and India rank second and fifth in world reserve holding, respectively, and have reserve holdings that have been growing exponentially. They also have different types of exchange rate regimes; China has a fixed exchange rate while India has moved towards a more flexible managed float regime. However, both countries have been experiencing rapid growth due to the somewhat recent openings of their economy, making a comparison between the two viable.

According to Aizenmann and Marion (2002) two variables have been consistently found to affect reserves: exchange rate variability and economic openness. This paper tests if these variables affect reserves in China and India. Exchange rate variability refers to the variability in the exchange rate, computed from daily nominal exchange rate data. The variable was used with a lag, and it is expected to have a positive effect, since the theory is that increased volatility yesterday would encourage more reserves today. Economic openness is a variable calculated as real imports over real GDP. The theory behind this variable is that the more open an economy is, the more vulnerable it is to external financial shocks, leading a country to hoard more reserves to protect itself. Preliminary results suggest these variables are strong predictors for Indian reserve holdings, but not for China.