A STUDY OF TRADE SURPLUSES: ASSESSING ALTERNATIVE STRATEGIES FOR RESERVE MANAGEMENT

Student Contributors: *Shashank Shekhar, Supriya Shailesh Sehgal*

Abstract

Some nations today have accumulated huge reserves and have trade surpluses by virtue of their economic recovery after the Second World War (Germany and Japan), resource wealth (Russia and Saudi Arabia) or sheer advancement in skill and technology (China). This article explores the various reserve management strategies available to nations which have trade surpluses. It also analyses the effectiveness of these strategies in terms of better investment alternatives for China, Russia, Japan and Saudi Arabia.

Introduction

Since time immemorial, trade and commerce have played an indispensable role in global integration. Rapid advancement in telecommunication and transportation technologies in the last two centuries have further boosted the value-share of trade in the economy. Also, the increased emphasis on GDP, inflation, growth and employment, and the linkages these variables have to a nation's overall trading activity, have made National Trade Balance a critical economic parameter. A trade surplus is when a nation's exports exceeds its imports, leading to a positive balance in the Goods and Service Current Account. Likewise, a negative balance implies a trade deficit.

The last few decades have led to a considerable shift in global financial power distribution with the rise of the G-20 countries, which together constitute about 85% of world GDP and over 80% of global trade[1]. A look at their historical trade balances shows that while the United States runs a huge trade deficit; China, Russia and Saudi Arabia have been accumulating trade surpluses. The strategies to use their surpluses vary based on the geo-political and economic objectives of each nation.

The Ideal Condition: Trade Surplus or Deficit?

Economists around the world hold contradicting views on the benefits and costs of a trade surplus or deficit. One school of thought looks at trade deficits with gloom since it necessitates maintaining a forex reserve from which a nation pays for its imports in foreign currency. This makes the country vulnerable to external shocks and in extreme circumstances may lead to a Balance of Payments crisis. While the other believes that it is necessary for a developing nation to run deficits to boost its consumption and national demand.

A Trade Surplus, on other hand, leads to currency appreciation due to increased demand for the domestic currency. This erodes the competitiveness of the nation's exports. To prevent currency appreciation, a country may build forex reserves to hedge against external shocks or increase their productivity at a faster rate than currency appreciation. In either case, economists today concur that in the short term, we need a case by case analysis of trade balances, carefully analysing the pros and cons of each.

[1] G20.org. Retrieved 19 June 2014.

Alternatives for Utilization of Trade Surpluses

Nations with trade surpluses use various alternatives for investing the same. The following section discusses the most common techniques used by nations to absorb trade surpluses.

Building Foreign Exchange Reserves within Central Bank

Since the 1990s, there has been a rapid rise in accumulated forex holdings of the world economy. Most of this growth has come from the developing and underdeveloped countries. The reserves have climbed to almost 30% of developing countries' GDP, and to almost 8 months of imports[2].

Build-up of other reserve assets

A central bank also maintains other reserve assets in the form of monetary gold, special drawing rights of IMF, reserves of IMF members held by IMF (reserve position in the IMF) and other reserve assets to diversify risks of their existing reserve portfolio.

Creating Sovereign Wealth Funds (SWF)

SWFs are a mechanism to manage state-owned public funds by investing in cross-border long term assets. They diversify risks by investing in high-risk high-return assets across various areas. However, with increasing size, impact and lack of transparency, SWFs have become a topic of recent debates raising questions on their political motive. Hence, there is an imminent need to regulate and monitor the same to curtail their clout.

Forex Intervention to Manipulate Exchange Rates

Countries have in the past deliberately engaged in the act of forex accumulation to prevent their currencies from appreciating and hence maintained the competiveness of exports. Apart from providing import cover, countries create huge reserves to support domestic exchange rates and maintain their value within target ranges.

Infrastructure and deficit Financing

Countries use trade surpluses to finance deficits in other national accounts like the current account deficit (CAD). They also use it to finance long-term infrastructure projects, create developmental institutions, and/or pension funds and social security programs.

Thus a trade surplus gives a nation the power to secure its future and earn returns on this surplus by means of the above mentioned alternatives.

Analysis of Strategic Asset Allocation by China, Russia, Japan and Saudi Arabia

The authors did a detailed analysis of the trade surpluses of four countries: China, Russia, Japan and Saudi Arabia to understand their investment strategies. The reason for choosing this particular mix of countries was to cover a comprehensive set in terms of their trade endowments and competencies. While Japan is an export hub, China is a fast-yet-still-emerging exporter. Russia and Saudi Arabia, on the other hand, are commodity driven economies. The key insights from this study are discussed below.

The study shows that there is a strong correlation of the nation's forex asset reserve build-up and the national account surplus in trade (also, overall balance of payments surplus). For China,

---

[2] Dani Rodrik, *The Social Cost of Foreign Exchange Reserves*, NBER Working Paper, January 2006.

the correlation was 0.97, while it was 0.68 for Russia. Both these countries are using trade surpluses for augmenting their forex asset reserves as shown in Exhibit 1 and 2.

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013
Trade Surplus (in $ billions)	125	209	308	349	220	223	182	232	235
Overall Bop Surplus (in $ billions)	136	236	356	424	247	242	142	220	186
Total Official Surplus (in $ billions)	228	281	447	461	442	525	402	184	509
Change in Forex over last year (in $ billions)	209	247	462	418	453	448	334	130	510
Foreign Exchange Reserves (in $ billions)	819	1066	1528	1946	2399	2847	3181	3312	3821

Correlation Coefficient = 0.97

Exhibit 1: Forex Reserve and Trade Surplus in China; Source: International Monetary Fund (IMF)

Year	2008	2009	2010	2011	2012	2013
Trade Surplus (in $ billions)	157.2	95.6	120.9	163.4	145.1	121.7
Overall BoP Surplus (in $ billions)	103.8	37.9	67.4	97.4	66.1	32.3
Total Official Surplus (in $ billions)	204.6	69.4	125.7	186.2	121.8	52.8
Change in Forex over last year (in $ billions)	171.2	-55.0	4.9	26.9	10.4	32.6
Foreign Exchange Reserves (in $ billions)	466.8	411.7	416.7	443.6	454.0	486.6

Correlation Coefficient = 0.68

Exhibit 2: Reserves and Surplus in Russia; Source: International Monetary Fund and Central Bank of Russia

Reserve Management by China

China, the rising global super-power, started registering trade surpluses in 1991. Between 1997 and 2007, China established a total of four bodies which operate like Sovereign Wealth Funds. These are the SAFE Investment Company (SAFEIC), National Social Security Fund (NSSF), China

Investment Corp. (CIC) and the China-Africa Development Fund (CADF). Each fund has a different objective, ranging from maintain China's forex reserves through overseas investments to developing a pension fund to ensure social security.

China has an aggressive investment strategy with strong geopolitical considerations. The government takes active interest in the investment decisions, and tries to further its objective through the SWFs and Central Banks as its operational arms. Considering sectors, China has primarily invested in projects relating to energy and infrastructure. Geographically, over 40% of the investments are in one single continent – Africa. Though exact Return on Investment numbers are not available as the quantum of investments is shroud in secrecy, some of these projects are economically unviable. For China, it appears as though it is ensuring its energy security in the near future by buying stakes in African mines and oilfields.

China has also invested around 25% of its SWF holdings in the US, stoking political debates in US Congressional circles. Getting inward access into intellectual property and confidential technological information is also sometimes the objective of these funds. These concerns led to the enforcement of SWF monitoring law in the US, the Foreign Investment and National Security Act or FINSA. There are discussions of implementing such a law among other developed countries as well to check the potential harmful effects of letting unregulated SWFs.[3]

Reserve Management by Russia

Russia is an oil exporting nation accumulating trade surpluses and reserves from high price of oil exports. To prevent itself against a downturn in oil prices, Russia established its first sovereign wealth fund in 2004 called Stabilization Fund. In 2008, the Russian Government split the former to the Reserve Fund, and the National Wealth Fund. The Reserve fund withheld the Stabilization Fund's function of balancing budget deficit and foreign debt, while the National Wealth Fund's aim was to provide a cushion for the pension fund of the Russian Federation. For Russia, the safety and liquidity of the funds' assets have a greater priority over the returns that they earn. Russia's geopolitical interests are also not as embedded as those of China.

Reserve Management by Japan

Japan is unique in its surplus and reserve position. Despite running into a trade deficit after the 2011 tsunami disaster, it has burgeoning reserves. The reserve surplus cushion is of utmost importance to the nation – to maintain its trade competitiveness through periodic currency interventions, to prevent currency appreciation. Japan has also created the world's largest retirement fund called Government Pension Investment Fund. Its sovereign wealth fund aims to providing pension cover to an aging population and has followed a strictly conservative investment strategy till recently. However, with the introduction of 'Abenomics' the fund plans to enter a riskier portfolio to improve returns.

Reserve Management by Saudi Arabia

The largest oil exporter of the world, Saudi Arabia has been running a trade surplus since 1968. Saudi Arabia utilizes its trade surplus in 3 major avenues which are income repatriation, deficit financing of government budget and investing in low-risk low-return assets.

---

[3] http://www.em-economics.com/2013/03/11/sovereign-wealth-funds/ , http://www.geopoliticalmonitor.com/tag/china-sovereign-wealth-fund/

The Saudi Arabian Monetary Agency, the SAMA, or the central bank, holds the responsibility of managing Saudi investments in foreign assets, and thus acts as an SWF. Currently, it is the third largest SWF in the world. Over the years, the fund has adopted a low-risk, low-return investment strategy, with over two-thirds of its total assets[4] invested in the US Treasury bills and bonds. The exact details of the same are unknown. The strategic intent behind investing two-thirds of its investment in US treasuries is quite evident. As elucidated by author Thomas Piketty in his work "Capital in the 21st Century", forfeiting higher returns from slightly riskier assets is a cost of national security paid by Saudi Arabia. The US has kept a significant troop presence in the country to defend it against some of the hostile neighbours like Iran and Syria. To have a debt liability offered to such a country is thus, a strategic geo-political choice.

Conclusion

Overall, we conclude that there is no 'ideal' method to manage a trade surplus. Depending on the state of economy and the government's roles and objectives, a nation may choose to utilize its trade surplus to build reserves, obtain a high Return on Investments or to increase geopolitical clout. More often than not, nations forgo economic fundamentals, investing in low return assets backed by geo-political motives. Secrecy and non-transparency of such investments leads to cross border tensions. However, each strategy can find a justification based on the context it is used in, thus making it impossible to define an ideal strategy to utilize a nation's trade surplus and reserves.

Contributors

Shashank Shekhar (PGP 2013-15) holds a Bachelors Degree in Electrical Engineering from Indian Institute of Technology, Roorkee and is currently pursuing his Post-Graduate Diploma in Management from Indian Institute of Management, Bangalore. He can be reached at shashank.shekhar13@iimb.ernet.in

Supriya Shailesh Sehgal (PGP 2013-15) holds a Bachelors Degree in Electronics from VJTI, Mumbai and is currently pursuing her Post-Graduate Diploma in Management from Indian Institute of Management, Bangalore. She can be reached at supriya.sehgal13@iimb.ernet.in

Key-words

Functions: Economics
Others: Trade Surplus, Forex Reserves, Sovereign Wealth Funds, China, Russia

Acknowledgement

The authors would like to thank Dr. Rupa Chanda, Professor at Indian Institute of Management, Bangalore for her exemplary guidance and constant motivation in completing this piece of work.

[4] http://www.sovereignwealthcenter.com/fund/39/Saudi-Arabian-Monetary-Agency.html#.U_pc1vmSyCQ