

Reserve accumulation. Implications for Central Banks

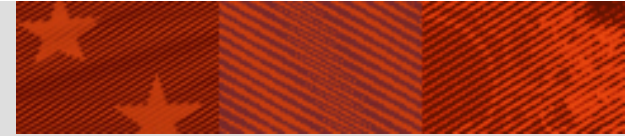
Enrique Alberola

Banco de España

CEMLA-ECB Meeting

Frankfurt, March 2007

OUTLINE OF THE PRESENTATION



1. INTRODUCTION

2. DRIVERS OF THE PROCESS

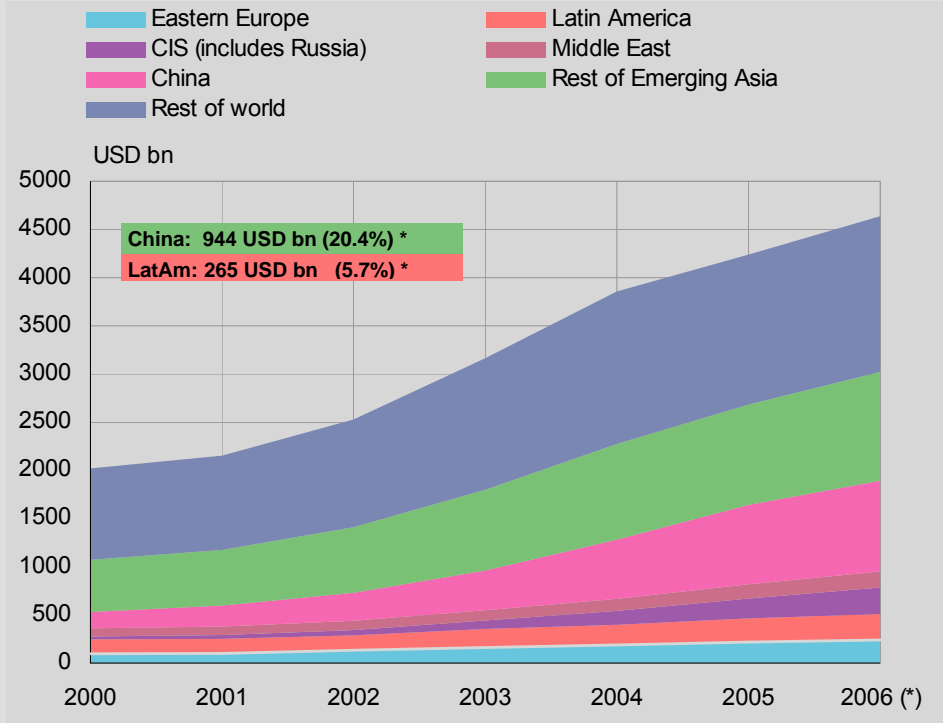
3. COSTS AND CENTRAL BANK MANAGEMENT

4. PERSPECTIVES AND ISSUES FOR DISCUSSION

INTRODUCTION

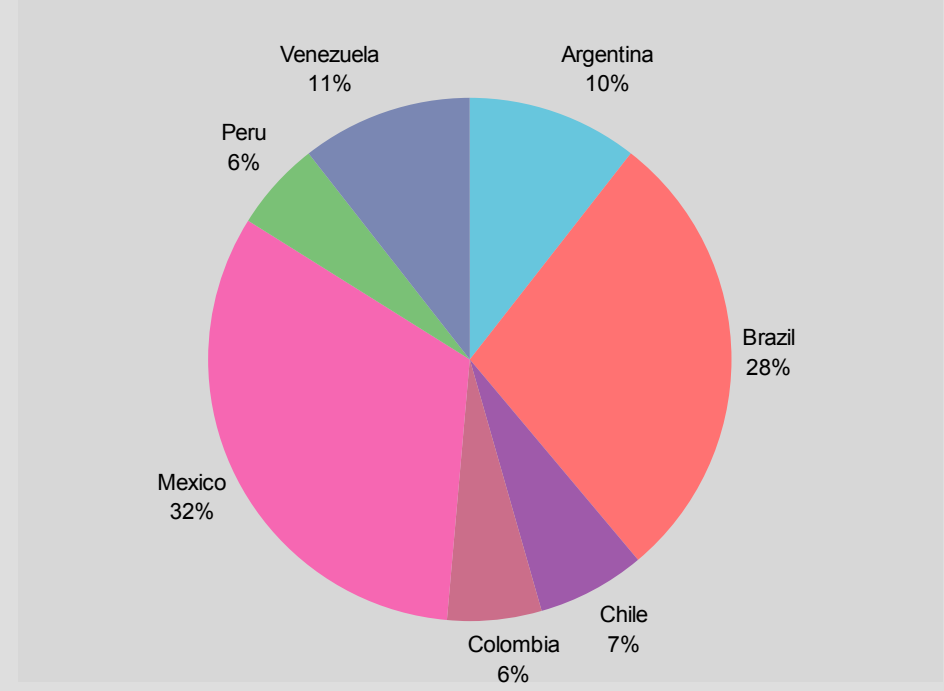


HOLDINGS OF RESERVES 2006 (*)



SOURCE: International Monetary Fund (International Financial Statistics)
 (*) Second quarter

HOLDINGS OF RESERVES 2006 (*)

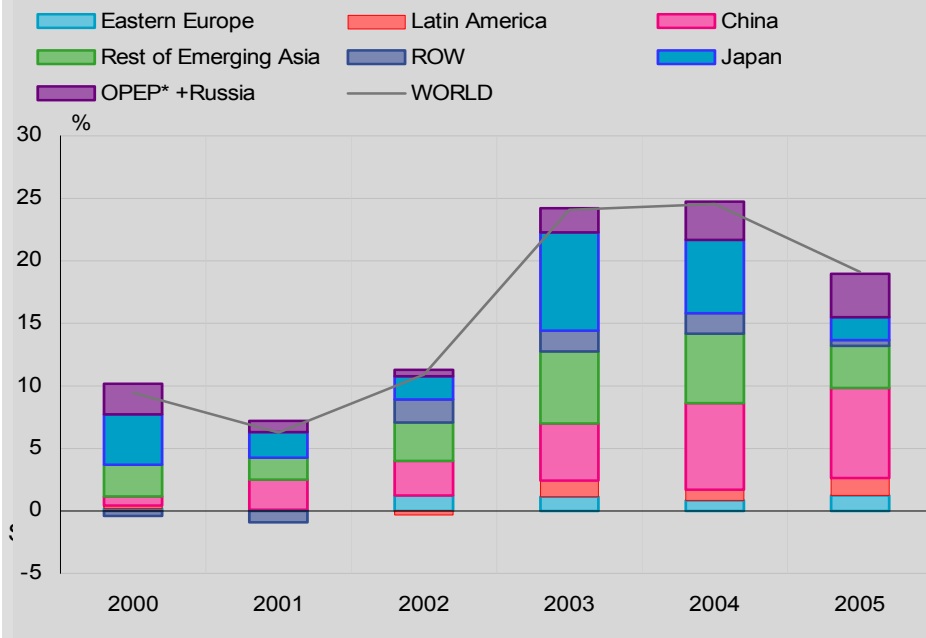


SOURCE: International Monetary Fund (International Financial Statistics).
 (*) Total reserves minus gold. 3rd quarter 2006.

- **Huge increase in international reserves since 1997**
- **Leaders of the process are emerging economies: Asia, Oil exporters, ...Latam**

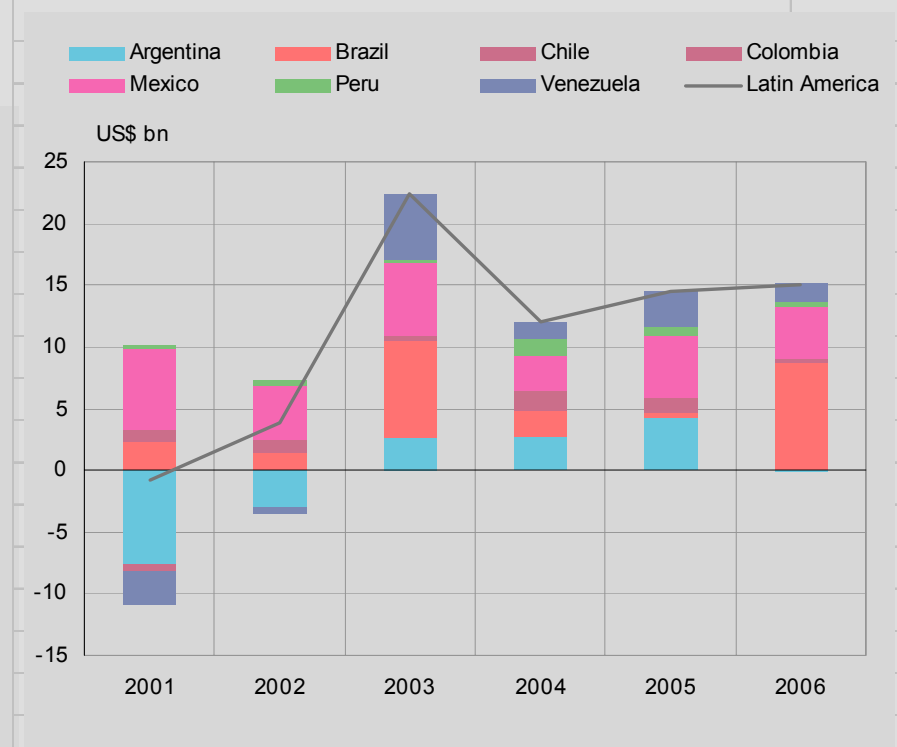
INTRODUCTION

Contribution to growth in reserves



SOURCE: IFS

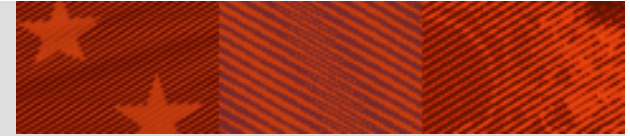
CONTRIBUTIONS TO CHANGE IN INTL. RESERVES IN LATIN AMERICA



SOURCE: International Monetary Fund (International Financial Statistics).

- **Growth of reserves close to 20% in the last three years**
- **Leaders of the process are emerging economies: Asia, Oil exporters,**
 - **...Latam: less and minor contribution (around 10% to growth in last period)**

INTRODUCTION



- **The process is receiving substantial attention:**
 - The benefits –as potential explanations of the process.
 - *Drivers*
 - The global consequences and costs:
 - *Global imbalances*
 - *Domestic impact and implications for Central banks*
 - The asymmetric balance
 - *Internally: perception of costs rather muted v. evident benefits*
 - *External: negative externalities and coordination problem*
 - Or New BW II system of optimal equilibrium?

- **Key policy issue, both internally and externally:**
 - How long will this process go on?
 - Could the domestic costs eventually put an end to the process?

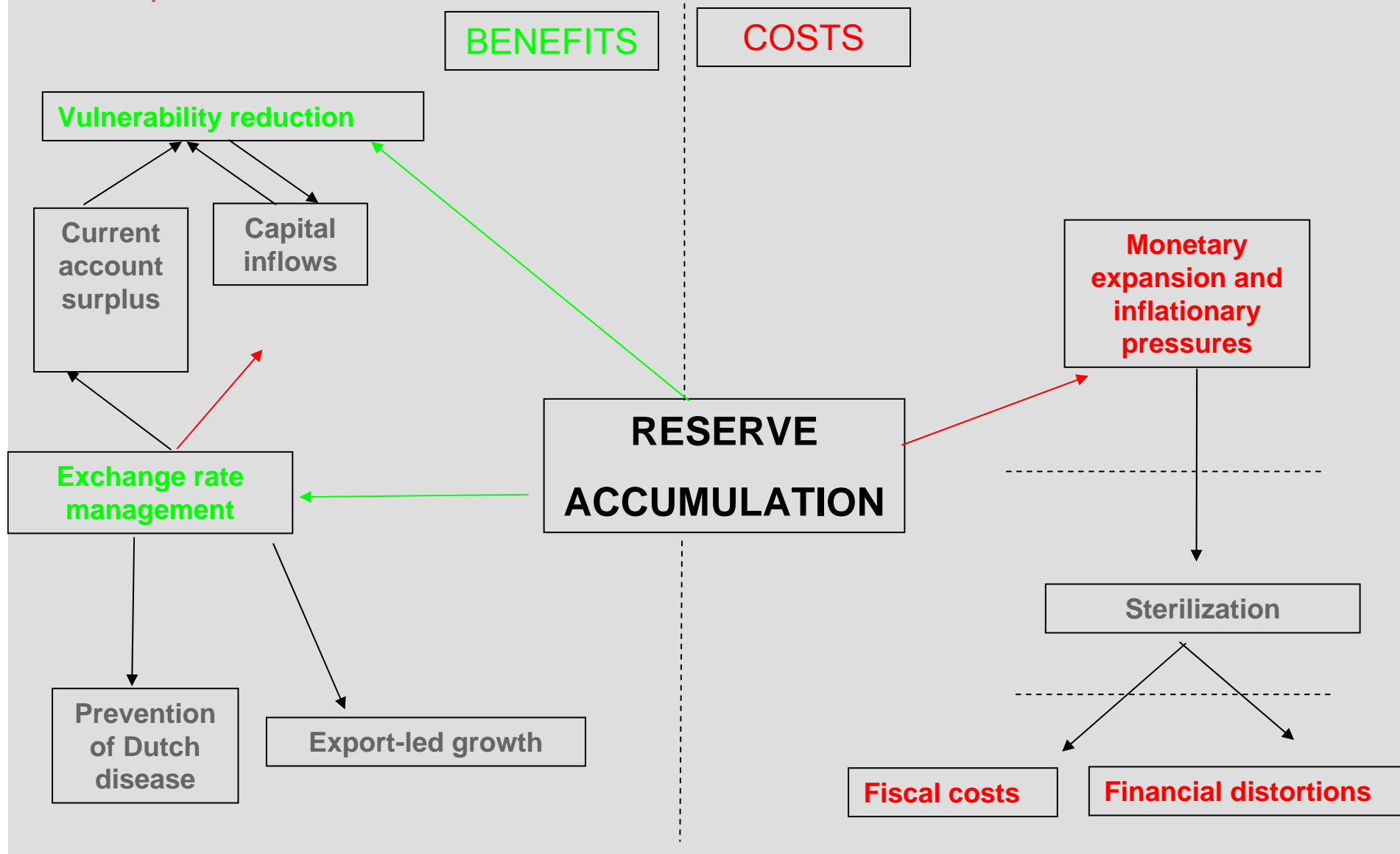
INTRODUCTION



**Who wants to be a
trillionaire?**

INTRODUCTION

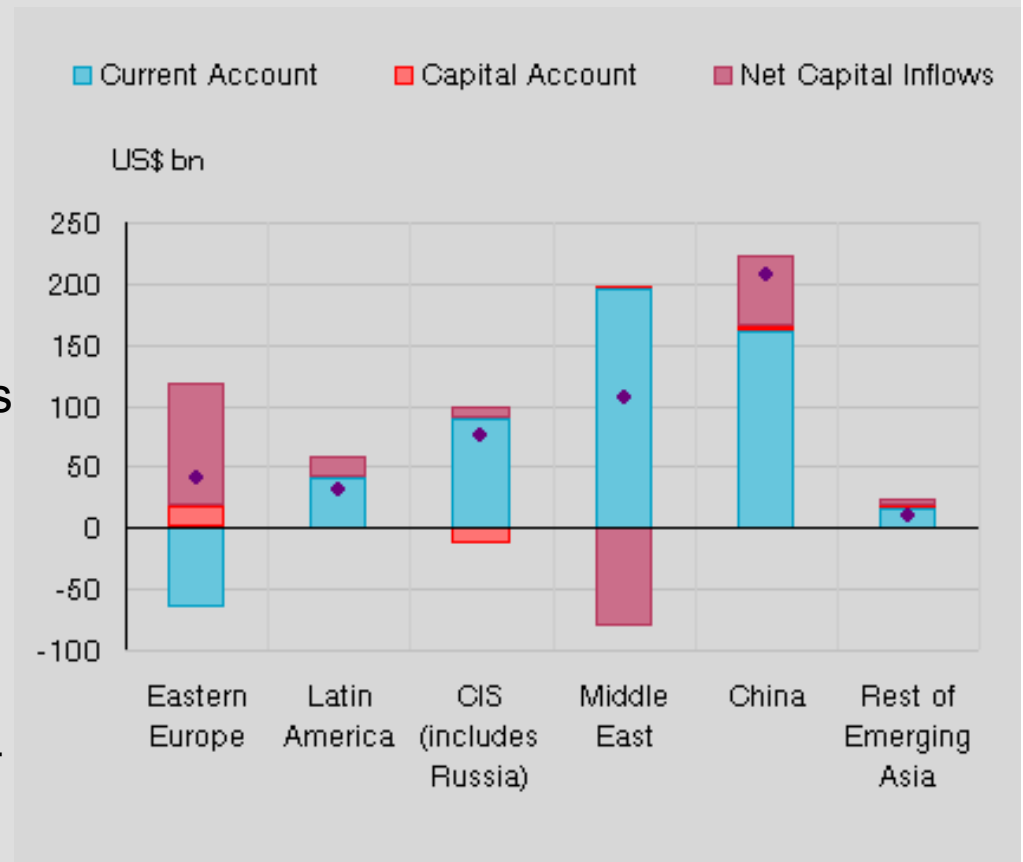
A conceptual framework



DRIVERS OF THE PROCESS

A BoP approach

- Most emerging countries are experiencing current account surpluses.
- Some emerging countries are also large net capital inflows
- The counterpart are increases in international reserves in all the groups of emerging countries.
- **GLOBAL CONDITIONS**
- Loose financial conditions and large capital flows
- Export demand of commodities, TOT shocks
- Muted inflationary pressures



DRIVERS OF THE PROCESS

A BoP approach

How is Latin America behaving?

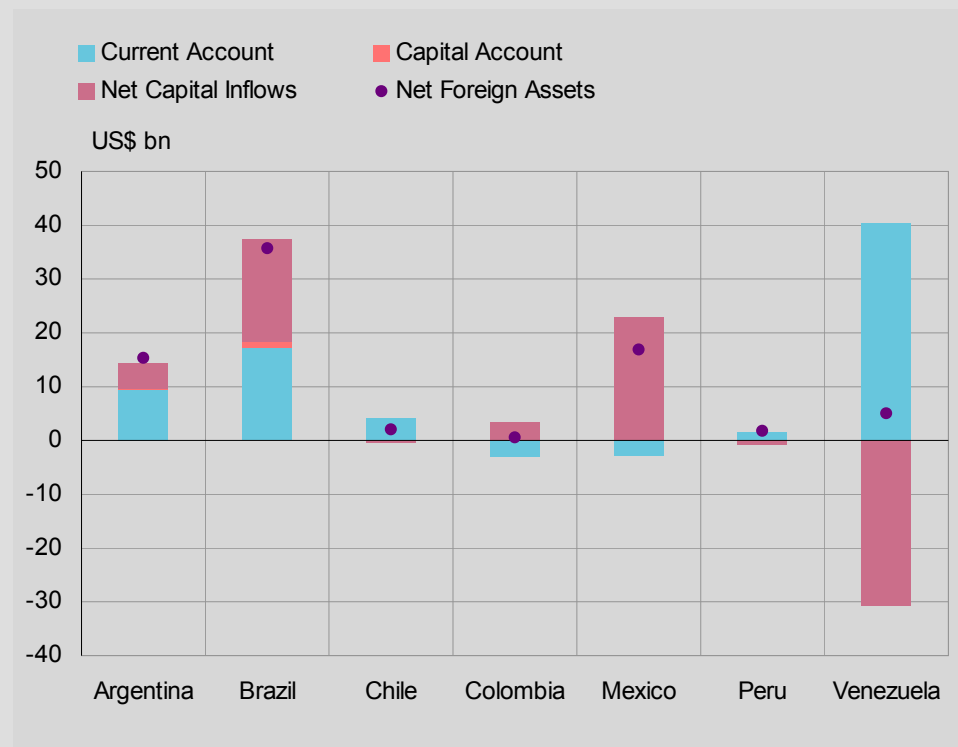
TOT shocks prominent

- Unusual CA surpluses

Net capital flows less, but composition important

- Contraction of net official flows
- Sizable private inflows

CURRENT ACCOUNT, CAPITAL FLOWS AND RESERVES IN 2005-2006 (*)



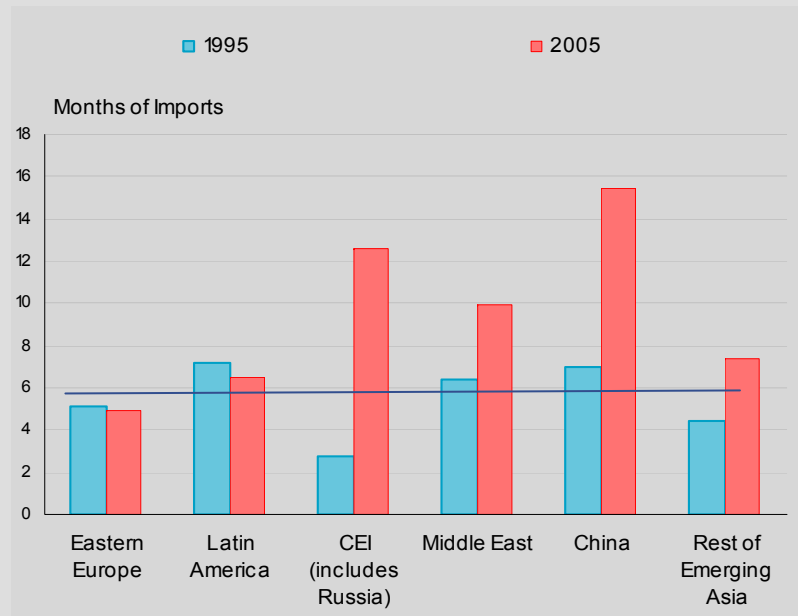
SOURCE: International Monetary Fund (International Financial Statistics).
 (*) 2005 + Q1 2006 + Q2 2006

2. DETERMINANTS OF THE PROCESS

Benefits: Self-insurance

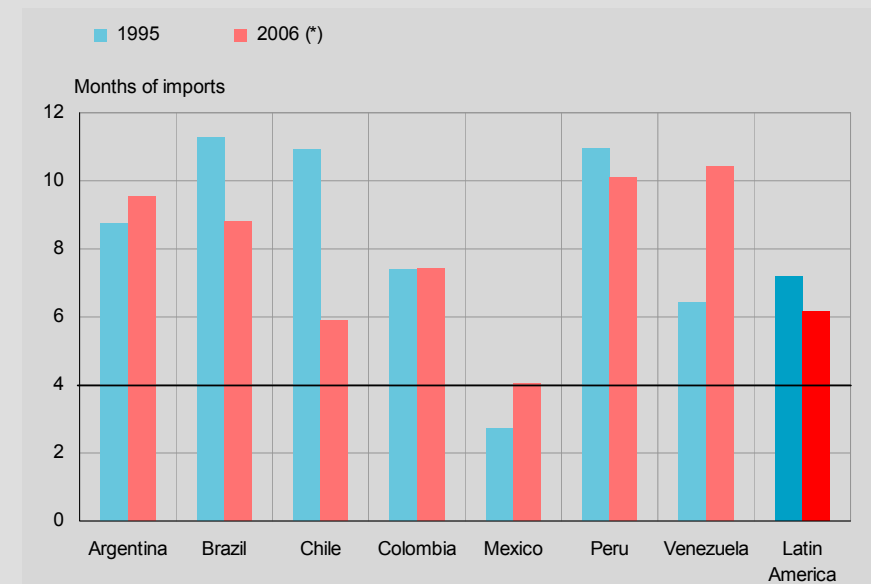


Reserves over imports: by region



Reserves/ imports LA

RESERVES OVER IMPORTS IN LATIN AMERICA



SOURCE: International Monetary Fund (International Financial Statistics).
(*) 3Q 2005 to 2Q 2006

•Self-insurance I. Reserves over imports

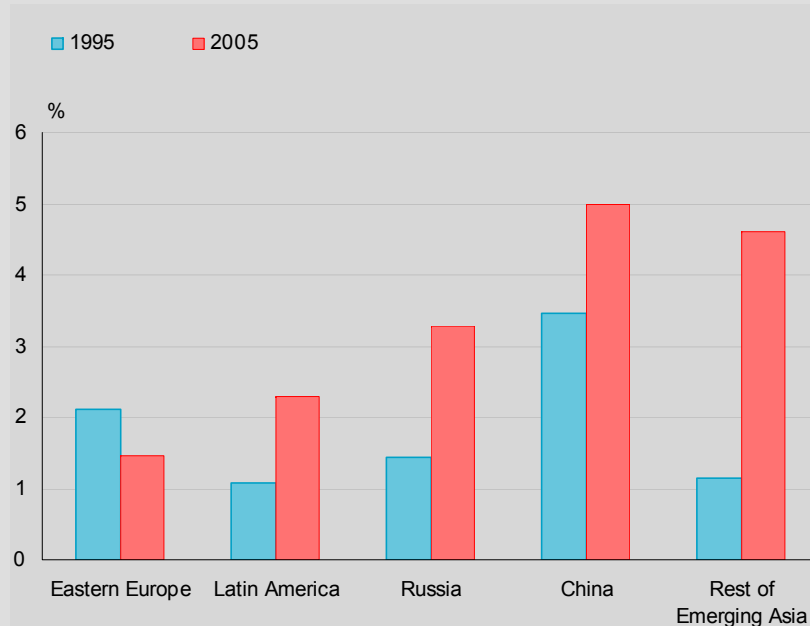
- Beyond necessary in oil exporters, Asia
- ...not in Latin America

DRIVERS OF THE PROCESS

Benefits. Self-insurance

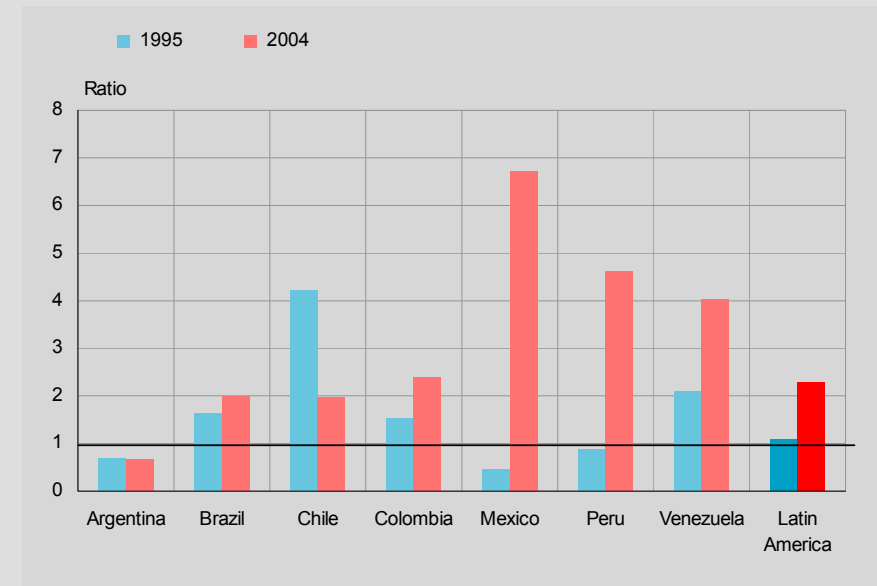


Reserves over short term external debt; by region



Reserves/ short term external debt.LA

RESERVES OVER SHORT-TERM EXTERNAL DEBT



SOURCE: International Monetary Fund (International Financial Statistics).

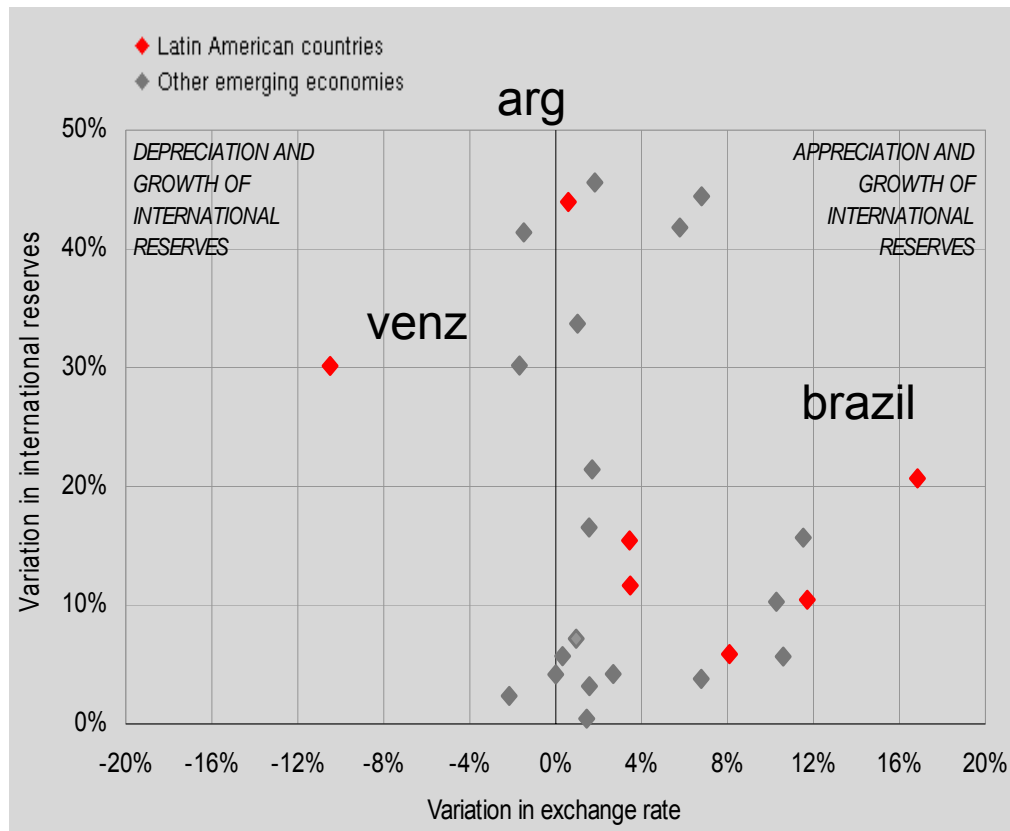
- Self-insurance II. Reserves over short term debt
 - Latin American large improvement
 - ...importance of local debt markets development (denominator reduction)

DRIVERS OF THE PROCESS

Exchange rate management



EXCHANGE RATE AND RESERVE ACCUMULATION (2004-2005)



SOURCE: International Monetary Fund (International Financial Statistics).

Exchange rate management

-Increasingly perceived as the main driver

•also in Latin America?

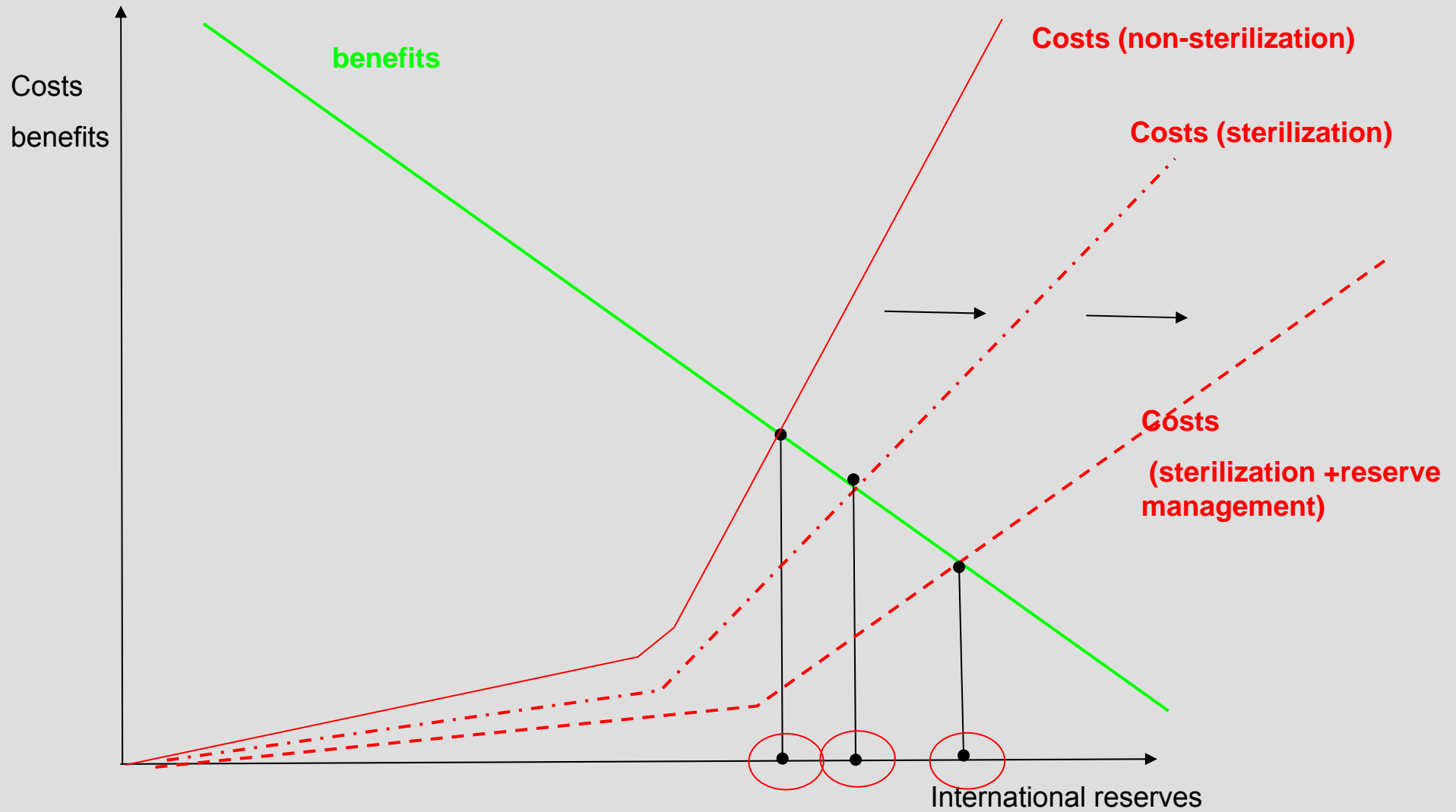
-large real appreciations v. smaller nominal depreciations

-accommodating TOT shocks

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COST AND CB MANAGEMENT

Cost benefit analysis



COST AND CB MANAGEMENT

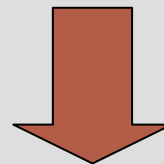


- **COSTS OF NON-STERILIZATION:**

- Monetary expansion
- Inflationary pressures
- Credit and asset booms

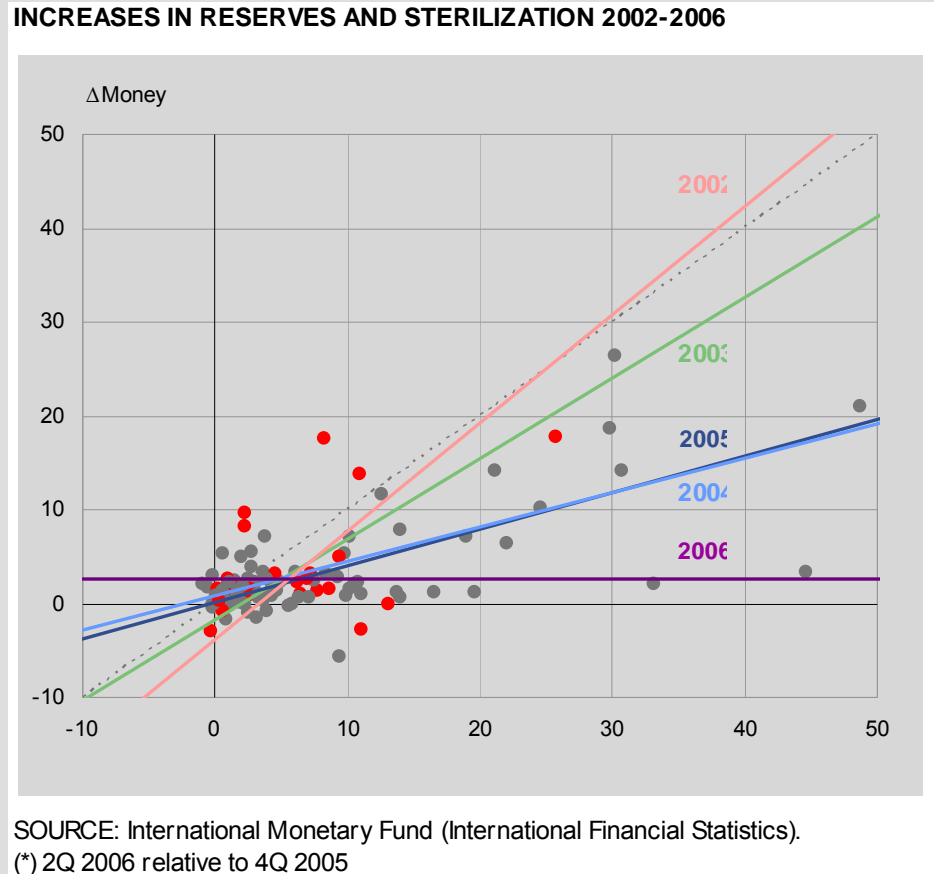
- **SIZE OF THESE COSTS:**

- Depends on the ability of the economy to cope with increases in liquidity:
 - *Development of the banking sector*
 - *GDP growth...*



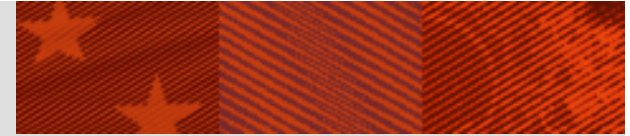
THEREFORE, MANY COUNTRIES ARE STERILIZING THE ACCUMULATION OF RESERVES

COST AND CB MANAGEMENT



- Until 2002 there was not a clear pattern.
- Since then, sterilization has become more intense.
- Latin America sterilises more intensely
 - Globally 28% bw 2002-05
 - LA 43%

COST AND CB MANAGEMENT



■ COSTS OF STERILIZATION:

– Open market operations:

- *Quasifiscal costs (differential between returns on assets and liabilities)*
- *Crowding out of the private sector*
- *Increases in interest rates*
- *Increases in public debt (risks of monetization)*
- *Increase in the debtor position of the central bank towards the commercial banking system*

– Reserve requirements:

- *Tax (and associated distortions) on the banking system*

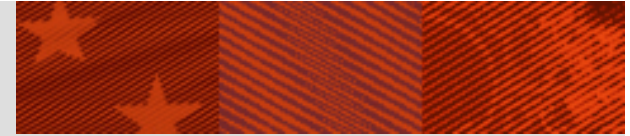
– Government deposits:

- *Dependence on the government, reduction in autonomy.*

– Overall financial stability

- *Distorsion in resource allocation by financial system*

COST AND CB MANAGEMENT



■ COST MITIGATION

– RESERVE MANAGEMENT

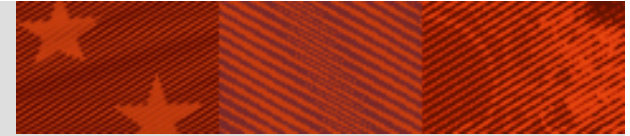
- *Overcome fiscal, monetary costs by investing reserves within or outside CB balance sheet*
 - » *Singapur, Taiwan, Hong Kong*
 - » *Rusia, other oil exporters*
- *Use reserves to reduce external indebtedness, recompose debt holdings*
 - » *Brazil*
 - » *Argentina*
 - » *Mexico, Colombia*

– NON-MONETARY MEASURES

- *Price controls. Monetary policy drift*

– WHAT ROLE FOR CENTRAL BANKS?

- *Autonomy, independence*
- *Price stability objective*



CONTINUATION OF THE PROCESS AT THE GLOBAL LEVEL?

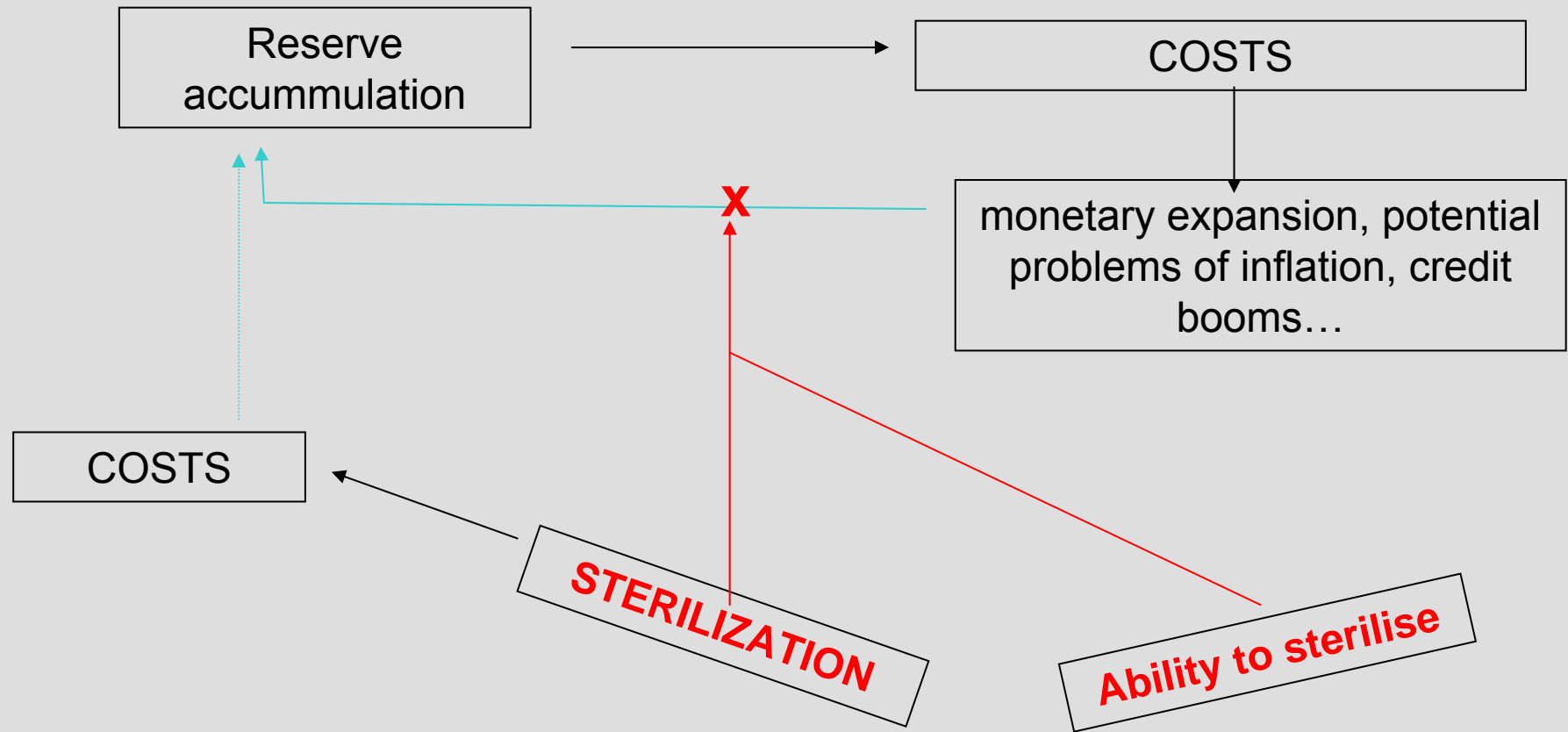
- Usual suspects non biting
 - *Inflation, interest rates ...*

- Hints of mounting problems
 - *China: financial distortions, liquidity, asset booms*
 - *Emerging Asia: capital mobility management*

- Will halt the process?
 - *Empirical evidence (Alberola & Serena (2007))*
 - Increasing sterilization due to increasing non-sterilization costs
 - Ability to sterilize impinge on the magnitude of accumulation
 - ...but only very marginally

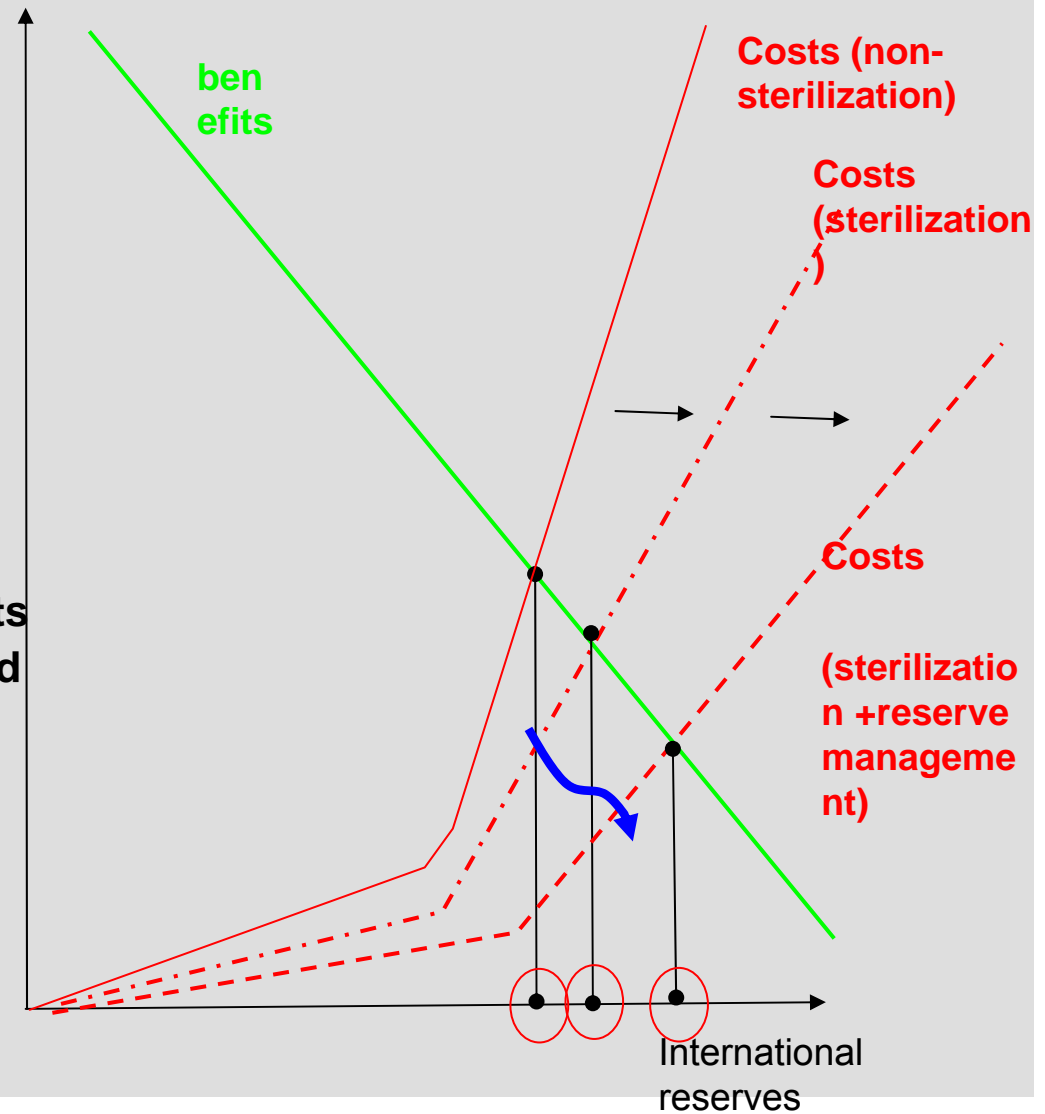
ECONOMETRIC APPROACH

Outline

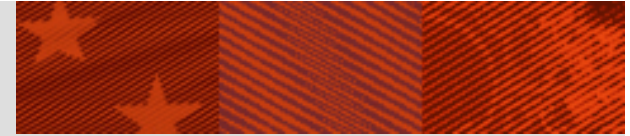


CONCLUSIONS

- Accumulation proceeds at strong pace
- Costs are becoming evident, in different disguises...
 - all countries are sterilizing
 - Active reserve management
- But active policies to overcome the perceived costs
 - Not there yet
 - Strong enough pressure to overcome strong policy commitments (to e-r management)?



PERSPECTIVES AND ISSUES FOR DISCUSSION



- **THE PROCESS WILL CONTINUE, AT THE GLOBAL LEVEL**

- Manageable costs
- overriding exchange rate strategies

- **RISKS**

- Path dependence = perverse incentives
 - *CB balance sheets : natural currency mismatch*
 - biases towards continued intervention (under appreciation pressures)
- Increasing distortions
 - *Financial system*
 - *Involution, delays in capital account liberalisation*
 - *Whither monetary policies?*
- Costs not evident, perceived benefits overrule dangers

PERSPECTIVES AND ISSUES FOR DISCUSSION



▪ IN LATIN AMERICA

- TOT shock as driver of accumulation?
- Is self insurance still main driver?
- Inflationary pressures building up?

▪ RISKS

- Whither monetary policy?
 - Drift towards DDD measures ?(discretionary,disuasory,distortionary)*
- Financial system consequences
 - Obstacle to development of markets, or fostering?*
 - Is the banking(financial) system distorted?*
- Fiscal conflicts
 - Conditional on sterilization instruments. Are they arising?*
 - Stabilization funds, who owns the reserves?*
- Reputational issues on central bank
 - Jeopardize reputation building process?*

▪ Should the process continue?