CENTRO DE ESTUDIOS MONETARIOS LATINOAMERICANOS

XII BIS–CEMLA Roundtable, This time on Reserve Management and FX Intervention

Cartagena de Indias, Colombia
June 17 and 18, 2019

Manuel Ramos-Francia
General Director, CEMLA

Welcome and Opening Remarks

Good morning to all of you. I would like to welcome everyone to the XII BIS–CEMLA Roundtable, this year on Reserve Management and FX Intervention. I would also like to take this opportunity to thank my colleagues from the Central Bank of Colombia, especially, Andrés Murcia, Pamela Cardozo and Mauricio Villamizar. for their generosity as hosts. It is an honor and a pleasure to have the historical city of Cartagena as venue. I would also like to thank Enrique Alberola who, as you well know, leads the Mexico City Office of the Bank for International Settlements, and with whom CEMLA jointly organizes this Roundtable.

The topics that gather us here today are of keen interest to central banks. Even before the GFC, much work had been done in analyzing International Reserve Accumulation, ER intervention, and International Reserves Management. The GFC, the years in its aftermath, and for various reasons, provided renewed impetus for studying and analyzing these topics, given their importance for policy making.

The Global Financial Crisis led to an unprecedented accommodative monetary policy stance in the main advanced economies, which, of course, included unconventional monetary policies. These had several repercussions for the world economy, but particularly, for many EMEs.

Monetary accommodation and capital flows. Topics that gained relevance.

The unprecedented amount of monetary accommodation in AEs led to an increase in the amount and volatility of capital flows to many EMEs leading, in many cases, to considerable pressures for currencies to appreciate and thus, to the perception of a potential loss in competitiveness. Various issues came to the fore. A few: 1) Trilemma or Dilemma (is there a Global Financial Cycle? 2) Externalities? 3) Capital Flow Management? Capital Controls? Macroprudential policies? 4) Global Monetary Game and coordination?

The Global Financial Crisis provided incentives for central banks to accumulate international reserves. 1) A prominent one being self-insurance. In effect, countries that accumulated higher levels of international reserves performed better during the crisis and its wake. Of course, the accumulation of international reserves needs a congruent monetary policy. In short, both policies need to be consistent with each other. 2) Another one was related to the discussion of a non-cooperative game for global growth based on a) competitive easing on the part of AEs, and of b) Reserve Accumulation on the part of EMEs. In effect, the latter issue leading to a discussion on whether the world was in the midst of Beggar-Thy-Neighbor equilibrium.

International Financial Architecture.

Another related topic that gained relevance concerned the International Financial Architecture. Two topics: 1) In general, a country having a stock of international reserves can address some specific problems, but it does so at a cost and, clearly, they are only a second-best solution. 2) Additionally, what could be best for individual countries, may not be best for the system.

Take the first topic. That is, consider having a stock of international reserves with the objective of self-insurance. In most cases, self-insurance is suboptimal. In general, self-insurance is more costly than other options, due to a lack of risk-pooling. In many ways, accumulating international reserves is no different.

As a benchmark, consider that under complete financial markets a central bank would buy insurance only for specific contingencies. Evidently, financial markets are incomplete. International reserves are mostly seen as a war chest. Thus, while such an insurance would be for certain contingencies, central banks invest heavily in noncontingent bonds. This leads to a situation in which they are over-insured with respect to some contingencies and underinsured with respect to contingencies.

The closest we have to a global insurance mechanism is the IMF through its GFSN. Also, having an institution like the IMF can make a coordinated equilibrium more likely. However, it has limited resources and, potentially, political economy issues.

Capital Outflows

Starting with the Taper Tantrum, we have the other side of the coin. Capital outflows. Topics: Capital controls, macroprudential policies, FX intervention.

Putting everything together: Global Monetary Game.

Low natural rates in AEs, monetary accommodation in those countries, the search for yield, the nature of the players in international financial markets and the response of EMEs taken together with their own vulnerabilities, have led to a fast paced global monetary game, where policies like International Reserve accumulation, ER intervention and International Reserves Management are most relevant policies for EMEs. As I previously noted, in the aftermath of the GFC, the policy responses from several economies, particularly so those of the AEs, gave place to extraordinary levels and volatility of capital flows.

Capital flows are quite sensitive to changes in interest rates, and even to news on their changes. The incentives faced by players in international financial markets have implied sudden changes in capital flows, some of which are not necessarily explained by economic fundamentals. Arguably, the Global Monetary Game has provided another reason for authorities to have international reserves as self-insurance.

Policy makers have responded to capital inflows mainly by accumulating international reserves, while responding to capital outflows mostly by FX intervention. Some economies, in addition, have implemented capital controls. Moreover, even capital flows management has been encouraged by the IMF. In this roundtable, we will only focus on international reserves and FX interventions.

FX interventions

Interventions in FX markets face similar challenges as international reserve accumulation. They are based on the development of several economic events. One has to pay close attention to their determinants. Their correct identification is crucial for the interventions´ effectiveness. In effect, it is critical to identify whether the determinants are fundamental or not, permanent or transitory, and liquidity related or not, among others.

The following particular cases illustrate this point. First, under a fundamental shock, if it is temporal, it is reasonable to intervene, in particular, if doing so allows for a smoother adjustment in key variables. In effect, it acts as a shock absorber, enabling consumption smoothing. If the shock is permanent, it is preferable not to intervene. One should consider that intervening could possibly lead to more volatility in key macroeconomic variables. Second, if the shock is a nonfundamental, say a bad expectations shock, an intervention would probably be warranted. If it is deemed that it will avert a bad equilibrium, then there would be more reasons to intervene.

Moreover, we know that, for instance, even in a country with a solid macroeconomic management, an external shock might be detrimental to an adequate functioning of the foreign exchange market; in particular, given that the size of the shock can be large relative to the size of an EME´s financial markets. In particular, this type of shocks can affect the liquidity of the FX markets. For instance, under a market microstructure issue in the FX market, one could possibly have to intervene to provide liquidity.

Global Monetary Game and Capital Flows. Push, Pull and Pipes.

Pipes: Liquidity issues have gained in importance. Reasons.

Relatedly, given an intervention, the nature of its operation has changed in several ways recently. There has been the perception that rules-based interventions are quite favorable for signaling and transparency purposes. Then, the possibility that agents could seize the predictability of rules-based interventions for their benefit made central banks reassessed discretionary interventions more favorably. This has been an important change in terms of their relative assessment.

As underscored, these elements have become even more important in the aftermath of the Global Financial Crisis for EMEs. In addition, with the implementation of unconventional monetary policies by the main advanced economies, even more enquiries have been raised on these and related topics.

Reserve Accumulation and incentives

Taking their importance as a given, we have that reserves are costly and their benefits are not directly quantifiably. For instance, beyond their benefits as self-insurance, it has been documented that a high level of international reserves is associated with a lower sovereign premium. This could imply that the fiscal costs related to the issuance of international bonds could be lower as a consequence. This has to be considered when accounting for their overall benefits. Their benefits are time-varying, and their costs are constant and palpable. In effect, it is hard to convince the average citizen of a country, not to mention the typical elected official, of the relevance of having international reserves during relatively good times, particularly so if there might be some pressing social needs.

Accumulation of International Reserves and 1) Public Finances and 2) Moral Hazard.

As a way of conclusion, it is fundamental to recognize that international reserves are one component in the policy toolbox commonly available to policy makers. Thus, they gave gathered a lot of attention given the recent and present juncture. Of course, I have only begun to scratch the surface of these issues and there are many more that I expect will be covered in the discussions that follow. Let me stop here but not without again conveying my gratitude to the organizers, the Bank of the Republic and, of course, the BIS and Enrique personally. I hope that all of you have a very productive couple of days.

Thank you very much.