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

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Cartagena de Indias, Colombia

June 17 and 18, 2019

Session I - Goals, benefits, and costs of reserve accumulation/draw downs

Reserve Accumulation: Overview

1. The **Global Financial Crisis (GFC)** led to an unprecedented accommodative monetary policy stance in the main AEs (UMPs). This led to an increase in the amount and volatility of K flows to EMEs.
2. Arguably, such a stance **led to the overvaluation of exchange rates** in several economies.
3. Some of these responded by accumulating international reserves, attempting to **maintain their “competitiveness”**.
4. The **GFC** provided additional incentives for authorities to accumulate international reserves, prominently, **self-insurance**.
5. One should think about **international reserves** from a **broad perspective,** knowing that they are **a second-best solution to several challenges**.

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Reserve Accumulation: Global Monetary Game

1. The global environment has been characterized by low interest rates, low economic growth, and what seems to be low inflationary pressures in AEs. Secular stagnation?
2. **Low natural interest rates** in the US and the main AEs (Laubach and Williams, 2003, Holston et al. 2017). Search for yield. Competitive fund industry.
3. Increase in the amount and volatility of capital flows. Risk taking channel of monetary policy.
4. Changes in the nature of players in international financial markets and ways in which markets operate.
5. Policy responses: IR Accumulation, FX intervention.
6. Liquidity risks.
7. The aftermath of the **GFC** has provided additional incentives for authorities to accumulate international reserves, prominently, for **self-insurance purposes**.

Reserve Accumulation: Issues

1. A precautionary/self-insurance objective.
   - *EMEs with large reserves have done better in crises.*
   - *Sudden stops (Calvo et al., 2004) .*
   - *New players and frictions (Ramos-Francia et al., 2018). Liquidity risks.*
   - *Contagion risks.*
   - *“Leaning against the wind”.*
   - *Ambiguity aversion (uncertainty) → Robustness.*
2. “Mercantilist” objective. Non-cooperative global growth game. Individual country vs system´s benefits.
3. As a by-product of other objectives.
   - *Price stability.*
   - *Financial stability.*
   - *Competitiveness.*

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Reserve Accumulation: Issues

4. **International reserves** are a part of a **policy toolbox,** which includes:
   - *Monetary policy.*
   - *Fiscal policy.*
   - *Microprudential policy.*
   - *Macroprudential policy.*
   - *Other saving mechanisms, such as a Sovereign Wealth Funds.*
   - *Capital flow management (?). Capital controls?*
5. Individual country vs system´s benefits. GFSN. There are related **safeguarding mechanism** such as:
   - *Currency swap lines among central banks.*
   - *IMF´s FCL and SBA.*
   - *Regional Financing Arrangements (e.g., FLAR, CMI)*
   - *Multilateral Institutions (e.g., IMF).*

Reserve Accumulation: Costs

1. Accumulating **reserves is costly**. The direct one is the **cost of carry** (liabilities´ rates > reserves´ rates).
2. In addition, there are **valuations risks.**
   - Profit-sharing rules / arrangements. They are generally asymmetric, unfavorable to central banks (Archer et al. 2013)
   - Losses might lead to political economy issues and could eventually affect a central bank´s autonomy (Mohanty and Turner, 2006).
3. **Moral hazard** in the private and public sectors (Fatum and Yetman, 2018).
   - Partly a catch-22 predicament(?).
4. **Safe assets** supply/demand and US interest rates.
   - Safe assets (McCauley, 2019)
   - Financial stability.

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Final Remarks

1. The **GFC´s aftermath** has been a watershed for EMEs´ economic policy.
2. The current environment has been characterized by low interest rates, weak economic growth, and low inflation. The way markets operate has changed as well.
3. These elements, among others, have favored a **Global Monetary Game**, which has involved several channels, changes in risk-aversion, externalities and, generally, have complicated monetary policy in EMEs. It has made **herd-like** behavior in **capital flows** more likely. Presence of important **liquidity risks**.
4. Arguably, this environment has heightened **the self-insurance motive for EMEs´ international reserves**.
5. We should not feel complacent to the apparent benign setting. **Instead, we should stay vigilant**, understanding the underlying mechanisms, so that we respond with the adequate policies, many of which involve international reserves.

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