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The Acting Chair's Concluding Remarks
Liquidity Management
Executive Board Seminar 04/3
May 24, 2004

Our seminar discussion on the interactions between international reserves, public debt management, and private liability management in limiting liquidity risks has provided most useful guidance to staff on how to pursue the various strands of ongoing work in this area. Liquidity management is, of course, important for crisis prevention more generally, and complements our other work such as on debt sustainability analysis and financial sector surveillance. Most Directors have supported the approaches to liquidity management outlined in the staff paper; however, a number of Directors underlined that it would be premature to prepare an operational guidance note to staff at this stage. Directors have encouraged staff to undertake further analytical and empirical work, to keep developing their diagnostic "toolkit," and to continue integrating liquidity management analysis in country work. They looked forward to formal discussion of this work at an appropriate point in the future. During today's discussion, Directors have made many helpful suggestions for taking forward this work, and the staff will give careful consideration to these suggestions.

Directors noted that foreign exchange reserves, along with the exchange rate, have a key role to play in helping countries cope with external shocks, as they provide a temporary buffer to limit immediate disruptions and give time to put in place appropriate policy responses. By extension, reserves can add to market confidence when they complement sound policies, thereby strengthening economic and financial stability. At the same time, Directors have rightly stressed that international reserves can neither substitute for sound macroeconomic policies and prudent debt management nor make up for fundamental external imbalances.

Most Directors recognized that pressures on foreign exchange reserves can arise from both external obligations and foreign-currency-denominated claims held by residents. Directors have also stressed that the cost of reserve accumulation must be considered when assessing reserve and exchange rate management. In particular, rapid reserve accumulation may reflect exchange rate rigidity and/or exchange rate misalignment, which can generate significant macroeconomic risks.

Reserve indicators are of course only a guide and a starting point in the analysis of reserve adequacy, and Directors have cautioned against a "one-size-fits-all" or mechanistic approach. Reserve indicators will need to be carefully interpreted, based on a complete analysis of, and careful judgments about, a country's macroeconomic circumstances, including its exchange rate regime, current and capital account flows, and structural and institutional characteristics.

Directors have had a broad-ranging discussion on how the Fund can strengthen its assessments of reserve adequacy. Most Directors have supported enhancements to the Fund's current approach to assessing reserve adequacy, which includes as a benchmark that reserves should be at least as large as the economy's short-term external debt (on a remaining maturity basis), although in this context also careful judgment on a case-by-case basis will be necessary. In this connection, there is broad support for the use of augmented reserve adequacy ratios that reflect risks associated with foreign-currency-linked public domestic debt to residents and foreign currency deposits held by residents in domestic banks. However, Directors have cautioned that the public sector should not be perceived as taking responsibility for private sector mismatches. Furthermore, a few Directors did not consider foreign currency-indexed public debt held by residents to be a source of pressure on reserves, as in their view the demand for such instruments is mainly related to the hedging of private sector external liabilities. These Directors also considered that this proposed augmented reserve adequacy ratio would involve double counting and that it was highly correlated to other indicators adding little informational value. Directors generally supported the use of rolling liquidity analyses, which project reserve coverage ratios under alternative medium-term scenarios. However, some Directors stressed the need for caution in the public dissemination of such projections to avoid generating adverse market reactions. It was emphasized that liquidity management analysis should pay particular attention to factors that can have a substantial impact on the strength of domestic balance sheets and the transmission of shocks across sectors. These include exposure to international capital markets, local financial market development, public debt management, financial sector supervision and regulation, the insolvency regime, and corporate governance.

An important lesson from recent capital account crises is that the structure as well as the level of public debt can create major vulnerabilities in a country's balance sheets. More broadly, sound liability management by both the public and private sectors can play a major role in containing exposure to interest rate, currency, and rollover risks embedded in the structure of national balance sheets. Against this background, Directors saw merit in enhancing the Fund's policy advice on public debt management, building on the recently-issued Guidelines for Public Debt Management. Directors emphasized the role of short-term foreign-currency-linked debt in generating crisis vulnerabilities, and thus the need to monitor and address the combination of currency and maturity risks in debt structures. They noted the importance of integrating the analysis of public debt structures with that of macroeconomic developments and policies such as exchange rate issues and the currency composition of debt. Directors also pointed to key trade-offs and options involved in improving public debt structures that deserve particular attention, such as the different impact on liquidity and solvency of lengthening debt maturities or buying back debt, and the relative merits of inflation- and exchange rate-linked debt. In this connection, the development of deep and broad domestic capital markets can be crucial for improving the structure of public debt and reducing government dependence on foreign or short-term borrowing, and Directors have underscored the contribution that well-coordinated research and technical assistance from the Fund and the World Bank can make in this area.

Directors have also discussed how analysis of public sector balance sheets can be complemented by analysis of macroeconomic risks from private liability management and of the benefits of promoting appropriate buffers and hedges in private balance sheets. In this context, Directors agreed that the combination of maturity and currency mismatches in the banking system, as well as currency risk indirectly borne by banks as the result of credit risk in their loan portfolios should be subject to disclosure requirements and regulation. Directors also noted that interest rate risk is often a key source of vulnerability of the corporate sector that warrants close monitoring. Noting the paucity of corporate sector data, a number of Directors considered that monitoring balance sheet exposures in the corporate sector is likely to be most efficiently done through the supervision of financial institutions. Directors have stressed the importance for countries to put in place the appropriate regulatory, legal, and institutional arrangements to ensure that the private sector optimally manages its liquidity risks and has no expectation of a bailout in the event of a crisis.

Directors noted that the increased focus on liquidity management confirms the importance of key balance sheet statistics in countries with access to international capital markets. In particular, it highlights the need for sufficiently detailed data on the structure of public debt and on assets and liabilities of the banking sectors. A number of Directors also stressed the need to improve availability of corporate sector data. It was noted that progress in this area will form part of the implementation of the pragmatic action plan agreed at the conclusion of the recent review of data provision to the Fund.

On the basis of today's discussion, staff is encouraged to pursue work in a number of analytical and operational areas related to liquidity management. These include, in addition to the work on public debt issues mentioned above, the reconciliation of data on public debt stocks, fiscal flows, and valuation changes; fiscal concepts that may better capture the potential consequences of poor debt structures; further analysis of debt-related reserve indicators; more complete cost-benefit analysis of reserve accumulation; funding of reserves; and the role of current and capital account flows in assessing reserve adequacy. Some Directors suggested extending the empirical work presented in the staff paper to cover advanced countries, including their public debt management policies and their policies that have a bearing on the appropriate level of reserves in developing and emerging market countries. The forthcoming biennial review of surveillance will provide a further opportunity to reflect on coverage of balance sheet issues in staff reports for Article IV consultations.