Office Memorandum

To: Members of the Executive Board May 27, 2010

From: The Secretary

Subject: **Reserve Accumulation and International Monetary Stability—Statement by the European Central Bank Representative**

Attached for the **information** of Executive Directors is a statement by the European Central Bank representative for the Executive Board seminar on Reserve Accumulation and International Monetary Stability, to be held on Friday, May 28, 2010.

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Statement by the ECB representative on
Reserve Accumulation and International Monetary Stability
(Preliminary)
Executive Board Seminar
May 28, 2010

We thank staff for their set of papers, which provides a detailed and sound analysis of the main factors behind reserve accumulation. This contribution takes also an adequately broad perspective on possible ways to mitigate risks to the stability of the international monetary system arising from such accumulation. Our remarks are focused on issues pertaining to: (i) external imbalances adjustment; (ii) capital flows volatility; and (iii) supply of alternative international assets.

External imbalances adjustment

Under certain conditions, like prolonged over-reliance on net export demand for growth or lack of exchange rate flexibility, the build-up of reserves is likely to generate medium-term distortions, costs and risks. At the global level, such accumulation gives rise to a large-scale re-allocation of capital flows managed by the public sectors of countries building up reserves. Combined with large capital inflows, these domestic savings outflows result in an external financial "re-cycling" process. Given its size, such "by-passing" financial mechanism may have important implications for global liquidity conditions and financial asset price developments, including global exchange rate configurations. At the domestic level, reserve accumulation can also undermine stability oriented monetary policies, as well as hamper the development of sufficiently deep and efficient domestic financial markets. Reserves exceeding prudent levels are also likely to distort resource allocation and income distribution, having a bearing on consumption growth. In order to address these underlying economic imbalances that are reflected in reserve build-up, one needs to facilitate external adjustment. The G20 MAP is instrumental in this respect and the IMF has a critical role to play, in particular, by providing sound analytical input and facilitating collective action. In addition, the IMF should strengthen its ability to conduct multilateral surveillance, mainly by identifying spill-over effects, which might require to be better internalised by the policy-makers concerned.

Capital flows volatility

Another factor behind reserve accumulation is the so-called precautionary motive. Several avenues could be explored to mitigate the need for countries to build up reserves for self-insurance purposes. First, the IMF could develop analytical tools to better measure reserve adequacy. This would contribute to a better informed decision-making process in the countries concerned and provide useful benchmarks for international surveillance. Second, as part of its ongoing efforts to better integrate its macroeconomic and financial surveillance, the IMF could pay more attention to domestic financial deepening in large emerging economies. More rapid progress in this area would help reduce vulnerability to capital flows volatility by relying more on domestic and less on international financial intermediation. Third, ongoing work on global financial safety nets should be pursued within the G20 to determine whether such facilities would help reduce the need for own reserves, and if so, how this could be achieved without introducing distorting incentives.

Supply of alternative international assets

IMF staff are exploring the alternative avenue of developing a reserve currency disconnected from individual nations and able to remain stable in the long run. This far-reaching approach includes two options, which raise a host of questions.

A first option would be to gradually promote the SDR as one of the key reserve assets. For the international monetary system to develop into a truly SDR-based system, the outstanding stock of SDR-denominated assets would need to rise substantially. This would be difficult to achieve while complying with the current criterion for additional SDR allocations, i.e. a long-term global need to supplement existing reserve assets. In addition, it is not clear how an open-ended fund denominated in SDR and managed by the IMF ("substitution account") would contribute to an orderly diversification of foreign reserve holdings at low cost or how these costs would be shared.

A second option would consist in establishing a supranational central bank, which would issue a new global supranational currency, either floating against national currencies or – ultimately – being adopted as a global currency. The desirability and feasibility of such a proposal would rest ultimately on the willingness of countries to surrender their monetary sovereignty to a supranational central bank.