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**Statement by Mr. Bakker, Ms. Barendregt, and Mr. Yotzov on Seminar--Reserve
Accumulation and International Monetary Stability
(Preliminary)
Executive Board Seminar 10/2
May 28, 2010**

We welcome the staff's paper on reserve accumulation and International Monetary Stability and share its main findings. In particular, we agree that imbalances matter. The real challenge is how to ensure stronger discipline in steering national policies towards international financial stability. We agree with staff that policies designed to meet domestic concerns typically do not consider, at least not sufficiently, effects on the global economy. Here we see a clear and well established role for the Fund especially through more multilateral surveillance and comprising cross-country experiences as well as inward and outward spillovers of domestic policies. Monitoring and providing policy advice to overcome spill-over effects of domestic policies should be at the core of the Fund's work, combined with a substantive policy dialogue with the relevant authorities. This also requires a strong commitment of the membership. Countries should be willing to implement Fund's policy advices and should be held (and hold each other) more accountable.

Reserve accumulation: causes and effects

Staff seems to assume that precautionary motives are the most important drivers of reserve accumulation as according to staff estimates between half and two-thirds of global reserves are precautionary. This seems somewhat high as there are other important causes for reserve accumulation. In particular, we are of the view that reserve accumulation, as a by-product of certain domestic policies, has been much more important in recent years, especially in Asia. Staff rightly notes that the bulk of the global excess reserves are concentrated in relatively few countries, some of which may have a misaligned exchange rate. A clearer picture of the importance of these various motives is essential, as measures aimed at the wrong motive will not have the intended effects.

Staff's underlying assumption seems that high savings and, more specifically, high reserve accumulation in emerging market economies is one of the root causes behind the global imbalances and the current period of monetary instability. While there is a wide consensus that global imbalances and the financial crisis are at least interrelated, the literature is still divided on the exact nature and the exact importance of the contribution of surplus countries

to the crisis. We agree with staff that savings and reserve accumulation in surplus countries have probably depressed long-term interest rates and thereby indirectly contributed to excessive risk taking. But it is unclear how this contribution weighs against the influence of exceptionally low policy interest rates in the major advanced economies. It is also unclear how it weighs against the influence of excessive leverage in the financial sector, where financial innovation and the development of the shadow banking system ran ahead of the evolution of financial supervision.

Mitigating the demand for reserves

Staff rightly notes that strong capital inflows have fueled asset bubbles in many countries and generated currency appreciation pressures that further complicated macroeconomic management. Understandably, policy makers in those countries have sought to buffer their economies from such inflows by accumulating reserves and intervening on the FX market. This chair has long stressed the need for a more pro-active stance from staff on the role of volatile capital inflows, including policy advice on how to deal with such flows. In this regard, we strongly support Fund initiatives to provide guidance on desirable ranges of precautionary reserve levels and look forward to the forthcoming staff paper. In particular, we welcome the idea to monitor capital flows and identify possible instabilities. We also support staff in addressing underlying factors responsible for capital flows volatility and other problems associated with capital flows. We could consider the development of a multilateral framework aimed at dampening capital flow volatility and here we see a stronger advisory role for the Fund. Moreover, bilateral and multilateral surveillance, including spillover reports, should address the issue of excess reserve accumulation as a result of domestic policies.

Diversifying the supply of reserve assets

We note that some of the staff proposals aim specifically to promote diversification of international reserve holdings away from US dollar denominated assets. Staff's underlying assumption is that most foreign currency reserves are in US dollars because the US has the deepest, most liquid and most mature financial markets. While we agree with staff that a further diversification of international reserves is welcome, we are doubtful whether the measures proposed will have the desired effect. A greater use of the SDR has serious practical drawbacks. For instance, since SDRs always need to be converted in other currencies, they are unable to compete with the dollar in terms of depth and liquidity of the markets and confront holders to possible changes in the basket which could lead to uncertainty and speculation. The circulation of a *sui generis* global currency alongside other currencies may raise even more serious issues, in particular regarding the monitoring and governance of global liquidity. More generally, changes in the use of currencies in international reserves can only be market driven, and only happen very gradually. One important example in this respect is the introduction of the euro more than ten years ago. Even though this has greatly stimulated the breath and liquidity of euro financial markets, the introduction of the euro has not yet resulted in a significant change in the currency composition of official reserves away from the dollar. The use of international currencies displays a high degree of inertia, for instance due to network externalities that create

path-dependence.

Supranational reserve assets

The SDR is rather an instrument, not a currency and can hardly replace the US dollar. And even if that were possible, it would entail substantial costs and time. A first course of action would lie in improving the stability of the existing international monetary system: Countries (at least systematically important ones) can contribute to global financial stability by allowing their currencies to be more flexible. Furthermore, the authorities of the reserve issuing country should ensure that reserve demand does not lead to higher domestic inflation or to unsustainable increases in credit growth and asset prices. This should be easier to implement than a complete overhaul of the international monetary system. Furthermore, making the SDR an international currency or introducing a bancor currency implies that the countries must (partly) hand-over their monetary policy to the IMF, which (at least in the near future) is not in the cards. It is not clear to us how promoting the SDR as a global reserve asset or introducing a single world currency (bancor) would establish adequate checks and balances. Most importantly, the question is how greater use of the SDR in itself would discipline against building up imbalances. *Could staff elaborate on how the SDR would contribute to a more stable global financial system?*

Finally, we have some doubts regarding the desirability of the substitution account. Any scheme which would deal with reserve accumulation and prevent a disorderly adjustment of the dollar would need to be accompanied by measures that deal with the underlying reasons for reserve accumulation.