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Statement by Mr. Virmani and Mr. Patra on Seminar--Reserve Accumulation and International Monetary Stability
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1. At the outset, it has to be recognized that the set of staff papers tread on terrain not travelled since the debates that led up to the establishment of the Bretton Woods institutions. Nonetheless, that they respond to overarching issues relating to the international monetary system (IMS) stirred up in the heat and dust surrounding the current crisis is commendable. We compliment the multi-departmental approach to building up the analysis, with inputs from eminent outside experts. The key issue is to assess the degree to which the various proposals made find resonance with the expectations of the membership of the Fund on the international monetary and financial architecture of the future. This is intimately interlinked with exchange rate arrangements and capital flows, and consequently a fuller assessment would need to be informed by the forthcoming paper on capital flows.

2. Against this backdrop, it is understandable that the arguments offered are tentative and mostly in the counterfactual, and evidence where offered is patchy and indirect. Furthermore, a balanced approach needs to recognize that large reserve accumulations occurred in the post-Asian crisis years in reaction to the perceived gaps in multilateral insurance against crises. The recent crisis has raised new questions about measures of reserves adequacy. Countries that, by conventional criteria, had more than ample reserves were hit very hard, bringing into question the accuracy of simple measurements of underlying forex exposures, in particular, allowing for exposures through derivatives, and the flight of domestic capital.With these general observations, we turn to specific responses on the issues for discussion proposed by staff.

Are there long-term threats to the IMS in reserve accumulation patterns?

3. This is not clear from the information provided in the papers. While the skewed pattern of reserve accumulations is a reflection of the gaps and asymmetries in the international financial architecture as well as the lack of adjustment mechanisms akin to the specie-flow under the gold standard, it is possible that global imbalances and the IMS are in equilibrium, perhaps unstable, and this state could continue without encountering a tipping

point. The jury is still out on whether or not global imbalances were the cause of the crisis. There is an influential view that more than these imbalances, it were defects in financial regulation and supervision that precipitated the crisis.

4. An important consideration is the optimal level of reserves and what are the criteria for judging it. In the context of the criteria given in the current set of papers, why only imports and short-term debt? Why not, for instance, fluctuation in export proceeds? Short-term debt by original or residual maturity? In the context of episodes of volatility in capital flows, the assessment of reserve adequacy needs to go beyond the conventional cover for short-term debt only. Equity flows can turn volatile and moreover, in a crisis of confidence, even long-term debt can become callable. These questions underscore the importance of more intensified work on defining the optimal level of reserves at the country-specific level, and recognition of the possibility that a bottoms-up approach – summation of country positions – could yield a globally acceptable criterion. In this context, it is worthwhile to recognize that for most emerging and developing economies, the reserve adequacy criterion is often additive – import cover plus debt servicing requirements plus volatility of capital flows because of the 'sudden stop' phenomenon.

5. The assessment of the stability of reserve accumulation has to be informed by supply-side considerations, apart from the conventional demand-for-reserves approach that permeates the staff papers. Illustratively, the availability of reserve assets depends on the supply of US dollars, Euros, pound sterling and yen – the reserve currencies that also comprise the SDR basket. The total reserves holdings of the world are less than a third of the money supply of the US, the Euro area, the UK and Japan taken together. Moreover, reserve holdings are invested back in the key reserve currencies. Capital flows uphill and thus holdings of reserves do not affect the money supply of reserve issuers. Reserve issuers would, in fact, earn seigniorage, and as long as the rate of seigniorage is in some correspondence with the cost of holding reserves, equilibrium conditions referred to earlier could well hold. Analogously, if the rate of seigniorage is low, reserve holders would be willing to accept lower yields on reserve assets and this balance can be sustained even in a uni-polar world as long as macroeconomic policies in the pole are sound and prudent, markets are deep and contestable, and financial power is not wielded politically. When these conditions are difficult to obtain, it is in the interest of reserve holders to seek alternate sources of supply of reserve currencies.

6. A careful assessment of costs of reserves is warranted. For most emerging and developing countries, the fear of sudden stops and reversals of capital flows provides the main rationale for holding reserves, as the papers rightly point out. Here, credit ratings play a pro-active role in amplifying the ratchet effects, a factor which does not receive adequate attention in the staff paper. Credit ratings are usually conditioned directly by the stock of international reserves, a factor which has to be taken into account by emerging and developing countries. The insurance that reserves provide against sudden stops in growth due to capital drying up far outweigh the opportunity costs, especially when capital receiving countries lack the absorptive capacity to turn capital inflows into higher consumption and

investment. Moreover, sterilization costs are low – less than 0.5 percent of GDP. Furthermore, for countries that run current account deficits or large capital outflows, the danger of deflation is nil or low. More generally, the potential for global deflation risks cited in the paper as negative externalities associated with reserve accumulation is contingent upon the dynamics of the overall global economic outlook. While deflationary pressures may be relevant in the current situation when the global economy is pulling out of the trough, they may not be so when the recovery has gathered full steam and the output gap is closed. The fact of reserve accumulation is subsumed in the propensity of reserve issuers to run deficits or at least to issue monetary liabilities in excess of amounts required for domestic transactions/precautionary purposes. This also serves to underscore the fact that reserve accumulation is also a function of the policies of reserve issuers.

Reactions to Proposals and Likely Areas of Collaboration

7. We look forward to the forthcoming paper on reserve adequacy and would engage constructively in the debate on criteria, however broad, for distinguishing between precautionary and non-precautionary levels of reserves. We also see considerable merit in improved mapping of cross-border capital flows with a view to identifying the sources of volatility and mechanisms to manage volatility. It is useful to consider a dedicated paper on the data requirements, how they dovetail into existing reporting frequencies for statistics on the balance of payments and the international investment position, and the resource implications. We can also support a careful assessment of more specific contours of a multilateral framework for monitoring capital flows that encompasses all options and draws on the cross-country experience. We emphasize our preference for an advisory role for the Fund in this regard rather than *de jure* jurisdiction over the capital account, the latter having been evaluated in the late 1990s and rejected. In fact, the Fund can engage in such an advisory role even at the present juncture with more intensive studies and analyses of capital flows. Within this advisory role, we expect even-handed treatment in the sense that sources of volatility in capital originating countries are given as much emphasis as the issue of capital controls in destination countries. We welcome the recent change in the approach of the Fund on capital account issues and hope that policy advice on full capital account liberalisation is not thrust upon emerging and developing countries.These proposals, in our view, can form part of the immediate agenda of action points.

8. We do not support the proposal for penalties on non-precautionary reserves. Apart from feasibility considerations given in the paper, there is the issue of moral hazard – countries could be willing to pay the penalty and resort to excesses if the incentives are right at a point of time, and wait for the bail-out from the global pool when times turn bad. We are also not in favour of a more intrusive role for the Fund in the currency composition of reserves, as it would impinge on sovereignty concerns as well as members' perceptions of market sensitivities. The Fund should not allow mission creep and engage in tasks that befit a fund manager. In the ultimate analysis, the choice of a reserve currency to hold is based on several considerations, including usability, invoicing patterns, acceptance in international transactions, perceptions of value both current and prospective, and the like.

9. For the medium- and longer-term, we look forward to a more detailed examination of staff proposals for a greater role for the SDR. In our view, this will require pre- and attendant conditions, many of which are proposed by staff. First and foremost, there are major governance issues to be resolved so that the Fund itself is invested with legitimacy, independence and effectiveness. Second, the SDR basket can be diversified further to reflect changing global economic realities along with a realignment of weights. Third, the SDR should be a monetary liability of the Fund, as is the case with every currency that circulates by fiat, and national currencies can be valued with reference to the SDR. Fourth, a deep and liquid market for trading in SDRs should be developed, and instruments denominated in SDRs of varying maturities could be issued, initially by the Fund, so that an SDR yield curve develops for pricing purposes. Furthermore, the Fund should stand ready to expand the supply of SDRs through regular allocations (and held in escrow in the SDR department), develop clearing and settlement mechanisms and promote invoicing international transactions, both current and capital, in SDRs.

10. Intellectually, there are considerable merits in the bancor, but it may have been overtaken by the global experience since the time it was first proposed. At the current juncture, it would require far-reaching changes – a global currency union with the Fund operating as a world central bank; loss of discretion in national monetary and fiscal policies; and a convergence of exchange markets, to name a few. This is ambitious, but if there have to be concerted efforts to build a better global monetary and financial system for the future, there has to be a trade-off between the desirable and the feasible.