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**Statement by Mr. Lushin on Seminar--Reserve Accumulation and International
Monetary Stability
(Preliminary)
Executive Board Seminar 10/2
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We thank staff for a thought-provoking paper that deals with the existential issues of the IMS and the global economy at large.

We would like to begin our statement with a direct answer to the first question suggested by staff for discussion. Yes, indeed, there are long-term threats to international monetary stability, but these threats are not necessarily coming from the recent patterns of reserve accumulation. Reserve accumulation is just a symptom and not the cause of potential instability. Staff notes that the current IMS has proven resilient but at the same time observes that all previous systems, too, looked resilient until the moment they fell apart. We cannot agree more with this. All the crises of the last 30 years attest to vulnerability of the current IMS based on national monies serving as reserve currencies, floating exchange rates and (mostly) unlimited capital mobility. It is symptomatic that countries that suffered the most during the previous crises (Latin America, Asia, Russia) has gone (so far) through the current crisis more or less unscathed because they have learned well their lessons, including those saying that a solid amount of reserves does make a difference and that accumulating large current account deficits is dangerous. On the contrary, those countries that remained untouched by the previous crises and that relied heavily on market financing of their sizeable private and/or public deficits are now either feeling the brunt of the market turnaround (some states in emerging and Southern Europe) or are approaching it at various speeds. All this suggests that abundant global liquidity (which apparently has something to do with monetary policy in major reserve centers) and the associated large and hugely volatile capital flows are the main sources of instability in the IMS.

“Demand” for reserves

So how does reserve accumulation fit into this picture? In larger part the reserve accumulation is a natural defensive reaction of countries to capital account volatility and may be compared (in medical terms) with an elevated body temperature of a sick individual for whom lowering the temperature does not necessarily provide cure.

The staff seems to firmly associate precautionary reserve accumulation with capital flow volatility assuming that accumulation of certain (and large) amount of reserves is a country's deliberate response to the risks of large capital inflows/outflows. As we have argued on a number of previous occasions, accumulating reserves in response to capital inflows is not necessarily associated with an intention to reach a pre-determined level of reserves. More often than not it is a forced reaction of monetary authorities to excessive appreciation pressures even when they are quite satisfied with the level of their reserves on precautionary grounds. In other words, reserve accumulation of this type may reflect not so much "demand" for reserves but "supply" of capital from abroad. From this it follows that even the existence of an effective global safety net may not necessarily stop reserve accumulation if large capital inflows/outflows continue. Having said this, we do not deny that precautionary motives in reserve accumulation exist; we only want to say that many countries with large reserves may already be way above their optimal precautionary levels for the reasons that are out of their control. The traditional reply to this is that allowing greater exchange rate flexibility is a better response to inflows than reserve accumulation. This may be correct, but only up to a point. When the magnitude of inbound and outbound capital flows in relation to the economic size is such that the exchange rate has to fluctuate within the band of ± 100 percent or even more, we doubt that any monetary authorities could be prepared to go along with this.

We also somewhat differ with staff in assessment of the "export-led growth strategy" as a source of non-precautionary accumulation of reserves. Again, we do not deny that the objective of preserving market shares may be linked to reserve growth in some cases. However, we see a clear precautionary motive behind the countries' reluctance to accumulate current account deficits. If anything, the past crises and the current one demonstrate clearly that running large current account deficits financed by capital inflows is dangerous. Small and medium-size countries with such type of policy usually end up in the Fund's intensive care following the reversal of flows and usually have to go through a brutal adjustment. It is understandable, therefore, that in the context of the current IMS realities more and more countries find it much safer and consider it legitimate to run current account surpluses rather than deficits, with all corresponding consequences for the reserve accumulation process.

Supply of reserves

A multi-polar reserve system based on national currencies may well be the direction where the IMS is progressing. However, there may be two caveats on this way:

- a) The multiplicity of reserve currencies may result in the emergence of regional currency unions (like the euro zone), which to some extent bears the risk of fragmentation of the global economy. Also, volatility between reserve currencies, which is already a problem today, may become even more acute between regional currency unions;
- b) Reserve currencies based on fiat national monies are prone to mismanagement and destabilization, including for political reasons. As was acidly observed in one economic newspaper, nowadays the contest of reserve currencies (components of the SDR basket, for example) is not the contest of the prettiest, but the contest of

the least ugly. Indeed, looking at the fiscal challenges facing these countries, one could be excused for being skeptical about the potential of their currencies to be a reliable store of value.

The above considerations may suggest that going for supranational reserve assets could be a way out of the current difficulties. However, this way is quite challenging. Options for strengthening the SDR-based system could surely be explored (and introducing a reconstitution requirement is one the obvious ways to do this). However, the SDR has a major drawback – it is not itself a currency, but a sort of a coupon to use other members' currencies/forex reserves. As such, this entire system depends on the willingness of members to voluntarily finance the exchange of SDRs. We doubt that this could be achieved on such a grand scale, as envisaged in staff's design (para 40-46).

Considering a transition to a global currency (aka *bancor*, although *globo* seems to be an even better name), only an option of its circulation alongside national currencies looks realistic, but even this could be enormously challenging. Creating a supranational monetary authority will be next to impossible politically in the current environment, even though on economic grounds this would be a logical step to make given the observed financial globalization. In the end, we believe that a gradual and coordinated transition to a radically new IMS is hardly feasible, and that any radical changes in the international monetary architecture will happen not earlier than the present IMS collapses (if it will). That is what the history tells us and we don't see why this time it should be different.

International collaboration

What are the productive areas for international collaboration to make the IMS more resilient?

As we stated above, we see the major problem in the propensity of the current IMS to generate the exponentially growing amount of private international capital flows. This process is definitely unhealthy and destabilizing, leading to asset price bubbles, misallocation of resources and mispricing of private and public debt. The associated boom/bust cycles wreck havoc in the global economy, as we could clearly see in 2008-2010 and on a number of previous occasions. The problem is not only with volatility, but also with the size of international capital flows. Therefore, reducing the threats to the IMS may begin with detecting the sources of this *deluge* and trying to somehow cap it. It is in this context that consideration could be given to possible international collaboration, including in regards to monetary policy in reserve issuing centers. A multilateral framework for managing capital flows, entertained by staff in para 29, may be a promising avenue to follow, but again, this exercise should not be about volatility and/or capital controls only, but about the size and origins of capital flows as well.

Finally, a “concerted approach” towards reducing non-precautionary accumulation of reserves (para 31) looks bizarre. According to this proposal, greater exchange rate flexibility in some systemic countries could be swapped for reserve issuers' commitment “to sustain credibility in their currencies”. It may be understood in such a way that without adopting flexible exchange-rate regimes by some members reserve issuers may be willing to consider

policy options aimed at depreciating the real value of their liabilities. While this may not be excluded, of course, we believe that credibility of reserve currencies is something that should not be traded.