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

We thank staff for a valuable, thought-provoking and well-written paper that touches upon topical issues regarding the reform of the International Monetary System (IMS). Equally important, the paper poses many relevant questions on both global stability and the role of the Fund, and helps set the stage for more in-depth discussions. We also commend staff for framing the debate on reserve accumulation in the broader cooperative-based context that encompasses the correction of external imbalances, the scope for addressing capital flows volatility at the multilateral level, and the possibility of supplying alternative international assets. The latter includes a gradual expansion of the use of the SDR. Since a crucial precondition to this end is a very substantial increase in SDR liquidity, the consequences for global price stability would need to be carefully and thoroughly examined.

We also appreciate staff's realism on the feasibility of the floated ideas: first, it is clearly recognized that the current system may endure for some time longer, so efforts to find ways to strengthen the IMS should remain high on the reform agenda, including improving Fund surveillance; secondly, it points out the need for extraordinary international cooperation to support some of these ideas.

The debate on reforming the IMS lay on the fact that, in the years preceding the crisis, the system has shown a lack of effective mechanisms (either market-driven or surveillance-based) to rein in excessive current account deficits/surpluses toward their equilibrium levels. As a result, the IMS supported a low-yield environment (and ensuing underpricing of risk) and the accumulation of external imbalances (mirrored by increases in official reserves), two factors that in turn contributed to create the macroeconomic preconditions of the global crisis.

In short, the IMS was unable to correct “*inconsistent and insufficiently coordinated macroeconomic policies*”, which are unsustainable in the long run. We would like to underscore that the G-20 Multilateral Assessment Process aims explicitly at filling this gap, as it represents a multilateral mechanism to foster coordination of national economic policies and the global consistency of national objectives. This is all the more important since

¹ G-20 Leaders Declaration, Washington, 15 November 2008.

external imbalances, following the recent crisis-induced cyclical decline, are set to enlarge again.

Different Causes of Reserve Accumulation: Self-Insurance or Export-Led Strategy

The paper correctly builds a case for devising alternative instruments to self-insurance in order to avoid its costs and counter the current trend of reserve accumulation. In order to more fully substantiate this case, it would have been useful to try to quantify the relative importance of the root causes behind reserve accumulation, by distinguishing between: self-insurance motives, whereby reserves are the “*ultimate rainy day fund*” of a country; and the by-product of an export-led strategy based on an undervalued exchange rate and supported by sterilized interventions in FX markets (also in the face of capital inflows).

The relative dimension of these determinants is still under debate. In fact, it has been argued² that, if one excludes those countries that the IMF judges to have an undervalued currency, the actual pattern of reserve accumulation is closer in line with (admittedly more ambitious) non-traditional benchmarks of reserve adequacy (e.g., six months of import coverage instead of three).

In this regard, the staff itself had in the past³ suggested that the analysis of reserve adequacy should take into consideration additional indicators to complement the traditional ratio of short-term external debt to reserves; and staff aptly identified augmented ratios of foreign currency liabilities to reserves. These indicators try to capture additional (while still precautionary) motives to accumulate reserves, such as a protection against “*double-drain*” crisis scenarios, i.e. a run on domestic bank deposits coupled with capital flights. We look forward to further discussing these issues in light of the forthcoming staff paper on “Assessing Reserve Adequacy”.

Extrapolating Reserve Demand

The extrapolation exercise run by staff to estimate future reserve demand is a useful first approximation. In the near-term scenario, global reserves are projected to increase, as a ratio to U.S. GDP, from 14 percent in 2009 to 120 percent in 2015. Although the reasons that make this trend unsustainable are almost self-explanatory, it would have been useful to elaborate more on the possible dynamics associated with this projection, not only those triggered by the constraints on the supply-side, but also on the demand side.

For example, to the extent that the bulk of reserve accumulation reflects a policy of avoiding appreciation of the (possibly undervalued) domestic currency, this is associated with an equally rapid increase in sterilization operations by central banks (issuance of their own bonds or sales of domestic government bonds held in central bank portfolios). The staff point to the quasi-fiscal costs at the *country* level associated with sterilization. However, increased sterilization could lead to rising domestic interest rates and further appreciation pressures at the same time when interest rates in reserve-issuer countries are expected to remain low for

² Bini-Smaghi L. (2010), *Reserve Accumulation: The Other Side of the Coin*. European Central Bank. February.

³ *Liquidity Management*. April 2004 (SM/04/149).

an extended period. It follows that carry-trade strategies could be further stimulated, bringing with them accentuated risks of a disorderly unwinding with potential *global* spillovers.

Although, before the crisis, the IMS was unable to correct unsustainable trends, everything is not necessarily going to be the same following the global turmoil. For example, in light of the increased issuance of government debt as a result of the crisis-induced deterioration of public finances in reserve-issuer countries, the sensitivity to debt sustainability is higher in the post-crisis environment. It is thus likely that the limit to the amount of debt that a given country can issue before international investors (including official ones) begin to question debt sustainability is now lower. This may increase the incentives for Emerging Markets (EMs) to adjust their reserve policies more quickly than implied by the extrapolation exercise, as mentioned by staff itself in Box II.1.

Reserve Diversification

The distinction between reserve *currencies* and reserve *assets*, mentioned in paragraph 2 of Supplement 1 (and also in paragraph 6 of SPN/09/26), is often overlooked in the main paper, as the two terms are usually used interchangeably, most notably in Section IV. The distinction between diversification across reserve currencies and diversification across instruments is important, as it points to two separate issues: finding alternatives to the dollar as a reserve currency; finding alternatives to US Treasuries as a reserve asset.

In paragraph 2 of Supplement 1, the staff notes that a striking feature of the IMS is the absence of EM currencies in the global reserve system. A parallel issue is the potential for more diversification of reserves portfolios across dollar-denominated assets, including those issued by EMs with an investment-grade rating.

Right before the outbreak of the global crisis, foreign central banks had started to marginally diversify away their holdings of dollar-denominated reserve portfolios into securities with higher credit risk and reward, notably those issued by U.S. Government Sponsored Enterprises (GSEs).⁴ This trend has likely been negatively affected by the crisis.

This notwithstanding, and given the seemingly limited scope, at least in the short term, for drastically affecting the current trend of reserve accumulation, a discussion on how to strengthen the IMS could also cover issues related to the diversification of official reserves.

⁴ U.S. Treasury (April 2010), *Report on Foreign Portfolio Holdings of U.S. Securities* (p. 12). Also: Wooldridge P. D., *The changing composition of official reserves*. BIS Quarterly Review, September 2006.