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**Statement by Mr. Gibbs and Mr. Hills on Seminar--Reserve Accumulation and
International Monetary Stability
(Preliminary)
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Even though it has proven quite resilient to date, the current IMS is associated with a range of externalities and other market failures. Global imbalances were one of the key determinants of the financial crisis, and remain a potential risk to global economic stability in the future. This paper is an important initial contribution to the debate, and we strongly encourage the Fund to continue its work in this area. We make some suggestions below for areas to focus on.

We broadly share staff's analysis of the key problems with the existing IMS – the costs and instability generated by a sharp build-up of international reserves and current account imbalances, coupled with the concentration of those reserves in a small number of reserve currencies – although we would stress, importantly, that reserves accumulation is not the only source of unsustainable imbalances.

In terms of the policies discussed in the paper to mitigate some of these imperfections, we would have preferred to see a greater focus on policies to mitigate the demand for reserves (on which there has already been significant progress, given the Fund's lending reforms, and G20 initiatives on financial safety nets, and the Framework). On the supply side, our general feeling is that it would be better to focus more on the underlying issues around the costs and benefits of different systems, and perhaps less on the specific role the SDR could play as a reserve asset. These points could all usefully be addressed in follow-up work.

Reserve accumulation: causes and effects

The paper provides a comprehensive overview of some of the key weaknesses in the current system. We would add that official reserves accumulation is not the only potential source of unsustainable imbalances in the IMS (eg if the purchasers of US government debt were not

foreign governments, but foreign pension funds, similar problems could ensue). And current trends of globalization and demographics are key drivers that could plausibly lead imbalances to widen again, in the absence of reforms to the system.

More generally, we judge that an IMS based solely on freely floating exchange rates – at least for systemic countries – is likely to be more stable than today’s hybrid IMS. It will be useful to set out precisely what are the likely costs, benefits and transition issues (for individual countries and the system as a whole) of systemic countries moving to flexible exchange rate arrangements.

In addition, it would also be useful to consider the optimal policy response of reserve issuers and other debtor countries, when hit by a surge of demand for their assets.

Mitigating the demand for reserves

In general, we are more optimistic than staff about the potential for demand-side policy options to reduce imbalances. In particular, given that most of the supply-side proposals are unlikely to be implemented fully in the near future, reforms to the provision of global financial safety nets will in practice be the most important means of helping to allocate liquidity in times of global financial crises.

Precautionary reserves adequacy

We look forward to the planned work on frameworks to assess reserve adequacy. The work should state very clearly the economic rationale for precautionary reserves – including covering vulnerabilities in debt structures – and should also consider whether more direct measures to mitigate these vulnerabilities would be less costly to the country concerned and the system as a whole. This analysis could point to the fact that countries that accumulated very large reserves suffered during the crisis from a sharp fall in the demand for their exports. It should also consider the role of the approach taken by ratings agencies to assess reserve adequacy (a key determinant of the ratchet effect). The Fund should take care to ensure that its multilateral analysis (excess reserve accumulation results in instability in the IMS) is also reflected in its bilateral policy advice to members; the developments of metrics to determine excess reserves will be helpful in this respect.

Another important means of reducing countries’ precautionary demand for reserves is to improve the structure of their external liabilities and national balance sheet management (eg to reduce currency and maturity mismatches). This could be achieved, for instance, by developing better hedging instruments (eg GDP-linked bonds and other innovative tools to address missing markets) and addressing data gaps so that risk can be better priced. It could also be helped by further analysis on the optimal configurations of capital controls and financial/supervisory/macprudential measures.

We would welcome further work on whether there is much scope to encourage EMEs to fund their reserve purchases by issuing their own debt. In this context, it would be useful to explore in more detail Caballero's proposal for the Fund to provide a systemic risk insurance contract to attach to EME government bonds.

Reducing underlying volatility

As well as discussing efforts to reduce capital flow volatility, this section should also highlight the need for measures to reduce the incidence of global macroeconomic shocks (which should reduce the need for precautionary reserve holdings) and ways to strengthen existing policy instruments available to countries at risk of contagion.

On the proposals in the paper, we strongly agree that developing more detailed monitoring of capital flows should be a key priority – which links to the reconsideration of the Fund's jurisdiction over the capital account in the review of the Fund's mandate. We also agree that more work needs to be done on the most efficient and effective use of capital controls, although it is not clear to us that a separate body needs be set up to do this. We are doubtful that a multilateral framework would provide substantial additional benefits, although we would be interested to learn more about how staff envisages it working as a forum for grievances.

Reducing non-precautionary accumulation of reserves

This strand of work is critically important, and the potential benefits are large. We agree with staff that the accumulation of non-precautionary reserves is not an objective but rather a consequence of other policy choices. A useful first step could be to develop a toolkit to discern which imbalances are 'safe' and which are 'unsafe'. Where imbalances are the result of domestic distortions in creditor countries, the Fund should consider whether technical assistance could help to address them. This could be particularly valuable in the area of financial development. The Fund could also consider the welfare properties of spillovers in the IMS. This would provide important guidance towards the design of any multilateral framework designed to reduce negative spillovers.

It is too early to conclude that a consensual solution would not be feasible. In particular, the G20 Framework for Stable, Sustained and Balanced Growth reflects its members' stated desire for mutually reinforcing co-ordinated policy action (indeed, this IMS workstrand is potentially an important input into the Framework). For the same reason, we do not agree with the argument in para 33 that significant reforms are "unlikely to materialise absent a sort of grand bargain on IMS reform also involving changes to the supply of reserve assets".

The question of whether a rules- or penalty-based system would be appropriate is an

intriguing one. A consensual approach would clearly be preferable, but it is worth thinking in detail about alternative approaches. In this respect, it would be instructive to examine in more detail the lessons to be learnt both from the failures of previous rules-based frameworks (eg gold standard, Bretton Woods etc), and from successful rules-based regimes (eg WTO).

Diversifying the supply of reserve assets

Although there are some interesting and worthwhile policy ideas in this section, we feel that more clarity is needed on the underlying analytical issues. These include: whether or not it is important that a reserve currency should be tied to a particular country; whether a multiple reserve currency arrangement would be more stable than the present arrangement; and how we should interpret the gradual increase in the use of non-USD reserve currencies in recent years. The fact that there have been few periods in history when more than one reserve currency has co-existed suggests the key choice is the nature of the reserve asset rather than the number of reserve assets, but we would welcome comment on this.

Overall, we do not feel that the case has yet been made for a greater role for the SDR as an option for a reserve asset not tied to one country. There are certainly some promising policy ideas here: for example the idea that SDRs could be issued to a limited group of countries automatically in the event of a systemic crisis, which deserves further analysis in the context of other proposals to reform the Fund's precautionary lending.

But, as the paper notes, it will be difficult for the SDR to operate as a reserve currency, since it is not actually a currency. The extent to which it can act as a useful reserve asset depends very much on the capacity and willingness of other countries to exchange them for currency (and the current trading arrangements are far from ideal).

Other potential difficulties related to any significant increase in SDR issuance include the fact that it has no link to either ex ante or ex post conditionality or performance, and could raise debt sustainability problems for some countries. A substitution account represents a transfer of exchange rate risk from countries with accumulated reserves to the rest of the world, and is not obviously attractive to the latter group outside a 'grand bargain'.

Although the paper is relatively positive about the potential benefits of SDR-denominated instruments, it is not clear what level of interest would be shown by either issuers or investors. It might not achieve more diversified reserves holdings – for instance, US government-issued SDR bond markets would probably continue to be deeper and more liquid than those for other countries and institutions. And governments might introduce vulnerabilities by issuing more debt in currencies other than their own. Given all this, it is probably premature to do much additional work at this stage on a global currency.