



**Afi**

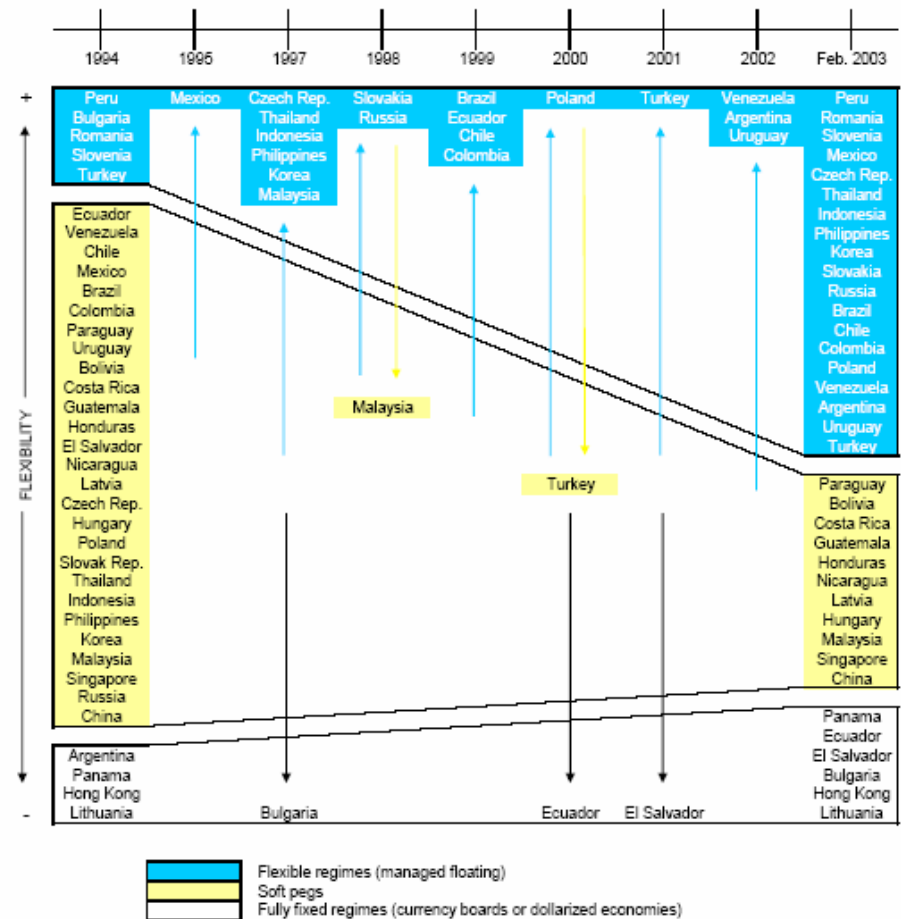
Analistas Financieros  
Internacionales

# *FX Reserves*



## Are global imbalances the root of fx reserve accumulation?

- The great moderation: high sustained growth and low inflation environment reduces the opportunity cost of keeping depreciated currencies. Increases the risks of “exchange rate manipulation”
- Global imbalances: current account; trade and financial globalization
- In theory floating implies: no reserve accumulation
- Since Asian crisis: polarization of exchange rate regimes, especially to floating ...
- ... which paradoxically coincides with unprecedented reserve accumulation ...
- ... only partially explained by self-insurance

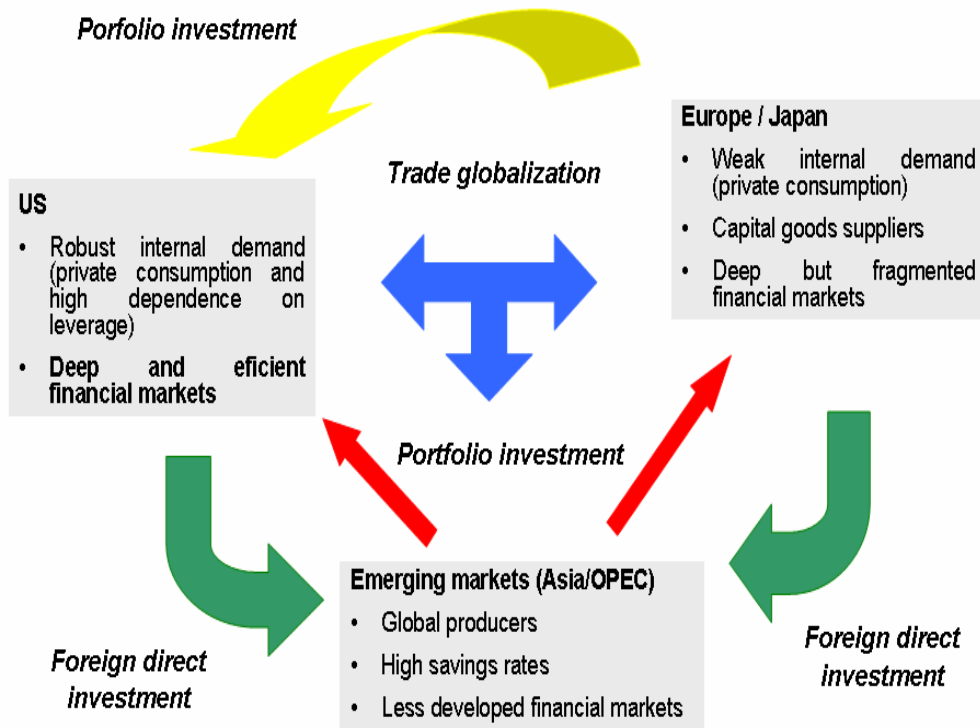


Source: Casas et al (2004): A review of progress in the reform of the international financial architecture,  
Banco de España

# Global imbalances

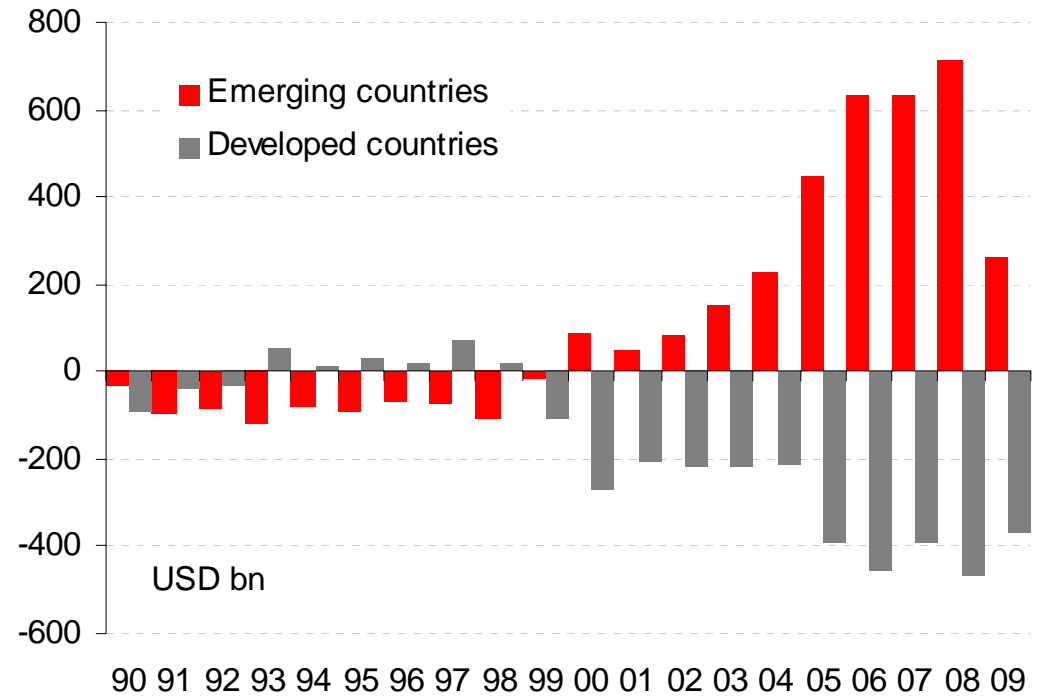
Key question: will the crisis imply a correction of global imbalances?

*The pre-crisis global regime (tentative)*



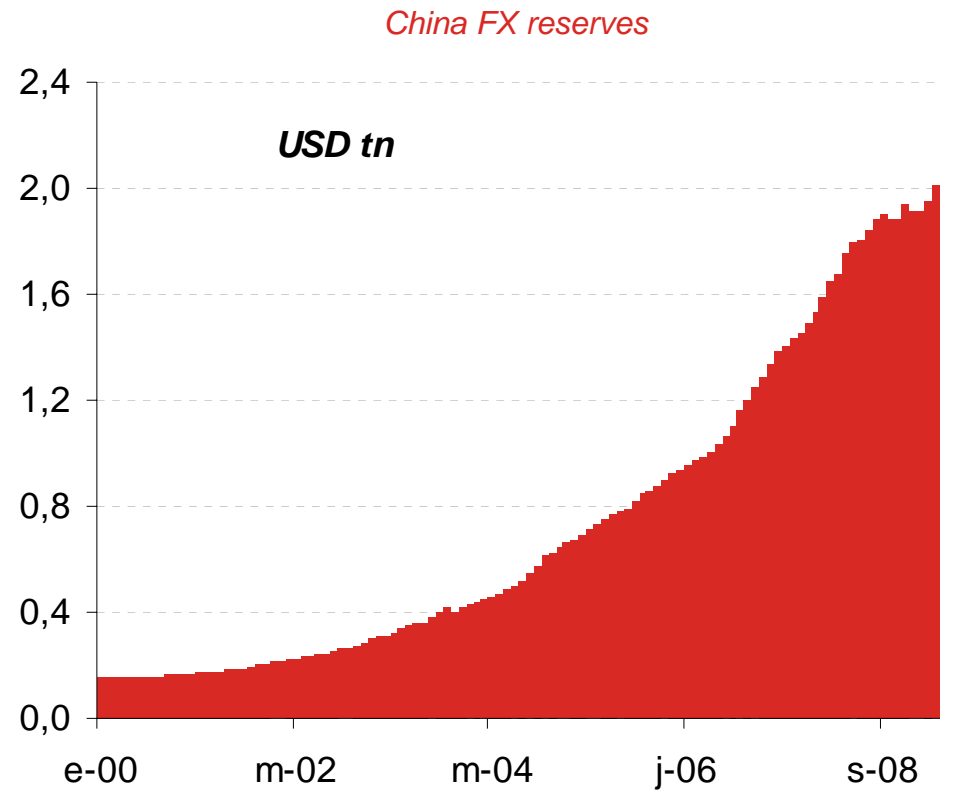
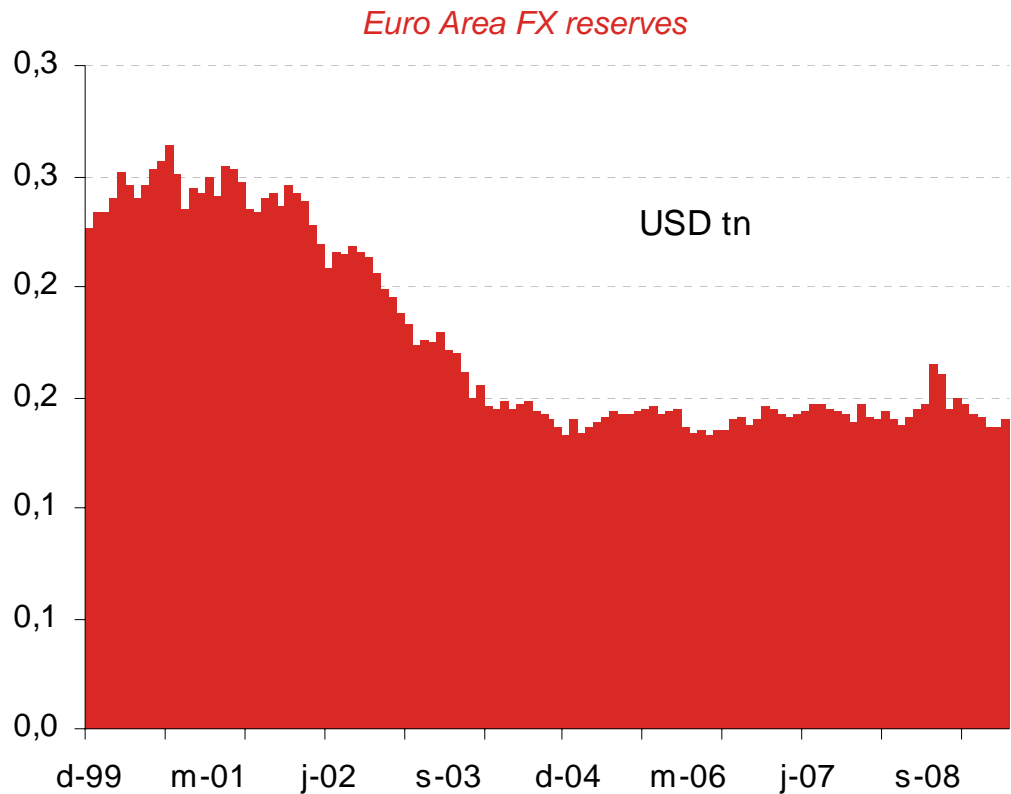
Source: AFI

*Current account balance (USD billion)*



Source: IMF

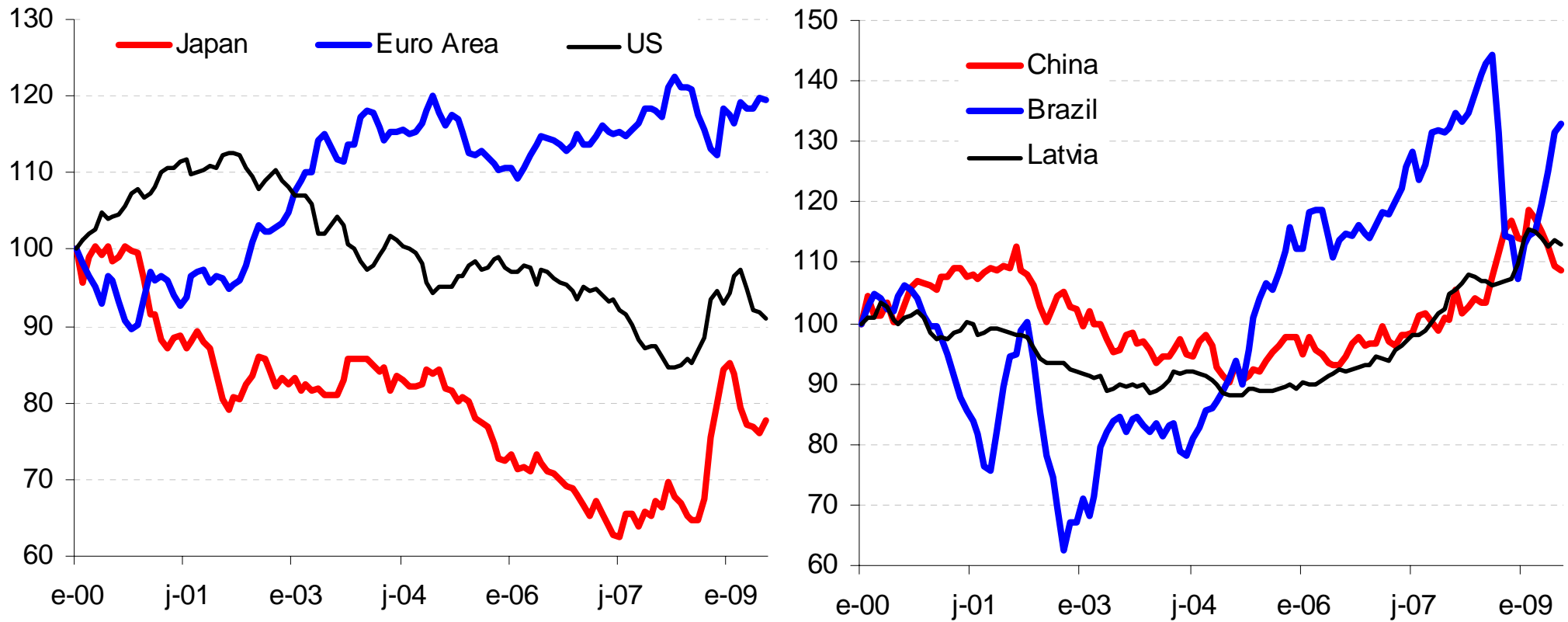
## Perfect world?



Source: Central Banks

Fact: imperfect world

REER evolution; JAN00=100



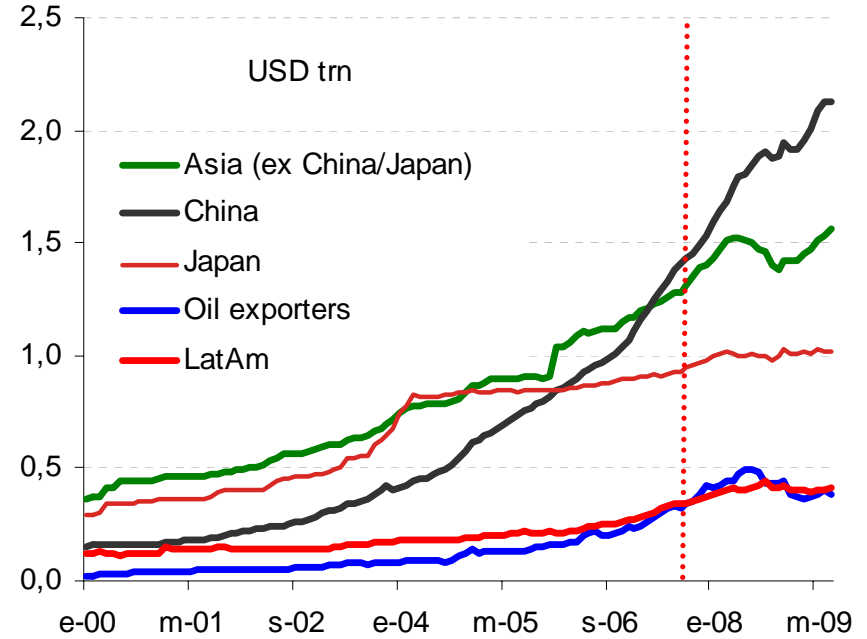
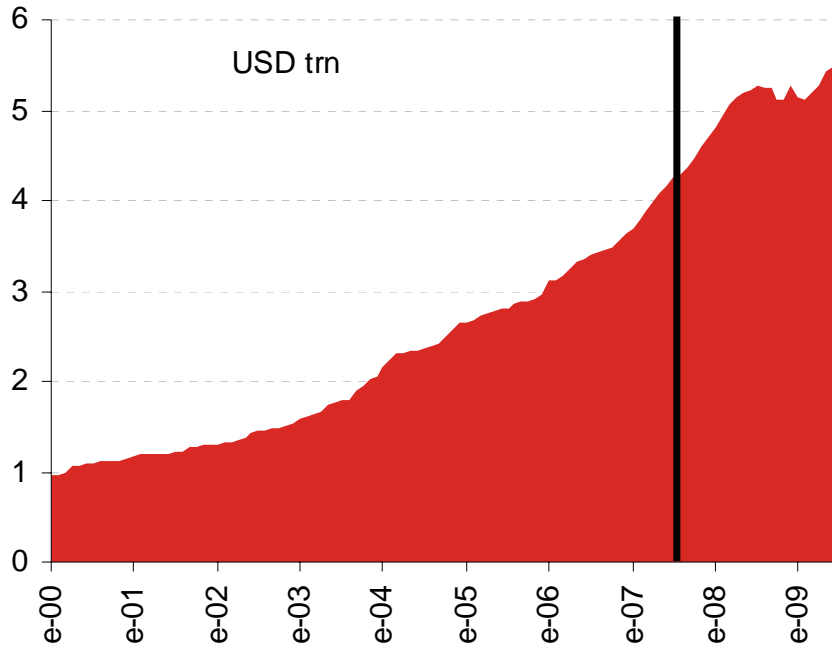
Source: BIS

## Recent trends in fx reserve accumulation

- Lower speed of accumulation. Factors:
  - World liquidity contraction
  - Reduced trade and financial flows
  - “Financial protectionism”: increases “home bias”
- Flows between SWFs and Central Banks: are they substitutes?
  - CBs reserves: more transparency requirements (IMF) imply incentive to shift reserve accumulation to SWFs
  - SWFs: Santiago Declaration increases transparency ...
  - ... but minimum requirements still much lower
- Diversification: natural trend, but slow.
  - Inertia forces very strong in currency denomination of world financial flows
  - Central Banks still very conservative in their investment strategies

## Recent trends in FX reserves: speed of accumulation

*Fx reserve accumulation (emerging markets and Japan)*

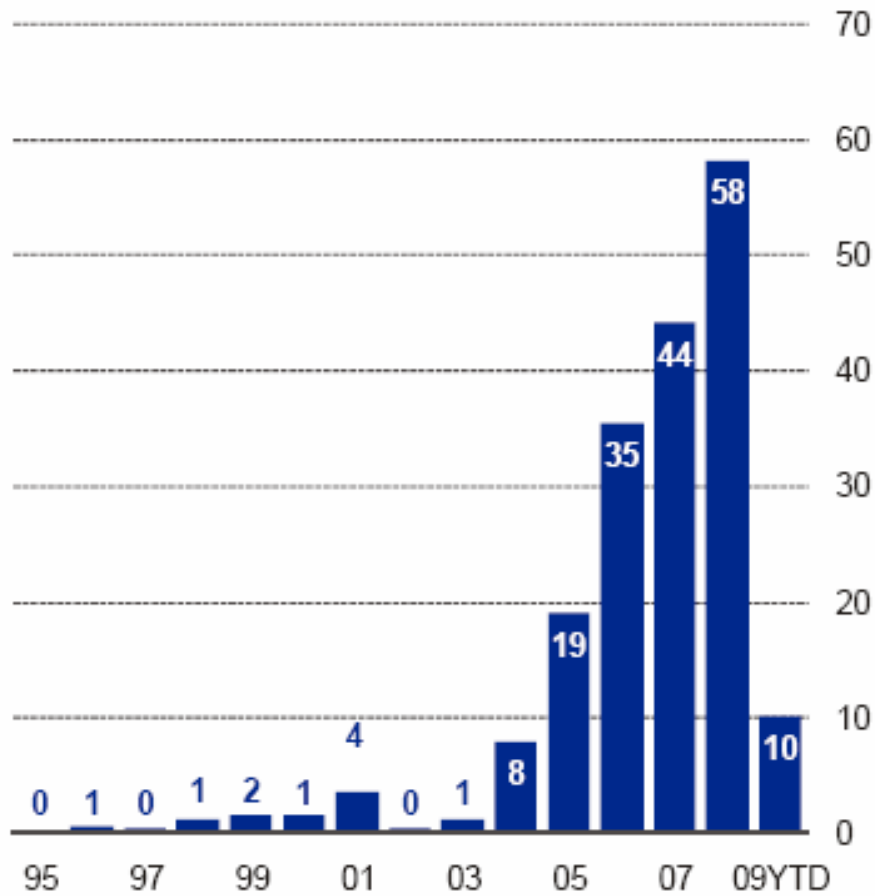


*Fx reserve growth by region*

	<b>YTD</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Asia	<b>9,7%</b>	1,5%	20,2%	28,5%	5,0%
China	<b>9,5%</b>	27,3%	43,3%	30,2%	34,3%
Japan	<b>-0,8%</b>	5,9%	8,7%	5,7%	0,3%
OPEC	<b>-12,3%</b>	4,8%	74,2%	49,4%	13,1%
LatAm	<b>-3,4%</b>	14,7%	39,4%	21,2%	14,9%

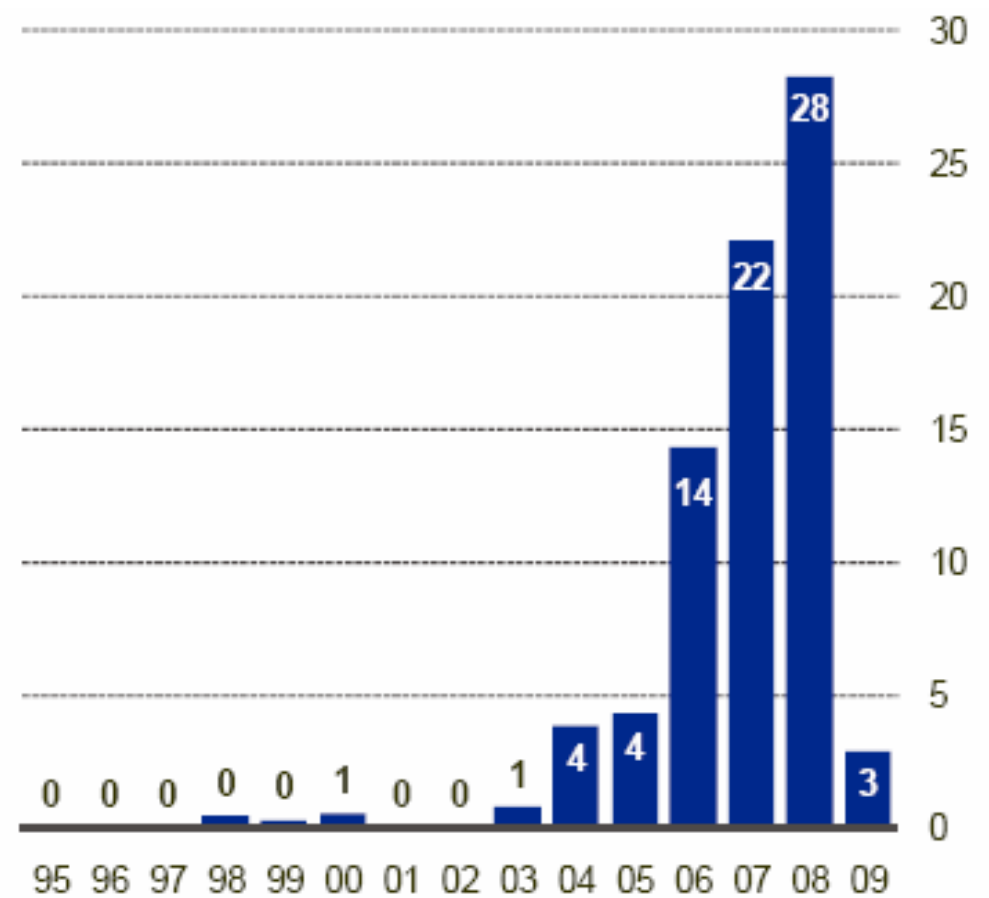
## Recent trends: substitution between SWFs and central banks?

SWF investments over time



Source: Deutsche Bank

SWF investments in the financial sector over time

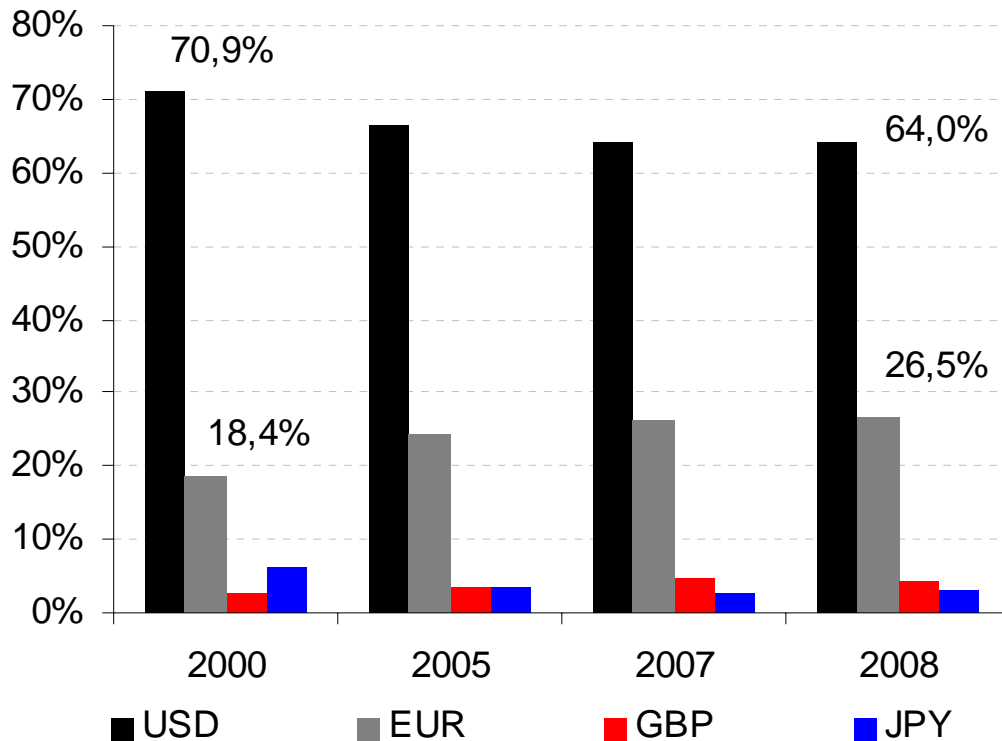




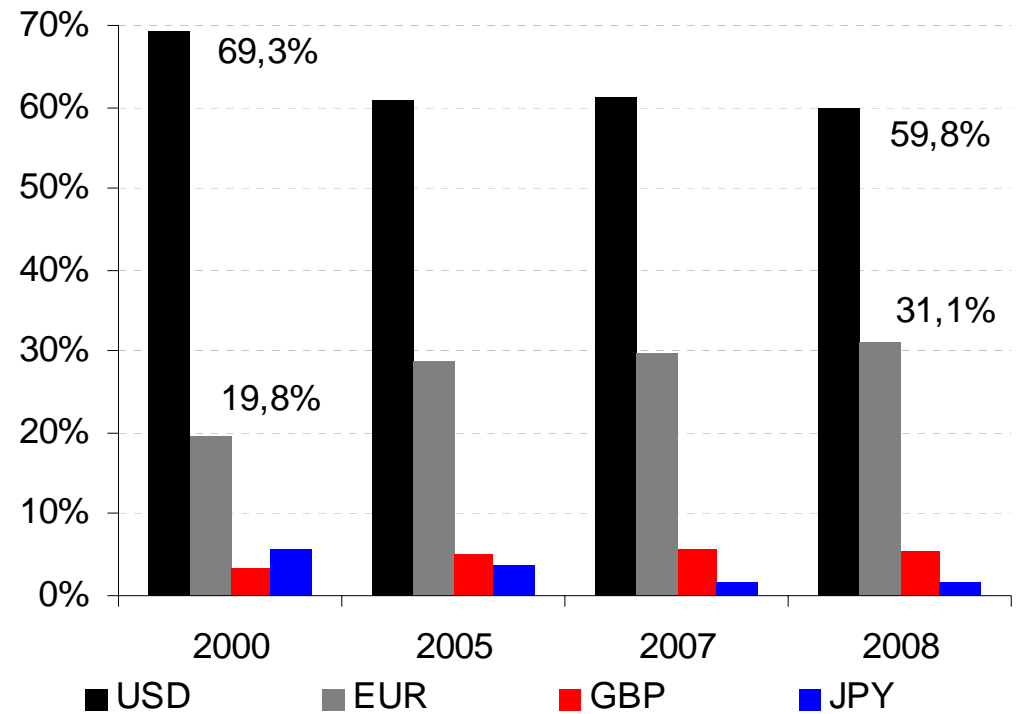
## Recent trends: diversification process: at snail's speed

- Emerging economies need to reduce their dependence on the USD.
- A disorder adjustment is not a zero-sum scenario

Share of total world foreign exchange reserves



Share of emerging central bank foreign exchange reserves



Source: AFI from IMF data

## Does the crisis bring any changes?

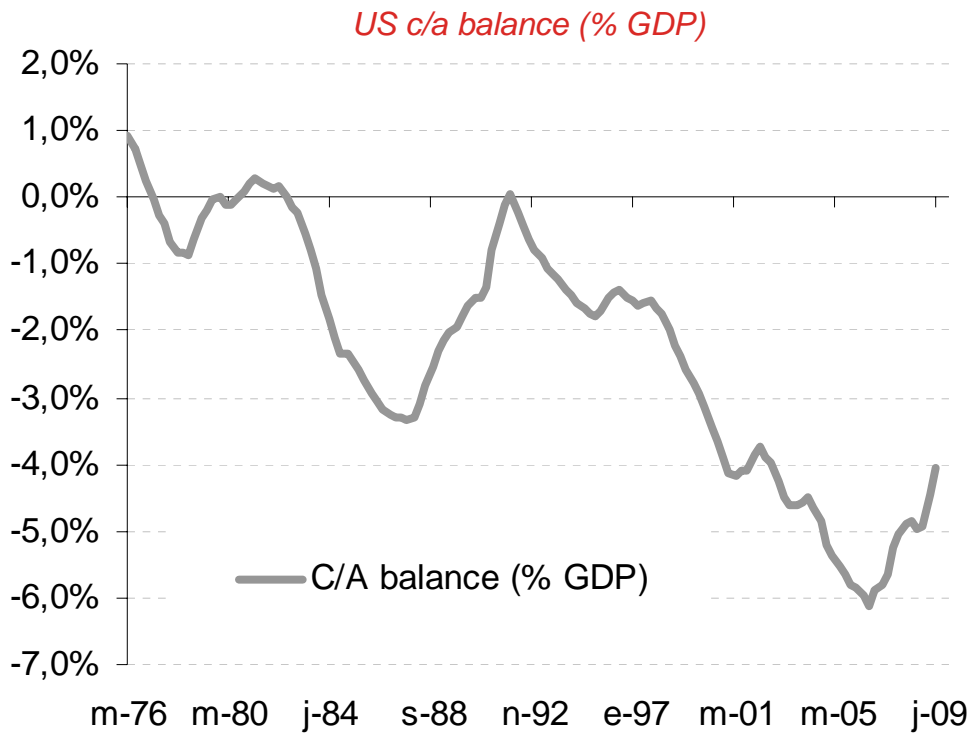
### **Change in incentives** in real exchange rate determination and reserve accumulation:

- Reduced liquidity and international capital flows: decrease in world reserves
- C/A unbalances “genuine” adjustment
- Recession and deflation: incentive to depreciate REER and (if intervention used to that purpose) increase reserves
- Crisis countries: reduced reserves to fight speculative attacks (Russia)
- Protectionism: additional incentive to competitive devaluation of REER.

### **Change in attitude** of the international financial community:

- Increase in multilateral funds for crisis countries reduces ceteris paribus the need for reserves (less rationale for “self insurance”).
- This in its turn increases the need to monitor exchange rate manipulation by countries (IMF role).

## Does the crisis bring any changes?

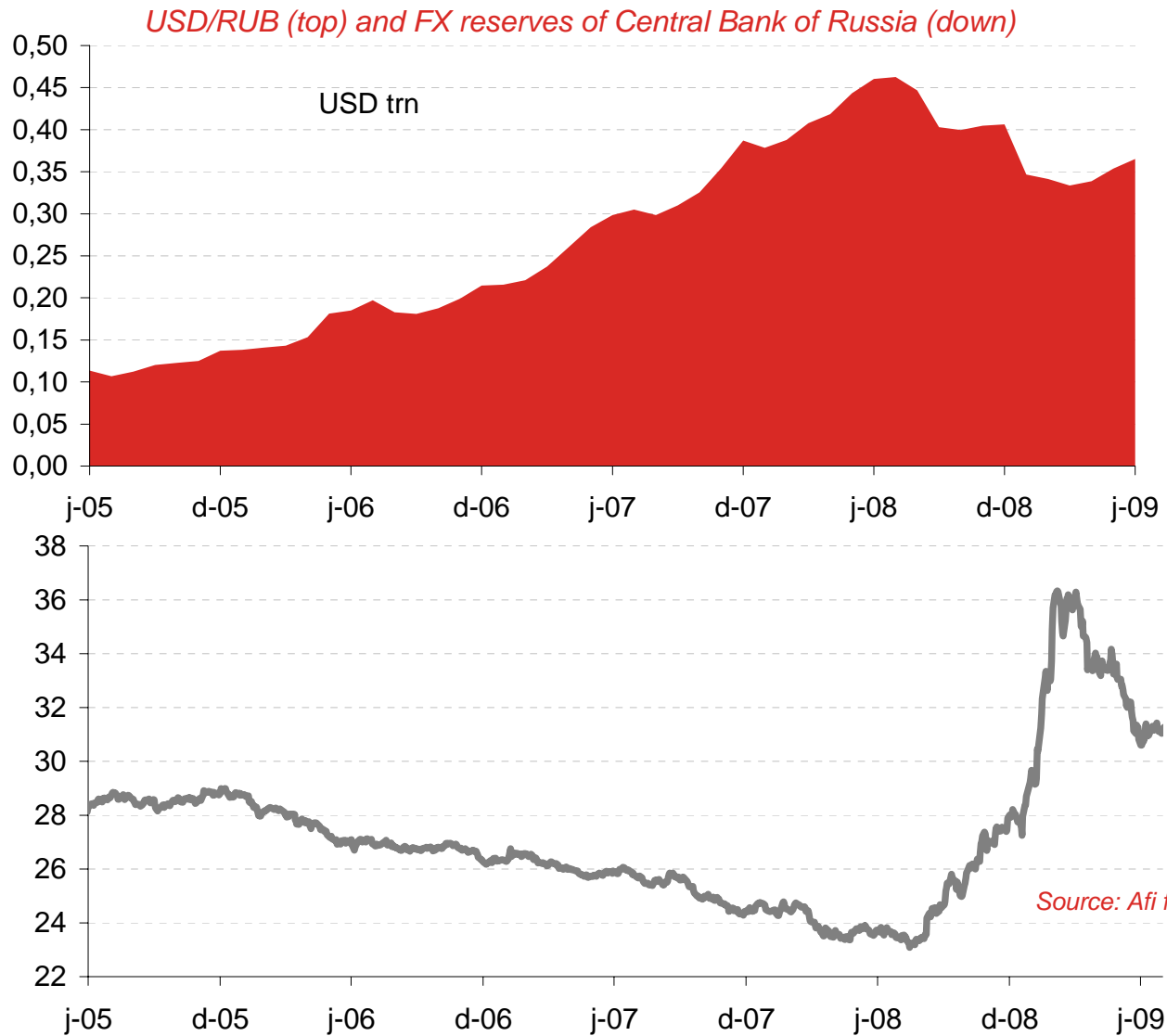


Source: AFI from US Department of Commerce



Source: AFI from Bureau of Statistics, China

Not all countries have reacted in the same way: Russia had to protect rouble, whilst China had not



## Some thoughts on self insurance and reserve accumulation

Have reserves acted as insurance against country default?

- normally when market expectations of devaluation/default are very strong central banks' tools (as a "contrarian player") are insufficient.
- IMF backing has been necessary in the worst cases (Hungary, Ukraine, Latvia, Iceland), which shows that reserves have been insufficient.
- Banking crisis are particularly costly, especially if the size of the banking sector is big compared to the size of the country (see Iceland)
- Interestingly, we have not seen country defaults (so far) in the traditional sense, despite the huge increase in (expected) public debt ratios. The increase in international safety nets agreed in the London summit probably explains that.
- This increase in multilateral funds for crisis countries reduces *ceteris paribus* the need for reserves.
- This in its turn increases the need to monitor exchange rate manipulation by countries.