November 26, 2012

Staff Response to the Independent Evaluation Office Report on International Reserves—IMF Concerns and Country Perspectives Executive Board Meeting December 7, 2012

We welcome the opportunity to discuss the IEO's evaluation of this critical policy area, and its findings that Fund research on the topic is at the frontier, and that Fund surveillance of the largest reserve holders was commendable. However, this report fails to acknowledge that many of its general recommendations are already reflected in Fund policy papers and other initiatives. We are also concerned that the report misconstrues the motives of the Fund in undertaking this work.

International Monetary System Issues

The IEO mischaracterizes the objectives and contributions of the International Monetary System (IMS) and reserve adequacy workstreams. Specifically, there was never a narrow focus on reserves as suggested in the report. The IMS work was very broad based and designed to make the system more resilient to shocks. The buffer provided by adequate reserves is but one aspect of this. A strong global safety net, adequate policies to manage volatile capital flows (both inward and outward), and an understanding of the externalities associated with the multiple aspects of external sector policies—including the interplay of large demand and limited supply of reserve assets—are key to ensuring the resilience of the IMS. All these aspects have been important parts of the Fund's IMS agenda, which was directed by the IMFC, and implemented by the Board through numerous meetings and decisions. As such, the Fund has not ignored "more pressing issues," and its focus on reserves was not "too narrow," as suggested by the IEO.

Reserve policies are relevant to the stability of the IMS. The report suggests that since reserves are relatively small when measured against the global stock of financial assets under private management, they are not really relevant. This seems misplaced. The bulk of reserves are invested in highly liquid government fixed income securities, mostly denominated in U.S. dollars. This would be the appropriate comparison, and reserves are now about the equivalent of a, non-negligible, one-third of advanced country bond markets. Moreover, the smaller size of transactions that can be carried by market-makers becomes increasingly relevant as the size of reserves grows relative to market-making ability and market liquidity. The IEO report thus misses the point that *excessive* reserve accumulation could have detrimental effects on reserve currency issuing economies, or on the IMS as a whole, by distorting the price of risk.

The IEO report incorrectly suggests that the discussion on reserves was merely a way to reopen the debate on global imbalances, or that it was focused on symptoms of problems rather than the causes. The large and unrelenting rise in global reserves holdings is a fact not in dispute, and the IMS workstream explicitly presented this accumulation as a symptom of other distortions, as well as a cause, of potential instability. The causes and consequences of the rapid growth in reserves would thus seem perfectly valid questions for the staff of the IMF to address. Moreover, the *Assessing Reserve Adequacy* paper made clear that it was approaching reserve adequacy purely from a *precautionary* perspective, that is, reserves for smoothing consumption during crises and enabling countries to manage large crisis-related outflows. It was *not* trying to address the separate question of exchange rate and intervention policies that might have implications for global imbalances or the demand for reserves from a non-precautionary (e.g., mercantilist) perspective. Such policies are properly covered by separate workstreams in the Fund, including CGER/EBA and other surveillance products.

The IEO report should have acknowledged that reserve accumulation can be costly, and may impose externalities, thus reflecting a collective action problem. Appropriate reserve holdings can deliver sizable benefits. However, staff analysis suggests that beyond a certain level, the precautionary benefits of additional reserves diminish rapidly, while costs rise at an increasing pace. Further, even if individual members see benefits from very high reserves, or the intervention policies that lay behind them, these policies could be collectively detrimental, particularly if the rise in the reserve holding in one country leads other to ratchet up their reserves. This could arise through increasing systemic risks and/or potential policy spillovers resulting from the need for large countries to manage high or increasing reserve portfolios. As noted above, reserves already account for a large share of the limited supply of advanced country sovereign assets in which reserves are usually held, and the prices of these assets are critical to all other asset prices. Focusing on individual country authorities' views of the costs and benefits of their own reserve accumulation misses this point, particularly as large reserve holders are heavily represented in the IEO's sample of country authorities.

The *Assessing Reserve Adequacy* paper and the facilities reform workstream were simply not created to limit reserve holdings. Rather the reserve adequacy work sought to address a need to update guidance on reserve adequacy, as well as motivate more thorough coverage of reserve issues in Staff Reports, a need also pointed to by the IEO. Similarly, the lending reforms work was aimed at providing an effective form of country insurance tailored to the strength of countries' fundamentals and policies with a view to reducing the stigma sometimes associated with Fund arrangements. Indeed, since the new instruments required adequate reserves for normal times, they cannot form a substitute for member reserves, only temporarily complement them. Finally, reserves can constitute a distortion in their own right—grossly inadequate reserve coverage, for instance, potentially create externalities on others.

Recommendations

We welcome the report's positive findings on surveillance and research, but most of its recommendations are already part of Fund policy and practice (see Annex). Many of the recommendations either repeat (without attribution) the views expressed in recent IMF staff work or have already been tackled through recent Fund initiatives. Specifically, recent Fund work has sought to (i) provide simple and flexible guidance on precautionary reserve needs; (ii) account for multiple policy tradeoffs facing authorities and cover all types of economies and balance sheet risks; and (iii) better integrate advice across related policy areas. This can be seen through the new initiatives taken to broaden the discussion of the IMS and strengthen the integration between bilateral and multilateral surveillance. The work undertaken on managing capital flows (which contrary to the IEO's assertion has considered both push and pull factors), and the *Spillovers* and *External Sector* reports specifically integrate the discussion of multiple aspects of external policies and their potential externalities in large countries. That said, we cannot support the IEO recommendation 3 to design Fund policies based on the relative size of countries' contribution to generating externalities as this would be at odds with the uniformity of treatment across members built into the Fund's Articles.

Although invisible in the IEO report, the *Assessing Reserve Adequacy* paper did look beyond EM reserve needs and called for flexibility in applying the proposed metric. The paper's contribution includes a substantive development of new methods for thinking about reserve adequacy for LICs, thinking on the post-crisis needs for reserve coverage of advanced economies, and a discussion of the appropriate measures of the cost of reserve holdings. The paper is also clear that the proposed metric is but one approach to think about reserve adequacy, especially emphasizing the role that scenario analysis can play. Flexibility was also emphasized, although there are limits to the desirability of ad hoc adjustments, so that the metric is kept simple and transparent, with country-specific circumstances principally brought in to explain measured adequacy or where the class of economy is clearly distinct (e.g., commodity producer). Otherwise, there is a risk of "over-fitting" the metric to explain whatever a country had decided to do.

The IEO's advocacy of peer comparison for reserve adequacy assessment is questionable and points to inconsistencies in the report. Peer comparison, in the form of reserve demand regressions, have their place in illuminating the factors behind the accumulation of reserves by countries, but they cannot themselves provide a measure of adequacy since they ignore the fact that fundamentals matter in assessing vulnerability to crisis. Peer comparisons with countries that have built high reserves for non-precautionary motives will not correctly inform an adequacy assessment from a precautionary perspective. Peer comparison with those holding inadequate reserves also cannot help. This would then seem to show the inconsistency between the IEO's view that several advanced economies had too few reserves before the global financial crisis (a view we share), and an advocacy for peer comparison, since a pre-crisis peer comparison would not have indicated any problem. Moreover, we cannot support the implication of much of the analysis in the IEO report that countries should feel free to accumulate reserves in a manner consistent with "keeping up with the Joneses," ignoring any potential consequences for others.

IEO RECOMMENDATIONS AND EXISTING FUND WORK

IEO Recommendation 1: *Target perceived policy distortions directly* (paragraph 68).

Staff Reaction: ***The Fund's advice has always been focused on policy distortions***, with exchange rate assessments playing a critical role in all Article IV assessments. In addition, the 2011 *Triennial Surveillance Review* called for a broadening of external stability assessments encompassing an analysis of balance sheets and including coverage of exchange rates, capital flows and reserves policies—this has been implemented as an operational priority for surveillance and is set out in revised surveillance guidance. Furthermore, the pilot *External Sector Report* contains a comprehensive discussion of the underlying causes of global imbalances and potential policy actions. Finally, reserve policies may form a policy distortion in their own right. For instance, inadequate reserves clearly pose externalities on other members.

IEO Recommendation 2: *Embed the discussion of reserve accumulation in the multilateral context in a more comprehensive treatment of threats to global financial stability that is informed by developments in global liquidity and financial markets* (paragraph 69).

Staff Reaction: ***The Fund has already developed products to address this recommendation.*** This is particularly the case for the new *External Sector Report*. Further, the metric developed in the *Assessing Reserve Adequacy* paper also goes towards addressing this concern. Specifically it incorporates the vulnerabilities associated with the structure of private and public external balance sheets. For instance, if there is a rise in the extent of portfolio liabilities, whether associated with global liquidity or any other factor, then the metric would suggest a higher need to hold reserves for the associated vulnerabilities. More generally, the Fund has a vast array of work, including the GFSR, Spillover Reports, the Vulnerability and Early Warning Exercises, which looks at threats to global stability, including those originating from global liquidity and financial markets. Obviously reserves are only a limited part of these risks, but when they are a stability concern, they are raised as an issue in these exercises. In addition, recent Fund work on interconnectedness and the *Spillovers Reports* have advanced the understanding of financial inter-linkages.

IEO Recommendation 3: *Policy initiatives that are meant to deal with systemic externalities must take into account the relative size of countries' contributions to the externality* (paragraph 70).

Staff Reaction: ***The Fund's multilateral surveillance and analysis routinely focuses on the impact of policies in countries that are likely to be systemically important.*** This was the exact motivation of the *Spillover Reports*, but is also a feature WEO and GFSR analysis, as well as initiatives such as the *G20 MAP*. Nonetheless, there are limits on the extent to which the Fund can focus its policies and activities on only a subset of the membership, given the need to maintain the uniformity of treatment across all members. For instance, the issue of reserve adequacy is important for all economies, big and small, and rightly forms a necessary part of bilateral surveillance.

IEO Recommendation 4: *Reserve adequacy indicators should be applied flexibly and reflect country-specific circumstances* (paragraph 71).

Staff Reaction: ***The Assessing Reserve Adequacy paper already proposes a flexible and country-specific approach. Flexibility was also shown in pilot ESR assessments***. In paragraph 42, the paper states "Considerable judgment would be required in application to individual countries. […] Adjusting the metric in this way can be seen as a first step towards the full scenario analysis approach that is needed for a complete assessment of potential liquidity buffers […] And given a strong premium on simplicity and ease of use, it is probably better to maintain a highly simplified metric against which judgment can be transparently applied according to a country's particular circumstances." Paragraph 71: "Analysis of reserve adequacy should rely on country characteristics, directly exploring pressures against which reserves are held." Paragraph 72: "In addition to the approaches presented in the paper, country specific factors should be taken into account by considering additional measures of analyses. As relevant, country authorities and teams may wish to supplement adequacy assessments with alternative metrics and scenarios reflecting the relevant risk profiles. The latter is likely to be especially relevant for countries that face different vulnerabilities than the ones on which the proposed metric focuses." Nonetheless, there are limits to the desirability of ad hoc adjustments, so that the metric is kept simple and transparent, with country-specific circumstances principally brought in to explain measured adequacy or where the class of economy is clearly distinct (e.g., commodity producer). Otherwise, there is a risk of "over-fitting" the metric to explain whatever the country had decided to do.

IEO Recommendation 5: *Recognize the multiple tradeoffs involved in decisions on reserve accumulation and reserve adequacy at the country level, and integrate advice on reserves with advice on related policy areas* (paragraph 72).

Staff Reaction: ***Over the past two years the Fund has undertaken several efforts to address this concern***. The policy framework articulated in the *Recent Experiences in Managing Capital Inflows* paper (February 2011), as well as many other papers by Fund staff, place reserve accumulation squarely within the broader policy framework (including the monetary-fiscal policy mix and the use of capital flow measures). In addition, the new *External Sector Report* integrates reserve adequacy at a country level with advice on other external sector areas.

IEO Recommendation 6: *Advice should also not be directed only to emerging markets but, when necessary, take into account the concerns in advanced economies that have arisen after the crisis* (paragraph 72).

Staff Reaction: ***This recommendation is already reflected in the Fund's thinking on reserves, as expressed in the IMF's Assessing Reserve Adequacy paper.*** Paragraph 65 states: "Relatively little attention has been paid to reserve adequacy in AMs until very recently." Paragraph 66: "However, the recent global crisis and ensuring stress in some European countries has generated considerable interest in revisiting reserve adequacy in AMs." Paragraph 67: "Full insurance against financial stress in AMs could imply impracticably high levels of reserves." Paragraph 68: "AMs may rely on central bank swap lines instead of reserves, especially for systemic events." Paragraph 70: "Thus the metrics developed for EMs might—in some modified form—have relevance for some AMs, but for most, reserve needs depends on detailed country-specific factors. […] In the end, there may be no alternative to scenario analysis based on detailed attention to country circumstances for most AMs."