CHAPTER

# 5 Conclusions and Recommendations

## A. Conclusions

62. The emphasis on reserve accumulation as a risk for the international monetary system has led to a loss of clarity in discussing options to reduce such risks. Moreover, factors other than reserve accumulation—notably the leverage-induced fluctuations in global liquidity, inadequate financial sector regulation, and capital flow volatility—are more pertinent sources of concern for systemic resiliency.

63. A common view among interviewees for this evaluation was that the IMF's recent attempts to cast excessive reserve accumulation as a risk for the international monetary system reflected some shareholders' interest in ensuring greater exchange rate flexibility in key Asian economies.

64. The IMF has not presented a persuasive analysis of why excessive reserves constitute a major problem for the international monetary system, nor has it explained how it would identify when a country's or a group of countries' reserves are large enough to pose such a problem. The IMF has also not presented a compelling argument to convince authorities to reduce their reserves for the benefit of the rest of the world.

65. The new reserve adequacy metric that appeared at the time when Management emphasized reserves as a problem for the international monetary system was received with skepticism by country officials, who worried that it could become a rigid benchmark to limit reserve accumulation, and to assess members' compliance with obligations vis-à-vis the IMF. Many authorities were uneasy about potentially prescriptive assessments of reserve adequacy based on this indicator, especially at a time of heightened uncertainty in the global economy.

66. While research has identified a number of sources of vulnerability that shape authorities' decisions about the level of reserves to hold, it has also shown that no single indicator or model can capture the complex set of factors that determine the adequacy of reserves in an individual country or across a group of countries. When they assess the adequacy of their reserves, country authorities in practice consider a number of factors. Some of these are difficult to quantify—for example, the resilience of the economy to exchange rate volatility, the effect of reserves on market confidence, and the robustness of the domestic financial system including the regulatory framework. The importance of each of these factors varies across countries and evolves over time.

67. In its consultations with advanced countries, the Fund very rarely broached the topic of reserve adequacy, and though in emerging market countries its reserve adequacy assessments were more frequent, its policy advice on reserves was frequently seen as pro forma and of limited value added for its members. Interviewees for this evaluation identified some weaknesses in the Fund's analysis of reserve adequacy in the context of bilateral surveillance, noting that often this analysis was insufficiently embedded in country-specific information and too narrow in scope. In hindsight, IMF's policy advice did not adequately take into account the sources of risk associated with the foreign currency liquidity needs that arose as a result of the global financial crisis.

## B. Recommendations

68. *Target perceived policy distortions directly*. In discussing remedies for potential instabilities of the international monetary system, the focus should be on underlying causes of instability and not on symptoms. If the main problem is persistent current account imbalances, then the most direct way to address it would be to emphasize policies that have predictable impacts on current accounts: namely traditional expenditure-changing and expenditure-switching policies. Attempting to articulate a solution based on excess reserve accumulation leads to a loss of clarity.

69. *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.* The Fund needs to present a robust and comprehensive analysis of the multifaceted risks afflicting the international monetary and financial system before it assesses the risks, if any, from reserve accumulation. Such an analysis would include the nature and drivers of global liquidity, the factors that have led to rising and more volatile capital flows, and the role of financial regulation in this context.

70. *Policy initiatives that are meant to deal with systemic externalities must take into account the relative size of countries' contributions to the externality.* If a sound analytical basis were found as to why excessive reserves at the global level pose a threat to international monetary stability, then the appropriate measure of the contribution of a specific country to this threat would be the size of its excess reserves relative to global excess reserves and not the size of its excess reserves relative to the size of the country's own economy.

71. *Reserve adequacy indicators should be applied flexibly and reflect country-specific circumstances.* Evidence has shown that countries accumulate reserves for many reasons that cannot be captured in single indicators or models, and sources of vulnerability evolve over time. Reserve adequacy assessments and advice therefore need to rely on a broad range of indicators which should be adjusted when circumstances change. Standard indicators of external debt need to be complemented with other measures of potential sources of foreign exchange drain and relevant financial sector exposures. Country authorities and staff should be encouraged to adapt the IMF's new reserve adequacy metric to country-specific circumstances in order to render it applicable and useful in bilateral surveillance. In constructing indicators of reserve adequacy, in addition to relying on gross reserves at the central bank, the Fund should take into account other sources of liquidity such as the potential availability of bilateral swaps and multilateral credit facilities, the accessibility of funds under the management of sovereign wealth funds, and the potential access of the economy to credit from international financial markets.[28]

72. *Recognize the multiple trade-offs involved in decisions on reserve accumulation and reserve adequacy at the country level, and integrate advice on reserves with advice in related policy areas. Advice should not be directed only to emerging markets but, when necessary, should also take into account the concerns in advanced economies that have arisen since the financial crisis.* Country authorities regularly need to assess the trade-offs associated with policy measures in different areas of the economy. International reserves are involved in a number of these cases, for example in decisions related to: regulatory policies versus building up reserves to deal with cross-border exposures in the domestic financial system; allowing the exchange rate to adjust freely versus intervening in the market to moderate such adjustments in response to surges of capital flows; implementing capital account measures versus building reserves to insure against sudden stops in capital flows; building reserves to preserve independence versus relying on uncertain bilateral swaps and multilateral facilities; holding reserves that ensure speedy and secure access and foster market confidence versus bearing the fiscal costs of holding liquid reserves. Authorities' views on these trade-offs determine their attitude toward reserve accumulation. The Fund needs to be cognizant of their importance in each country and to calibrate its analysis and advice accordingly.

[28]The Data Template on International Reserves and Foreign Currency Liquidity (Reserves Template) already incorporates many of these items.