

# Foreign Exchange Reserve Diversification and the “Exorbitant Privilege”

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conventional and unconventional monetary policy.

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# Summary

- Very nice and relevant paper!
- **Methodology** : As opposed to standard multi-country models, the results of the paper are very intuitive.
- **Economics**: Very important question for the international monetary system. What are the implications of a higher demand for euros as an international reserve currency ?
- **Answer** : The euro area will benefit. Lower interest rates lead to higher consumption and aggregate demand, and a reduction in the trade balance.

# Summary

- **Model Assumptions:**
  - Five regions: US, EA, China, Japan, RW
  - Reserve accumulation: US and euro area government bonds.
  - Tradable and non-tradable goods.
  - Local currency pricing
  - Sticky price and wages.
  - Habit formation.
  - Follows Canzoneri, Diba and Lopez-Salido (2013).

# Summary

- **Simulation**

- Three scenarios:

- A. “So far, so good” (Global imbalances):

- China, Japan, and RW accumulate both dollars and euros
    - EA and US trade deficit widens and their currency appreciate.

- B. “Rebalancing” (Increased demand for euros):

- China, Japan, and RW increase exposure to euros and reduce dollar position.
    - EA trade deficit widens and currency appreciates.

- C. Asymmetric reserve management.

- One or two countries accumulate reserves (China, Japan, and RW)
    - Countries with no reserve accumulation experience a widening in the trade deficit.

# Summary

- **Welfare analysis**

- “A build-up in official reserves always increases the welfare of the reserve currency countries, while it always hurt the accumulating countries”

Table 8: Welfare

	EA	US	CHN	JAP	RW
[1] “So far, so good”	-0.0040	-0.0078	0.0159	0.0141	0.0067
[2] “Rebalancing”	-0.0229	0.0074	0.0156	0.0154	0.0053
[3] Only CHN increases reserves	-0.0014	-0.0031	0.0198	0.0002	-0.0003
[4] JAP and RW increase reserves, CHN pegs	-0.0025	-0.0049	-0.0034	0.0144	0.0065
[5] JAP and RW increase reserves, CHN sells	-0.0011	-0.0016	-0.0238	0.0147	0.0063

- **Bottom line:** The euro area will benefit if the euro plays a larger role in the international monetary system.

# General Comments

## 1. What is the first-best in the world economy ?

The Triffin Dilemma (The country with reserve currency is in a catch22 position)

- A country issuing reserve currency will have a bias towards current account deficits. Eventually, this situation could erode the confidence in the reserve currency.
- An attempt to reduce the current account deficit could affect global liquidity

**Solution** : Creation of a new reserve currency (not linked to gold, US dollar, or any other currency).

**Model extension:** How global imbalances will change in response to a “neutral” reserve currency ?

# General Comments

## 2. Why do countries accumulate reserves ?

- Reserves accumulation depreciates the currency, triggers expenditure switching effect and leads to a reduction in consumption. Decline in welfare.
- In the model households decide the optimal level of reserves, but in practice the reserve accumulation policy might not be optimal (i.e. favors exporters at the expense of consumers)
- **Model extension:** Evaluate a rule for reserve accumulation (i.e. reserves increase in response to exchange rate appreciation).

# General Comments

## 3. Is the transmission mechanism of reserve accumulation realistic?

- Reserve accumulation leads to:
  - Lower consumption (✓)
  - Higher trade balance (✓)
  - Lower investment (✗)
  - Lower employment (✗)

What is missing ?

- **Calibration:** size of the tradable sector.
- **Frictions:** Learning-by-doing (Lama and Medina, 2012).



# General Comments

## 4. Is the welfare measure appropriate?

- Reserve accumulation increases consumption, but also increases net foreign liabilities. It is not clear that is an optimal intertemporal decision. Need to compare against the first-best.

## 5. What is the impact on core/periphery countries?

Might increase consumption, but are the effects uniform across core/periphery countries ?

Initial conditions matter ! Periphery countries might need to reduce private debt, and the first-best policy should be to increase net exports and reduce consumption.