Expanding central bank balance sheets in emerging Asia: a compendium of risks and some evidence
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* Comments are my own and not those of the Bank of Korea.
Summary: Reserve accumulation in EM Asia

- Central bank balance sheet expansion in emerging Asia
  - Precaution against sudden stops in international capital flows
  - Exchange rate management.

- Matched increasing reserves accumulation with increased sterilization
  - Link between reserves and non-monetary liabilities
  - Changes both the B/S position of the domestic banking system and the central bank.
Summary: Effects of reserve accumulation

- First order effects on the domestic banking system
  - Negative relationship between FX reserve holdings and domestic bank lending

- Second order effects on the domestic banking system
  - Large holdings of sterilized reserves mitigate the adverse effects of the global crisis on banks
  - But during normal time, no strong evidence of these effects
Summary: Effects of reserve accumulation

- Macroeconomic policy impact of the large holdings of sterilised reserves
  - Impose heavy financing costs on central banks
  - Undermine central bank objectives such as price stability
  - Positive relationship between increases in non-monetary liabilities and increases in inflation
  - Threaten independence and credibility of central banks
  - Weaken the effect of monetary policy on long-run inflation expectations
Causes of the FX reserve accumulation

Motives for the accumulation of FX reserves changed over time

- Pre-global crisis: demand side factors such as precautionary incentives and exchange rate policies
- Post-global crisis: supply side factors such as excess global liquidity due to QE

Empirical analysis shows that the excess global liquidity mainly causes an increase in FX reserves in emerging Asia

- Capital inflows and TED spread are main determinants of FX reserves accumulation after global crisis
FX reserve accumulation and Global imbalance

- Reserve accumulation may contribute to the persistence of global imbalances
  - Global imbalance pose risks for global financial stability and economic growth

- Address the issue of reserve accumulation from both sides
  - Legitimate precautionary strategy
  - Potential source of externalities that requires international policy coordination
Costs and benefits of FX reserve accumulation

- Adequate level of FX reserve accumulation
  - If FX reserves < adequate levels ⇒ benefits > costs
  - If FX reserves > adequate levels ⇒ benefits < costs

- No guidance on reserve adequacy and it very difficult to quantify the costs and benefits of reserve holdings
  - Size of sterilization costs can be very different depending on estimation methods
  - Hard to quantify the indirect costs such as crowding out effects, inflationary pressure, and contraction in domestic economy

- Assessment must be made on the basis of each country’s circumstances and policy preferences

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Paradox of advanced EMEs’ capital flows

- EMEs with sound economic fundamentals and sophisticated capital markets are more likely to witness the stronger procyclicality of capital flows (Ocampo, 2011)
  - In a boom period, advanced EMEs show a concentration of global capital inflows
  - During busts, massive capital outflows tend to occur

- Future global capital flows could be highly volatile, depending on the developments in the euro-zone sovereign debt crisis.

- EMEs even with strong fundamentals could be innocent by-standers owing to volatile global liquidity

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Currency swaps between central banks

- A backstop for preventing the spillover of global financial instability into the domestic economy
- Alleviate the FX market crunch both through the actual liquidity injection effect and the announcement effect of liquidity assurance
Alternative policy measures II

- Enlargement of Global Financial Safety Nets (GFSN)
  - GFSN have public goods-like characteristics and are an essential component of a stronger international monetary system
  - Develop a framework for a more coordinated, predictable, and evenhanded global response to systemic crises
  - Ensure that existing financial safety nets have sufficient and readily available resources