Comments on

'International Reserves and Swap Lines: Substitutes or Complements?'

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This is an excellent paper, on an interesting and important current policy issue. One measure of its importance is that the BIS has recently published not one, but two papers on this broad topic[1].

If I were to try to find points of disagreement to foster discussion, I might identify the (non-core) argument that East Asian countries have more-than-ample reserves. My point would be that each of the usual adequacy measures is largely irrelevant to the relevant issues. The old-fashioned trade-based measures (months of imports) are clearly no longer relevant to a world of volatile capital flows. Measures related to money (M2) seem to imply that residents (anecdotally, the shoe-shine boy or becak driver) will flee their currency, which has rarely been the case so far. The Goidotti rule (which this paper quotes) may have some relevance for Latin American countries where a central issue is the roll-over of large foreign debt, but has little relevance for East Asia, where the volatility of capital flows comes from existing foreign holdings of domestic instruments such as equities and bonds – portfolio flows. The issue is to identify the 'hot money', not the debts needing roll-over.

Thus the real issue is: how much intervention do the authorities want to do (with the corollary question 'how much foreign exchange reserves do they need in order to achieve the sort of stability that seems to be the consensus exchange rate regime?')? Gone is the 'corner solutions' approach; greatly

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[1] William Allen and Richhild Moessner *Central bank co-operation and international liquidity in the financial crisis of 2008-9* BIS Working Paper 310 June 2010

Naohiko Baba and Ilhyock Shim *Policy responses to dislocations in the foreign exchange swap market: the experience of Korea* BIS Quarterly Review June p29-39

modified is the Impossible Trinity. We are left with the issue of what level of reserves is needed to facilitate effective intervention.

I might add that, in this context, the cost of reserve holding is not fully reflected simply in the interest differential. If I was a believer in Uncovered Interest Parity, I would argue that the cost of reserve holding is small because an unfavourable interest differential is compensated by an expected exchange rate gain. But if intervention is the name of the game, then you have to count the profits/losses on the intervention. If the exchange rate is moving over a range of 30 percent or more (as was the case in Indonesia and much more in Korea), then judiciously timed intervention will be profitable, even allowing for an unfavourable interest differential.

With this minor criticism out of the way, my focus is on the experience of two countries during the Global Financial Crisis (GFC): South Korea and Indonesia. In both cases they had good economic fundamentals (including sound financial systems), high foreign exchange reserves, but their currencies came under strong downward pressure.

In both cases, the explicit market feedback as the exchange rate was falling was that the market was focused almost exclusively on the *rate of fall* of reserves: in the case of Korea, the market was ready to panic if reserves fell below $200 billion, and in the case of Indonesia, it was ready to panic if reserves fell below $50 billion. These panic levels were, in fact, levels which on many standards were still quite adequate. In any case, countries have reserves in order to use them, so it is farcical if the market essentially won't let the reserves be used for the purpose for which they were intended. In both cases, there was substantial foreign exchange intervention by the authorities to support the currency. As noted in the paper, the accepted view is that the market was unimpressed by the intervention by the BoK but took notice of the availability of the first swap – from the Fed.

This raises the issue of why this was apparently so much more effective than foreign exchange intervention. It can't have been the amount: the BoK did more then $60 billion intervention (6 percent of GDP) and provided other very substantial support for its banks (where the problem was centred: perhaps best seen as a maturity mismatch in the banks' balance sheets), while the Fed swap amounted to $30 billion. Nor is it sensible to argue that the swap was more effective because it was aimed directly at the problem (the banks' mismatch), because some of the BoK intervention was equally

specific. Nor does it seem sensible to argue (as Baba and Shim do) that swaps add to the reserves. The market can't believe that, surely: the swap is like a borrowing, having a counterpart liability to reverse it later.

This is conjecture, but it seems the best answer might be that the market was impressed that the Fed had come to the rescue, and that once the cavalry had appeared over the horizon, it would do whatever it took to win (hold the line on the exchange rate). We know from watching movies that the cavalry always wins! We also know that the Fed has a limitless supply of US dollars.

Indonesia is a subtext here. It would have liked to get a swap facility (and eventually got one from the PBoC), but in the end had to handle things by itself and made sure reserves did not in fact fall below $50 billion. They squeaked through. With both Korea and Indonesia, the exchange rate in due course recovered much of the lost ground.

Where does that leave the question of exchange rate policy?

Let's check the starting point. Thankfully, we seem to be over the 'corner solutions' view that countries should have either an immutable fix or a pure float. While the IMF was trumpeting this doctrine, the countries of East Asia just got along with what seemed to them to be a more sensible view: that they didn't want to be caught with a vulnerable fix, but nor did they have enough faith in markets to 'float and forget'. What they did seemed to work well enough in practice. Most of the Asian countries, post Asian Crisis, have had a reasonably high degree of stability in their rates (whether measured against the US dollar or in effective terms), with some (Malaysia, Singapore) showing particular stability or persistence, which most of the policy-makers regard as good for the economy, giving a steady signal to the tradable sector, which is the dynamic heart of the economy. Thus the issue is how to maintain this stability in the face of shocks: through their own reserves, collective reserve pooling, drawing on the IMF, or, (our special attention here) through swaps.

The powerful success of the swaps in the Korean case might suggest that this mode should be widened and given more institutional basis. The great advantage of the swaps was their ad hoc flexibility. Done between central banks largely on the basis of trust, they can be implemented at a speed not possible with other methods. As this paper suggests, however, there may be limited room to do this. It's hard to see the Fed taking on this responsibility

for the whole world, or even a substantially widened range of countries (you will recall the problem the Fed got into with Congress by providing support for Mexico in 1994). The governance issues seem significant. Would the Fed have been ready to lend to Bank Indonesia, considering that at the same time Bank Indonesia was allowing its wholly-owned Dutch-based subsidiary (Indover) to go bankrupt?

Thus the short answer seems to be that this vehicle should be kept ready (in as much as an ad hoc instrument can be) and in good repair. Its use will be handy in times of trouble, but limited.

The lesson is, perhaps, different: how can the *other* sources of support be *given the attributes* that seem to have made the swap operation in Korea so successful. Let's try to identify these attributes. Speed. Lack of bureaucracy (CB-to-CB, lots of trust). Low key degree of transparency and low prominence.

First, with foreign exchange reserves, there seems to be a need to educate the market that reserves are there to be used. One problem with intervention is that there has been such opprobrium attached to intervention that there is very little discussion of it ('it is the spouting whale that gets harpooned'). Even after the successful foreign exchange interventions in Korea, the subsequent IMF Article IV discussion elicited an undertaking that Korea would use its foreign exchange reserves only for 'smoothing and testing'. Rather than praise a well-executed successful operation, the IMF ensures that Korea feels bashful about what it did, and discourages a detailed discussion that might record how much profit was made in this operation, how successful it was and reinforces the basic point that reserves (all of them!) are there to be used in time of need.

An alternative source of foreign exchange support is, of course, the IMF. Until the Flexible Credit Line was established, the IMF had nothing to compare with a central bank swap line for no-conditionality. Such was the legacy of the Fund's performance during the Asian Crisis that no East Asian country has shown any interest in tapping the FCL. This is a pity. If the Fund is to become more relevant, the customers (as well as the Fund itself) need to remain flexible. There is, however, a very real psychological block here. Would a FCL drawing be seen as a positive endorsement by a deep-pocket outsider (in the way the Fed's swap for Korea seems to have been seen) with promise of continuing support, or as a last-ditch crisis stand? A

lot would depend on the body-language at the time of the agreement. For all their understandable reluctance to use the IMF, the East Asian countries are probably unnecessarily penalizing themselves. Perhaps one way of breaking the impasse on the FCL would be for, say, all the countries in the Chiang Mai Initiative (CMI) to make a small token drawing of FCL money at some time when it is clearly not needed. Just as frequent use will improve the market's understanding of foreign exchange intervention, frequent use of FCL may make it less of a big deal and more as a normal part of foreign exchange and central bank balance sheet operations. Familiarity breeds understanding.

Speaking of CMI, one of the great puzzles of the GFC is why the CMI was not used. Some say that now it is in multilateral form, it is more accessible. But there seems (at least) one serious stumbling block still to be removed: to draw more than 20 percent of quota requires an IMF program. In the case of the multilateral version this, in effect, means that countries can withdraw just their own contribution and not much more. This seems a puzzling requirement, in the context of the sort of problems East Asia experienced in the GFC. Some of these countries needed assistance, but not (as, say, with Greece) because their own policy making was deficient and required the stern tutelage of Fund conditionality to discipline them, but rather they were caught up in the slip-stream of world events. No disciplining of policy was required. Thus there is no requirement for a Fund program. Until this basic issue is sorted out, it's hard to see the CMI serving the enormously useful role that it could, potentially, provide. What ought to be the closest analogue of the Fed swap operations, with the speed and flexibility that comes with prearranged agreements, close trusted partners and common interests, seems to have gone up a backwater. Time to steer it out again.