

International Reserve Holdings with Sovereign Risk and Costly Tax Collection

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Abstract

We derive a precautionary demand for international reserves in the presence of sovereign risk and show that political-economy considerations modify the optimal level of reserve holdings. A greater chance of opportunistic behaviour by future policy makers and political corruption reduce the demand for international reserves and increase external borrowing. We provide evidence to support these findings. Consequently, the debt-to-reserves ratio may be less useful as a vulnerability indicator. A version of the Lucas Critique suggests that if a high debt-to-reserves ratio is a symptom of opportunistic behaviour, a policy recommendation to increase international reserve holdings may be welfare-reducing.

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