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Financial Stability, the Trilemma, and International Reserves

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Abstract

The rapid growth of international reserves, a development concentrated in the emerging markets, remains a puzzle. In this paper, we suggest that a model based on financial stability and financial openness goes far toward explaining reserve holdings in the modern era of globalized capital markets. The size of domestic financial liabilities that could potentially be converted into foreign currency (M2), financial openness, the ability to access foreign currency through debt markets, and exchange rate policy are all significant predictors of reserve stocks. Our empirical financial-stability model seems to outperform both traditional models and recent explanations based on external short-term debt. (JEL E23, E43, E44, F31, F32, F34)

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JEL Classification

E23 Macroeconomics: Production

E43 Interest Rates: Determination, Term Structure, and Effects

E44 Financial Markets and the Macroeconomy

F31 Foreign Exchange

F32 Current Account Adjustment; Short-term Capital Movements

F34 International Lending and Debt Problems

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