Discussion of “Foreign Reserves Management and Original Sin” by Mick Devereux and Steve Wu

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Javier Bianchi[1]

[1]Federal Reserve Bank of Minneapolis

Introduction

- Documents that increases in international reserves are associated with increases in the share of LC debt and lower risk premium
- Proposes a model with sovereign debt currency portfolio + CB reserves + risk premia

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- Great topic
- My discussion
  - Review key mechanism
  - Comments

Overview of Mechanism

1. Higher reserves $\rightarrow$ reduce RER variability...
   - Macroprudential role (Arce et al. 2019; Davis et al. 2021)

2. Lower RER variability + IT $\rightarrow$ lower NER variability...

$$P = e_t \mathcal{P}\left(\frac{P_t^N}{e_t}\right)$$

3. Lower NER variability $\rightarrow$ lower exchange rate risk premia...

4. Lower risk premia $\rightarrow$ Higher higher LC debt

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  How does this work?

- Govt. maximizes utility of public good
  - Consumption-saving problem, currency debt portfolio, e_t, π_t
  - Tax policy exogenous, spending in tradables, flex. prices

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Extreme separation a useful *starting point*, but need explicit connections for "management" of risk premia

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Overall effects on risk premia?

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Overall effects on risk premia?

- Empirically, control for NFA

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- Traditional explanation emphasizes higher inflation credibility
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Evaluate possible hypotheses with joint time-series

Role of multiple equilibria calibration?

- Only fundamental shocks—good equilibrium always selected
- Amplify role of pecuniary externalities?
    - Also strong pec. externalities with unique equilibrium
- Countercylical FX policies?
    - Also true in unique equilibrium calibration (Arce et al. 2020)

Other Comments

- Paper emphasizes the discretionary nature of optimal policy
    - Time inconsistency for govt. choice for e_t, but not for CB
- No resource costs from reserve accumulation
    - No default risk
    - Lump sum taxes finance govt. losses
    - Intermediaries profits rebated to households

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- When profits are shipped abroad, policy no longer time consistent and significant effects on optimal policy (Arce et al. 2022)

Conclusions

- Interesting paper on exciting agenda
- Suggestions
  - Expand/clarify "reserve management" and role of risk premia
  - Tighten connection between model and data
    - Model simulations consistent with model regressions?
    - What drives the joint increase in LC debt and reserves?