“International Reserve Management under Rollover Crises”

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Should governments save for a rainy day?

In particular, should we ever issue debt to accumulate reserves?

Important for policy analysis (and maybe even for avoiding a crisis!)

Clean, stripped down model that nicely clarifies the fundamental tradeoff.

Risk-neutral investors, rollover risk is the only source of risk.

Important features

Reserves are safe, liquid and cannot be taken away in default.

Useful savings vehicle, but also raises the value of default.

Reserves yield only the risk-free rate: a costly "reverse carry trade."

Debt maturity is not too short and not too long.

Per-period payments are "small" and can be managed with savings.

Different words from different settings

You are a household/corporation which sometimes faces "liquidity shocks."

Should you hold some cash, or pay down debt immediately?

If default and/or external finance are costly, better hold cash.

Close analogue to the current setting:

Rollover risk $\approx$ infinitely costly external finance / expenditure shock.

The interesting nuances

Optimal reserve accumulation is highly state- and preference- contingent.

Not worth it for very high or very low debt levels.

– "Moral hazard effect:" investor are worried you will run away.

But useful tool for intermediate debt levels.

– "Insurance effect:" investors know you can overcome short-term shocks.

This is different from standard corporate settings where cash can be seized.

Beyond the model: some important factors

1. How costly is it to save in reserves?

   For risky countries, home-foreign spread can be large.

2. Interaction with bond maturity.

   May be able to avoid dilution cost of long-term debt.

3. Structure of markets and contracts.

   In the theory, it would be good to pledge reserves as collateral.

Conclusion

- Crystal clear paper that beautifully illustrates an important policy trade-off.

- Optimal policy in practice probably sensitive to accurate risk pricing.