What Is the Appropriate Level of Foreign Currency Balances for Industrialized Countries?

Large foreign currency reserve balances may not be needed to maintain an effective exchange rate policy over the medium and long term, according to a recent article in *Current Issues in Economics and Finance* (vol. 19, no. 1, Do Industrialized Countries Hold the Right Foreign Exchange Reserves?).

Authors Linda Goldberg, Cindy Hull, and Sarah Stein observe that the need for foreign currency reserves has been an important tenet of the post-Bretton Woods international financial order. Recent growth in the reserve balances of industrialized countries, however, raises questions about what level and composition of reserves are “right” for these countries.

As the authors explain, countries hold reserves as a tool for intervening in foreign exchange markets to stabilize the value of their currency and as insurance against disruptions to capital market access. However, the evidence is mixed on whether foreign exchange interventions can influence exchange rate levels for more than a short period of time. In addition, authoritative metrics are lacking on the level of reserves needed for such interventions. The authors argue that if interventions achieve their effects on exchange rates by signaling the intentions of policymakers, the purchase or sale of a small amount of reserves might suffice to send the appropriate message. Moreover, while reserves may provide insurance against a loss of access to the capital markets, countries may have other ways to alleviate funding pressures.

Goldberg, Hull, and Stein also contend that reserve accumulations entail costs. In particular, countries incur an opportunity cost by maintaining funds in currency and asset portfolios that, while highly liquid, produce relatively low returns. In addition, large reserve holdings can leave central banks and, ultimately, taxpayers exposed to future movements in exchange rates. Finally, the authors suggest that countries that have accumulated large reserve balances may experience a period of exchange rate distortion when they begin to “unwind” their holdings.
The authors also provide some context for their arguments by considering the differing experiences of six industrialized countries—the United States, Canada, the euro area, the United Kingdom, Japan, and Switzerland—in acquiring and holding foreign exchange reserves. They note that while the first four countries have seen their reserve holdings expand, the reserve portfolios of Japan and Switzerland have grown at a markedly faster pace. In addition, while all six countries mandate that their reserves be held in highly liquid assets, three—Canada, the euro area, and Switzerland—have diversified their portfolios to include a somewhat broader range of investments. Goldberg, Hull, and Stein provide some suggestive evidence that this investment strategy has yielded higher returns and thus tempered some of the opportunity costs associated with large reserve holdings.

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**Research Group Publications and Other Media**

- *Second District Highlights*—a regional supplement to *Current Issues*.
- *Staff Reports*—technical papers intended for publication in leading economic and finance journals.
- *The Research Group of the Federal Reserve Bank of New York*—a guide for economists interested in joining the Group, as well as an overview of our staff, structure, and functions.
- *Publications and Other Research*—a guide for economists interested in joining the Group, as well as an overview of our staff, structure, and functions.
- *Liberty Street Economics*—a blog that enables our economists to engage with the public on important economic issues quickly and frequently.
The Liquidity Benefits of the TBA Market

The U.S. residential mortgage market has experienced significant turmoil in recent years, leading to important shifts in the way mortgages are funded. Since 2007, mortgage securitization by private financial institutions has declined to low levels, while the agency mortgage-backed-securities (MBS) market has remained strong. A recent article in the Economic Policy Review shows that the presence of a forward market for trading agency MBS—the “to-be-announced” (TBA) market—supports the greater liquidity of the agency MBS market.

In TBA Trading and Liquidity in the Agency MBS Market, James Vickery and Joshua Wright describe the key institutional features and mechanics of the market, highlighting recent trends and changes in structure. They document the market’s robust liquidity, even during the financial crisis.

Vickery and Wright also present suggestive evidence that the liquidity associated with TBA eligibility raises MBS prices and lowers mortgage interest rates. Making use of the fact that not all agency mortgages and MBS are TBA-eligible, the authors estimate the liquidity premium associated with the TBA market to be on the order of 10 to 25 basis points during 2009 and 2010, and magnified during periods of market stress. The presence of a government credit guarantee by Fannie Mae, Freddie Mac, or Ginnie Mae alone does not appear to offer sufficient explanation for the liquidity of agency MBS.

The TBA market currently serves a valuable and important role in the mortgage finance system. Accordingly, the authors suggest that “evaluations of proposed reforms to the U.S. housing finance system should take into account the potential effects of those reforms on the operation of the TBA market and its liquidity.”

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Top Blog Posts of Q1

Our Liberty Street Economics blog publishes on economic topics twice a week—more frequently when there is a post on a newly released report or on a pressing topic.

Listed below are the top five posts in the first quarter.

- **Why Isn't the Thirty-Year Fixed-Rate Mortgage at 2.6 Percent?**
  Andreas Fuster and David Lucca
  December 31, 2012 – 7,507 downloads

- **Grading Student Loans**
  Meta Brown, Andrew Haughwout, Donghoon Lee, Maricar Mabutas, and Wilbert van der Klaauw
  March 5, 2012 – 4,738 downloads

- **Is Job Polarization Holding Back the Labor Market?**
  Stefania Albanesi, Victoria Gregory, Christina Patterson, and Ayşegül Şahin
  March 27, 2013 – 3,985 downloads

- **Historical Echoes: Cash or Credit? Payments and Finance in Ancient Rome**
  Marco Del Negro and Mary Tao
  February 22, 2013 – 3,960 downloads

- **Underwater and Drowning? Some Facts about Mortgages That Could Be Targeted by Eminent Domain**
  Andreas Fuster, Caitlin Gorback, and Paul Willen
  February 13, 2013 – 2,962 downloads

Most Downloaded Publications

Listed below are the most sought-after Research Group articles and papers from the New York Fed’s website and from the Bank’s page on the Social Science Research Network site.

**New York Fed website, first-quarter 2013:**

- **A Structural View of U.S. Bank Holding Companies**
  Dafna Avraham, Patricia Selvaggi, and James Vickery

- **Why Did FDR’s Bank Holiday Succeed?**
  William L. Silber

- **Shadow Banking**
  Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, and Hayley Boesky
  Staff Reports, no. 458, July 2010 – 2,579 downloads

**SSRN website, first-quarter 2013:**

- **The Shadow Banking System: Implications for Financial Regulation**
  Tobias Adrian and Hyun Song Shin
  Staff Reports, no. 382, July 2009 – 283 downloads

- **The Corporate Governance of Banks**
  Jonathan R. Macey and Maureen O’Hara

- **Determinants and Impact of Sovereign Credit Ratings**
  Richard Cantor and Frank Packer

For lists of the top-ten downloads, visit our website.
Recently Published


Papers Presented


New Titles in the Staff Reports Series

Macroeconomics and Growth

No. 592, January 2013
A Boost in the Paycheck: Survey Evidence on Workers’ Response to the 2011 Payroll Tax Cuts
Grant Graziani, Wilbert van der Klaauw, and Basit Zafar
While workers intended to spend 10-18 percent of their 2011 payroll tax-cut income, they actually spent 28-43 percent of the funds. This higher share exceeds the estimates reported in studies of recent tax cuts, and is arguably a result of the 2011 tax cut’s design.

No. 595, January 2013
Jeffrey Moore, Sunwoo Nam, Myeongguk Suh, and Alexander Tepper
The authors examine whether the Federal Reserve’s large-scale asset purchases influenced capital flows from the United States to emerging market economies and the degree of pass-through from long-term U.S. to long-term emerging market government bond yields.

No. 602, March 2013
Household Leveraging and Deleveraging
Alejandro Justiniano, Giorgio Primiceri, and Andrea Tambalotti
U.S. household debt skyrocketed between 2000 and 2007, and has been falling ever since. This leveraging (and deleveraging) cycle cannot be accounted for by the liberalization, and subsequent tightening, of credit standards in mortgage markets during the same period.

No. 608, March 2013
The Inflation-Output Trade-Off Revisited
Gauti Eggertsson and Marc P. Giannoni
Eggertsson and Giannoni reconcile the monetary policy lessons of the 1970s and 1980s with the more recent literature, which argues that higher inflation is useful to increase demand.

International

No. 600, February 2013
Capital Controls: A Normative Analysis
Bianca De Paoli and Anna Lipińska
The authors develop a welfare-based analysis of whether (or, in fact, how) countries should tax international borrowing.

Microeconomics

No. 605, March 2013
Geographical Reallocation and Unemployment during the Great Recession: The Role of the Housing Bust
Fatih Karahan and Serena Rhee
Karahan and Rhee suggest that the housing bust is responsible for the decline in migration and the increase in the dispersion of unemployment in different locations.

Banking and Finance

No. 594, January 2013
Securitization and the Fixed-Rate Mortgage
Andreas Fuster and James Vickery
Fixed-rate mortgages (FRM) dominate the U.S. mortgage market. The authors find that government credit guarantees for securitized mortgages are not necessary to maintain a high FRM market share as long as private securitization markets are liquid and well functioning.

No. 596, February 2013
A Sampling-Window Approach to Transactions-Based Libor Fixing
Darrell Duffie, David Skeie, and James Vickery
The authors estimate how the use of different sampling windows could affect the statistical properties of Libor fixings at various maturities.
Rollover Risk as Market Discipline: A Two-Sided Inefficiency
Thomas M. Eisenbach
Using rollover risk as a disciplining device is only effective if all banks face purely idiosyncratic risk.

Money Market Funds Intermediation, Bank Instability, and Contagion
Marco Cipriani, Antoine Martin, and Bruno M. Parigi
Banks are relying more and more on financial intermediaries, such as money market funds, to finance their investments. This trend, while providing investors with valuable diversification opportunities, may increase instability in the banking system.

Financial Stability Monitoring
Tobias Adrian, Daniel Covitz, and Nellie J. Liang
The authors present a framework for financial stability monitoring that centers on the systemic vulnerabilities that increase adverse shocks, rather than on the shocks themselves, which are difficult to predict.

Identifying Term Interbank Loans from Fedwire Payments Data
Dennis Kuo, David Skeie, James Vickery, and Thomas Youle
The authors present novel stylized facts about the characteristics of term loans made or intermediated by banks—before and during the recent financial crisis.

How Much Do Bank Shocks Affect Investment? Evidence from Matched Bank-Firm Loan Data
Mary Amiti and David E. Weinstein
Idiosyncratic bank shocks—movements in bank loan supply net of borrower characteristics and general credit conditions—can explain 40 percent of aggregate loan and investment fluctuations.

Buyout Activity: The Impact of Aggregate Discount Rates
Valentin Haddad, Erik Loualiche, and Matthew Plosser
The authors argue that buyout waves form in response to fluctuations in aggregate discount rates.

Risk-Neutral Systemic Risk Indicators
Allan M. Malz
Malz describes a set of indicators based on current market prices of equity and equity index options that have some predictive power for systemic risks and provide useful information about the risks presented by individual firms.

Chinese Exports and U.S. Import Prices
Benjamin R. Mandel
Mandel’s analysis provides some of the first measures of the dual nature of trade’s procompetitive effects: Exporters respond to tougher competition by simultaneously adjusting markups and quality.

Gender Discrimination and Social Identity: Experimental Evidence from Urban Pakistan
Adeline Delavande and Basit Zafar
Gender discrimination is not uniform in intensity and nature across the educated Pakistani society, and it varies as a function of the social identity of both individuals who interact.

The High-Frequency Response of Energy Prices to Monetary Policy: Understanding the Empirical Evidence
Carlo Rosa
Rosa sheds further light on the determinants of energy prices by examining whether, and to what extent, the Federal Reserve’s conventional and unconventional monetary policy affects prices.
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