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“International Reserves in Emerging Market Countries: Too Much of a Good Thing?”
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This paper considers whether the recent buildup in emerging market countries' international reserves can be justified as precautionary insurance against volatility in capital flows. It presents a simple, welfare-based model of the optimal level of reserves to deal with the risk of capital account crises and calibrates the model for emerging market countries. The levels of reserves observed in many countries in the recent period, in particular in Latin America, are found to be within the range of the model's predictions. However, the reserves buildup in Asian emerging market countries seems difficult to justify on precautionary grounds. A large fraction of their reserves could thus be diversified into less liquid but higher-yielding foreign assets. The paper concludes by discussing the challenges and opportunities associated with the management of large quantities of sovereign assets in emerging market countries.

JEL classification codes: E58, F32