INTERNATIONAL SANCTIONS, FOREIGN EXCHANGE RESERVES AND DEBT

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Following the invasion of Ukraine, financial sanctions were taken against Russia. For the first time in modern times, those sanctions included the freezing of foreign exchange reserves. This Policy Brief discusses the potential consequences on the international monetary and financial system. It projects that US sanctions on the Central Bank of Russia will not affect the dominant role of the dollar and the composition of global foreign exchange reserves. But it could change the behavior of emerging economies. They may reduce their dependence on reserves by limiting their exposure to financial shocks and partially restricting capital movements by closing their capital account.

WHAT ARE FOREIGN EXCHANGE RESERVES

Foreign Exchange (Forex) reserves are (1) liquid and safe assets (2) generally held by a Central Bank (3) in internationally accepted currencies. Holding reserves in a non-universally accepted currency is meaningless.

A key – and often overlooked – characteristic of Forex reserves is their unconditional availability. Countries have potentially access to multiple sources of international liquidity. They can borrow on global capital markets. Official liquidity can be provided by the IMF as well as by swaps between Central Banks. All these sources are subject to limits or conditions and therefore uncertain. Liquidity may not be available in times of crisis when it is most needed.

The function of reserves is to serve as an ultimate and unconditional buffer against liquidity shocks. For this reason, the choice to invest in reserves is very different from other portfolio allocation decisions. Reserve managers do not no search for yield. They want full safety and no risk. This puts strict limits on possible strategies of diversification. Reserves are very different from Sovereign Wealth Funds. In most countries, separate agencies oversee the two functions.

FOREX RESERVES, FOREIGN DEBT AND FINANCIAL STABILITY

It is interesting to look at Forex reserves from the perspective of a country's balance sheet. If the capital account is open and movements are free, all domestic residents can engage into borrowing and lending into foreign currencies. For instance, banks can get deposits in dollars and use them to finance international trade and investment. Domestic corporates may seek funding in global capital markets. And Governments themselves frequently issue debt denominated in foreign currency.

In aggregate, the country is in effect taking and managing an exchange rate risk coupled with a liquidity risk. If funding in dollar suddenly stops, or if the exchange rate depreciates, the domestic banks, corporates, and the Government itself may face the possibility of default. By holding liquid reserves in foreign currency, the Central Bank in effect protects the country - and its government- against a sudden stop of capital flows. They allow to continue international payments and the financing of imports. More precisely:

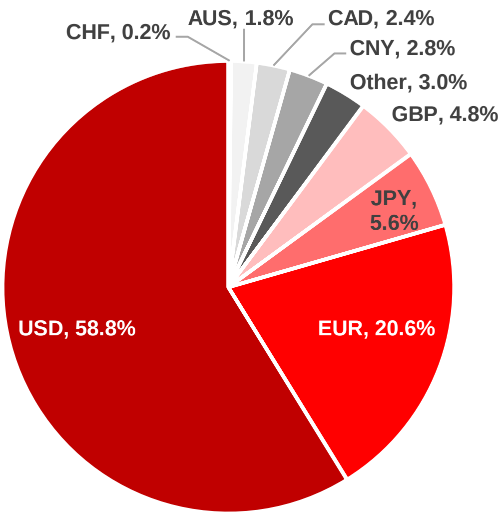
- Forex reserves reduce eliminate the risk that Government would default for lack of foreign currency. As a consequence, higher Forex reserves may lower the risk premium on external debt.
- Because banks, corporates, and households accumulate maturity mismatches in foreign currency they may be facing liquidity crises and need a lender of last resort. Forex reserves allow the Central Bank to fulfill that role even when domestic residents are using a foreign currency. This is an essential – but often overlooked- function of forex reserves, in a financially globalized world.

SANCTIONS AND RESERVES

This analysis will leave aside the case of China which holds about 3 trillions USD in dollar Forex reserves. That amount, together with the strategic nature of US -China relationship create a special situation of mutual dependence that has been described two decades ago, as a "financial balance of terror"

Apart from China, around twenty countries in the world each holds Foreign Exchange Reserves for more of 100bUSD. Most of them are emerging economies. A large majority is in dollar assets and the proportion has not significantly changed over the last decades.

Figure 1 – Currency composition of Official Foreign Exchange Reserves (2021)



Source: IMF

Prima facie, the nature and safety of those reserves may have been affected by the sanctions taken against Russia. Countries may perceive that their access to reserves is less unconditional than before. They face a new “tail risk “of sanction, an event with very low probability but very high impact. Forex reserves may be seen in the future as carrying a political risk.

Implications may be limited, however, for three reasons:

- The freeze is taking place in a situation that may be perceived as truly exceptional: an invasion carried out by a major country. No one would expect standard financial relations and arrangements to hold in those circumstances
- All actions taken by the US authorities over the last decades demonstrate their commitment to promote and preserve the dollar as a reserve currency. In particular, numerous facilities have been deployed by the FED to ensure the liquidity of the Treasury market - some of them specially designed for official foreign holders. With the possible exception of the Trump Administration, successive US Treasury secretaries have been adamant that “ a strong dollar is in the interest of the United States”.
- Above all, there is no alternative. Being a reserve currency certainly brings privileges and power. It is also very demanding. Apart from the US, no other entity in the world can meet the necessary requirements of providing in all circumstances an elastic supply of a safe and liquid asset. In particular:

  - The Eurozone does not have a large and liquid Treasury bond market as national Government bonds present different degrees of safety, liquidity, and risk
  - China seems very far from having a fully and unconditionally open capital account

A quick look at other possible mentioned alternatives confirms that diagnosis:

- Currencies such as the Australian dollar are mentioned as possible reserve instruments. While fully open and accessible, the size of the Australian Treasury Bond market is only 2.5% of the US.
- There have been recurrent attempts to make the SDR into a genuine alternative to reserves – a course actively promoted by China in the aftermath of the Global Financial Crisis). They have largely stalled, for reasons of size and accessibility (the possible use of SDRs are closely restricted by design).
- Some observers stress the potentialities of crypto currencies, pointing to their role to channel funds to Ukraine after the Russian invasion (However, they have no ability to process transactions on a large scale (daily amounts mentioned in relation with Ukraine are in the millions of USD). Despite some fascinating technological features, crypto currencies are even further from having any significant role as reserves. Their day-to-day functioning relies on the initiatives – and incentives – of private operators (the “miners”), whose activity is purely voluntary and profit motivated. A non-negligible proportion has migrated to Kazakhstan after having been prohibited to operate in China.

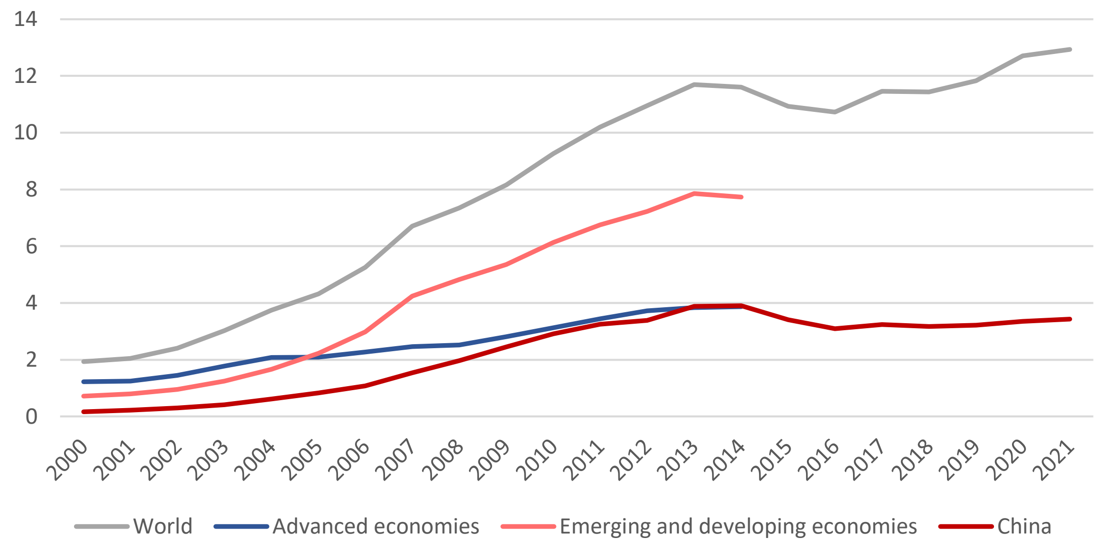
THE LONGER-TERM EFFECTS OF SANCTIONS

Despite their negligible impact on the dollar, sanctions may affect the International Monetary System in a different way. If countries are not certain that their reserves will always be available, they might want to become less dependent. They might seek to cut on those activities and policies that create a need for reserves. They might want to reduce their exposure to external financial shocks and limit their integration to global financial markets.

Reserves are traditionally viewed as a tool for exchange rate management. But, as described above, they play a broader role. They allow Central Banks in those countries to act as lenders of last resort in foreign currency and protect domestic, as well as external, financial stability. This is the fundamental reason why reserves have, over the two last decades, expanded to levels that are impossible to explain and rationalize by traditional metrics of trade and financial openness.

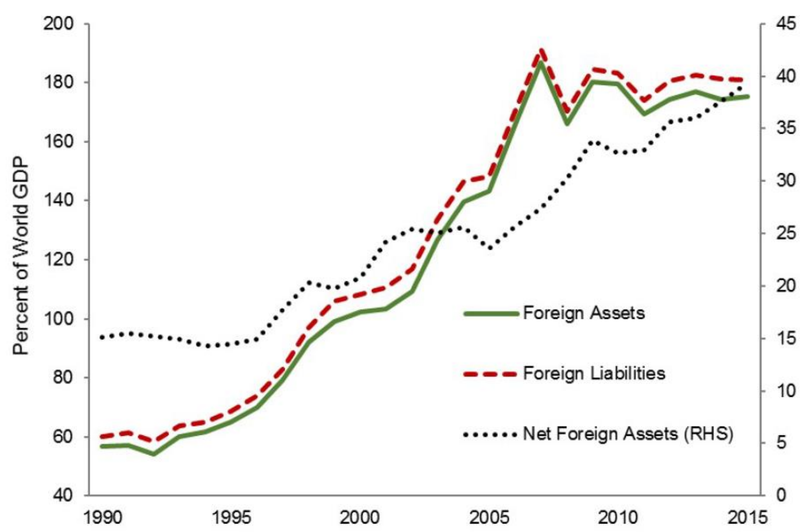
There has been a constant increase in Forex Reserves until 2015 and a plateauing since then. That evolution almost mirrors (with a lag of a few years) the trends in gross cross border capital flows and international exposures - which expanded until 2010 and then stabilized as a consequence of the global financial crisis.

Figure 2 – Foreign exchange reserves (USD trillion)



Source: IMF

Figure 3 – Global foreign assets and liabilities (% of world GDP)



Source: IMF WP 18/79 (p2)

This is not a coincidence. It shows that, except for China, countries' demand for reserves is a direct result of their financial integration with the world.

Those policy choices may well be reversed if and when reserves are carrying new risks. Financial globalization had basically come to a halt well before the invasion of Ukraine. New forms of sanctions, even if very rare, may lead to a further retreat and segmentation of the world financial system.

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RESUME EN FRANÇAIS

Pour la première fois dans l'histoire contemporaine, les sanctions américaines contre la Russie ont frappé les réserves de change d'une Banque Centrale.

Une caractéristique essentielle des réserves de change est leur disponibilité inconditionnelle en toute circonstance. En cela, elles différent des autres sources de financement externes auxquelles les pays émergents ont accès : emprunts sur les marchés, facilités du FMI.

Les sanctions marquent donc un changement dont il faut examiner les conséquences.

Il est douteux, contrairement à certaines analyses, que les sanctions conduisent à une réduction du rôle du dollar dans le système monétaire international. Aucun actif de réserve alternatif n'est disponible. Aucun ne présente les deux caractéristiques essentielles et nécessaires : un large et liquide marché de la dette (celui de l'euro est segmenté en plusieurs dette avec des risques différenciés) ; un compte de capital inconditionnellement libre et ouvert (la Chine contrôle étroitement les mouvements de capitaux)

Les sanctions peuvent néanmoins transformer le système monétaire international. La fonction centrale des réserves est de protéger contre les chocs financiers extérieurs, notamment en cas de crise aigüe. Si une incertitude apparaît quant à la disponibilité des réserves de change, elle peut inciter les pays émergents à réduire leur dépendance extérieure et freiner ou inverser leur intégration au marché mondial des capitaux.

Les sanctions peuvent ainsi conduire à une segmentation accrue et un retour sur la mondialisation financière.