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Author: Mika Kato Christian R. Proaño Willi Semmler

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Does International Reserves Targeting Decrease the Vulnerability to Capital Flights?*

Mika Kato^a, Christian R. Proaño^b, and Willi Semmler^c

^aHoward University, Washington, D.C.

^bUniversity of Bamberg, Germany

^cNew School University, New York

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Abstract

Numerous episodes of financial turmoil such as the 1997-1998 East Asian currency crisis have shown that economies are more vulnerable to currency runs if their currency reserves are low and have not been targeted by central bank policies. These issues have recently become again relevant as a significant capital flight could be observed with respect to China's currency by the beginning of 2016, which however did not develop to a full fledged currency crisis due to the availability of large currency reserves by the Central Bank of China. Against this background, we study the design of optimal monetary policy rules in a theoretical framework where foreign investors react in a nonlinear manner to the evolution of the central bank's currency reserves. We show that by allowing the central bank to give some significantly positive weight to the level of precautionary foreign reserves as one of its targets, a currency crisis scenario can be avoided, while such a crisis is likely to occur when this weight is zero or sufficiently low. The effects of the central bank's monetary control on the output, the inflation rate, and the foreign reserve level corroborate the economy's vulnerability for insufficient foreign reserves targeting. By means of numerical simulations, we show that the larger the relative weight of the foreign reserves target in the central bank's loss function, the larger is the domain of attraction of the stable equilibrium where the economy is not vulnerable to capital flight shocks.

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