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Undervaluation through Foreign Reserve Accumulation: Static Losses, Dynamic Gains☆,☆☆

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Highlights

- Reserve accumulation sacrifices current domestic spending – a static welfare loss
- But it depreciates the real exchange rate, i.e. raises the price of tradable goods
- This raises returns in the capital-intensive tradable sector
- Higher returns foster learning-by-investing externalities – a dynamic welfare gain

Abstract

This paper analyzes foreign reserve accumulation as a second-best policy in economies with learning-by-investing externalities that arise disproportionately from the tradable sector. Under closed capital accounts, reserve accumulation requires an increase in net exports, which reduces the domestic supply of tradable goods, raises their relative price in terms of non-tradable goods – i.e. undervalues the real exchange rate – and stimulates the production of tradable goods. The cost of such a policy is to reduce domestic tradable absorption. However, since the tradable sector generates learning-by-investing externalities, it leads to dynamic gains. Reserve accumulation always increases growth in our framework, but the net welfare effects depend on

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☆☆The views expressed in this paper are ours and do not necessarily reflect those of the World Bank, its Executive Directors, or the countries they represent.

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