The Financial Crisis and Sizable International Reserves Depletion: From 'Fear of Floating' to the 'Fear of Losing International Reserves'?

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Summary

In this paper we analyze the degree to which emerging markets adjusted to the global liquidity crisis by drawing down their international reserves (IR). Intriguingly, only about half of the emerging market economies depleted their international reserves as part of the adjustment mechanism. To gain further insight, we compare pre-crisis demand for IR of countries that experienced sizable IR depletion, to that of countries that did not, and find different patterns between the two groups. Trade related factors (such as trade openness, primary goods export ratio, especially large oil exports) seem to play a significant role in accounting for the pre-crisis IR/GDP level of countries that experienced a sizable IR depletion during the first phase of the crisis. Our findings suggest that countries that internalized their large exposure to trade shocks before the crisis, used their IR as a buffer stock in the first phase of the crisis. After a rapid initial depletion of reserves, within seven months they reached a markedly declining rate of IR depletion, losing not more than one-third of their pre-crisis IR. On the contrary, in the case of countries that refrained from a sizable IR depletion during the first phase of the crisis, financial factors seem more important than trade factors in explaining the initial IR/GDP level. Our results indicate that the adjustment of emerging markets was constrained more by their *fear of losing IR* than by their *fear of floating*.