

Foreign Exchange Reserves and FDI

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September 30, 2019

Abstract

Why do emerging market economies hold high levels of foreign exchange reserves? What is the optimal level of reserves, and do economies accumulate reserves over this optimal level? I argue that foreign exchange reserves help emerging markets attract foreign direct investment inflow. This incentive should be taken into account when analyzing central banks' reserve accumulation. I study the interaction between foreign exchange reserves and foreign direct investment to explain the level of reserves through a small open economy model. The model features domestic social planners and foreign investors. The optimal level of reserve-over-GDP ratio generated by the model is close to the level of East-Asian economies. Additionally, the model generates positive co-movement between technology growth and current account. This suggests high technology growth corresponds to net capital outflow, speaking to the 'allocation puzzle' in cross-economy comparisons. The model also generates positive co-movement between foreign exchange reserves and foreign debt, speaking to the puzzle of why countries borrow and save simultaneously. Finally, compared with a fixed reserve regime, optimal reserve policy features instantaneous or lagged buildups of reserves upon different kinds of technology shocks. Both responses prolong the shocks' positive impacts on output and consumption, delaying them from going back to the steady state.

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