Output Concerns and Precautionary Savings in Emerging Markets' Debt and Reserve Accumulation

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Abstract

We study the joint behavior of external debt, international reserves, and the real interest rate based on a dynamic regime-switching small open economy model that incorporates the salient features of economic crises in emerging markets. Unlike reduced form analyses where contributions from different channels are difficult to determine, our model allows separately assessing the two possible motives behind reserve accumulation: mercantilistic behavior (output externalities) and precautionary savings. Using data from 20 emerging countries for 50 years, we estimate the model and show that both motives matter, but to differing degrees, in many of our sample countries. International reserves serve as an instrument to sustain higher levels of output and insure against disruptions from crises. The model we propose is quantitatively successful at matching various aspects of the data that exhibit substantial variation across these countries. Our findings also explain why many countries choose to hold debt-financed reserves, as we show that reserves lower the finance premium faster than debt increases it, up to a finite level.