

High Capital Mobility and Precautionary Demand for International Reserves

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The volatility of reserve increment and the opportunity cost of holding reserves play prime role in models of optimal demand for foreign reserves. Most empirical studies find significant rise in the response of reserve demand to volatility during the era of high capital mobility. In contrast, we find that volatility measured as rolling standard deviation of reserve increment provides upwardly biased estimates whereas conditional volatility derived from GARCH models eliminates such bias and provides elasticity estimate closer to the prediction of buffer stock model (0.5). Though the time varying elasticity estimates derived from Kalman filter exhibit a sharp rise during crises period it does not exceed theoretical prediction. The RBI's intervention policy seems to be asymmetric; *leaning with wind* when rupee depreciates and *leaning against wind* when rupee appreciates. This evidence seems to indicate that the policy of exchange rate stability had an in-built objective of providing a competitive edge to exporters.

Key words: buffer stock model; volatility; adjustment cost; opportunity cost; asymmetric intervention; Kalman filter

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