bility, the ratio of short-term debt to reserves has been identified as the most significant empirical reserve-related indicator. The rule of thumb that emerges is that reserves should be broadly equal to short-term debt by remaining maturity: R (reserves) = STD (short-term debt).This ratio has an intuitively appealing interpretation in terms of stress testing. For example, consider a simplified situation in which the current account has a zero deficit (as a percent of GDP), and there is no capital flight by residents. In such a situation, a level of reserves that is equal to short-term debt by remaining maturity allows a country to honor all its debt obligations if no new capital inflows take place and old debt is not rolled over or renewed.

In practice, such a simplified situation does not prevail, but it provides a natural departing point for considering more complex situations arising in individual country cases or enhanced stress tests. To illustrate, using an enhanced stress test, one could consider that the country is likely to benefit from continued foreign direct investment (FDI) inflows during a mild crisis. The FDI inflows then are a source of financing and reduce the reserve need as compared to the R = STD benchmark implied by the simplified test.

A central bank applying such a stress test approach may also consider exposure to the risk of capital flight by residents and exposure to the need to finance a current account deficit. Users of this framework may also judge that lack of access for a full year is too long or too short a time period in view of the capability to take adjusting measures—for example, as a result of the political cycle or the effectiveness of fiscal and monetary policies. It is also very useful to consider as parameters in such stress tests the type and size of flows that occurred during previous crises.

Considerations beyond R = STD

As noted, the rule of a level of reserves equal to short-term debt should be viewed as a starting point for analyzing reserve adequacy for a country with significant but uncertain access to capital markets. Several other considerations for assessing reserve adequacy also have been found to be key.

• General empirical analysis strongly suggests that other fundamentals, notably the current account deficit and real effective exchange rate misalignments, affect the need for reserves.

• While private debt (including corporate and banking sector debt) should be included in reserve cover, in line with empirical results, the need for reserves to be held against these exposures declines for cases where private sector risks are soundly managed, as in many industrial countries.

• A flexible exchange rate regime may promote sound micromanagement of risks and thwart some of the risks of speculative capital flight. However, a flexible exchange rate regime does not negate the risk of crisis, given the

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