

Abstract

Foreign exchange reserves are a useful tool and a buffer but maintaining an amount that is too large can be costly to the economy. Recent accumulation of these reserves points to the importance of this topic. This thesis focuses on one specific part of the effect of FX reserves on the economy – the inflation. I use panel data for 74 countries from the year 1996 to the year 2017. There is a certain degree of model uncertainty for which this thesis accounts for by using Bayesian model averaging (BMA) estimation technique. The findings from my model averaging estimations show FX reserves to not be of importance for inflation determination with close to no change when altering lags, variables, when limiting the sample to fixed FX regimes nor when limiting the sample to inflation targeting regimes. The most important variables are estimated to be a central bank financial strength proxy, exchange rate depreciation, money supply, inflation targeting, and capital account openness. These results are robust to lag changes, prior changes, and for the most part remain the same when Pooled OLS is used.