

Report on Bachelor Thesis

Institute of Economic Studies, Faculty of Social Sciences, Charles University

Student:	Jakub Tabášek
Advisor:	Prof. Tomáš Havránek, Ph.D.
Title of the thesis:	Should Central Banks Try to Make Profit on their FX Reserves?

OVERALL ASSESSMENT:

Short summary

Overall, bachelor thesis by Jakub Tabášek offers a detailed discussion of several topics related to the role of foreign reserves and proper way of their management by central banks. In chapter 2, the author describes process of FX reserves accumulation and related considerations. Empirical part of the thesis in chapter 3 analyzes effect of FX reserves on investment and household consumption in several countries and finds a positive impact of the reserves on the latter variables. Chapter 4 (which most closely corresponds to the title of the thesis) deals with possible approach of central banks towards more active approach to reserve management (in particular an explicit effort to form long-term portfolio with a goal of generating a profit), including discussing experience of university endowments as well as several risks specific to central banks.

Contribution

The topic of the thesis is surely a relevant one in area of central banking and the thesis deals with the topic in a comprehensive way. I appreciate the author's ability to link several economic areas (such as monetary policy including institutional issues in central banking together with portfolio management), treat them in detailed context and draw his own conclusions. The author describes potential benefits of more active approach towards foreign reserve management by central banks, but he is also well aware of related risks, such as those to reputation and independence of central banks, as well as smaller but still relevant practical implementation obstacles.

On the other hand, the thesis might benefit from a bit narrower and clearer definition of the topic. The thesis is unnecessarily long and the link between individual chapters is relatively weak. E.g. chapter 2 – while well written – is not pivotal for questions examined in the latter chapters and could probably be substantially more concise and contain only the key points. Similarly, I find appendix rather redundant here. At the same time, there could be a bit more emphasis on the empirical part of the thesis and the discussion of the results in chapter 3 could be extended a bit (see below). Overall, I recognize a lot of effort put into the thesis and its value added, but a bit more direct, up-to-point approach would probably make contribution of the thesis clearer.

Methods

The key empirical part of the thesis is contained in chapter 3, which uses VAR model to estimate the effect of FX reserves on investment and household consumption in several countries. To my knowledge, VAR models are beyond curriculum of bachelor econometric courses and the author thus had to learn the method by himself; and at the same time I consider VAR approach as appropriate in this context.

Overall, the author shows a positive impact of foreign reserves on investment and consumption. One thing I am wondering about is the causality. As the author discusses in chapter 2, there may be several reasons for accumulation of foreign reserves – and for example in case of reserves being just a residual of monetary/exchange rate policy, could not the policy itself (which is not taken into account by the estimated model) possibly be at least partially a driver of the estimated effect of FX reserves on investment and consumption? I also suspect certain non-linearities might be important in practice (e.g. when a country has low amount of reserves, increasing the reserves could have a positive effect on the macro variables, but with sufficiently high amount of reserves, further increase might not bring any additional benefits).

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Dealing with these issues econometrically would likely be beyond scope of bachelor thesis (and would be difficult to conduct anyway given limited data availability), but at least a bit more detailed discussion would be appropriate. At the same time, the author himself is aware of certain limitations of the estimated model and treats the results with a caution, which I appreciate.

Literature

Overall, the author offers detailed overview of literature ranging from FX reserves management through monetary policy up to general portfolio allocation topics. The relevant literature is thus very well covered.

Manuscript form

The thesis is overall well written and the author repeatedly uses neat and high-level expressions (sometimes the language is perhaps even too fancy and slightly simpler English would be sufficient and welcome). There are several cases of missing words or spelling errors (e.g. on p. 2, expression "I consider and how" misses a word; on p. 6 "willingness of foreign lenders extend new credit" misses "to"; p. 16 writes about "interest rate hakes" instead of "hikes"; p. 19 "commitment by a central bank do deploy" should be "to deploy"; p. 21 misses a dot after sentence ending "financial innovation" and so on), and there are a few cases where some special character (such as apostrophe) does not show correctly and looks as "â€™" or similarly (this can be found e.g. on pages 15, 23, 29, or a few times in the appendix). At the same time, the number of these spelling or format errors is not so large that it would be too disruptive or would somehow make the thesis difficult to read.

Overall evaluation and suggested questions for the discussion during the defense

Despite a few of my remarks mentioned above, the thesis is overall a solid piece of work for a bachelor level. Jakub shows understanding of a broad range of topics, he is able to take into account various aspects of the problem in a balanced manner, uses econometric estimation beyond bachelor level and overall it is clear that he put a lot of effort into the thesis.

The thesis thus surely fulfills requirements for a bachelor thesis and I recommend it for defense with grade A.

The results of the Urkund analysis do not indicate significant text similarity with other available sources.

For the defense, I suggest following questions:

- Apart from passive investing into equity indices, the author also discusses potential investing of reserves even more actively. Even in a hypothetical case where risks to central bank's reputation etc. would be successfully managed, according to the author's opinion, how active should central banks be in the actual asset allocation decisions (e.g. in private equity or real estate) in a free market economy, given their specific nature and mandate?
- Currently we are in a period of the highest inflation in decades, with substantial part of inflationary pressures coming from abroad. According to the author, should the Czech National Bank be actively supporting the koruna by FX interventions to alleviate inflationary pressures? Would it be possible to both actively intervene at the FX market and at the same time have a significantly large long-term portfolio of FX reserves?

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SUMMARY OF POINTS AWARDED (for details, see below):

CATEGORY	POINTS
<i>Contribution</i> (max. 30 points)	27
<i>Methods</i> (max. 30 points)	27
<i>Literature</i> (max. 20 points)	20
<i>Manuscript Form</i> (max. 20 points)	17
TOTAL POINTS (max. 100 points)	91
GRADE (A – B – C – D – E – F)	A

NAME OF THE REFEREE: *Vojtěch Molnár*

DATE OF EVALUATION: 29. 5. 2022

*Digitally signed (29. 5. 2022):
Vojtěch Molnár*

Referee Signature

EXPLANATION OF CATEGORIES AND SCALE:

CONTRIBUTION: *The author presents original ideas on the topic demonstrating critical thinking and ability to draw conclusions based on the knowledge of relevant theory and empirics. There is a distinct value added of the thesis.*

METHODS: *The tools used are relevant to the research question being investigated, and adequate to the author's level of studies. The thesis topic is comprehensively analyzed.*

LITERATURE REVIEW: *The thesis demonstrates author's full understanding and command of recent literature. The author quotes relevant literature in a proper way.*

MANUSCRIPT FORM: *The thesis is well structured. The student uses appropriate language and style, including academic format for graphs and tables. The text effectively refers to graphs and tables and disposes with a complete bibliography.*

Overall grading:

TOTAL	GRADE
91 – 100	A
81 - 90	B
71 - 80	C
61 – 70	D
51 – 60	E
0 – 50	F