THE GLOBAL ECONOMIC EXPANSION, INFLATION DYNAMICS, FINANCIAL STABILITY AND MEANINGS FOR GLOBAL ASSET MANAGEMENT: SESSION 3

THE NATIONAL BANK OF THE REPUBLIC OF MACEDONIA
REINVENTING BRETTON WOODS COMMITTEE

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Introduction

- Long period of low/negative interest rates: multiple challenges for reserve managers
- “Normalization” is arriving ? Different speed and still new challenges for reserve managers
- Need to be more agile, to revisit some strongly anchored principles of reserve management, including the risk tolerance and find new ways of mitigating risks
- However, central banks’ challenges are not the same and their risk mitigation techniques may vary

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Group 1: advanced market central banks with large financial sectors

- This group contains central banks such as SNB, SWE, Eurozone central banks, Singapore.
- Large accumulation of reserves (SNB, SWE, Singapore) as a result of ER management policy and the willingness to be able to face a financial sector crisis.
- These central banks are characterized by: strong reputation, strong governance structure; well established tranches structure to cope with the objectives of holding reserves, explicit risk tolerance and investment horizons, enlarged asset classes, a diversification process which started well before the global financial crisis.
- Therefore those central banks were well equipped to cope with the challenge of negative yields and they have pursued their strategies of diversification.

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Group 1: advanced market central banks with large financial sectors

- The SNB was "naturally" protected since the domestic interest rates are even more negative than the euro interest rates.
- Sweden introduced one change to mitigate FX risk by introducing the GBP, CAD and AUD in the currency composition.
- Turning to eurozone central banks, as the euro is not a reserve currency anymore, they were confronted to the low yields of the US curve.

▪ Traditionally conservative central banks: it does not seem that they have changed their risk tolerance, investment horizon and strategic asset allocation in a dramatic manner.

▪ However two moves can be highlighted:

- more currency diversification: GBP, AUD, CAD, NZD and sometimes emerging market currencies (Latin American currencies), and of course RMB;

- introduction of HTM portfolios in order to increase the duration and avoid the volatility of the mark-to-market

▪ This however means that FX risk can be managed and HTM opportunity cost can be supported with time

Group 2: emerging market central banks

- This group can be quite heterogenous too, with quite different level of reserves, different ER arrangements and different risk appetite.
- However, some geographical distinction can be applied between South-East Asian central banks and Central and East Europe central banks.
- In South-East Asia, clear trend to:
  - Accumulate reserves as much as possible to be able to face macro economic shocks and foster financial stability
  - With the accumulation of reserves, the use of tranching has become more and more prevalent to be able to diversify, enhance return and enlarge the investment horizon
  - Clear trend in currency diversification, with growing role of the RMB at the expense of the euro in general;
  - Clear trend in asset class diversification (corporates, equities, EMs) with increased use of external asset managers
  - As a result: more sophistication, more risk mitigation techniques.

Group 2: emerging market central banks

- The group of East and Central Europe central banks displays very interesting and challenging characteristics:
    - An ER policy very often pegged to the euro which greatly dictates the objectives of holding reserves: to ensure the credibility and the sustainability of the peg and also ensure financial stability
    - Currency composition naturally is a by-product of those high level objectives: 80% in euro is the strategic allocation
    - Very often, FX reserves represent almost 100% of the Balance Sheet assets; cost of sterilization of the FX reserves is quite high; therefore the financial sustainability of the CB, its independence, its credibility and reputation depend heavily on the capacity of generating enough revenue from the FX reserves to cover the central bank operating costs.
    - Traditional objectives for managing the reserves: safety/liquidity/return

- How to cope with negative or very low interest rate or in an environment of rising interest rates, under such challenging circumstances?

Group 2: emerging market central banks

- Several responses have been brought, however there is “no free lunch”
  - Negative yields have challenged the first objective of managing reserves (safety); this has triggered Boards of CBs to review the meaning of capital preservation objective with different outcomes: for some no negative yields allowed at all, whereas others have increased their risk tolerance to negative yields
  - Increase the duration of the portfolios in order to pick-up some positive interests; however this was challenged by the resistance of taking more market risk.
  - The use of HTM portfolio has been introduced in order to isolate the result of the central bank from mark-to-market volatility. However re-investment cost is not a trivial issue, in particular in an environment of raising interest rates.
  - Deviation from the strategic currency allocation of 80% euros has also been implemented; however currency risk is a difficult game since FX is the most volatile asset class for central banks, and in the LR expected returns are null.

Group 2: emerging market central banks

- Several responses have been brought, however there is “no free lunch”
  - Increase the credit risk appetite by moving along the credit curve and lowering the minimum credit rating thresholds. This is a reasonable strategy as long as there is a robust credit risk monitoring framework in place; and this also allows to make the credit risk tolerance of the Board explicit.
- Very challenging times for this group of central banks which resulted in revisiting the principles of reserve management, strengthening the risk management framework and introducing more agility in terms of active management.

Group 3: small and constrained central banks

- This group gathers central banks with low levels of reserve adequacy, low tolerance for market risks and limited internal capacity
- For these central banks, FX reserve revenues are an important source of revenue and any volatility of the revenues could have damaging consequences.
- One of the main consequences of the low interest rate environment has been an increase in credit risk for those central banks:
  - The proportion of money market deposits has stopped decreasing; diversification into fixed income portfolios has stopped;
  - Credit risk rating thresholds have been lowered
  - Maturity of deposits have been increased.
  - In some cases, some diversification has been introduced with the hiring of external asset managers for corporates in particular
- Such an evolution may not be the most satisfying, but the normalization of monetary policies may help in bringing back a more balanced risk profile.

CONCLUSION

Central banks are not equal and their reaction to a low/negative interest rate and to a normalization of monetary policies in the world will remain quite different.

However, there are some common characteristics which make the reserve management process successful and able to cope with different situations:

- Strong governance and ownership of the main risk and return parameters at the highest level of the institution
- Strong adherence to the objectives of managing the reserves
- Permanent improvement of risk management methods to be able to be agile and reactive

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We were in the Jungle

ARE WE GOING TO END UP IN A FRENCH STYLE GARDEN?

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OR AN ENGLISH STYLE GARDEN?

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