Ajith Nivard Cabraal: Foreign exchange reserve management

Inaugural address by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, at the SAARCFINANCE seminar on Foreign Exchange Reserve Management, organised by the Centre for Banking Studies of the Central Bank of Sri Lanka, Colombo, 15 August 2008.

*   *   *

Deputy Governors, Director of the CBS,

My dear friends,

1. I am pleased to participate at the opening ceremony of this SAARCFINANCE seminar on **foreign exchange reserve management**. I also welcome all participants to this course and extend to the participants from the central banks of our neighboring countries, our resource persons from BIS, Deutsche Bank group, Citigroup and Reserve Bank of India, a very warm welcome to our country as well.

2. At the 17th SAARCFINANCE Governors' meeting held in Washington in April 2008, it was decided to organize a seminar in foreign exchange reserve management. It was also decided that the Centre for Banking Studies (CBS) in Sri Lanka, with its over 26 years of experience in training and developing financial sector professionals, together with the International Operations Department of the CBSL, should host this seminar, so as **to provide a forum within the region to discuss the latest challenges facing the managers of sovereign reserves at present.**

3. **My dear friends, foreign exchange reserve management has gained increased importance in Central bank activities in the recent past, due to two factors.**

   Firstly, due to the phenomenal rise in reserve holdings of central banks, in our region, and secondly, due to the intensive public scrutiny that reserve management has attracted as a result of the significant increase of foreign reserves in the national wealth of countries in our region.

   The drivers of this sharp rise in reserves are many. High commodity prices, increase of exports of natural resources, and increased remittances, have been among the main contributors to this situation.

   Consequently, many countries have been able to systematically accumulate large foreign exchange reserves over the past few years, and, in a way, reserve accumulation is now possible, not only for the wealthy industrialized countries, but for the so-called developing countries as well.

4. However, these reserve accumulation has not been without pain. **In fact, developing countries, being those still requiring improvements in their domestic infrastructure and other systems, have found that the increasing of their foreign exchange reserves has resulted in a huge opportunity cost.** This is particularly so because the funds collected in the form of foreign exchange have been generally applied to acquire low risk, low-return investments, mostly in fixed income securities in industrialized countries. This situation has indirectly led to such funds being used to fund the huge fiscal deficits of several Western countries, or the expansion plans of their large corporations, instead of being utilized for domestic infrastructure, which, on most occasions have been funded with high cost loans from those very same countries.

   This situation therefore, suggests that there must be now some innovative re-thinking, about this process of reserve management. It should also prompt the reserve managers of the reserve accumulating countries to look beyond their

traditional methods, and intensely search for new avenues for performance enhancement.

1. The philosophy in reserve management in our region has been historically based upon a very conservative approach which focuses on managing foreign exchange reserves, by limiting investment decisions to very low risk, very low return, high-grade instruments.

   Perhaps, as a result, there has been no significant cross investments of foreign exchange reserves within the countries in the South Asian Region. Of course, there is evidence of mostly concessional loans or similar types of direct investments, but not in the case of traditional financial investments, issued by our respective countries.

   It may therefore, be useful for those of us in the South Asian Region, particularly in the context of SAARC, to explore the possibilities of cross investment in financing instruments within our own Region. **In that way, we would be able to shift and retain capital in this Region, which can then be applied in the development of our own Region.**

   My dear friends, we speak of regional cooperation in lofty terms. We speak of our historical ties. We speak of our shared destinies. We speak of our common culture. But, we have still not been able to truly cooperate in this field of reserve management, and it is perhaps time for us to take the preliminary steps to move towards such practices in the foreseeable future. It may be controversial. It may pose some new challenges. But, explore, we must. So, I hope you would also start thinking about this new philosophy as well.

2. **My dear friends, achieving higher returns, given the current financial turmoil and other factors associated with it, is a challenge faced by many central banks today**. The manner in which central banks respond to this challenging task of reserve management has also, had to change rapidly to meet with these new conditions. In fact, it is seen now that central banks have started to gently move away from traditional asset classes like the government Treasury Bills to more sophisticated asset classes. **With this development, we now witness changes in the asset portfolios of central banks in the current context, since Central Banks have moved into more dynamic instruments to achieve its return objective within certain acceptable risk parameters.** Consequently, gold and Treasury bill holdings traditionally held by central banks are now being challenged by investments like derivative products, securities lending and securitised products, and this trend opens out a new canvas for the reserve managers of central banks.

3. The experience of the financial market turmoil has led to fresh new challenges as well, which are quite formidable. At one time, mortgage backed and asset backed securities of government owned or government sponsored agencies, were considered good alternatives for the generation of added spreads for central banks. **However, today, the market fluctuations and credit concerns arising from the mortgage and housing market crises due to overall market downturns and increased mortgage defaults in developed countries, has exposed new vulnerabilities and risks attached to such investment avenues**. As a result, the vital importance of managing risks associated with reserve management have been increasing exponentially in recent times.

4. That development will lead us to another important aspect in this discussion. In the past, measuring risk was mostly based on credit ratings. For this purpose, the yardstick for measurement was usually provided by the rating agencies who were supposed to rate countries and institutions in accordance with certain pre-determined norms. **However, it is now clear that the rating agencies on whom we relied heavily to provide us with independent assessments of the standing**

of institutions and instruments, have obviously failed to warn of possible weaknesses in the balance sheets of such institutions and investment houses. In fact, perhaps unwittingly, they may have even contributed to the turmoil, by their ratings of pooled assets with large vulnerabilities, as assets of prime class.

This may have been due to the weaknesses in their approaches, the lack of proper skills or the weaknesses of their governance frameworks. But, whatever may be the reasons behind these failures, the challenge that we now face is as to how to manage risks optimally in this even more challenging environment, knowing that the opinions provided by the rating agencies may not be too accurate, after all.

5. Let me now highlight another couple of recent developments. **One such development is the greater significance of the sovereign wealth funds in the context of the phenomenal rise in reserves in non-Western countries.** In the midst of the recent sub prime crisis, these funds have injected significant amounts of long term funds to the large ailing institutions to resurrect them or to prevent them from continuing with poor financial health. In that sense, the sovereign funds have acted as an immensely useful stabilizing force during the financial crisis. However, the injection of such funds has been received with mixed feelings in the geo-political context. I would think the debate on this development is just beginning and it would be useful for all of us to carefully watch the movement of this issue in time to come.

Another important development in reserve management is the extensive use of external fund managers. External fund managers are being increasingly engaged by central banks, as many central banks are yet to acquire the technical skills and competencies required to manage the new asset classes that are developing in these dynamic market conditions. I would think this factor too, would be one that we would have to give a lot of attention in the future, and as to how we make use of such expertise without compromising central banks' core objectives, would be a challenge for all of us.

6. My dear friends, given the importance of reserve management, it is timely to organize a seminar on this subject. When reading through your program, I realized that the organizers and the resource persons have done remarkably well in selecting the topics to be covered. **In my view, the topics and presentations are just the right blend that a reserve manager would wish to focus on, in this day and age.**

Finally, let me take this opportunity to sincerely thank the resource persons who have accepted our invitation to share their knowledge and experiences on various subjects relating to reserve management, the Central banks of our member countries for showing high interest in this program, our own CBS for organizing this event, and I wish that all of us could benefit significantly from the program.

I wish this seminar all success.