Daniel Mminele: Challenges today – opportunities tomorrow

Keynote address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the African Central Bank Reserves Management 2020 Conference, Arusha, 1 December 2015.

* * *

Good morning, ladies and gentlemen.

It is indeed a privilege to have been invited to deliver the keynote address at this prestigious African Central Bank Reserves Management Conference. I would like to thank the Bank of Tanzania, Allianz Global Investors, and the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) for affording me the opportunity to share some thoughts regarding the challenges and opportunities we face in managing official reserves. Thank you also for creating this valuable opportunity to discuss and swap notes on best reserve management practices.

The ever-changing landscape in the financial markets poses significant and exciting challenges for reserves managers, but change can also bring new opportunities, which could require a rethink in the way that central bankers manage official reserves.

As is always the case with change, new risks also emerge. This is even the case when considering only the primary objective of capital preservation, for which historically there were seemingly simple solutions. In the not so distant past, there was a clear formula for achieving capital preservation by placing deposits with AAA– rated counterparties or buying highly rated government bonds. However, holding government bonds in the current environment may not necessarily guarantee capital preservation. For instance, in countries such as Germany, negative yields prevailing in the short to medium maturity notes actually guarantee not being able to achieve capital preservation.

How to deal with negative interest rates is just one of the challenges we face as reserves managers. Judging by the structure of the agenda and the speakers for this conference, I have no doubt that many other issues will be unpacked, to help enhance our understanding as we grapple with these extraordinary economic circumstances that have created today's trying conditions under which reserves managers have to operate.

In my remarks this morning, I will touch briefly on the global economic and financial markets context; then talk about recent developments in reserves management, and the challenges currently facing central bank reserve managers. Before exploring, towards the end of my remarks, possible opportunities stemming from this changing global landscape, as we cast our eyes out to 2020, I will briefly share with you how we at the South African Reserve Bank (SARB) have been thinking about and approaching these challenges.

Recent economic and market trends

Due to the global financial crisis in 2007 and 2008, there was coordinated global easing in monetary policy in an effort to boost the global economy. Given the severity of the crisis, it is probably fair to say that investors and other market participants had believed this would remain the policy stance for a protracted period. But the game changer came in May 2013 with what is now commonly referred to as the 'taper tantrum', when the then Fed Chair, Ben Bernanke, indicated that the authorities may consider reducing the pace of asset purchases. This was the starting point of markets needing to adjust to a world of diverging monetary policies.

Since then, the Federal Reserve has entirely ceased with its asset purchases by slowly reducing its monthly purchases to zero from December 2013 to October 2014. Subsequently, the debate shifted to the timing of the rate hiking cycle. While the United States (US) has shown sound economic performance amid resurgent domestic spending, and indications by the monetary authorities of the need to reduce the accommodative stance in interest rates, the market chose to focus on the lack of consumer and wage inflation. Consequently, there was a divergence between the indication from Fed officials and the market pricing about the expected path of interest rates, adding uncertainty and volatility to the market. More recently, labour market statistics and Federal Open Market Committee (FOMC) communication has seen the market move to bring forward its rate hike expectations, with the chance of a December hike now priced at around 74 per cent.

During this period of uncertainty in the US markets, the European Central Bank (ECB) embarked on quantitative easing with consequential negative interest rates. On 18 November 2015, Germany issued 2-year bonds at a record low of –38 basis points! The spread of the US 10-year yield over the equivalent maturity German bond is now trading around 175 basis points, close to its historic high of 190 basis points.

At the same time, China's process of transitioning to a more domestic, consumption-driven economy from one that is investment-led and relies heavily on exports, was a major factor in slowing down its overall economic growth. We are all acutely aware that this slowdown adversely affected commodity prices and export-driven countries, which has severe repercussions for emerging-market economic growth, including on the African continent. In addition, the falling oil prices, partially due to downward revisions to Chinese growth expectations, contributed to keeping inflation tame and adding to the deflation dilemma in some developed markets.

Today, we therefore face divergent monetary policies, with the US on the verge of increasing interest rates, likely to be followed by the United Kingdom next, while the Eurozone and Japan are set to continue with looser monetary policies. This dichotomy presents reserves managers with a clear dilemma: investments in US treasuries may produce negative returns during an interest rate hiking cycle. At the same time, with reserves generally reported in US dollars, non-US dollar investments are expected to underperform in response to an expected stronger US dollar. This is of course adding to the complexity faced in global policy-making and investor decision-making.

Trends in reserves management

With the investment environment clearly becoming more complicated, it may be useful to review recent trends in reserves management, both globally as well as on the continent.

According to International Monetary Fund (IMF) data, global foreign-exchange reserves (excluding gold and Special Drawing Rights (SDR) increased from US$2,5 trillion to US$8,3 trillion, or 332 by per cent, in the ten years to 2014. Over the same period, total foreign-exchange reserves in Africa increased from US$81,9 billion to US$271,8 billion, or 331 per cent. This sudden increase in reserve accumulation did not happen in isolation. The increased globalisation of economic relationships brought with it the requirement for holding additional reserves. This as many of the reserves adequacy metrics will involve the ratio of either trade data or debt levels to gross domestic product. Consequently, as economies open up, so their required reserve holdings need to increase. Such strong growth in reserve holdings brought with it a number of changes in reserves management practices.

According to the April 2015 HSBC Reserve Management Trends Survey, conducted in association with Central Banking Publications, central banks continue to focus on diversification into non-traditional markets, such as Australia, Canada, Scandinavia and, recently, China. Central bank respondents to the survey expect that the Chinese Renminbi will reach 10 per cent of global reserves by 2025. In terms of asset classes, more than 20 per cent of central banks are either investing now or considering investment into emerging-market bonds and equities. Furthermore, more than 10 per cent of the respondents indicated that either they are investing now or considering investment into exchange-traded funds.

Interestingly, the survey also points out that about 70 per cent of central banks are active in, or considering, securities lending.

Based on our interactions with colleagues in other central banks on the continent, the recent focus among African reserves managers has been on: (i) formalising the investment decision processes; (ii) introducing the use of bond futures for efficient portfolio management; and (iii) investigating the viability of including Chinese bonds, onshore and/or offshore, into their reserves portfolios.

Work currently under way under the auspices of the Committee of Central Bank Governors of the South African Development Community (SADC) indicates convergence in reserves management practices in this sub-region of Africa. The initial research results show that reserve management activity in the region is governed by proper policies and guidelines, and nearly all central banks have adopted strategic asset allocation (SAA) frameworks. It also notes that there is a general approach of using tranching when constructing reserve portfolios. The SAA framework determines tranche sizes where relevant. Most central banks invest in cash, cash equivalents and fixed income instruments, with the US dollar and the euro being common currencies in all portfolios.

Challenges facing reserves managers

With that contextual backdrop, and before moving on to discuss some of the challenges faced by reserves managers, it is worth reflecting on one of the consequences of the global financial crisis that we are still grappling with today. This is the deterioration in the credit quality of the reserve currencies. Since 2008, using Standard & Poor's ratings, we have seen the Japanese government debt being downgraded from AA to A+ and the US drop from AAA to AA+. Within Europe, while Germany has remained AAA-rated, France was downgraded from AAA to AA and peripheral European countries such as Spain (from AAA to BBB+) and Portugal (from AA- to BB) saw an even more dramatic drop in their ratings. This narrowed the high-grade investment universe, requiring, in some instances, adjustments in investment guidelines to accommodate these changes. With issuers consequently falling outside the traditional investment universe, finding yield-enhancing assets became more difficult. These challenges persist and with the continued subdued global economic growth outlook are unlikely to go away anytime soon.

Moving on to developments that are more recent, and with reference to my earlier discussion on diverging monetary policies, the key challenges that reserves managers have been facing since the latter part of 2013 have been around the ongoing uncertainties on the timing of the rise in US interest rates and the negative yields in Europe. This has required reserves managers to take stock of their SAA as well as review their tactical strategies.

For central banks with low reserves, the SAA tends to be set along the currency patterns of their foreign trade and external debt. While debt obligations tend to be dollar based, trade patterns can vary more significantly. I remarked earlier that all SADC central banks have euros in their portfolio, which reflects the importance of this region to the continent. However, central banks typically invest in maturities up to three-years, and this part of the German yield curve has negative yields of around 40bps. For countries with larger reserve holdings, there are opportunities to enhance returns through lengthening the maturity of investments or adding credit risk to the portfolio. However, such strategies in turn bring additional market and credit risk to the portfolio, potentially coming into conflict with the overarching objective of capital preservation.

With expectations of higher interest rates in the US, the dollar has strengthened and investors have started to shy away from investing in commodities, including gold. According to Bloomberg, the amount of gold held in exchange-traded funds has dropped from 2,633 tonnes in late 2012 to 1,494 tonnes in November 2015. There has been a striking correlation between the gold held by these funds with the dollar price of gold. Gold holdings in these funds are still substantially higher than pre-2008 levels and therefore there is a risk of further unwind. For South Africa, the decline in the gold price has seen the dollar value of gold holdings decline from US$ 7,1 billion in September 2012 to US$ 4,6 billion at the end of October 2015.

Another consequence of the global financial crisis was a significant tightening in the regulatory framework. The new regulatory environment (introduction of Basel III and Dodd-Frank) in financial markets has raised concerns about liquidity, especially in fixed income markets. The concerns stem from the fact that many global investment banks and market makers are adjusting their balance sheets, and consequently their business operating models, in order to comply with these new regulations and deal with the associated costs structures. As reserves managers, we should be acutely aware of how market liquidity develops so that we are confident that we will be able to convert assets into cash when required. The risk is that it is exactly in crisis times when central banks may need to tap into reserves, and it is in crisis times that market liquidity tends to disappear.

Finally, we should not overlook the role of technology, which is another challenge reserves manager are dealing with. With the growing complexity of the investment environment reserves managers are required to enhance their analytical skills and capabilities, but the increasing cost of technology could stand in the way of a proper assessment of the long-term benefits of such essential investment. This is particularly important for central banks diversifying into new assets classes across various currencies and instruments. It is essential for reserves managers to invest in prime technology in order to receive an optimal risk-adjusted return and reduce the probability of negative returns. At the SARB, we are keenly aware of the benefits and risks associated with new technology, a subject I will return to in a moment.

The South African Reserve Bank's response to these challenges

One of the steps the SARB took when thinking about how best to deal with expected higher rates in the US was to include the use of bond futures in its investment guidelines in order to provide an efficient way to protect the internally managed bond portfolios invested in the US and other major markets. Secondly, the SAA was diversified to allow investment into currencies of some of the high credit-rated and liquid bonds from markets with low debt to gross domestic product (GDP) ratios. For the SARB, this meant fixed income investments in Canada, Sweden, South Korea, and China. The diversification into the Chinese onshore bond market was a result of a strategic view on the long-term outlook for the role of China in the global economy and its economic relations with South Africa. The Chinese bond market also offered good yields together with diversification benefits that have proved to be very valuable.

In addition to the diversification of our currency universe, the SARB included high-rated covered bonds and mortgage-backed securities in the SAA in order to diversify the sources of return and reduce the negative impact of rising rates on the overall portfolio.

Other strategies employed by the SARB to reduce external vulnerability and ensure access to foreign exchange in times of stress included negotiating swap lines with the Peoples Bank of China (PBoC) and the Contingent Reserve Agreement among the BRICS nations.

Lastly, the SARB is making considerable investments in improving technology by acquiring new systems and staff capacity so as to future-proof the reserves management function. We have undertaken a comprehensive review of our system architecture used in the management of gold and foreign-exchange reserves. To this end, we have decided to replace our existing IT system with a new one, more appropriate to our current and future needs, so as to enhance the reserves management value chain.

Potential opportunities for reserves managers

What opportunities does the current environment provide when we think about the next five years or so? Firstly, the prospect of higher rates in the US will provide an opportunity for reserves managers to invest in higher yielding but safer investments. The indication by the FOMC that it intends to raise rates at a measured pace should help manage the risk of negative portfolio returns. As central banks tend to invest in short maturity bonds with a duration of three years or shorter, a 'sweet spot' may exist in that when rates are expected to increase modestly, longer maturity investors may shorten durations in order to avoid losses, keeping the short end of the yield curve somewhat supported. As the bulk of global reserves are held in US dollars, there is no doubt that after some initial mark-to-market losses, higher rates will in due course increase the yield in the portfolio. Here it becomes important for reserves managers to focus on the investment horizon, and not on annual financial accounting outcomes.

After the global financial crisis, bond yields in the developed economies became highly correlated as these countries added stimulus to their economies in order to avoid, among other things, deflation. Consequently, risk adjusted returns of portfolios invested in advanced economies were depressed owing to the loss of diversification benefits. The current diverging monetary policies may in future provide diversification benefits, which will improve the risk-adjusted returns of the overall portfolio of reserves.

Furthermore, African countries have improved in respect of overall political and economic stability, thus providing possible opportunities for long-term stable investments. As these countries provide both hard and domestic currency investments, the weaker exchange rates could now be providing entry points for reserves managers who may want to diversify their investments and benefit from the higher yields.

Likewise, the devaluation of the Chinese Renminbi in recent years may have created an opportunity for reserves managers to enter the market at a more favourable exchange rate. With the Chinese authorities taking steps to support economic growth and recent measures announced to further internationalise the Renminbi, the Renminbi is likely to become more attractive. The most recent reforms have certainly made things a lot easier for central banks in particular. In this light, and with the Renminbi set to be included into the IMF's SDR basket from October next year, following approval by the IMF executive board yesterday, central banks and other official institutions are likely to include this currency into their reserves portfolios (or increase current holdings). An opinion piece by Jukka Pihlman in yesterday's Financial Times pointed to the potential significant demand for Renminbi, estimating that even a conservative one per cent reallocation of global reserves each year would result in inflows of about USD80bn annually.

Amid the lack of allure of traditional government bonds, which could be in play in the foreseeable future, alternative instruments and assets, such as equities, could feature in future SAAs. Some research has shown that improved capital preservation, while generating somewhat higher returns, is on offer from equities relative to bonds. But any broad based moves into equities will be highly country-specific.

Concluding remarks

There can be no doubt that the game has changed for central bank reserves managers. The fast changing world and investment landscape is requiring of reserves managers to adapt to a playing field that is characterised by high levels of uncertainty and volatility, resulting in the need to reconsider investment strategies on a more frequent basis. This will necessitate SAA processes that are vigilant and rigorous. Old and trusted assets are not yielding returns and some are even eroding capital. New instruments and assets that fall within the familiar and accepted investment universe are not plentiful.

Reserves managers must keenly evaluate factors such as investment time horizons, what constitutes and acceptable risk-return balance, what role alternatives should play alongside traditional asset classes, and whether our traditional benchmarks still fit it in with new strategies. However, at all times reserves managers must also remember that they are custodians of public funds, and have to be guided by prudent strategies, which implies that there must be a limit to "thinking outside the box" in the quest for ever higher returns.

Dealing with these challenges will certainly require human capital that is appropriately skilled, and equipped with the right technology. Conferences such as this one present a unique opportunity to share experiences, and transfer skills and knowledge among African central banks, as it brings together central banks with private-sector players, and development institutions, a uniquely powerful combination. I understand that the conference is the culmination of two years of work involving members of the East African Community. I would encourage the organisers to find ways of sustaining this momentum.

Finally, I trust that you will leave Arusha with better insights and an improved network of contacts in the central banking community to help you navigate the future as you strengthen reserves management practices in your own environments to the benefit of your respective central banks and countries.

Enjoy the rest of the conference.

Thank you.