Reserve Management Challenges in the Current Economic and Financial Environment

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Good afternoon, ladies and gentlemen. Let me thank the State Bank of Vietnam for co-hosting this event with the BIS. As a former reserve manager, I am excited to be here to learn more from the distinguished speakers about their experiences of managing international reserves in these turbulent times for economies and financial markets.

In keeping with the conference's focus, my remarks will cover three broad themes:

- The key challenges facing reserve managers;
- How reserve mangers are responding to those challenges; and
- How the BIS's banking services can support you in your endeavours.

Let me discuss each of these themes in turn.

Reserve management has always been an important aspect of central bank operations. But the nature of the role has changed over time as monetary policy frameworks have evolved. Monetary policy and market developments in the aftermath of the Covid-19 pandemic have made the task particularly challenging.

Consider first the changing nature of reserve management.

Historically, at least for countries that did not peg their exchange rate, reserves tended to play a relatively passive role as a buffer that would be drawn upon in times of crisis. While that role continues, many central banks now deploy their foreign exchange reserves more nimbly, as an active policy tool for managing short-run exchange rate volatility. This type of foreign exchange management is often part of a broader macroprudential policy framework that prioritises low inflation as its main aim but uses a range of policy instruments to achieve it, often in conjunction with the pursuit of other, secondary, goals.[1]

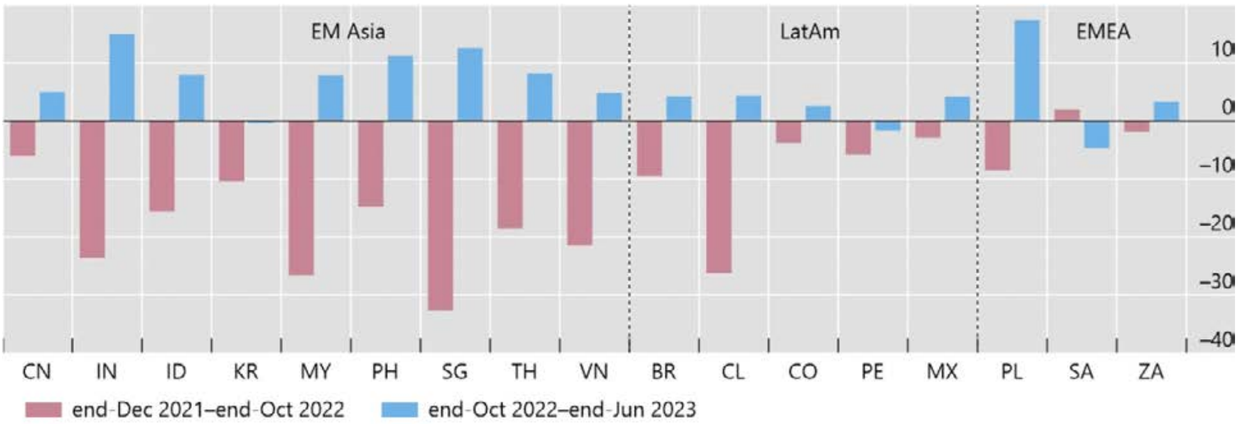
[1] See "Monetary policy frameworks in EMEs: inflation targeting, the exchange rate and financial stability", *BIS Annual Economic Report*, June 2019, Chapter II.

Recent experience provides a concrete example of the use of these frameworks and their benefits. To remind you, in the first 10 months of 2022, in the context of a broad US dollar appreciation, many central banks in emerging market economies (EMEs) drew down their foreign exchange reserves (from their end-2021 peak) to limit the speed and extent of exchange rate depreciation (Graph 1). In conjunction with prudent adjustments to domestic policy interest rates, these measures helped to keep inflationary pressures in check while ensuring stable domestic financial conditions. This, in turn, helped preserve investor confidence in the face of a global and domestic macroeconomic backdrop that had proved hard to navigate in the past.

Change in FX reserves in 2022–23

In per cent

Graph 1



FX reserves include net forward positions.

Sources: IMF; BIS.

Then, starting in late 2022, as the US dollar depreciated and global inflationary pressures eased, central banks took the opportunity to rebuild some of their depleted reserves, to the tune of about $0.5 trillion.

The developments I have just described illustrate how this more dynamic use of central bank reserves has made reserve managers' jobs more challenging and, perhaps, more interesting.

Central banks can't deploy reserves they don't have. The increased use of reserves as a stabilisation tool has gone hand in hand with an increase in the volume of reserves to manage. Despite a recent decline, according to IMF data, total reserves are measured at around $12 trillion (down from their peak of $12.9 trillion at end-2021).

At the same time, to guarantee that those reserves can be actively deployed, potentially in times of market stress, they need to be held in reasonably liquid form, at least up to the level of reserves that corresponds with conventional adequacy metrics (often representing so-called liquidity tranches).

And, on top of this, reserve managers are still and, perhaps increasingly, expected to turn a profit on their investments.

The bar for successful reserve management has thus been raised; an additional demand that you will all be aware of.

Adding to these intrinsic challenges, reserve managers have faced rather difficult market conditions. For the decade or so leading up to the pandemic, this reflected the low interest rate environment. This made it hard for fixed income investors, particularly those holding portfolios of liquid, low-risk assets, to generate healthy, stable returns. Indeed, at the peak, bonds trading at negative rates amounted to around $18.3 trillion, highlighting the pressures on reserve managers in terms of return expectations.

On this basis, it is no surprise that many reserve managers may have welcomed a gradual rise in interest rates as inflation turned out to be more stubborn than previously expected. Yet, the resulting abrupt shift in the interest rate environment proved hard to navigate. To a large extent, this reflected the fact that the rise in interest rates was unusually rapid and unusually synchronised across countries.[2] Indeed, the past 18 months has seen the largest and most coordinated global monetary policy tightening since at least the 1970s. Fixed income investors have borne the brunt of the associated valuation adjustments, with little room to diversify out of these exposures.

As well as its effect on fixed income markets, the global policy tightening has also reverberated through currency markets, particularly via the large US dollar appreciation that I described before. These currency movements have posed a further challenge for reserve managers to navigate.

Faced with these developments, reserve managers faced many choices:

- How to manage duration risk amid rapidly rising interest rates;
- The question of how far to hedge currency exposures;
- Whether to diversify into assets, such as gold, that may serve as a safe haven when inflation and general market uncertainty are high;
- And how to balance all of the above choices with the need to maintain a prudent approach to liquidity management.

Let me now address the question of how reserve managers are facing those challenges. To answer this question, I will draw on survey results gathered by the BIS in 2022 and 2020.[3]

The surveys confirm that the key reserve management objectives have remained rather steady over the years. In particular, almost all reserve managers report that safety and liquidity are the

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2 See "Navigating the disinflationary journey", *BIS Annual Economic Report*, June 2023, Chapter I.

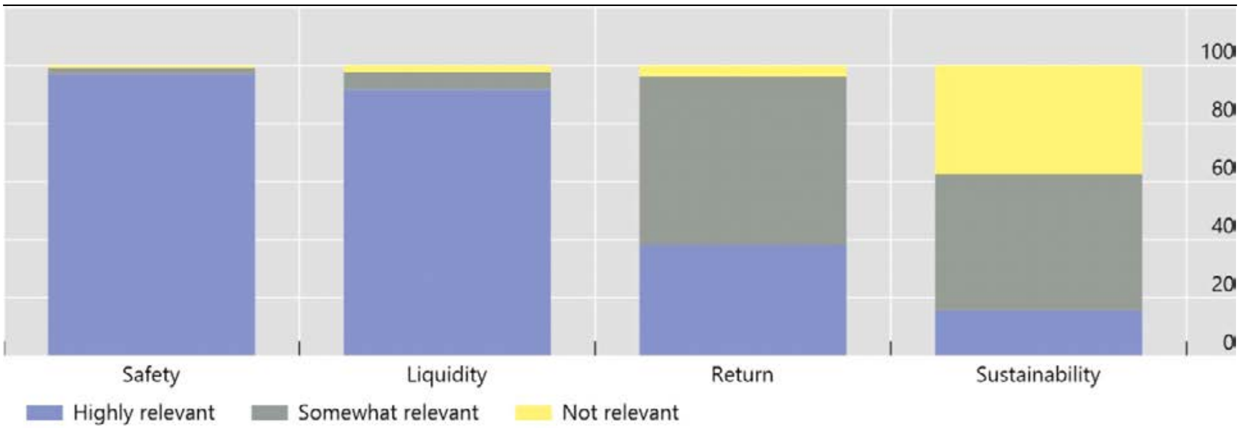
3 See "The bank for central banks", *BIS Annual Report*, June 2023, Chapter 4.

most important objectives in designing their portfolios (Graph 2). This is consistent with the use of reserves as a flexible policy instrument to be deployed in challenging market conditions.

Main reserve management objectives

Percentage of respondents

Graph 2



Source: BIS, based on over 130 responses from reserve managers collected in 2022.

Achieving solid returns is also a relevant objective for most reserve managers. However, it is generally seen as less important than safety and liquidity. Nevertheless, reserve managers have taken a number of steps to boost returns over recent years, most notably by expanding the range of eligible asset classes for investment. For example, a decade ago, only around one fifth of reserve managers invested in corporate bonds, but this share has grown to nearly 45% in 2022. The proportion investing in equities has roughly doubled over the same period, now reaching 20–25%. Of course, careful risk management is a key necessity for reserve managers. The vast majority of those investing in corporate bonds restrict themselves to investment grade issues, often only single A and above. Careful duration management is also an area of constant focus, in addition to a measured approach to any currency risk. Indeed, between our 2020 and 2022 surveys, we found a rather significant shift in emphasis from liquidity risk in 2020 to interest rate risk/duration in 2022. This was at the very beginning of the recent rise in interest rates. I am sure, therefore, that the focus on duration has risen even more since.

Finally, around 60% of respondents indicate a fourth objective, namely sustainability, as being relevant for their investment decisions. The importance of this objective has been growing particularly rapidly, since over 50% of reserve managers reported that it had become a more important objective between 2020 and 2022 (Graph 3).

Change in reserve management objectives between 2020 and 2022

Percentage of respondents | Graph 3

Source: BIS, based on over 120 responses from reserve managers collected in 2020 and 2022.

Sustainability is a broad, and not particularly well defined, term. In practice, I suspect that, for most reserve managers, it refers to the consideration of environmental factors, in particular climate-related risks and opportunities in their decision-making. For investors with long investment horizons, sustainability objectives may be justified from a pure risk management perspective.[4] All investors have good reason to hedge against the physical and transition risks associated with climate change. For others, where mandates allow, making an impact on climate outcomes may also be a goal, for example by purchasing bonds whose proceeds go to green energy projects.

The BIS stands ready to assist reserve managers in pursuing all four of these objectives.

BIS investments are among the safest available to reserve managers, with a product range that caters specifically to the needs of reserve managers, who need to safeguard their assets. The BIS is itself a highly robust and secure institution; our banking operations are performed on the basis of a strong capital position and a prudent financial risk management framework. And with the establishment of our dealing room in Mexico City in 2020, we became the first supranational institution to offer central bank services over the full trading day, increasing both the robustness of our operations and the service provided to our clients.

In addition to safety, highly liquid products are another of the BIS's core strengths. Liquidity is a hallmark of all our tradable instruments, which are available in all the major reserve currencies. We have a strong franchise when it comes to our foreign exchange services, conducting FX transactions on behalf of central bank customers. We have also developed advanced electronic FX trading capabilities to assist central banks with their foreign exchange needs, including our e-FX

[4] See I Fender, M McMorrow, V Sahakyan and O Zulaica, "Reserve management and sustainability: the case for green bonds?", *BIS Working Papers*, no 849, 2020.

platform, which aggregates across pricing sources to offer the most efficient execution possible for our customers. We also offer gold services, including both trading in various products and physical services, such as quality upgrading, refining and location exchanges. And, as well as providing swift convertibility into cash for most of our products, we also offer access to liquidity facilities against high-quality collateral in four of the five SDR currencies. These include both standalone facilities, where we provide liquidity against BIS instruments, high-quality collateral or gold and central bank liquidity facilities, established with the support of reserve currency central banks. Some of the latter also offer a degree of maturity transformation.

BIS products offer a favourable risk-return trade-off, given the institution's credit quality. Our deposits and tradable instruments offer attractive returns relative to comparable offerings, even on highly liquid products. Further out the curve, we offer an expanding range of longer-duration products with maturities of up to five years, including our Medium-Term Instruments (MTIs).

Given the rising interest in the reserve management community in environmental sustainability, we have bolstered our sustainable product offerings in recent years. These include a range of green bond funds, including one focused on green bonds issued in the Asia-Pacific region. A key question for many green bond investors is the question of impact. To help answer this question, all investors receive an impact report that details the environmental benefits expected from the associated projects, based on impact metrics provided by the issuers. With the demand for these investments evolving, we intend to further expand the range of our sustainable investment products in the future.

Finally, I would like to note that the range of products and customer support that we provide has greatly expanded in recent years due to the significant investments we have made in our technology infrastructure. We will continue making enhancements in this area to remain flexible and nimble in the products that we can offer you and to ensure that the service you receive is "best in class".

Let me conclude. The role of reserve managers has become more complex and dynamic over time as it has come to play a more central role in day-to-day policymaking. In conjunction with often difficult market conditions, this has created a challenging environment for reserve managers. Safety, liquidity and return all matter for reserve managers. At the same time, they are being increasingly asked to achieve sustainability objectives. The BIS stands ready to help you in this challenging task with a range of product offerings that cater to all the objectives of reserve managers. Thank you for your attention.