

Mardayah Kona Yerukunondu: Reserve management - what to expect and watch out for in the next decade?

Speech of Mr [Mardayah Kona Yerukunondu](#), First Deputy Governor of the Bank of Mauritius, at the Pan African Central Bank Conference on Risk and Reserve Management, Port Louis, 22 June 2023.

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- Governor
- Deputy Governors
- Representatives of GIZ and Allianz Global Investors
- Distinguished guests
- Ladies and Gentlemen
- All protocol observed

Good morning

It is with great pleasure that I address you on this very interesting topic 'What to expect and what to watch out for in the next decade' in the world of reserve management. We have had two and a half days of fruitful conversations and knowledge sharing which have already set the tone for the future of reserve management.

One decade is short or long, depending on how one views it. In reserve management, time horizon is a key factor influencing our decisions. In the decade to come, we will be bound to see foreign exchange reserves evolve further in terms of size, composition and adequacy. Recent events underscore the necessity for central banks to continue building reserves to consolidate economic and financial resilience against shocks, including Black Swan events. But the core investment principles for reserve management by central banks are broadly expected to remain the same.

Ladies and Gentlemen, marked changes have been observed in reserve management style during the past few years. There have been the reinforcement of governance around the investment framework, increased reliance on technology, and diversification away from traditional reserve assets to a broader spectrum of asset classes such as corporate and agency bonds, equities and even alternatives.

Let me now elaborate on the various points that we central bankers need to consider when managing reserves going forward.

Ladies and gentlemen, I would like to share with you the comments made by the Deputy Governor from the Banco do Central do Brasil, Mr Bruno Serra Fernandes, when he was conferred the Best Reserve Manager of the Central Banking Awards 2023. I quote: "Managing - reserves amidst an adverse environment - requires a great precautionary capacity to deal with multiple market and operational risks while having openness and flexibility to rethink pre-established processes and promote innovative solutions in the face of new paradigms." Unquote.

This viewpoint sets the tone for reserve managers for the years to come. They will have to adapt their investment style, governance structure and risk management processes to navigate volatile market dynamics. Investment in human capital and systems will be a priority to keep pace with higher volatility and growing complexity of financial instruments and markets.

The survey done by the Official Monetary and Financial Institutions Forum – the OMFIF – in 2022 provides further insights in what reserves managers foresee over the next few years. Most of them believe that inflation will remain high for longer or at least be more volatile. The majority of reserves managers indicated they will not make any fundamental change to their investment approach. But they can become more active and opportunistic in the day-to-day management of reserves. Portfolios will be designed to weather economic turmoil, such as by extending duration. They will be more prudent and will put in greater efforts into capital preservation and to ensure liquidity of the portfolios.

Ladies and gentlemen, capital preservation and liquidity remain the prime investment objectives of reserve management. Return maximisation has been only a secondary objective. However, the challenges of falling reserves and exchange rate pressures in recent years have drawn greater focus on return, particularly in emerging economies, as evidenced by recent reserve management surveys. Although safety and liquidity will remain the core principles of investment frameworks, a rise in the importance of return over the coming years is anticipated.

The increased focus on return is already more apparent among emerging economies. For instance, some central banks have to generate further return to make up for growing operational and funding costs. We have seen a steep and rapid rise in interest rates in the past year or so.

Going forward, the search for better yielding avenues may prompt more central banks to expand their universe of eligible asset classes, including venturing into emerging market debt and equities. The integration of new asset classes as well as currencies in the reserve portfolio and the need to access new markets will require further operational enhancements and strengthening of the governance framework. Central banks in our region are increasingly hiring the services of external managers to manage complex investment solutions that require specialised skills and infrastructure.

Ladies and gentlemen, investors generally mitigate risks to portfolios by diversifying into assets classes that have negative or low positive correlations. However, with the change in market dynamics since the Global Financial Crisis, the traditional correlations across asset classes have broken down. This phenomenon is nowadays more pronounced across diverse asset classes and is anticipated to persist in the years ahead. Reserve managers will have to make up for the loss of diversification with new investment strategies.

Recent surveys have revealed a shift by central banks globally towards integrating ESG considerations into their investment framework. This transformation has been taking place at a faster-than-expected pace in recent years and is bound to gather further momentum. We have also heard several experts in this gathering talking about the

efforts made in various fora to incentivise and facilitate access to ESG products that meet central banks' investment criteria. Many central banks already have an official ESG framework in place, namely the Monetary Authority of Singapore, Sveriges Riksbank and Danmarks Nationalbank. Other central banks use ESG labels or use of proceeds as a means of embedding ESG in their reserve portfolios. In the years to come, technology, policy and societal preferences will continue to drive the proliferation of ESG products. ESG datasets and business intelligence platforms are continuously being developed, providing support to investors in their search for investment opportunities.

The de-dollarization paradigm shift is taking place, albeit at a gradual pace. This trend is widely believed to continue into the next decade, amid ongoing geopolitical fragmentation. In the past fifteen years or so, the share of the US dollar has been trending down with less traditional currencies making inroads into reserve assets. Going forward, other currencies like the Renminbi, Indian rupee, Australian dollar, New Zealand dollar and Swedish Krona are expected to gain at the expense of the greenback. Hence, reserve managers would need to build competencies to tap into these currencies and markets.

We also expect to see more geographical diversification in reserve portfolios. Aside from Latin America, India or China, we believe there are great opportunities to unlock within Africa itself. For instance, at the Bank of Mauritius, we have developed and are fostering relationships with leading Pan African financial institutions. As we look to further diversify our portfolios, we believe that more reserve assets could be invested on the continent for its long-term sustainable growth.

Some central banks firmly believe that digital currencies could become an eligible asset class for reserve portfolios at some point in the future. Others are avoiding such assets for various reasons. Virtual assets and cryptocurrencies are still far from the reserve management world today, given their intrinsic volatility. These factors are expected to keep them away from reserve portfolios in the decade.

With all these new investment and diversification strategies, central banks will inevitably have to invest more in human capital and IT systems to rise to the challenge. Regular training for reserve management staff alongside frequent interactions with asset managers and peer central banks are paramount. Sharing of experience among central banks in Africa has to be encouraged and facilitated.

I here have in mind the regional groups – such as SADC, COMESA and the Association of African Central Banks. They can play important roles in setting up the right fora for the sharing of knowledge and expertise. Of course, the collaboration with international institutions and national agencies fostering international cooperation – like the GIZ – will be of great assistance.

Central banks will also have to keep pace with technological advances to ensure a secure and efficient environment for the management of reserves. As a complement, proper risk management solutions would need to be in place to ensure consistent approach in the management of portfolio risks.

In the aftermath of the pandemic and ongoing geopolitical tensions, African central banks experienced significant exchange rate pressures and witnessed a decline in reserves. This further exacerbated a funding crisis in the continent, leading to a surge in external debt service burden. Based on IMF statistics, a slow-down in foreign exchange inflows and central banks' interventions to finance imports led to about a quarter of countries in Sub-Saharan Africa with reserves levels less than three months of imports at the end of 2022. Countries with the most significant declines in reserves include Angola, Gambia, Mauritius, Mozambique, Kenya and Ghana.

For Mauritius, the pre-pandemic reserves level was USD 7.4 billion in December 2019. Being a tourist destination, the impact of the pandemic on our domestic FX market was quite severe. Since March 2020, the Bank has sold a total amount of approximately USD3.8 billion to support the domestic foreign exchange market. I can assure you that managing reserves during such challenging period warranted a major overhaul of the reserve management strategy at the Bank of Mauritius.

Before I conclude, I will highlight some key takeaways on what to watch out and what to expect over the next decade.

- First, the global macroeconomic landscape will remain challenging. Geopolitical tensions are expected to linger. Business and interest rate cycles could recur over shorter time span relative to historical trends.
- Second, financial market dynamics will bear the ramifications of a testing economic environment. Moreover, higher sovereign debt levels could constrain the ability of fiscal policy to lean against economic downswings and smoothen economic volatility.
- Third, reserve management in an evolving economic and financial environment will require investment in specific skillsets, a strong governance framework, well-defined risk appetite, up-to-date IT systems, and ongoing scrutiny of new investment opportunities. Continuous capacity building is key to dispense the requisite knowledge and skills to our central banking staff.

Central banks managed to steer their way out of those stormy waters and are still doing so. They had no choice than to innovate by adjusting their investment guidelines and principles, expanding their eligible currencies and asset classes.

It is as important to acknowledge that there should be clear understanding of what central banks can and cannot do, as well as an appreciation of the possible conflicts between the different objectives.

We, on the African continent, need to adapt ourselves to new trends and seize opportunities to resolutely face the future. It is imperative for our reserve managers to be more dynamic to respond quickly to new market conditions. I strongly believe that there is a lot we can collaborate on to make the continent more attractive to foreign capital and international trade in order to grow our foreign assets. This will assist countries safeguard macroeconomic stability and foster sustained economic growth.

Ladies and gentlemen, I thank you for your attention.