Welcome Address by Mr Leon Myburgh, Head: Financial Markets Department, South African Reserve Bank, at the Standard Bank 6th Annual Central Bank Reserves Management Conference, 3 November 2014

1. Introduction

Ladies and gentlemen, allow me in turn to welcome you to this Reserves Management conference, the sixth of its kind hosted by Standard Bank, yet the first I have the pleasure of addressing in my current capacity as Head of the South African Reserve Bank's Financial Markets Department. And I can only commend our hosts for putting together such a comprehensive programme, both in the diversity of topics covered and the calibre of speakers scheduled. While it is those speakers who will guide you through the intricacy of the different subject matter, allow me to share with you some brief remarks on the subject of reserves management.

The subject could not be more topical, in light not just of the continued growth in global central bank reserves but also of the numerous challenges that asset managers currently face. How much reserves should one accumulate and for what purpose? Where should one invest them? How should one balance the goals of higher returns versus capital preservation? And how do you deal with negative

interest rates when capital preservation is a top priority? I would not pretend to have the answers to these questions, but propose to briefly look at a few points.

2 Trends in global reserves

I have just said that official reserves under management have continued to grow in recent years. However, during the Gold Standard era, governments and central banks held gold as they later held dollars under the Bretton Woods arrangement, to satisfy convertibility requirements. One could have thought that, with an increasing number of countries allowing their currencies to float, and with capital account flows increasingly dwarfing current account ones, the era of elevated official reserves would gradually have become something of the past.

This has not been the case. The International Monetary Fund's COFER data show that the world's official reserves have grown roughly five-fold since the end of 2002, totaling as much as US$12,0 trillion at of the end of the second quarter of 2014. If one were to add the roughly US$5 trillion held in sovereign wealth funds, it sums up to around US$17 trillion, or about 23 per cent of 2013 world GDP. And while the pace of growth in total reserves has slowed since the 2008 global financial crisis, it remains positive, with a gain of 7,8 per cent in the year to June 2014 and of 6,0 per cent a year, on average, over the past three years. Equally interesting is the growing role played by emerging-market monetary authorities: From 40 per cent ten years ago, they now account for 67 per cent of total assets under management. Even after excluding the large holdings of the People's Republic of China, the share of emerging market central banks still rose from 27 per cent to 34 per cent over that period.

3. **Why should central banks hold reserves?**

I earlier mentioned that the historical reason for holding reserves was to allow for the settlement of current account imbalances while maintaining exchange rate stability, and indeed to this day, the majority of reserves continues to be held by countries with either fixed or managed exchange rate regimes. But sticking to an exchange rate target is not the only reason for reserve accumulation. Globalisation in recent times has presented another reason namely crisis prevention, owing to the high speed at which capital can flow between countries, via global banks and international conglomerates. In particular, since the Asian crisis of 1997 and the global financial crisis of 2008, monetary authorities are increasingly aware of the potential high volatility of capital flows and the risks of “sudden stops” in cross-border financing. Moreover, the global financial crisis taught us that a sudden fall in financial market confidence can trigger a “hoarding” pattern among private market players, resulting in dislocation of interbank and/or foreign exchange markets. We can, for instance, face a situation where some market participants hold reserve currencies but, for reasons such as perceived counterparty risk, are unwilling to lend them to other participants. In such circumstances, the monetary authority may need to step in to ensure market liquidity or provide some stabilizing actions. There were instances, at the height of the global financial crisis in late 2008-early 2009, when central banks stepped in to reduce volatility and improve liquidity in the foreign exchange market, either via direct FX auctions – this was the case, among others, in Brazil and India – or in the forward foreign exchange market via swap auctions, for instance in Korea.

Beyond protection against a “sudden stop” or reversal in portfolio inflows, central banks may equally wish to accumulate reserves as a protection against sizable currency appreciation, especially if they deem it out of sync with the country’s macro-economic fundamentals. In the current world of ample liquidity and “search for yield”, where international “push” factors like low interest rates can dominate the investment decision even while domestic “pull” factors may be weak, the risk of such disequilibria cannot be minimized. The policies followed recently in Switzerland and in the Czech Republic, where central banks accumulated reserves to enforce a cap on their exchange rate, bear testimony to this risk.

4 Challenges brought about by reserve accumulation

However, continued accumulation of reserves by a central bank does not come without challenges. If in decades past, the concern for policymakers was generally about an insufficient level of reserves, in recent times concerns can also be about the financial consequences of large reserve holdings, or indeed, about the uneven distribution of reserves holdings across the different emerging countries. Reserves accumulation typically comes at a cost, either through the cost of sterilization operations, or through an opportunity cost as liabilities on the central bank’s balance sheet could have been deployed in higher-yielding domestic assets. In fact, this gap between the yield on reserves and the sterilization cost is presently being compounded by the very low to negative returns generated by “traditional” reserve investments such as high-grade, low-duration government bonds. For example, an investor in German, French or Austrian government bonds will not obtain positive yields for maturities below three years, thereby undermining the original objective of capital preservation.

While this is a major challenge associated with reserves management, it is not the only one, and the panel of speakers scheduled to address this conference will guide us through some of the potential "pitfalls" awaiting reserve managers. We will hear later this morning about the outlook for US and European markets. This is a very topical subject as the present high valuation of most investment-grade fixed-income assets, a consequence of among others, elevated global liquidity, exposes portfolio managers to the risk of capital losses in the likely event of policy normalization by the world's major central banks. While one may argue that the continued presence of excess liquidity through central bank balance sheet expansion may keep a cap on long-dated bonds, higher policy rates in the US and UK will trigger a sell-off in short-dated bonds, and this is typically where foreign exchange reserves are invested. We will also hear about the current dangers of the geo-political environment, and this is another factor for reserve managers to consider as it may bring to an end the recent period of unusually low financial market volatility.

Another challenge may lie with the relative scarcity of high-quality assets, especially in view of the shrinking pool of AAA and AA+ rated securities, as this scarcity can distort the valuation of these securities. In turn, this may push reserve managers to look at lower rated assets, which in turn increases the credit risk in the portfolio.

Finally, we should not forget that many central banks still hold substantial amounts of gold as part of their reserves, making reserve holdings vulnerable to increased volatility in the price of the yellow metal, and the concomitant impact on central bank balance sheets. Further, if a sharp drop in the price is the cause of the volatility, it

presents a dual challenge for the gold exporting countries like South Africa, as not only may the value of gross reserves decline, but the trade account may equally deteriorate.

5. How can these challenges be addressed?

Some of these challenges will not go away, as they are linked to the very principle of reserves accumulation. But some of them can be mitigated, in particular with respect to the income loss resulting from low-yielding investments. Typically, there are two major ways for a reserves manager to increase returns, first by extending duration and second through diversifying into a broader range of assets. While the first approach, duration extension, would result in meaningful risk exposure ahead of an expected normalization of monetary policy in major economies, the latter has already been actively followed by some official reserve managers, and indeed, the remainder of the programme entails presentations on and around this topic.

The share of allocated reserves held in currencies other than the US dollar, the euro, the yen and pound sterling remains low, but at just above 7,0 per cent in June 2014 it has nearly trebled in the last five years. Amid these “new” currencies that central banks are investing in, particular mention should be made of the Chinese renmimbi, where investments by reserve managers should over time be facilitated by the growing international use of the currency and plans to gradually liberalise China’s capital account. Beyond currency diversification, central banks diversified into other financial instruments, such as mortgage-backed securities, and have also started to use derivatives to improve the efficiency of portfolio management and to assist in mitigating the risk of capital losses.

Admittedly, while diversification into a broader category of assets may help improve returns, it does not remove the risk of capital losses, especially in view of the likely normalization of major central banks' policy stances. A shift in asset allocation towards "riskier" instruments increases exposure to price volatility, which has been unusually low in recent quarters. At the same time, the influence of central bank quantitative easing programs on asset prices has tended to exacerbate the cross-correlation of financial assets. Thus, diversification may not necessarily reduce risk; rather, the reserve manager may be exposed to greater capital losses as the spread of higher-yielding assets relative to core assets also normalize from the present compressed levels. Consequently, such a market environment will require reserve managers to be "nimble" in the way they manage assets and allow tactical portfolio deviations from their benchmarks to try to reduce these losses through defensive strategies. Central banks, however, should guard against the temptation to use tactical strategies for enhancing returns, as the core mandate for managing reserves remains the preservation of capital.

6. Some words about the South African experience

I will conclude with a few words on our experience as reserve managers at the South African Reserve Bank. By international standards, South Africa's reserves are relatively low, at US$49,1 billion, equivalent to 15 per cent of GDP or about five months' worth of goods and services imports. While the Bank does not adhere to a "hard target" for the level of foreign exchange reserves, and always balances the benefits of reserve accumulation against its costs, it uses guidelines such as the IMF, Greenspan-Guidotti and Jeanne-Rancière

formulae, that currently indicate a desirability for a higher level of reserves. When a country's reserves are below one’s desired level, it necessitates a more conservative asset allocation, with the key focus remaining on capital preservation and liquidity, and enhancing returns must be subservient to these two objectives.

That said, prudence does not mean the absence of a sophisticated approach to reserves management. Addressing this same conference a year ago, the South African Reserve Bank’s Deputy Governor Daniel Mminele briefed the audience on some of the steps taken by the Bank to create a superior reserve and risk management operational platform, including a review of our custodial arrangements and a comprehensive systems renewal project. I am pleased to inform you of steady progress in the achievements of these two goals. The Bank has now finalized its decision on its new system architecture and systems service providers, and similarly, it has adopted a new custodian model and appointed a custodian. Both these projects are aimed at improving efficiency in business processes and the management of the reserves and reducing risk.

The next focus area for the reserves management team is to review our securities lending program. Historically, we have linked the securities lending activity with our custodian business, as it is convenient. However, there may be opportunities to exploit if the securities lending business is managed similar to a normal external fund management program, where an agent is appointed based on its product offering, and not simply by virtue of being the custodian.

The need for a prudent approach towards asset allocation has also not prevented the Reserve Bank from taking advantage of new

opportunities. In particular, with the new Strategic Asset Allocation that was rolled out in 2013, the Bank started for the first time to invest a portion of its reserves in the Chinese onshore bond market, and tomorrow my colleague Zafar Parker will share with you some of our experiences in that respect.

Increasing central bank access to Chinese assets, which up to recently was a fairly closed market, illustrates the opportunities offered by the changing international financial landscape. As the share of China and other large emerging markets in the world's economy grows, and as economic development makes these countries more willing to open up their capital markets, the range of assets which reserve managers are able to choose from in their asset allocation, is likely to increase.

Similarly, in the light of the shrinking AAA credit universe, central banks are forced to look at different investment vehicles. Admittedly, official reserves management will not be made easier by all these evolutions: Historically, the growth of "new" capital markets has typically been accompanied by elevated price volatility. But it seems equally clear that new challenges will breed new opportunities. We shall keenly await advice arising from this week's deliberations to help us manoeuvre through these murky waters.

I thank you.

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