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Keynote: The Changing Role of Sovereign Institutions

By
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It is a great pleasure being able to exchange views with you on such an important topic as the Changing Role of Sovereign Institutions in the management of international assets.

In my intervention, which I expect to be followed by questions and answers. I will present what I think may turn out to be a provocative proposition. In doing this I will somewhat force and simplify the argument in order to make it clearer. The questions and answers session could provide the opportunity to refine it and make it subtler.

My presentation will be organized in three sections. In the first section I will argue that the management of international assets by public institutions is normally torn between macroeconomic and investment objectives, with the former prevailing in advanced economies (AE) and the second more typical of emerging economies (EE). In the second section, which will probably be the most controversial, I will advance the proposition that the balance between macroeconomic and investment purposes is currently changing, especially as far as EE are concerned, with the former starting to prevail over the latter. This would imply that the style of managing official assets by EEs would move towards that of AE. In the third section, I will try and figure out what this change of emphasis could mean in practice for the management of international assets and for the global financial system overall.

Before I proceed with my three sections, let me make a methodological note: I will not distinguish, being aware of statistical limitations, between foreign reserves proper, held mostly by central banks, and the assets held by Sovereign Wealth Funds (SWF) and similar institutions. I find a broad concept more useful for the purpose of this speech, as both types of assets share the characteristic of being external assets under the ultimate control of the public sector. This is confirmed by the fact that often SWFs were created when reserves exceeded the level that was thought to be needed for macroeconomic purposes. Aptly, Nugee and Smith say that the transfer of part of the reserves to a SWF can be considered an extension of the tranching of reserves in different parts, with different degrees of liquidity. The broad definition of external assets I prefer is also consistent with the definition given by the IMF[2], according to which what is important is whether the funds can be used for macroeconomic policy purposes. In addition, the IMF reports that the statistical treatment of the assets held by SWF is not univocal and the dividing line between their assets and reserves is somewhat blurred[3].

I. The management of international official assets has been traditionally torn between investment and policy objectives.

[1] I wish to thank John Nugee for perspective comments to a first draft of this speech.

[2] *"Reserve assets are those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing."*

[3] *Some countries include their SWFs in reserves reporting to the Fund while others do not. The latter is usually the case when SWFs assets do not meet the definition of official reserves, but can be true also even if they would be liquid enough to be reserves."*

The IMF has a complex list of reasons why countries hold official international assets: “*Foreign exchange reserves have a central place in the policy tool kit of most economies. They are held for many different reasons, including to engender confidence in the national currency, counter disorderly market conditions, support the conduct of monetary policy, build assets for intergenerational purposes, or influence the exchange rate*.“ For the purpose of my presentation today, I prefer a simpler distinction: investment purposes vs. macroeconomic policy purposes. By investment purposes, I mean that the public sector holds and manages a part of the external wealth of the country to preserve it for the next generation or because of a view that it can do this better than the private sector (say because it has a longer time horizon). By macroeconomic policy purposes I mean that the management of the national economy requires, in certain conditions, the availability of foreign assets. The most obvious case is when it is seen useful to complement monetary policy with interventions in the foreign exchange market, but this is not the only possible case.

In my simplified approach, the investment motive is relatively stronger in the case of emerging economies while the macroeconomic policy motive is relatively stronger for advanced economies. Of course EE hold international assets also for macroeconomic purposes and AE hold them also for investment purposes, but the balance between the two objectives is, overall, different in the two cases. In a partially overlapping categorization, investment purposes are more important for SWFs while macroeconomic policy motives are more important for foreign exchange reserves narrowly defined. In the OMFIF-BNY report on collateral it is indeed mentioned that *:“ Sovereign funds, depending on the type and duration of trades, appear to be looking for higher returns than central banks,……”* .

Of course, there are important exceptions to these two categorizations: the Norwegian oil fund, i.e. the archetypal SWF, is indeed a clear case where assets are held with an investment motive, but Norway is obviously an advanced economy. In addition, central banks from AE have more tools than foreign assets to carry out macroeconomic policy moves when it comes to their external sector. This was demonstrated during the financial crisis that followed the demise of Lehman Brothers. When the ECB and other central banks in advanced economies needed dollars to provide them to their banks, which had been excluded from the currency swap market, they did not need to have recourse to their reserves: an agreement with the Fed provided them with in principle unlimited and in practice very large amounts of dollars through swap lines. Similarly, when the ECB intervened on the foreign exchange market at the end of the 1990s, when the euro was worth about 82 cents to the dollar, it was surely not limited by the amount of reserve it had: its partner central banks were willing to lend the international currencies it could have needed.

Let me add on this topic a little personal recollection. Nugee and Smith write that: “*Central bankers have found, when market sentiment turns negative, that the only correct answer to: How much reserves do we need?’ is More.’*[4] I believe this statement is generally true, but does not apply to the ECB, or to the FED for that matter: I never felt, in the long years when I was at the ECB, that we would have needed a larger amount than the relatively small one that we held. If anything, I felt we could have reduced the exchange risk derived from having still sizable dollar and yen assets.

What are the likely implications of the predominance of the macroeconomic over the investment purposes for the management of reserves? Again, simplifying, when assets are held for macroeconomic purposes I think they should have three dominant characteristics. First, their level should be relatively low, since the scenarios in which they would have to be used are unlikely to produce very large numbers. Establishing an upper limit in the case of investment purposes is, instead, much more difficult: when is it that external wealth become excessive? Second, there should be a concentration on globally relevant currencies, mostly dollars but also euros, as these are the currencies that can be really used for policy purposes. There can also be some role for other international currencies, say the Pound and the Yen, included in the SDR basket, but very little space for other currencies. Thirdly, there should be less instrument diversification, with an emphasis on bonds, as these are the most liquid instruments, which can be mobilized more quickly and more

[4] Gary Smith and John Nugée: The changing role of central bank foreign exchange reserves, OMFIF, September 2015.

smoothly in case of need. The specular characteristics should apply when assets are held for investment purposes: higher level and both more currency and instrument diversification.

Let me try and show that these broad characteristics do indeed prevail in practice by comparing the international assets of AE with those of EE, while recognizing that systematic statistics are somewhat insufficient and on some aspects I will have to rely on anecdotal information.

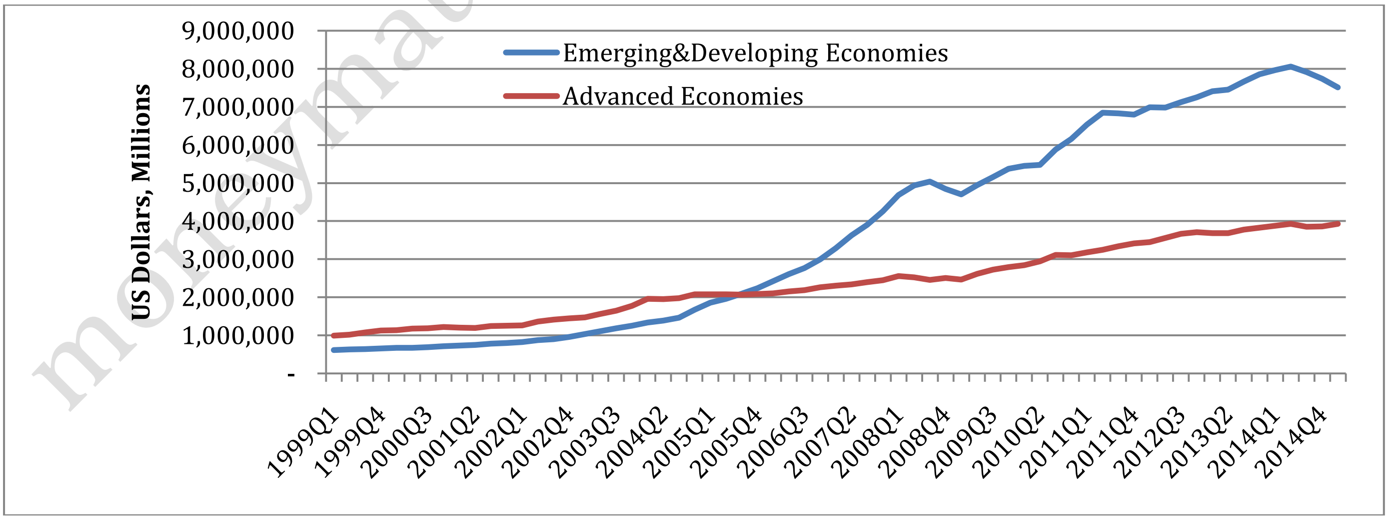
Let me start with the point about the level of reserves. Nugee and Smith provide in their interesting paper on foreign exchange reserves a table in which countries are ranked according to the size of their reserves. In the first 20 central banks by assets only Japan, Switzerland and Poland are AE, the other 17 are EE. And you do not find at all in the list the two largest central banks in the world: the FED and the ECB, which hold very small reserves relative to the size of the US and €-area economy. Indeed, as I have already alluded above, the FED and the ECB represent somewhat special cases, as they issue the only two genuinely global, reserve currencies.

The cases of Japan and Switzerland allow introducing an additional concept, also drawn from Nugee and Smith: the "unintentional build-up" of reserves. Indeed these two countries ended with their very large level of reserves not because of any desire to accumulate external assets but because of a by-product of their exchange policy, in particular the desire to limit the appreciation of their currency. In a way, their story confirms the prevalence of the macroeconomic purpose in the management of international assets by AE: reserves were accumulated following their intervention policy, which was in turn a complement of their monetary policy. While the Swiss and the Japanese cases clearly belong to the "unintentional build-up" category, they are not alone in that category. I would definitely add to it China and other countries that accepted the reserves increase as the inevitable consequence of exchange rate policies choices that did not really consider whether one or the other level of reserves was right.

Let me give another statistical indication of the fact that AE, which hold international assets more for macroeconomic than investment purposes, hold a lower level of them.

As can be seen in Chart 1, in the second quarter of 2014, when a peak in the holding of reserves was reached, EE held 8 trillion dollar of reserves, twice as much as AE, but their aggregate GDP

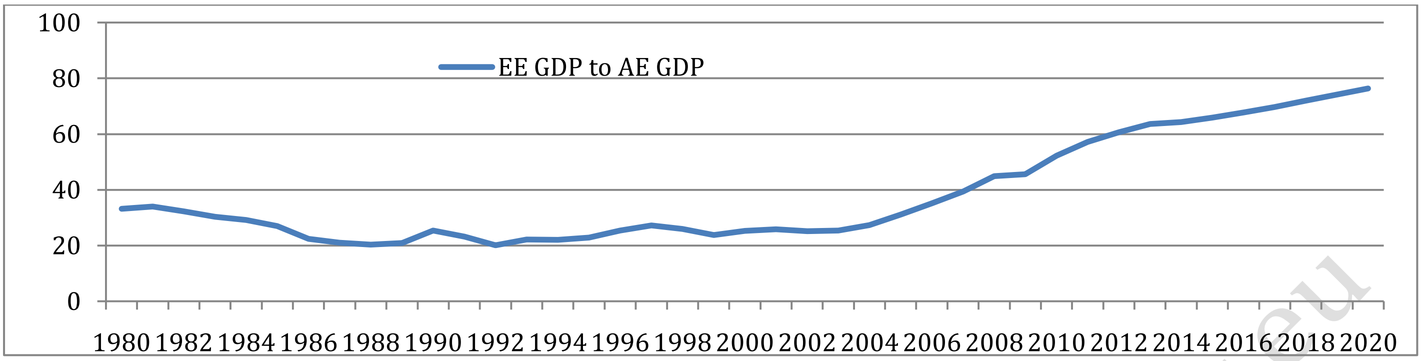
Chart 1. International reserves held by Advanced and Emerging economies.



Source: COFER

was only approximately 65 per cent of that of advanced economies, as can be seen in Chart 2.

Chart 2. Ratio of Emerging Economies (EE) to Advanced Economies (AE) GDP



As regards currency diversification, the state of statistical information is pretty poor because some countries, and in particular China, do not communicate to the IMF the composition of their reserves. Indeed we find that, again in the second quarter of 2014, only about one third of the reserves of emerging economies were allocated to a specific currency. Let me note en passant, that the insufficient information from China in this respect, even after the progress recently achieved, is inconsistent with the desire to make the renminbi an international currency and have it included in the SDR basket.

While taking duly into account this limited information, the available statistics in table 1 show that AE

Table 1. International reserves. Share of global currencies, in per cent.

	World		Advanced Economies		Emerging Economies	
Year	Ratio 1	Ratio2	Ratio 1	Ratio2	Ratio 1	Ratio2
1999Q1	89.31	98.09	88.47	98.09	91.54	98.08
2014Q2	84.85	92.74	85.80	93.63	83.67	91.64
2015Q1	84.94	93.05	86.20	94.06	83.23	91.66

Source:COFER

Note: Ratio1= share of EUR,and USD reserves of total reserves
Ratio2= share of EUR,USD, GBP, JPY reserves of total reserves

concentrate their reserves more on the global currencies, and in particular dollar and euro, than the EE, even if the difference is not large. The table also shows that this difference developed over the last 15 years or so, i.e. just when the level of reserves held by EE was rising: in 1999 EE had 92 per cent of their reserves invested in dollars and euro, in 2015Q1 this had come down by about 10 percentage points to 82 per cent. The diversification of reserves by AE was much less profound, as the share dedicated to the dollar and the euro came only down by 4 percentage points from 89 to 85 per cent.

I am not aware of systematic statistics on the instrument composition of international assets. All the anecdotal information that I have collected in my long years as central banker tells me, however, that AE have more plain vanilla instruments, in particular straight bonds, than EEs.

So to summarize, AE, which hold international assets more for macroeconomic policy than for investment purposes, indeed have a lower amount of foreign assets, which are more heavily concentrated in dollars and euros and in plain vanilla instruments. Symmetrically, EE, which give a greater weight to investment purposes, hold higher level of reserves, less concentrated on global currencies and with a richer variety of instruments.

Before you do, let me admit that I accept that I may be biased in my analysis by my long experience as central banker first in an AE and then at the ECB, issuing the second most important global currency. If indeed this is what you feel, the questions and answers question will be an occasion to elaborate on this point.

II. In current conditions the macroeconomic objectives are gaining in importance over the investment objectives.

Currently two strong developments are impacting the management of international assets, in particular by EE: the sharp and sustained fall in raw material prices and the downward pressure on their exchange rates, combined with capital outflows in EE, as recently documented by the IIF.

Table 2. Changing economic conditions in Emerging Economies.

Indicator	12 month Change
Net flows EE (*)	-287 USD bn
Exchange rates (**)	-12.0 %
Goldman Sachs Commodity Index (CME)	-37.4%

(*) 2014 vs 2013, IIF data
(**)Average of YTD change of CNY, BRL, SAR, KRW, RUB against the dollar.
Source: IIF, Reuters

The fall in commodities, in particular oil, has a direct impact on the international assets of commodities producing countries, as it reduces the revenue from selling these goods on the international market, worsening the current account balance and thus reducing external assets. The shrinking pool of foreign assets reduces, in turn, the degree of freedom in managing them. After an initial impact on the most liquid tranches of these assets from interventions to support the currency, there is likely to be a reallocation away from the less liquid, higher return, more diversified assets towards the more plain vanilla, lower return and global currencies assets. The process whereby the growing reserves that were not needed for macroeconomic purposes were placed in less liquid, more diversified tranches, including in SWF, could, to an extent, be reversed.

The downward pressure on exchange rates is already pushing some EEs, in particular we read a lot about China in this respect, to intervene in the foreign exchange market and thus contain the depreciation of their currency. This is another factor reducing the overall level of reserves and arguably pushing their instrument and currency composition towards a more conservative approach: high yielding but illiquid assets are of little value when you want to intervene on the foreign exchange market. The pressure is arguably increased by the prospect of a rate increase by the FED.

There is already a sign of an incipient reduction of the size of reserves as reported by the IMF COFER: between the peak, reached in the second quarter of 2014, and the first quarter of this year, the last data point for which the split between AE and EE is available, world reserves have come down from 12 to 11.4 trillion dollars and the decrease has all been in EE, whose reserves have come down from 8.1 to 7.5 trillion dollars (see chart 1). More recent, non-systematic information tells us that the reduction has continued in the last two quarters possibly at quicker pace.

There is no evidence as yet, instead, of a reallocation of reserves of EE towards the dollar and the euro, as the total share of these two countries has remained at 83% of the total. This is not surprising, however, as it probably results from a decrease of assets in dollars and euros to fund interventions, followed by a gradual reallocation towards these two currencies to replenish the reserves that can be used for macroeconomic purposes, and in particular interventions.

In conclusion, my contention is that the approach in the management of international assets of EE is moving towards that of AE, in which the macroeconomic purpose prevails over the investment one. You may find this conclusion controversial and, of course, I would like to discuss it with you, also because it may have wide financial and economic repercussions, as I would advance in my next section.

III. What are the implications of the growing importance of the macroeconomic objectives?

If my hypothesis, admittedly only partially supported by hard data so far, is right, then we should continue to see, as a first implication, the reduction of the reserves of EEs. This could give rise, in some extreme cases, to a negative spiral: the decrease of reserves could be taken as a weakening of the relevant financial position of the country, which could, in turn, further weaken the exchange rate and require more interventions and so on. Let me be clear, I do not regard this kind of event as either necessary or as having a high probability, but the risk is, in my view, there.

I tend, instead, to regard as unlikely that, as argued by some observers, the reduction of reserves by EE would have a **persistent** effect, analogous in size, but in the opposite direction, as that of QE policies by AE central banks. The reason for this is that, as I will argue in a minute, the reduction of reserves should affect, after an initial period, more alternative assets and non-global currencies than the bonds denominated in global currencies. But these are exactly the assets that are purchased by AE central banks and have global effects, so the two policy actions would display their direct effects, at least after an initial period, in different markets. In addition the portfolio balance effect could, over time, be reinforced by sales of non-bond/non-global-currencies assets by EE. So, I tend to see negative short-term effects on globally relevant bonds, and in particular treasuries, from the initial sale of liquid assets but positive medium and long term effects from the re-composition of assets towards global bonds.

The second implication, as I already hinted, is that EE countries are likely to gradually move the composition of their reserves towards global currencies, in particular the dollar, but also to some extent the euro, and away from other currencies, in particular the less international ones. I expect, in particular, something of a dampening of enthusiasm for investing in renminbi, even if I am aware that there is not even anecdotal evidence of this as yet. In theory, the move away from the renminbi and other currencies that in

COFER statistics are reported as “Claims in other currencies” could exercise a further downward effect on them. In practice, however, I do not expect this effect to be relevant, as the amounts of investment in these currencies have been very limited so far and possible disinvestments should not reach a significant size (in the first quarter of 2015 the reserves invested in “other currencies” were limited to about 100 billion dollars, i.e less than 1% of the total).

Finally, I also expect, as I have also mentioned above, that there will be a move away from alternative assets and equities towards bonds, in particular the most liquid of them. Treasuries could be, eventually, the particular winner in this reallocation. The effect on Treasury yields will thus result, over the medium term, from the net effect between two opposite developments: on one hand the reduction of reserves that, to some extent, will necessarily also affect treasuries, and, on the other hand, the concentration of the lower level of reserves in this asset. There may also be similar forces affecting bund, OAT and Gilt yields, in particular, among European securities, but I do not expect, however, a large effect there, as I think that the use of the euro for intervention purposes would be more limited and, over time, the move into German, French or UK paper not very sizeable.

Also the Repo and collateral management market may be affected by the changes I see coming. I have read the interesting OMFIF-BNY Mellon Report on collateral held by official institutions and its main emphasis, correctly so far, is about the “securities lending” side of the collateral management, seen as a nice return top-up to currently meagre returns. If my hypothesis is right, and EE will indeed move towards the management style of AE, it is the liquidation side of the repo market that will become more important. In the move towards making international assets more usable for macroeconomic policy purposes, official institutions, and particularly central banks, may repo out their assets in order to have liquidity for their policy actions, in particular interventions.

Conclusions

Let me summarize my arguments.

While the management of international reserves has been torn between investment and policy purposes, with the former prevailing in EE and the latter dominating in AE, I see current developments reinforcing the policy purposes, especially in EE.

This shift of emphasis will bring, indeed is already bringing, a reduction of reserves by EE and, after an initial period, a concentration of assets towards global currencies (in particular the dollar) and plain vanilla instruments (in particular bonds), away from non-global currencies and alternative investments.

The effects on the financial market will be the result of contrasting forces. I do not expect, however, the reduction of reserves to act as a strong counter effect to AE QE, because of the trend concentration of the lower level of reserves into global currencies, in particular the dollar.

Finally, the repo market will be used by reserve managers more to liquidate assets than to top-up returns.