Strategic Asset-Liability Allocation for Foreign Exchange Reserves

Some Comments

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Summary of Paper

- Problem
  - Central banks need to decide what assets to hold in their reserves

- Objectives
  - Maximize return
  - Hedge liabilities
  - Preserve capital

- Paper provides a framework for making this decision

- Concludes that in the case of Chile portfolio should include Asia-Pacific government bonds, European bonds, and US treasuries
What is the framework?
Why should we care?
Past: a non-issue

- Central banks have been money-making machines
  - Hold interest-earning assets (fx reserves)
  - Print non-interest bearing liabilities (currency)

- Investment rule:
  - No need to worry about returns
  - Keep reserves in safe, liquid assets = US Treasuries
What’s changed?
Answer: Growing Asset-Liability Mismatch in EM’s
Asset/Liability Problem

- Central banks hold foreign exchange reserves
- When they purchase fx, sell bonds ("sterilise")
- Prevents inflation, but creates currency mismatch
- Mismatch can lead to two problems
  - Valuation losses
  - Negative net interest income
Early 2000s: Growing Reserves

India: Reserves Excluding Gold
(Billions of US dollars)
Early 2000s: Valuation Losses

Rupee/Dollar Exchange Rate
Last Decade: Negative Net Interest Income

India/US Interest Rate Differential (10-year government securities)
Doom Loop

- High interest rates attract capital inflows, create appreciation pressure

- Central bank decision
  - Allow appreciation
  - Intervene

- Consequence of appreciation
  - Loss of competitiveness
  - Valuation loss

- Consequences of intervention
  - Reserves increase
  - Lose more money from yield gap
  - Exchange rate “guarantee” attracts more inflows
Income imperative

- Central banks have been paying more attention to bottom line

- Many have divided reserves into three tranches:
  - Safety
  - Investment
  - Intermediate
Key recommendation: diversify away from US dollars

Conventional view: many have made the same recommendation over the past decade

But central banks haven’t listened

Chile still holds two-thirds of its reserves in dollars

Why?
Evaluating Paper/2

- Unclear whether recommendations are truly robust
- Different models employed give very different results
- System used to rank models is not explained clearly
Paper recognises that reserves are used for three important roles:
- Fx intervention
- Lender of last resort in fx
- Bank bailouts

First two objectives met most efficiently by holding dollar assets:
- Asia-Pacific bonds would need to be sold for dollars, then converted to pesos
- After GFC there was a “dollar shortage”

Can paper be extended to take the special role of the USD into account?
Thank you!