Strategic Asset-Liability Allocation for Foreign Exchange Reserves

Some Comments

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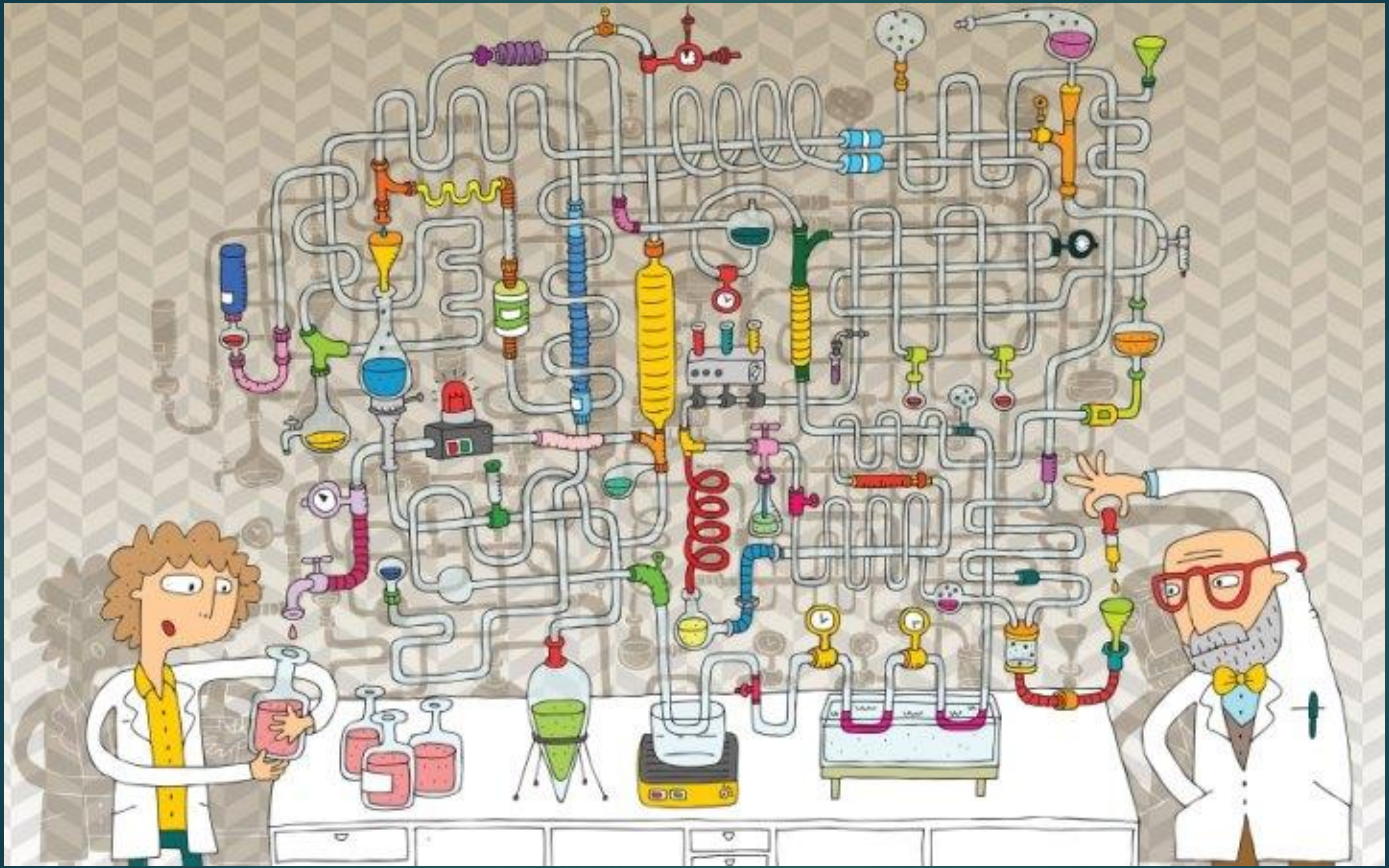
DECEMBER 18, 2017

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

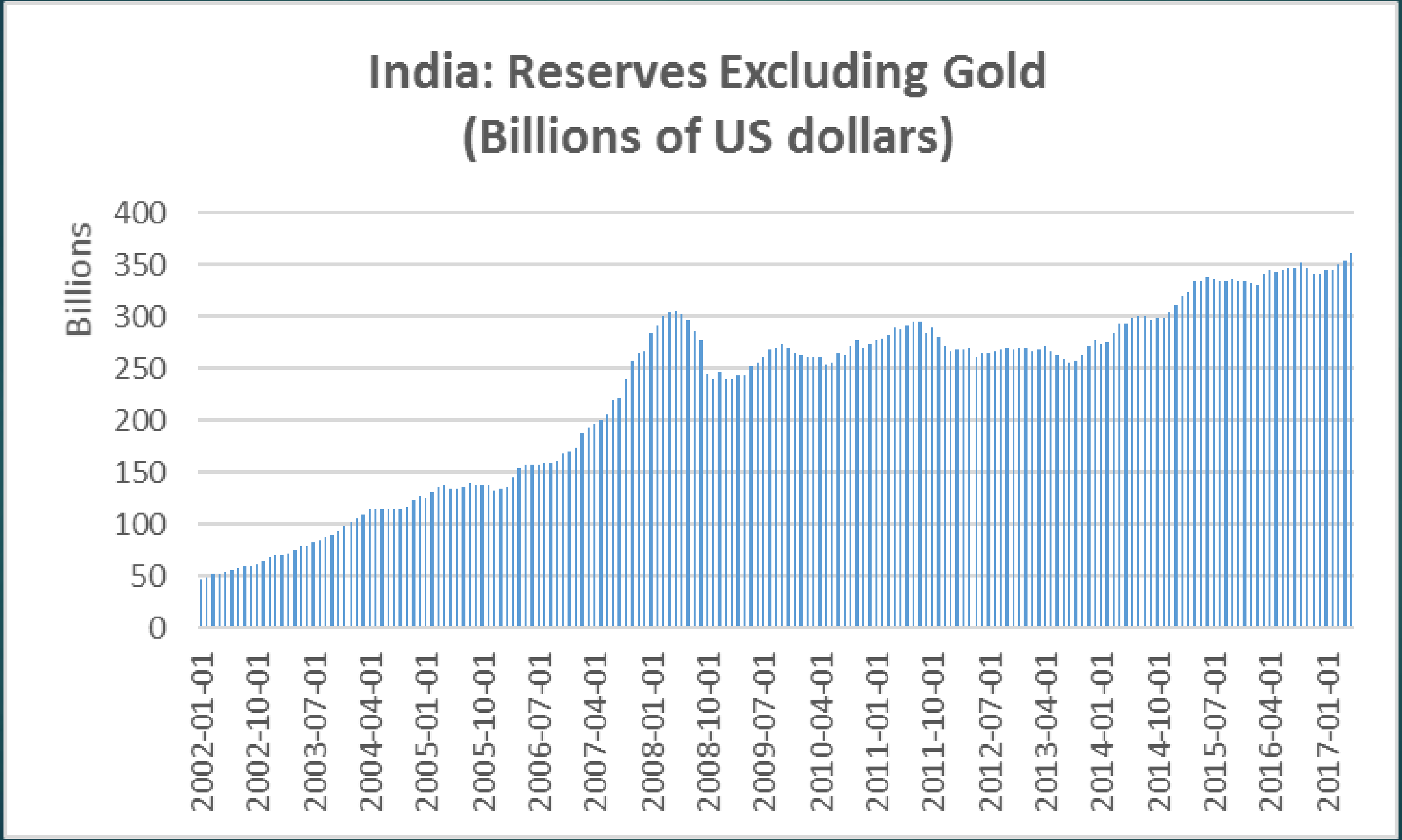
- What’s changed?

- Answer: Growing Asset-Liability Mismatch in EM’s

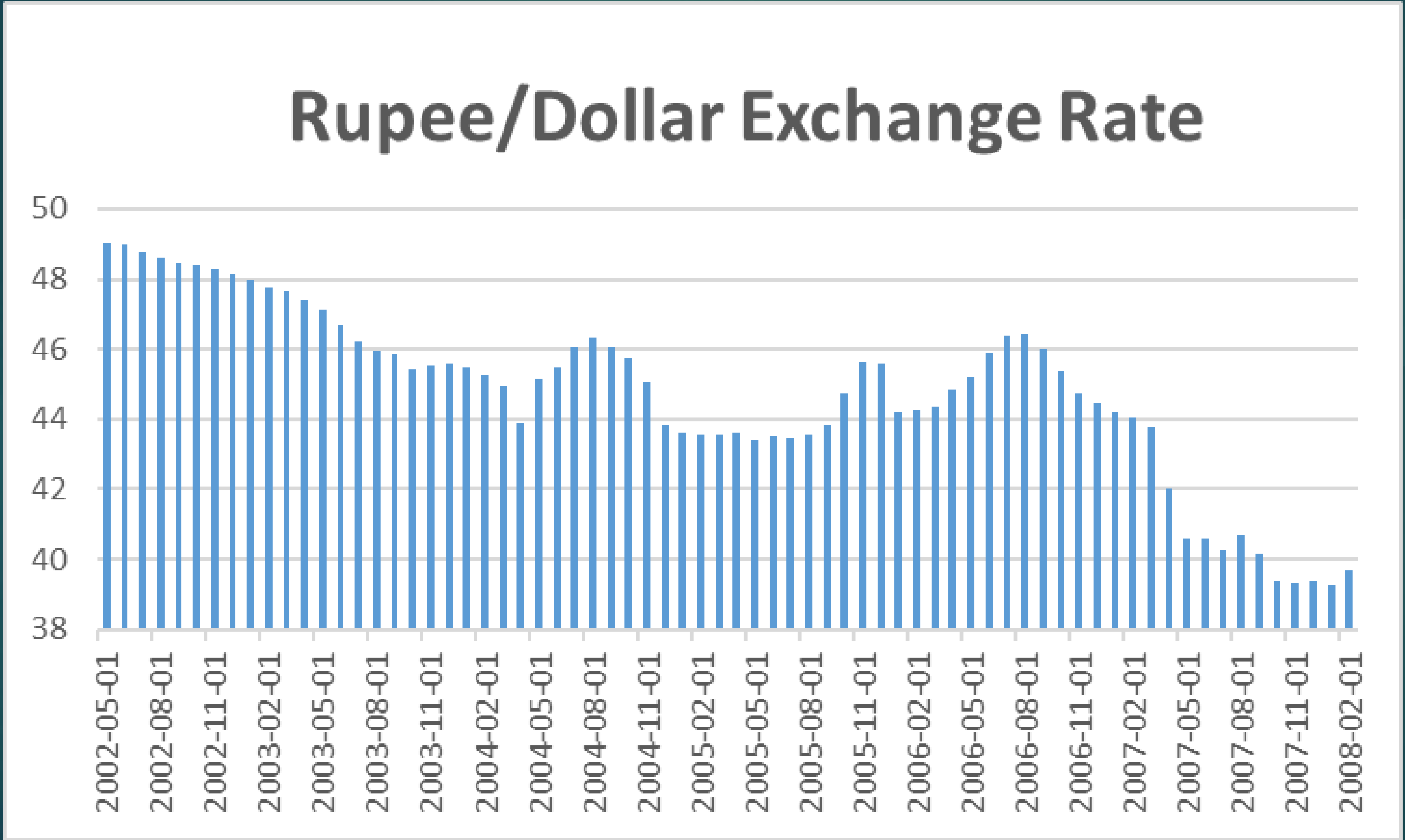
Asset/Liability Problem

- 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

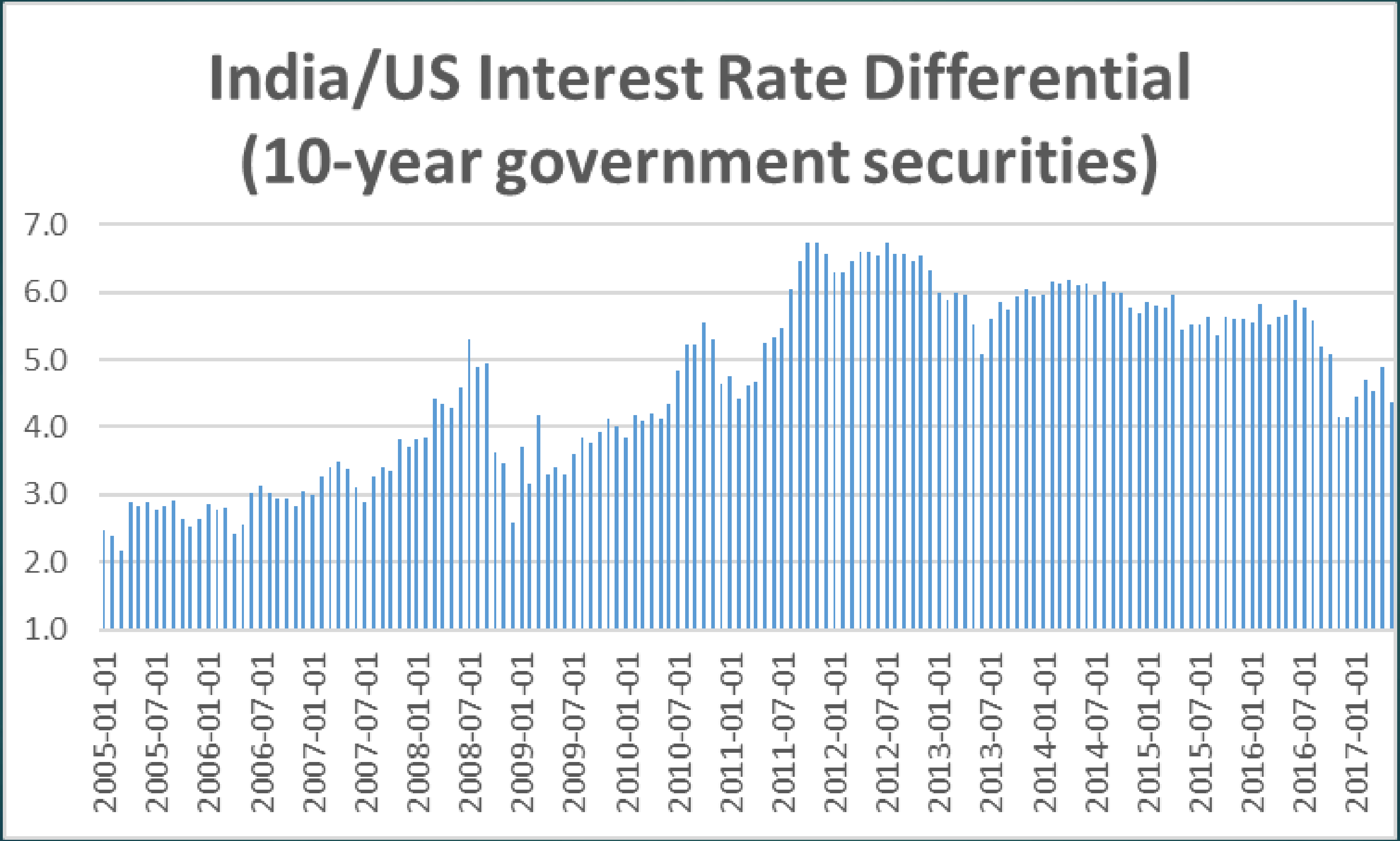
Early 2000s: Growing Reserves



Early 2000s: Valuation Losses



Last Decade: Negative Net Interest Income



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

Evaluating Paper/1

- 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

Evaluating Paper/3

- 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!