EXECUTIVE SUMMARY

MANAGING RESERVES IN A WORLD TURNED UPSIDE DOWN

Faced with a rapidly changing environment, most central banks plan to sit tight – at least for now.

FOR the past year or so, monetary policy-makers have been trying to convince markets that the return of inflation is transitory. It's not a line that their central bank counterparts in the reserves management divisions are buying any more, if they ever did.

More than 75% of central bank reserves managers surveyed by OMFIF for the 2022 edition of Global Public Investor believe inflation will either remain sustainably higher or at least be more volatile. Just 20% think it will relatively quickly return to the low 2010-19 average.

Coming alongside the rise in concerns about geopolitics, largely (but not exclusively) driven by Russia's invasion of Ukraine, the investment world has been turned on its head. And this presents a wide set of challenges for the people running the reserves of the world's central banks.

It's worth remembering that many investors (and policy-makers) have little experience of coping with inflation, which was last an issue in most developed economies 30 years ago. And that most reserves managers have mandates that restrict their ability to invest in a broad array of asset classes which could help them hedge against inflation.

Government and quasi-government bonds make up close to 50% of overall portfolios. Cash (which includes short-term money market instruments) is the next highest component, at 17%, although 25% of respondents plan to reduce their cash holdings over the next 12-24 months. Gold – a potential hedge against inflation – is at just under 10%.

> **THERE IS NO DOUBT THINGS HAVE MOVED FAST: IN LAST YEAR'S GPI, INFLATION WASN'T EVEN CONSIDERED A FACTOR IN THEIR DECISION MAKING.**

IT'S WORTH REMEMBERING THAT MANY INVESTORS (AND POLICY-MAKERS) HAVE LITTLE EXPERIENCE OF COPING WITH INFLATION, WHICH WAS LAST AN ISSUE IN MOST DEVELOPED ECONOMIES 30 YEARS AGO.

Equities, to which a small but growing number of central banks began allocating in an effort to boost returns in the lower-for-longer rate environment, remains at just 3% of overall portfolios.

Now, of course, lower is no longer. Inflation is rising, although hikes in interest rates so far have been relatively contained. The issue for many reserves managers is the level of real interest rates, which are now running as low as -7% in some markets. Those with exposure to equities are also absorbing losses as stock markets take fright at the prospect of stagflation.

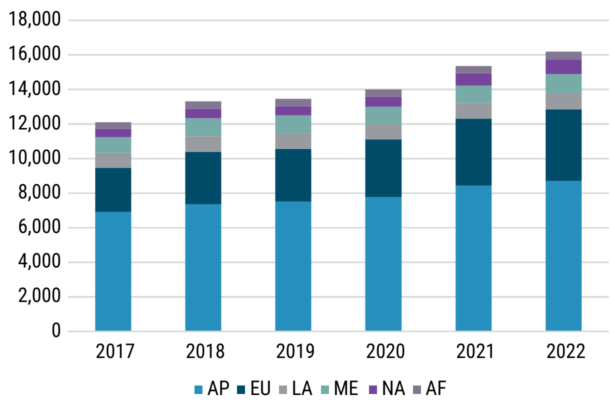
Reserves management is a slow-moving business. It can take up to two years to effect a fundamental change in investment approach, such as incorporating a new asset class. That makes it harder still to adapt to sudden changes in the market environment. And there is no doubt things have moved fast: in last year's GPI, inflation wasn't even considered a factor in their decision-making.

Most reserves managers are sitting tight, preserving capital and increasing liquidity in their portfolios. Just over half of the 73 central banks that completed our survey say the macro environment will prompt them to become more active, albeit mostly around the edges – for example, shortening duration of fixed-income holdings or moving into slightly higher-yielding safe assets, such as supranational bonds or asset-backed securities.

Meanwhile, reserve assets have continued to grow globally (Figure 1) reaching a new record of $16.2tn, representing growth of more than 20% since 2019. The vast majority of that growth continues to come from a combination of Asia Pacific, where growing economies are accumulating reserves, and from Europe, via central bank quantitative easing. Europe's reserves have grown by 62% since 2017, but at $4.15tn are still less than half those in Asia. But Asia's dominance of global reserve assets is declining (Figure 2).

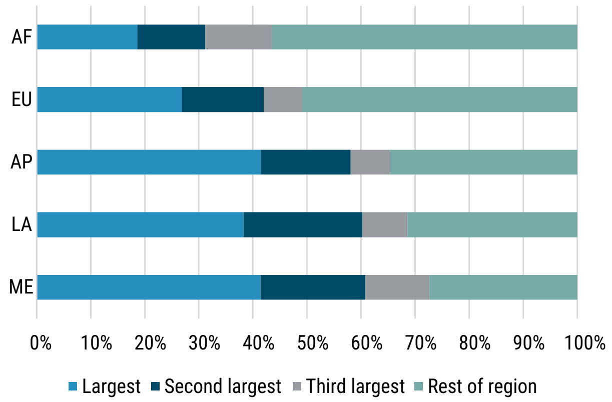
Total reserve assets as a percentage of global gross domestic product have fallen back almost to pre-pandemic levels as extraordinary central bank intervention continued, coinciding with the revival of GDP after the pandemic-related economic shocks of 2020-21 (Figure 3). Concentration of assets

1. CENTRAL BANK RESERVES REACH NEW HEIGHTS, DRIVEN BY EUROPE AND ASIA
Global reserve assets, $bn



Source: International Monetary Fund

2. DISPARITIES IN RESERVES BOTH BETWEEN AND WITHIN REGIONS
Concentration of central bank reserves by region, %



Source: International Monetary Fund

46.5%
proportion of global reserves held by five largest central banks (China, Japan, Switzerland, US, India)

63%
cite insufficient data or information as a major barrier to adopting or integrating ESG into their portfolios

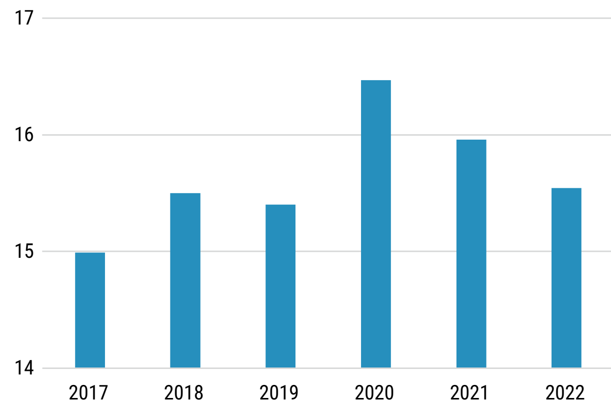
60%
believe that successful reserves management is critical to a central bank's public reputation

58%
of central banks excluding Asia Pacific believe inflation will remain sustainably higher

90%+
cite capital preservation and ensuring liquidity as their top two investment priorities

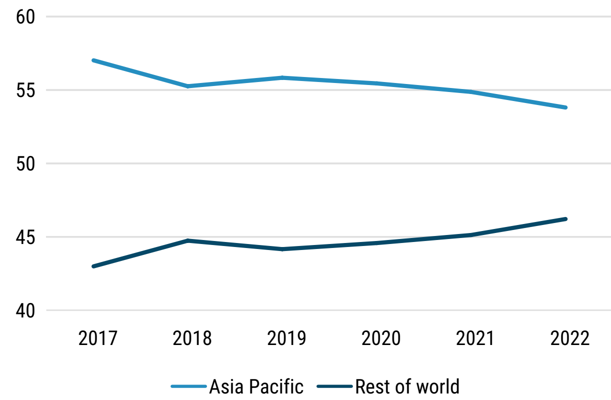
31%
of reserves managers plan to increase holdings of renminbi over the next 12-24 months

3. RESERVE RATIOS RETURNING TO PRE-PANDEMIC LEVELS
Global reserve assets, % of GDP



Source: International Monetary Fund

4. ASIA PACIFIC'S DOMINANCE OF GLOBAL RESERVE ASSETS LESS PRONOUNCED
Share of global reserve assets, %



Source: International Monetary Fund

86%
consider inflation to be one of the key factors affecting reserves management

$16.2tn
Total reserve assets under management of 171 global central banks

73
Survey respondents

41%
of survey respondents now own sustainable fixed-income assets other than green bonds, such as social, transition, blue or SDG bonds

57%
of total portfolios are held in dollars

33.6%
rise in global reserve assets since 2017

9%
of total portfolios are invested in emerging markets

TOTAL RESERVE ASSETS AS A PERCENTAGE OF GLOBAL GROSS DOMESTIC PRODUCT HAVE FALLEN BACK ALMOST TO PRE-PANDEMIC LEVELS AS EXTRAORDINARY CENTRAL BANK INTERVENTION CONTINUED, COINCIDING WITH THE REVIVAL OF GDP AFTER THE PANDEMIC-RELATED ECONOMIC SHOCKS OF 2020-21.

(Figure 4) continues to vary by region, with the top three central banks accounting for more than 73% in the Middle East (the highest by region) and 43% in Africa (the lowest).

In addition to traditional questions about asset allocation, future investment plans and the macro environment, this year's GPI includes a detailed focus on a number of specific areas.

CHINA: More than 30% of reserves managers plan to increase their holdings of renminbi assets in the next two years. Around 85% of them already own Chinese government bonds. Geopolitical concerns, poor market infrastructure and difficulties accessing the market for foreign investors are the main reasons for not allocating more to renminbi assets.

EXTERNAL MANAGERS: Globally, 12.6% of reserve assets are overseen by external managers. The highest region is Latin America, at 24%, and the lowest is Europe at 5.8%. Knowledge transfer – or learning how to manage new or complex asset classes internally – is the most popular reason for using external managers (85% of respondents).

EXCHANGE-TRADED FUNDS: In total, 0.98% of reserves managers' portfolios are invested in ETFs. Asia is the region which most uses ETFs, at 2.15% of assets under management. Some 18% of central banks plan to increase use of ETFs in the next 12-24 months.

SOCIAL BONDS: This year saw a steep rise in holdings of sustainable fixed-income assets other than green bonds (41% of respondents, up from 8%). Social bonds are of particular interest to reserves managers, with 66% of respondents saying they already own or plan to invest in this asset type.

Around 60% of survey respondents said that successful reserves management is crucial to a central bank's reputation. Getting the calls right over the likely turmoil in global financial markets over the coming years could, perhaps, help to offset the negative view that their colleagues in monetary policy have let the inflation genie out of the bottle, and are struggling to control it. •