



RESERVES MANAGERS FACE TOUGH NEW PARADIGM

Heightened volatility, risk and uncertainty. The return of inflation. Another economic slowdown. The macroeconomic environment for central bank investors has been upended. By Neil Williams and Taylor Pearce.

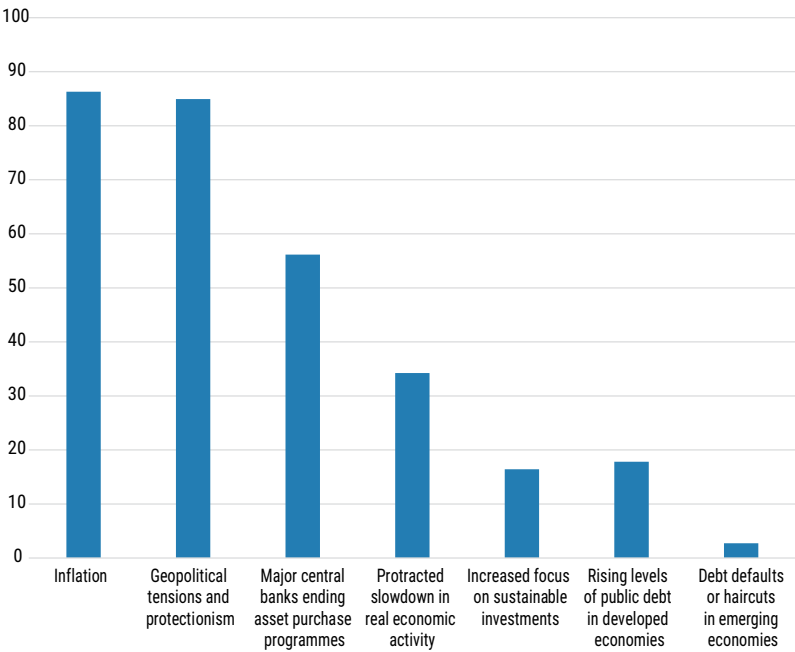
A year ago, the central theme of OMFIF's annual Global Public Investor was GPIs' continued drive towards portfolio diversification in a lower-for-longer interest rate environment. Last year, 76% of reserves managers listed major central banks moving further into negative rate territory as a primary concern, while only 16% reported geopolitical tensions and protectionism as one of the most important channels affecting reserves management. Inflation was not yet a major concern for most.

This year's findings could not be more different. Even before the Russian invasion of Ukraine, winding down pandemic emergency measures and prolonged supply chain disruptions posed daunting challenges for policy-makers. And yet, before markets had fully recovered from



1. INFLATION AND GEOPOLITICAL TENSIONS DOMINANT FACTORS AFFECTING RESERVES MANAGEMENT

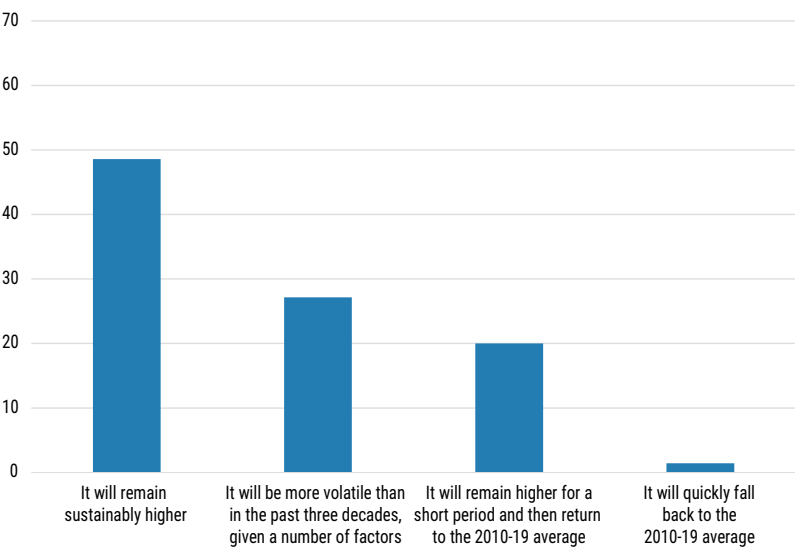
What do you see as the most important factors affecting reserves managers in the current economic environment? Share of respondents, %



Source: OMFIF GPI survey 2022

2. HIGH, VOLATILE INFLATION EXPECTED OVER SHORT TERM

How do you anticipate the rate of inflation will evolve across most major economies over the next 24 months? Share of respondents, %



Source: OMFIF GPI survey 2022

90%

still see Covid-19 as a major driver of economic activity

57%

of reserves managers do not believe central banks' monetary policy should be actively reconsidered

49%

of respondents expect inflation to remain high over next two years

20%

of respondents expect inflation to return to pre-Covid-19 levels over next two years

the ‘once-in-a-lifetime’ pandemic shock, they were thrust into a new paradigm – one of exponentially heightened volatility, risk and uncertainty. Skyrocketing commodity and energy prices stemming from the war in Ukraine have led to the highest inflation rates in a generation in most major economies. Swift and decisive sanctions from the West led Russia to become a pariah of global financial markets and payment systems overnight, further fragmenting the global economy.

As a result, central bank reserves managers are preparing for an environment of rising inflation and geopolitical risk. Higher inflation is expected by most, with a significant share appearing to expect stagflation.

Our survey findings suggest that, by far, the bulk of respondents consider inflation (86%) and geopolitical tensions (85%) to be the dominant factors affecting their operations (Figure 1). Across all regions, the majority expects inflation to remain high (49%) and/or volatile (27%) over the coming two years. This is consistent with the forecast horizon of most central bank interest rate setters. Within that time, though, more than 20% expect it to return to the pre-Covid-19 levels (Figure 2).

We found considerable regional divergence on inflation expectations, specifically between Asia and the rest of the world. While 60% of reserves mangers in the Asia Pacific region anticipate inflation in 2023-24 being more volatile than in the past three decades, only 18% of respondents from the rest of the world expected such prolonged volatility. Furthermore, while only 13% of respondents in Asia Pacific predicted that inflation will remain sustainably higher, 58% of respondents from other regions expected heightened inflation to remain over the short term. This most likely reflects the region’s calmer economic waters and relative detachment from the war in Ukraine.

Consistent with heightened inflation expectations are respondents’ other concerns of a protracted growth slowdown, partly as a legacy of Covid-19 – 90% still see the pandemic as a major driver of economic activity.

In the current monetary tightening cycle (rate rises, the end of quantitative easing and moves towards active quantitative tightening), this is understandable. As is the fact that, with

these processes underway and new factors in play (notably the war in Ukraine), the influence of monetary policy in the macro environment is considered slightly weaker than it was last year. The percentage of respondents who reported that monetary policy is having an excessive influence on financial markets and pricing fell to 64% this year from 75% in 2021 (Figure 3). There is debate as to how severe overheating might be: further policy tightening is anticipated, but this suggests it may be no more, and possibly less, restrictive than money markets expect.

Correspondingly, 55% of respondents highlighted ‘major central banks ending asset purchasing programmes’ as one of the most important factors affecting reserves management (Figure 1). Sentiments surrounding QE were mixed, with some more critical than others. One respondent commented that QE was ‘creating price bubbles’, with another maintaining that ‘the level of intervention within the market by major central banks (pumping cash into financial systems) has led to overpricing of some financial instruments.’

Others, while still insisting that QE should be reconsidered, remain more sanguine. ‘Huge monetary stimuli adopted during the global financial crisis and Covid-19 pandemic have inevitably influenced the cost of money significantly,’ one commented, emphasising that ‘gradual exits from such policies affect the financial markets markedly as expected.’ Another respondent remained confident that ‘the influence of monetary policy will wane as conditions normalise.’

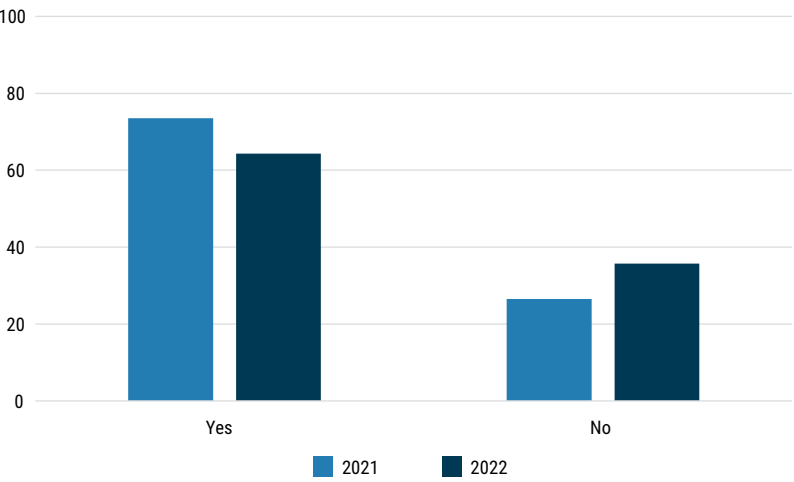
Despite sentiment that monetary policy is having an excessive influence on markets and pricing, the majority of reserves managers do not believe central banks’ monetary policy should be actively reconsidered (Figure 4). This is similar to last year’s share, decreasing by only three percentage points (from 58% in 2021).

Respondents’ comments back this up. One maintained that this influence is ‘inevitable, given the unpredictable impact of Covid-19, inflation, geopolitical tensions and other factors have had on economies and the need for interventions.’ Another noted, ‘Although it can be reconsidered to minimise the volatility it may create, it seems hard to remove such influence totally.’

Given these emerging themes, for those affected there is acceptance that little can usefully be done to break the link between monetary policy announcements and market reaction – especially given QE – such that current arrangements should not be reconsidered. In tandem, these factors are contributing to an increasingly complex macro environment, as policy-makers and market practitioners enter uncharted territory. •

3. INFLUENCE OF MONETARY POLICY CONSIDERED SLIGHTLY WEAKER THAN LAST YEAR

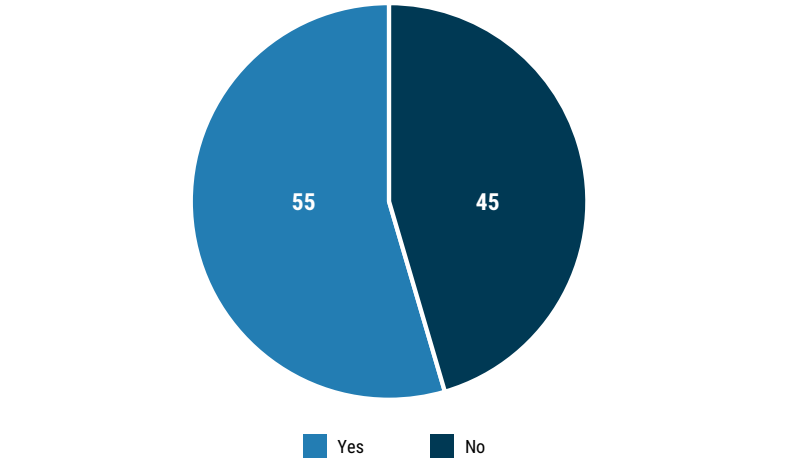
Do you believe that monetary policy is now having an excessive influence on financial markets and pricing? Share of respondents, %



Source: OMFIF GPI survey 2021-22

4. AMBIGUITY ON WHETHER CURRENT MONETARY ARRANGEMENTS SHOULD BE RECONSIDERED

Do you believe that monetary policy needs to be actively reconsidered to remove this influence? Share of respondents, %



Source: OMFIF GPI survey 2022



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CENTRAL BANK RESERVES MANAGERS ARE PREPARING FOR AN ENVIRONMENT OF RISING INFLATION AND GEOPOLITICAL RISK. HIGHER INFLATION IS EXPECTED BY MOST, WITH A SIGNIFICANT SHARE APPEARING TO EXPECT STAGFLATION.