Entering a new paradigm in central bank reserve management

Tue, Jul 23, 2024 2:47PM 33:24

SUMMARY KEYWORDS

central banks, diversification, reserve, rmb, survey, fixed income, geopolitics, year, respondents, geopolitical, managers, inflation, dollar, factor, monetary policy, interest rate, asset class, previous regime, impact, important

SPEAKERS

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00:00

You're listening to the ONVIF podcast, the show that explores the latest insights and discussions on global finance, economics, and policy for people who love staying informed about the rapidly evolving landscape of the financial world. Join us as we break down complex topics, interview key thought leaders, and provide essential insights to keep you informed about the evolving world of finance. Hello,

T Taylor Pearce 00:24

Hello, and welcome to OMFIF Podcast. I'm Taylor Pearce, lead economist of OMFIF's economic and monetary policy institute. Here with me today is Dr. Max Castelli, head of strategy, sovereign institutions at UBS asset management, and Phillip Solomon also on the team at UBS. We'll be discussing their recent event and publication on the investment outlook for central bank reserve managers and the factors influencing our investment decisions in the current macro environment. Thank you for joining Max and Philip. It's a pleasure to have you.

M Max Castelli 00:56

Thank you very much our pleasure.

T Taylor Pearce 00:59

This year, UBS celebrated the 30th anniversary of your reserve management seminar. What developments have there been and what has changed since the inception of the survey and conference a couple decades ago?

M

Max Castelli 01:13

This was the 30th anniversary. So we're very proud of it too, because we've been running this event in good and bad times, both for for our clients when they had a tough time in the market, but also for UBS. So actually, the longevity of the event is a very important factor behind the success of this very long time running event. So the conference in the survey are for us very important, because over the years, we have been able to follow the evolution in resource management. And actually we are talking about 30 years. So the last three decades when a lot happens. So first of all, I mean, this evolution has been marked by a factor which is very, very important when we talk about reserve management, which is the massive increase in global foreign exchange reserves that we experienced over the last 30 years. So just to put some numbers between early 2000. And now the foreign exchange has severed more than double. So reach when they were around the 7 trillion in early 2000. They are now more than $15 trillion. So this dramatic rise transform reserve manager not only central bank's not only is the holder of monetary policy, but also is one of the largest investor client segment or investor segment in global capital markets. That's very important. The dramatic increase in FX reserves has led to an acceleration in the diversification of reserves, that's probably I would say is the main factor that we've been observing over the last few years. Just to give you some example, which are based on on looking at the surveys over the years. In the early 2000s, for instance, only about just more than 20% of the central banks that we survey were able to invest in corporate bonds. Nowadays the percent has jumped to more than 70%. So if you look at for instance, said the equity which has been an important diversifier for reserve manager in early 2000, only 3% of the respondent mentioned listed equities as an investable as an eligible asset class. Now, that percentage is oscillating between the last few years between 40 and 50%. So one in two central banks globally, according to our survey are able to invest in listed equities. The interesting thing is that this diversification trend has continued in the following years, and also when we went through the big events which have been happening during in this period to think about the, for instance, the great financial crisis in 2008. When we failed, of course, with a massive sell off that we had in the equity market that this diversification trend might even reversed because central banks became more risk averse. Actually, this didn't happen. It was just a short pose. But then it continued and actually even accelerated after the great financial crisis in the era of quantitative easing and the low yield environment. During those years central banks continued to diversify to fulfill the primary investment target or investment goal, which is capital protection. This trend has continued over the years until late 2020 To where we could consider I consider 2022 as sort of a break here, when the previous regime or low yields and the QE ended with of course, inflation and interest rates rising course reserve managers suffered because as you know, this was the year when diversification did not work. Both equity and fixed income went down. And this of course resulted in losses for reserve manager. So the reserve manager became a little bit more risk averse in 2020 to 2023. But what is interesting in the last survey of this year that we saw reserve managers becoming again resuming the diversification trends Then the last factor which has become central in the solving the most recent year, of course, has been geopolitics. So I remember a few years back geopolitics was not a big topic. Now, this has changed dramatically. Topics like deglobalization, fragmentation, US-China confrontation and sanctions risk have become very, very important topics and are very present in the both the survey and also in the agenda that we put together for the last reserve management seminar. So the finally it is a change in the economic, financial and geopolitical environment is probably led to what we call a new investment paradigm for central banks, I know that you also use that term at OMFIF. So I'm very happy to share that that view, reserve manager as we know they can fulfill now their mandate is capital protection, without taking too much risk. Basically, fixed income is an asset class which can provide already good return, which was not the case before. But what is changing is that there is a manager session for macro hedges against, for instance, the volatility markets. And I will say also, at the geopolitical level, just think about the recent acceleration we saw in allocation to gold, we will continue observing the evolution in reserve management in the years to come. And for sure, the survey and the conference in the next years will reflect that evolution as well.

T Taylor Pearce 06:23

Thanks for outlining all the factors that are contributing to this paradigm shift for central bank reserve management, what were the key findings from the 2024 reserve management survey for sovereign institutions?

M Max Castelli 06:37

I would mention four, which are most important one, first of all, on the economic and financial outlook. Central banks are pretty positive about the global outlook. Actually, the two thirds of the respondents see a soft landing, as the most likely scenario, only 11% of things, the US suffered a recession because of the impact of higher interest rates. This was actually much higher last year. And also they expect inflation to contain falling and eventually conversion to target in 2025. That's for sure remarkable, because it means that even the holders of monetary policy, they believe that they've been doing a good job, basically, if I may say so. The second one is about the geopolitics concern. Like last year, it was already the case, geopolitics is the top concern for central banks for reserve manager, issues like China, US confrontation or over a geopolitics there, what I saw, so as well as the link between geopolitics and the politics, and the public debt sustainability, which came up pretty strongly in this year survey, which is something also new. And I'm pretty sure this will remain very topical. We had some example of this, for instance, in the concerning the Euro bond market because of the French election, which is very much related to fiscal sustainability. And the same topic is very present in the debate over in the discussion that we're having with clients about the upcoming US presidential election. Also, another factor in geopolitics, which came up pretty strongly is the weaponization of FX reserves. That's something that came up quite a lot from last year. And the recent events surrounding the frozen assets of the Central Bank of Russia, for sure, also was a factor behind this increase. The first factor is about the diversification story is already mentioned, this has been something that we were observing for decades. And what came out from the survey is that after the sort of softening of this trend in 2022 and 2023, because of the impact that higher interest rates on markets, we see this diversification resuming and this means that central banks and diversification or to diversification has become a tool for central banks to manage reserves. They are most similar basically to other institutional investors like pension funds or insurance funds. They see the benefit of diversification over the long term and one year or negative return and strongly positive correlation between a fixed income and equity has not changed his long term commitment to diversification. Final point about more sort of short term view what are the central banks are looking from an investment perspective, for sure fixed income is back. Most of the preferred asset classes are in the fixed income area started with government bonds, corporate bonds, we see also a growing interest in emerging market debt. And in the fixed income space, we see growing interest for green bonds, which is also something very important as you know, sustainability is an important trend is an important point on the agenda for many central banks. And last but not least, we definitely see interest in gold among central banks, which is a topic which of course is very much related to the geopolitical development that we are experiencing around the world.

T Taylor Pearce 09:57

So you mentioned four main trends observed in this year's survey, the macro outlook, inflation and interest rate and monetary policy expectations, geopolitics, diversification and short-term asset allocation. So let's just go through those. First, you mentioned that the majority of respondents believe we're in a soft landing or soft-ish landing scenario. Would you say that they think the fight against inflation has been won? Or is there still concerns there?

M Max Castelli 10:26

What emerged from the surveys I mentioned about what we call soft landing, which is basically a scenario of moderate growth and moderate inflation, has been voted by nearly 70% of the respondents. Stagflation, which was one scenario that was discussed at length, probably immediately in 2020, to 2023, when we had energy price jump because of the Ukraine conflict. And the higher inflation rate, there was some discussion about are we entering a phases similar to the 70s, I think that scenario really is now considered relatively low probability. And together with that, also the recession in the US, which was something that many were expecting, because they were simply looking at previous episodes of interest rate hiking, when actually the US always suffered a recession. So the resilience of the US economy, and in general, the global economy to this massive increase in rates has been something that definitely had an impact on the view of central banks and reflected in the survey on inflation, that there is a view that inflation will continue falling. But there is also a longer the more specific question on inflation that we asked. And there is a view that we are seeing that we probably entered a period of inflation remaining a little bit higher than target for probably longer than was expected. For instance, one year ago, when inflation was falling very rapidly. This is the famous last mile with something that I think will take will remain central for a little bit more. This is very important, because this creates some uncertainty over the interest rate path to the next, let's say 12-18 months. And that's something which has been observed very closely by central banks. On the question of inflation, I think what came out from the survey, but I will say also more from the debate that we had at the conference with governors and with very senior official for central banks on monetary policy. And the question which always came up and was debated at length is whether central banks have fallen behind the curve, in a sense that they were late in raising interest rates when inflation start rising. The question is being asked, as well by investor in the market, are they late now? Are they waiting too long to lower interest rate in the face of the moderation of growth in the US, and also some indicators that show that there is a slowdown going on. And I think that the debate is still evolving among the governance, they are really looking into their experience, they are very humble, in the sense that they understand that something is going on, in a sort of a new regime that we are in inflation is something very difficult to measure compared to the past, there was a big debate as well about the need for flexibility. And just to put things into perspective, essentially, I heard some governor saying, if inflation remains a little bit above or below target, should we immediately act with very robust policy response? In order to bring it to target? The answer was probably not. And the answer depends very much on how the economy is doing. So for instance, if in the future and inflation we start on the target, so we go back a little bit to the sort of deflation type of situation that we had before COVID. The question is, and the economy's doing well, with low unemployment with good growth, should central banks act once again? I believe that this will be different this time. And I believe central banks will become more active only when they really see a substantial deviation from target or significant deterioration in the economic situation surrounding monetary policy. That's something that I think we will discuss more in the future.

T Taylor Pearce 14:09

So the last mile will be bumpier than central banks were anticipating last year, but generally they're on the right path towards target range. Coming to you now Phillip on geopolitics, how concerned are reserve managers? And how are they adapting their investments to a volatile geopolitical environment?

P Phillip Salman 14:29

So as much as I would like, one of the key takeaways of the survey was how concerned reserve managers are about geopolitical risk. So each year we give participants a number of key risks to choose from, and we actually only added the further escalation in geopolitical conflicts to the list like three years ago. And since then, its ranking has only gone up and up and it already was a top concern last year and now this year more with a with a record value of 87% of participants that have chosen this as one of their top risks. And you'll see that echoed also in other questions we asked. Not a single respondent believes that the US China relationship will improve. And about half of the respondents believe, for example, that the Russia-Ukraine war will only end after 2026. Of course, fortunately, most believed that NATO and Russia will not get into a direct confrontation. So that's the other positive side, you would expect that when asked directly if they if participants had taken any actions yet in their portfolios to prepare for geopolitical risk, that the majority would say yes, but in fact, we have more than half say that they take no actions yet on a strategic level. However, among those that have taken actions, the most frequent answer was that they are now diversifying more across regions and currencies. So on the one hand, as Max's outline, we are seeing the overall trend towards diversification, and maybe with some some pauses, it's been also over the past two years. But on the other hand, we are maybe also seeing the start of a trend to not only diversify, to optimize portfolio metrics, but also to lessen the impact of geopolitical shocks. A link to that is probably also the interest in gold reserve managers, which is getting stronger and stronger each year of interest. Recently, our investment bank rates to yen forecast and official sector demand was mentioned as the key driver for that. And you really also saw that reflected through the discussions at the conference. And of course, also in the survey by gold was ranked quite high when it comes to asset classes that reserve managers plan to increase in the year ahead.

T Taylor Pearce 16:25

You mentioned diversifying across more regions and currencies. I also assume this is related to the dollar and diversifying away from concentration in the US and US financial assets. So in November, the US presidential election is coming up, and what would you say reserve managers can expect in the case of a Trump victory?

P Phillip Salman 16:45

So we asked participants directly two sets of questions, one about the economic impact and then one about the geopolitical consequences should Trump get elected for a second term. Now on the geopolitical side results were relatively clear that the participants think that a Trump victory will lead to more geopolitical confrontation further deterioration in the relations with China, a weakening of NATO and in general an increase in global protectionism. But as mentioned before, the the bleak outlook that the participants had, for example, for the US-China relationship is independent of who will become president, like 47% believe it will deteriorate in any case. And actually, nobody thinks that it will improve. Now on the economic side is a bit more interesting because the other participants expected Trump presidency to lead to higher public deficit levels, but also higher equity prices and lower US policy rates, maybe from additional pressure on the on the Fed to keep rates low. And interestingly, they also expect high inflation in combination. Now, this is interesting mixture was also topic at some of the panels at our event, and there we discussed quite at length are realistic, all of this is key risk here is really, that besides monetary and fiscal two, we could really get some inflationary interferences from the policy side. Because Trump would probably feel obliged to do something because there'll be at the core of of his campaign would be tariffs, and as well as severe restrictions on illegal - and probably also to some extent legal - migration. And that could have quite some inflationary consequences. The short term migration, even the legal on, boosts tomorrow that eases the labor market. So it acts somehow similar to productivity gains for some time and reason US data might have benefited from that maybe more than that some people realize and removing that pile starting another round of tariffs, and then we tell you retaliatory tariffs could have quite an impact. And I'm also not sure if the stock market would like that so much, right?

T Taylor Pearce 18:47

Well, that sounds quite disruptive, and taken together with the findings on geopolitics, it's not such a rosy picture for the US. But one of the other findings, maybe surprising this year, Max, was that the US dollar appears to remain quite strong. And there are no apparent signs of weakening of the dollar is dominant position. What do you attribute to that? And could this change in the future?

M Max Castelli 19:08

Yes, that's if you read the media, you you feel that we are on the we are closer to the demise of the central role of the US dollar in the global financial architecture. And of course, as well in foreign exchange reserve management. This is not the case. I have been saying this. We have been saying this for quite a while. And the survey confirmed that if you look at the average share of us holdings among all the participants that we survey is around the 55%, which is basically in line with the share that we see in the data and is basically unchanged compared to last year. So first of all, so no significant sign of a weakening of the US dollar, because of geopolitics and because of sanction risk or because of any other factors which could impact the US economy whether we'll come back to the Trump election in a minute. Second, when we ask about a little bit more to which other currency they're looking for diversification, because I would say that it's fair to say that particularly in emerging market, there is a desire to be more diversified there is demand for more currency diversification. It doesn't is not necessarily linked to geopolitics only. And the weaponization of effects of the effects reserve, I think it is also linked to the fact that emerging markets have always had the big impact from US dollar strength for US interest rate rising on their economy. So having a more diversified currency exposure is also beneficial in terms of financial and macroeconomic stability. But what came up is as well, two, I will say important elements, one is the return of the euro which was, as you know, was suffering because of the negative yield environment that we had before COVID. Also, because of many sort of structural factors surrounding the euro area, so we saw the Euro declining party for many years, actually in the last survey, which by the way, was done before the French election. So it will be interesting to see whether the French election had an impact on that view. But definitely there is more attention to the euro in terms of the intention of diversification that central banks signal in the survey. And also, I would highlight the fact that the yen as well is back on the radar screen of central banks, which is of course a reflection of the fact that they said it looks like the normalization of the of Japan and monetary policy is on its way. And this of course means no more negative yields as well. There when it comes to the RMB and the Chinese currency. I mean, we have been monitoring this for quite a few years now. So we saw the evolution about 70% of the survey respondent downs they are invested or considering investing in the in the RMB. This is a further decrease from last year, which was a 72%. And just to put things into perspective in 2022 was 85% that the respondents so we definitely see a stagnantion as I like to say in the allocation to the RMB fixed income. That's also something that we saw when we asked about the long term target allocation to the RMB, which also came down slightly from 5.2% to 5% of total reserves. But I would say I will be cautious to say that this is like a sort of a crisis of the RMB seems to me more a pause, which I think is reflecting a several factors. The geopolitics we already discussed about that different central risk is something that is being mentioned when we talk about RMB or location. But I would also say that factors relating to China, including for instance, the real estate crisis, the sort of macroeconomic issues surrounding the long term growth potential of China are also very important and last but not least, reserve manager or investor. And then when they look at the interest rate differential between RMB and US Treasury, it is very difficult to argue about increasing allocation to RMB in this current phase, and giving up on the US Treasury because expected return on these asset classes are very good. The question is looking ahead there is that when we ask about more long term view about the future, definitely the multipolar system is something that is mentioned by quite about half of the respondent. And we actually asked a question, where do you think what are which reserve currency are most likely to benefit from the geopolitical shift that we are seeing over the next five years, it is interesting to see that the two top currencies are the US dollar, the RMB, followed by the yen and the euro. So definitely, I think we, if I can summarize, no significant weakening in the US dollar so far, and definitely a move over the long term at all was a multipolar currency system probably centered around US dollar, euro and RMB. But let's not forget also the yen, which in Asia could play a role. And the final point is, it is about the US dollar going forward. I believe that US dollar could be more impacted more by domestic developments rather than global geopolitical developments. I mentioned already debt sustainability is a major concern and we know that Trump wants to continue the tax cuts. Also Biden re-election probably will lead to more public deficit and still rising public depths. And we could also see a scenario more political polarization in the US to think about contested election results. Even social tensions around the the president provide this could have a negative impact on the US dollar. But as I said, so far, the US dollar has been holding up pretty well. And in the short term is very difficult to see a scenario of a significant weakening of the US dollar in the global financial architecture.

T Taylor Pearce 24:49

T Taylor Pearce 24:49

That makes sense. So it sounds like cyclical factors are driving bumps in the road or stagnation and short term and it'd be demand but over the long term, it's still pretty robust And that's also something that we witnessed in our our survey of global public investors and central bank reserve managers. But it was interesting to see the US dollar pretty strong this year, and RMB stagnating in the short term. To come now to the last main finding that you mentioned from this year's survey, reserve managers have resumed asset allocation and diversification, how are they positioning their investments in the new economic and financial environment in this new regime or new paradigm?

M Max Castelli 25:27

Let me be brief also in the interest of time, but we've been saying already for quite a while fixed income is back in general among investor there's also very true for reserve manager, it was very difficult in the previous regime to achieve the main target of central banks, which is capital protection because basically the return on fixed income government bonds and over investment grade fixed income products were very low. Now, we are in a completely different environment, there are good return expected return in fixed income or are higher than what they were in the previous regime. And in fact, when we asked what are the most preferred asset classes, the top four are all fixed income asset classes, government bonds, corporate bonds, emerging market debt and a few others, supranationals, TIPS, etc, equity comes second, but as I said the what we saw is that after some sort of softening of equity allocation, in 2023 equity is back. We have not seen also based on our interaction with central banks a measure pulled back from equity. Of course, there are questions surrounding the concentration of performance into the tech stocks. Normally as you know, central banks are passive investors. So, they tend to be exposed to the massive role played by tech stocks. So, there is definitely a view that there might be more diversification in the equity market in order to reduce the concentration risk. Another big topic is the duration management. As you know southern central banks are looking at the interest rate pattern talking central bank has investor here. And of course, they are ready to increase duration when they are convinced that interest rates are declining path so that would lead to more capital gains. I think we are not there yet. But we are not far away from that. And this also leads to more activism by central banks in the way they look at their fixed income portfolio. They are looking at strategies that before we're not really looking at like what we call dynamic or flexible fixed income strategies. Final point I mentioned green bonds, and green bonds are definitely an asset class that is very much in favor among central banks, probably there is more demand than supply at the moment. So hopefully this will lead to more issuance of particularly sovereign green bonds. We saw some big sovereign issues actually in the last few months. And gold which of course is an asset class which is definitely an emerging market story. Most central banks for emerging markets are buying gold, we look at allocation to gold and 50% would have impacted that typical fixed income only central bank's portfolio actually would have added about 1% return over the last 20 years. So there is also an investment case to be made, should gold continue rising. And the question is more about whether gold is really an asset class, which is used as an edge. That's my last point about asset allocation compared to the previous regime, as I said, they can fulfill their capital protection. My goal via fixed income, which is a remarkable development compared to the last two decades after the great financial crisis. And but they're searching for edge in terms of hedge against volatility and a hedge against geopolitical risk and definitely gold and other real assets have a role to play there. But as I say, liquidity is still very important for central banks. Gold is an illiquid asset class in a certain sense, particularly if you buy physical gold. So it will be interesting to see whether this increasing gold or location will continue in the years to come. Right.

T Taylor Pearce 28:51

So it sounds like in this new, more uncertain world, they're balancing return with risk and liquidity as well as safety and agility. Just to wrap up, this year's survey had a session dedicated to the 80th anniversary of Bretton Woods and the future of the financial system and global financial architecture. What were the key takeaways there?

M Max Castelli 29:17

Yeah, we thought that the 80th anniversary was good time to ask some question a little bit broader about the global financial architecture. And in particular, we wanted to understand the from central banks, what is their view about the current set up because we should not forget that the global economy has changed dramatically the last two decades. And this is of course, something that is not being reflected in the global financial architecture. If you think about we talk about the role of US dollar. Yeah, it came down a little bit in the FX exchanges said but fundamentally still very central in the global financial architecture. Think about the role of the IMF, the World Bank or other international organization or the WTO, which is not really going through a great period. And the question was, do you think that there should be a reform of the global financial architecture in order to deal with the challenge that we currently face? Climate change, demographics, energy transition, etc? And the answer was, yes. Basically, in order to make the system capable, the global financial system capable of dealing with this challenge or reform is needed. Then when we asked where the focus of these reforms should be, it was very interesting to hear that actually, most of the respondent mentioned the future of multilateral cooperation in our increasingly fragmented word, I think it is very well said, we are in agreement to word the multilateral is mean, in a broad sense is is definitely not leaving a great period as well. And central banks are saying, Look, in order to deal with the challenge, we need to have more cooperation among the governments and central banks. And that's a very important because I think the call for multilaterals needs to remain stronger as we move into this more geopolitical, volatile environment. The second point was about the role of IMF and World Bank, we ask whether this entity should be still central in the global financial architecture? And the answer was yes. But there should be reform. In the sense, of course, as you know, many emerging market will want a rebalancing in the course, that something in the quarters, that's something that I think is coming very strongly from China. And I think that's something that will need to be addressed in order to make multilateralism once again, vital and capable of driving the agenda at the global level. Actually, when we asked, Do we need a new institution for dealing, for instance, with climate change? The answer was no. So that is definitely not the mandate for more international institutions, but rather leveraging what we already have maybe reform. Final point, we ask about the disruptive technology, but digital currency CBDC. You know, there are different views here, which could make the system less resilient because the role of central banks or the role of banks, for instance, will be diminished. It's interesting that the central banks see more benefit than cost about embracing the digital revolution. So basically, they think that digitization and CBDCs can become a tool to make the system better, which I think is very important, because it means the central banks are basically embracing the digital innovation story as a way to make the system more resilient, which is very promising for seeing a more step ahead in the use of digital currency the in the future global financial architecture.

T Taylor Pearce 32:34

Great. Well, thank you so much. It's definitely a very exciting time to be following central bank reserve management. I know I'm looking forward to seeing how this evolves. I'm sure you are as well. So thank you, Max and Philipp.

M Max Castelli 32:45

Thank you so much.

T Taylor Pearce 32:46

It's been great to have you both thank you as well to our listeners, be sure to check out our other content on central bank reserve management on our website and check out our other podcasts wherever podcasts are available for download. Thank you.

32:58

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