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What do geopolitical risks mean for central bank FX reserves managers?

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- **Two major industry surveys show that adjusting for geopolitical challenges will impact the way foreign exchange reserves are managed**
- **Although each central bank will approach this differently, they will all have a desire for larger FX reserves**
- **The challenge will become how to manage those reserves against a transformed fixed income investing environment**

Two surveys of central bank foreign exchange (FX) reserves managers have been published in recent weeks, both of which highlighted that geopolitical risks are now considered to be the primary investment challenge. Russia's invasion of Ukraine, war in Gaza, and political tension between the US and China are just three episodes that have fed into this.

The first survey, of 87 central banks and conducted by Central Banking Publications[1], identified geopolitical risk as the number one concern for the next 12 months. The second, of 73 central banks by OMFIF[2] (the Official Monetary and Financial Institutions Forum), revealed that 80% of respondents expected geopolitical risk to be the most significant factor impacting their long-term investment strategy.

Both surveys suggest a precautionary reaction will follow. In such a scenario we believe central banks will allow and encourage their FX reserves to grow. The challenge will then be to manage these reserves in a transformed fixed income investing environment. The survey data also suggests core fixed income strategies will be the first to benefit.

Unlike a concern about the future direction of Federal Reserve policy, which would impact all central banks in a similar manner, adjusting for geopolitical challenges will not. Each central bank will have a different playbook driven by their own government, and legacy international

[1] Central Banking, Trends in reserve management 2024: survey results, 15 May 2024

[2] OMFIF, Global Public Investor 2024

relations and alliances. For some nations it may mean getting closer to the US and the dollar, for others it may mean getting closer to China and the renminbi.

How might central bank FX reserves managers respond?

There may be implications for the choice of trading counterparty, external manager and securities custodian. There may also be an impact on asset class and currency choice. However, in one unique sense every central bank will be aligned – they will all have a desire for larger FX reserves.

A simple way to keep FX reserves high is to not deploy them. The OMFIF survey included a question on deployment thresholds. Approximately 65% of respondents would not spend more than 15% of their total reserves for market (usually FX) intervention. The conservation of reserves is a key route by which growth can be fostered.

This corresponds with our own feedback that there is a desire to conserve reserves in order to fight the next crisis. The makeup of the next crisis is of course unknown, and the required firepower to deal with it might be substantial. As one central bank official told me recently, "If it is a geopolitical crisis, double the number that you first thought of". For many Asian nations the bitter memories of the currency crises of the late 1990s are seared on the institutional psyche. Self-insurance is best.

At the International Monetary Fund annual meetings in 2024, Governor Das of the Reserve Bank of India was happy to explain the approximate doubling in FX reserves to around $600 billion that has occurred since 2016. The decision to allow reserves to grow during a period of capital inflows was "to build buffers against possible future capital outflows".

Self-insurance is an attractive tool for a non-aligned nation such as India, in a world where economic and geopolitical uncertainties have multiplied. The governor did not mention negative carry costs, but instead asserted that the current level of reserves "gives confidence to domestic financial players".

The primary cost of holding FX reserves is the cost of carry involved in FX intervention. In other words, the interest rate earned on a purchased US Treasury bond is usually lower than that paid on the domestic paper that is issued to absorb the capital inflow. Historically, this cost was cited as a reason to not hold large FX reserves.

In recent years it is rare to hear central banks mention carry costs. FX reserves are a form of self-insurance, and insurance has a cost.

How much is enough?

One Asian central bank spokesperson quoted in the OMFIF report declared that "in the event of a crisis there is no level of reserves that is adequate". Traditional metrics such as import cover ratios are seen as too narrow and simplistic. Although the IMF published a multi-factor model in 2015 (Assessing Reserve Adequacy)[3], this has been widely criticised by practitioners.[4]

There is an absence of a credible measure of FX reserves adequacy. The consequence is that the default position is often to allow reserves to grow. Moreover, when neighbouring nations are

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[3] IMF, Assessing Reserve Adequacy – Specific Proposals, April 2015

[4] OMFIF, Foreign exchange reserves in a volatile world by Gary Smith and John Nugée, June 2016

achieving growth in FX reserves, emulation pressures soon mount. The history of previous crises – especially the 1997 Asian crisis – is that market pressure falls first on nations that have the weakest coverage ratio.

Bilateral swap lines are not a substitute for FX reserves. Perhaps the only swap line that will succeed in a period of stress is with the US. The granting of these lines by the Fed has been unambiguously influenced by geopolitics: only friends need apply.[5]

Pooled FX reserves solutions are unlikely to pass a stress test. The Chiang Mai initiative was initially an ASEAN multilateral swap arrangement. It was imagined as operating outside of the IMF. It is now ASEAN +3, [6] and has doubled in notional size to US$240 billion. As the renowned Brazilian finance minister Guido Mantega said, the problem with these is that the nature of a crisis may well be that everyone will seek access from the pool at the same time.[7] If a pool has protected drawing rights, then it cannot really be considered a genuine pooled solution.

The OMFIF survey revealed that the two most likely currencies to be purchased over the next 12 months will be the US dollar and the euro. We suspect this is an expression of hope that FX reserves will grow, rather than an asset allocation switch in favour of the two largest reserve currencies. In simple terms, an increase in FX reserves will be mapped on to the existing currency allocation. In the vast majority of cases the biggest position will be in US dollars, followed eventually by a diversification into the euro and then other currencies.

For countries that can choose, the preference will be to allow FX reserves to rise. The challenge will then become one of how to manage those reserves against a transformed fixed income investing environment.

The final piece of the jigsaw contained within the OMFIF survey data relates to intended investments. Almost 90% of respondents expected to increase or maintain exposure to government bonds, 80% to quasi government bonds, and 55% to corporate bonds. We don’t think this represents an intention to switch out of equities but is simply a mapping of where inflows will be directed to. Global aggregate anybody?

[5] Harvard Kennedy School, The Geopolitics of Swap Lines by John Michael Cassetta, April 2022

[6] With the inclusion of China, Japan and Korea

[7] International Monetary and Financial Committee, Sixteenth Meeting, 20 October 2007

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