banco central Chile

Opening Remarks

Rosanna Costa, Governor of the Central Bank of Chile

Joint Forum on Asset and Risk Management – September 25th, 2023

Good morning, welcome to the Joint Forum on Asset and Risk Management co-organized by the Official Monetary and Financial Institutions Forum (OMFIF), the World Bank and the Central Bank of Chile. We are pleased to have representatives from several central banks, and from the public and private sector attending this Forum.

Introduction

As is well known, for many countries international reserves aim to ensure an adequate level of foreign currency liquidity, even in extreme situations where access to traditional sources of foreign currency may be very limited. In this sense, the international reserves act as an insurance against severe events of liquidity tightness, which could compromise financial stability, or the availability of foreign currency needed for economic activity.

In the last few years, International Reserves management has been as relevant as ever, but perhaps more challenging given the singularity of the multiple and diverse shocks and its impacts to the economy and hence to central banks.

This poses new challenges, making it pertinent to revisit the frameworks and assumptions that we have been using in asset management. On the one hand, the liquidity squeezes seen during the pandemic, where bid-ask spreads almost doubled, raise questions on how liquid the safe assets were at the time of need. On the other hand, as central banks raised their benchmark rates and inflation remained high, fixed income instruments and most financial assets had negative returns in 2022, raising questions about the fulfilment of the capital preservation objective.

In fact, in 2022 most assets typically associated with international reserve investments suffered losses. For example, the US Treasury Index reported losses of 12.5%, the Global Sovereign Bond Index lost 17.5% and even inflation-linked instruments suffered losses of 23%. Only the US Treasury bills closed the year with a return near zero. In that period, we saw a spike in correlations across asset classes and losses never seen before in the fixed-income markets. Before 2022, this scenario could only be included in risk analyses by extrapolating some of the key movements seen during the 1970s. But now, after experiencing it first hand, central banks must rethink how this could change their investment approach.

In this environment several questions arise, to which we need to figure out the answers: Is there still room for more diversification? Are asset classes available to central banks diversified enough not to compromise the capital preservation objective? Has the institutional risk profile changed? Will we see a rise in short duration dollar portfolios or, with the rise in rates, we are in the verge of a new surge in duration searching? All these are important questions that must be studied in a global and comprehensive way as the investment side of central banks continues to adapt to the new developments in the financial markets.

The Central Bank of Chile's experience in reserve management

Allow me briefly to share our experience with holding international reserves. The Central Bank of Chile holds foreign reserves to achieve its main objectives, as defined in the Organic Act, of ensuring the stability of the currency and the normal functioning of internal and external payments. In our policy framework of a floating exchange rate regime, these assets also reduce the probability of liquidity disruptions and make it possible to deal with exceptional situations where access to international markets is interrupted, minimizing the likelihood of having balance of payments problems. In this context, the primary objective that the investment policy of international reserves must guarantee is liquidity and capital preservation, so that the monetary authority can dispose, at a reasonable cost, of the resources needed at any time.

To achieve that, the Board of the Bank approves an Investment Policy which defines the relevant investment parameters such as currency composition, eligible asset classes, maximum risk tolerance, and the portfolio structure, among other variables. These criteria and limits are defined in the context of a well-established analysis framework, that aims to tackle financial risks in a comprehensive manner. With this in mind, we divide our investment portfolio into two tranches: the liquidity portfolio, and the diversification portfolio. The liquidity portfolio represents 60% and is composed entirely of nominal US Treasury bonds with maturities between one and five years. These instruments are considered highly liquid and safe. The diversification portfolio accounts for the remaining 40% and is composed of nominal and inflation-linked bonds in multiple currencies, with maturities between one and ten years. This sub-portfolio allows us to diversify risks and to achieve higher returns in the long run.

In terms of governance, central banks around the world have developed very strong frameworks. The independence between different key units responsible for reserve management is paramount to have sound practices. Importantly, reserve management best practices are well stablished at the Central Bank of Chile as a result of a continuous adaptation process, which is in line with the development of the financial markets, the international regulatory framework and the incorporation of new technologies, among other relevant developments.

The governance of reserves has been structured considering the segregation of functions. The Financial Markets Division is responsible for the front- and back-office activities, including the Tactical Asset Allocation, and also advises the Board in defining the Strategic Asset Allocation. The Corporate Risk Division reviews the different risk methodologies applicable to the management of international reserves and performs the compliance function. Furthermore, it also acts as technical counterparty to the Financial Markets Division regarding risk measurement and risk analysis.

This scheme allows the Central Bank of Chile to operate with two lines of defense and guarantees the independence between the business and risk assessments allowing for more robust analyses. Furthermore, our internal auditors play a key role as third line of defense, as they place a lot of emphasis in reviewing the processes that support all the investment activities, including aspects related to technology and cybersecurity. All this is complemented with independent auditors and an external advisory committee.

Also, on a yearly basis, we review our Investment Policy to assess asset liquidity in the context of the risk/return framework, including all new relevant information that could have shifted the Strategic Asset Allocation. This yearly review allows the Board to act based on facts, as new information, risk scenarios or changes in markets trends can be analyzed. Also, this review is a good opportunity to incorporate changes in liquidity preferences and possible changes into the desired risk/return profile. Moreover, peer review exercises are conducted to check whether our practices are advancing according to international standards.

It is worth mentioning that we also have in place an external manager program since 1996. The main objective of the current program is to be an active benchmark for the internal management and to enhance returns. Also, knowledge transfer is expected. The program is evaluated on a yearly basis by the Financial Markets Division and complemented with a risk assessment of the firms performed by the Risk Unit. The evaluation is conducted based on a both qualitative and quantitative analysis.

Main challenges

A key question that is always present is how to assess the adequate level of reserves needed by a Central Bank. For emerging markets, the most traditional measures include the IMF's ARA, the level of exports or rules like the Guidotti-Greenspan.

At the Central Bank of Chile, the Financial Markets Division oversees an integrated framework to determine the required level of reserves. In this exercise, we consider the traditional approaches, but also market analysis, risk measures, economic models developed by our Monetary Policy Division, and banking sector analysis provided by our Financial Policy Division. This integrated approach allows us to have a broader assessment on the potential needs of international liquidity, taking into consideration all relevant and changing variables.

It is important to underscore that our monetary policy framework relies upon a floating exchange rate regime. This contributes to mitigating the impact of shocks affecting the economy and facilitates the adjustment of different markets to those shocks. Nevertheless, during 2019 and 2022, several internal and external shocks strained our macroeconomic and financial stability, testing our policy framework. Consequently, the price formation process in the foreign exchange market was jeopardized. We implemented some exceptional measures to restore it, including selling a fraction of our international reserves. We succeeded in normalizing the price formation process in the forex market and now we are restoring our liquidity buffer by increasing the level of our international reserves to reach around 15% of GDP.

Now I would like to stress the importance of financial safety nets. Holding reserves is costly for emerging market economies and, in exceptional periods, action needs to be taken to restore and ensure the proper functioning of the foreign exchange market. This represents a challenge for our liquidity buffers. Hence the importance of having complementary sources of liquidity. In that context, we have been fortunate to partner with different institutions which grants us access to international liquidity on a precautionary basis.

As an example of that, currently the Central Bank of Chile has access to the IMF's Flexible Credit Line (up to US$18,5 billion). This allows us to count on complementary liquidity on a precautionary basis, while we replenish our liquidity buffers. Also, we have access to FLAR's liquidity facilities (up to US$ 1.25 billion), and to the swap line with PBoC (US$ 8 billion).

We also have other sources to guarantee access to foreign currency liquidity such as the New York Federal Reserve's FIMA Repo, a facility that allows us to obtain temporary liquidity in dollars against the delivery of U.S. Treasury securities as collateral.

In short, the discussion on the level of reserves must consider many variables. Among them is the level of risk of the economy, given internal and external risks, the strength and depth of the markets to react and adjust, and the existence of other liquidity sources. Another important element is the cost of holding reserves.

The Bank is constantly monitoring its level of international reserves to maintain its structural liquidity position in foreign currency, which allows us to have a strong policy framework.

Closing remarks

If something we surely learned the last couple of years is that financial markets are constantly changing and evolving, shifting the behaviors and preferences of the economic agents. As reserve managers, we must rapidly learn to deal with this new environment and determine how to integrate these changes into our reserve management framework. The Covid-19 pandemic and following years taught us lessons about the relevance of reserve management, and how important it is to have good management frameworks and practices in place to ensure adequate levels of liquidity, capital preservation, and diversification of risks. This balance is very important, because the reserves must be available in real time, at a reasonable cost, whenever needed.

But this isn't over. There are many other challenges that we are facing right now and for sure we will encounter new ones in the future. To mention just a few: geopolitical risks apparently are here to stay; extreme climate phenomena and their relation with financial and monetary policy is yet to be studied in more detail. The future evolution of interest rates and their neutral level are also drawing the attention of many market players. And of course, the optimal level of international reserves in a context where shocks appear to be more frequent requires further study, particularly for emerging markets' central banks, which must also consider the existence of the global financial safety nets to complete their analysis. In this way, we will be better prepared to deal with future shocks. That's why this forum is so important, walking together is always the safer way to advance, as these considerations cannot be postponed.

Let me finish by thanking you all for taking the time to join us today in this forum. We have two intense days ahead, where most of the questions and challenges I mentioned before will surely arise and I am sure that the discussion will prove fruitful. We have made substantial progress in managing the international reserves, but there is more work to be done. These seminars are a crucial place to share our knowledge and to help each other to better address the issues that most institutions and nations will face in the near future.

Thank you.