

CONFERENCE ON STRATEGIC DIRECTIONS IN RESERVES MANAGEMENT FOR THE NORTH AFRICA AND SUB-SAHARAN AFRICA REGIONS

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Opening Remarks

by

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It is an honour and privilege for me to be a part of this Reserves Management Conference which the World Bank is hosting in collaboration with the Bank of England and Banque de France. The range of topics to be covered over the next two days is impressive, and we should all be better reserve managers at the end of the conference.

Reserve Management Objectives

It is widely accepted that reserve management is a process that ensures official foreign exchange reserves are readily available to meet a range of objectives for a country. These objectives vary from country to country, but generally they include the following:

- reserves management can be part of supporting policies for monetary and exchange rate management where price stability is the ultimate goal;
- reserves can be used to meet obligations arising out of balance of payments transactions;
- they can also assist governments in meeting their foreign exchange needs for external debt obligations;
- as well as act as a buffer for national disasters; and,
- in some cases, reserves are used to back domestic currencies.

Importance of Sound Reserve Management Practices

It is extremely important for a country to have sound reserve management practices in place, for not only are the reserves crucial in increasing a country's ability to cope with unexpected developments and exogenous shocks, they can also assist the authorities to respond effectively to financial crises. Weak reserve management practices can have significant fiscal consequences. For instance, the deterioration of the international bond markets in 1994, which resulted from an unexpected large increase in US interest rates, had a major impact on reserves worldwide, with related adverse effects on government finances.

Reserve Management Principles

There has been substantial and, some would say, overdue advances in the sophistication of the management of foreign exchange reserves by central banks since the early 1990s. Increasingly, central banks are adopting an active rather than a passive approach to reserve management, while adhering to three major principles. First, central banks must ensure that adequate reserves are available when they are needed to meet a specific range of objectives, to which I referred earlier. Second, defined risks - in this case, liquidity, market and credit risks - must be controlled within well defined parameters and, third, a reasonable return should be generated from invested funds, subject to acceptable risk parameters.

Given that the external debt position of a country can affect reserve management objectives and operations, it goes without saying that coordination of debt and reserves management strategies go hand in hand. Indeed combined asset/liability management leads to better risk management than if the two are managed separately. It is advisable, therefore, to consider establishing matched asset/liability portfolios, and it is certainly necessary to pay attention to evaluating foreign currency liquidity needs and other foreign currency outflows that might be expected to occur at specified periods, when formulating reserve management strategies.

Where the reserves are sizeable, it is advisable to classify them into working balances and precautionary balances. Working balances should be held in highly liquid form, either in the currencies of major trading partners or in freely convertible currencies. The remainder of the portfolio (precautionary balances) should follow the investment principles of safety, liquidity and return, in this order of priority. It cannot be overemphasized that reserves should be kept in convertible currencies which are relatively less susceptible to frequent and sharp exchange rate fluctuations, generally free from restrictions on their use and the products of well developed financial markets.

Central banks are, by nature, prudent, and it comes as no surprise that they will have a very high preference for liquidity and a low tolerance for market and credit risks. There is, however, no investment option which can simultaneously neutralise all risk categories. A reduction in one type of risk can only take place at the expense of higher exposure to other risks.

Prudence suggests that the maximisation of return on reserves is rarely the first priority in reserves management. Safety, which is the need for managing and controlling risks to ensure that the value of assets is protected, should receive the highest priority. Liquidity follows next as it is the ability to convert investments into cash to facilitate the meeting of payment obligations.

Return on Reserves

As highlighted earlier, the objective of return on reserves is usually the last priority. However, it is true that portfolio managers are increasingly focusing on the need to maximise earnings on at least part of their reserves, within clearly defined liquidity and risk constraints. This is driven by the greater thrust in recent years for more transparency and accountability in the management of public resources. Furthermore, proper reserve management requires the adoption of the latest international best practice on accounting and disclosure requirements which no longer support the practice of drawing on hidden reserves to "massage" profits so as to compensate for losses or lower earnings.

Earnings on foreign currency investments can play an important role in offsetting the costs associated with some central bank operations, such as those related to monetary operations. In other cases where reserves may be borrowed from foreign markets, earnings contribute towards minimising carrying costs. Earnings from investing reserves are an important generator of foreign exchange; they also make an important contribution to balance of payments, thus increasing the

level of reserves. Furthermore, one of the key features of reserve management is the contribution that the related income makes to Government revenues. For newly established central banks, income derived from reserves management can be used to strengthen the balance sheet and to enhance the capital base, especially in situations where a central bank is permitted to allocate a specified portion of net profits to accounting reserves.

Botswana Experience

Given that this conference is mainly for African central banks and related institutions, I thought it would be useful to share some features of the Bank of Botswana's reserves management framework.

As one of the world's leading diamond exporters, Botswana's economy continues to be dominated by the mining sector, which contributes approximately one third of GDP and 83 percent of exports. Revenue from the diamond sector accruing to the Government, together with restrained expenditure and absorptive capacity constraints, have generally resulted in overall budget surpluses. Of course Botswana also has a high import bill, partly reflecting the purchase of capital goods used in infrastructural developments, but also reflecting a conventional characteristic of a small open economy. Nevertheless, the overall balance of payments situation remains reasonably strong and the level of reserves currently stands at USD 6 billion, equivalent to 35 months of imports of goods and services.

Tranching of Reserves

In 1989 the Government of Botswana, in collaboration with the World Bank commissioned a report on Financial Policies for Diversified Growth. One of the recommendations was that Botswana needed to maintain larger reserve balances than might be considered prudent elsewhere, because of factors over which it has little or no control. For instance, the country is a relatively undiversified primary exporter; its terms of trade depend partly on the real exchange rate between the South African rand and the SDR (which has been volatile in recent times); and Botswana is susceptible to periods of sustained drought. Following consultations between the Bank of Botswana and the Government regarding the evaluation of future balance of payments trends, it was decided to partition the reserves into separate segments. This decision also recognised that the level of reserves was considerably higher than those required for normal transactions purposes.

Hence the reserves are currently held in two portfolios, namely, the Liquidity Portfolio and the Pula^[1] Fund; these portfolios are managed separately in order to facilitate the meeting of different objectives.

Liquidity Portfolio

The Liquidity Portfolio is treated as a buffer against short-term trade and capital account fluctuations, and as a cushion to finance unforeseen developments in the external payments situation. Should holdings in the Liquidity Portfolio fall below an agreed level, the first line of defence to improve the balance of payments will be macroeconomic policy adjustments affecting interest rates, the exchange rate and government revenues and expenditures. For operational convenience, the Liquidity Portfolio is divided in two parts - the Transactions Balance Tranche and Liquidity Investment Tranche. Investment instruments for the Transactions Balance Tranche are money market instruments (call and overnight deposits) with maturity of up to 5 days, and this typifies the transitory nature of inflows and outflows. The Liquidity Investment Tranche is invested in money market and fixed income instruments with a modified duration of up to 3 years, and it is subjected to performance measurement.

Pula Fund

The Pula Fund is a long term fund for future generations. Its primary objective is to ensure that Botswana's national savings are deployed to optimise their contribution to sustained national economic development. To the extent that such resources cannot be absorbed in the economy for productive purposes without distorting domestic prices, long term offshore investments had to be considered. A secondary objective is to "depoliticise" the investment of financial resources so as to mitigate or deflect demands for their immediate utilisation for what could be unproductive or unsustainable public purposes.

Another objective of the Pula Fund is to take advantage of the high level of reserves and invest part of them in longer term assets, such as longer term bonds and equities, with the expectation of earning a higher return than could be achieved over time on conventionally managed foreign exchange reserves. Such earnings would allow sustained long term development even if export revenues were to be adversely affected by factors over which Botswana has no control. Based on historical data and over a long period, long term bonds and equities are normally expected to outperform short term investment instruments, such as cash and short term bonds, which characterise the Liquidity Portfolio. Returns on long term investments are, however, more volatile than returns on short term investments; hence it is necessary to have a longer investment horizon in order to forecast expected higher return with some degree of confidence.

The Pula Fund is, therefore, viewed as a prudent and yield-maximising alternative to investing in Botswana, until opportunities to do so arise and can be programmed into national development plans. Its investment instruments are long term bonds (with a modified duration of up to 6 years) and equities.

Investment Policy

As the nation's reserves manager, the Bank of Botswana's philosophy is that of conservative asset management. The general framework employed in managing risk exposure involves a number of steps. The main risks are identified and measured, an acceptable risk level is defined and a framework for monitoring and managing identified risks is established. Accordingly, the investment policy of the Bank is guided by three considerations I alluded to earlier, which are treated as interactive elements; these are the maintenance of value (safety), liquidity and return, in this order of priority for the Liquidity Portfolio only. Given the longer term nature of the investment instruments of the Pula Fund, which permits the assumption of additional market risk, the prioritisation of investment policies is slightly different such that return is ranked second.

Institutional Framework

In discharging its statutory responsibility for reserves management, the Bank of Botswana is continuously seeking to improve the art of managing reserves prudently and professionally. An institutional structure that seeks to reflect best practice is in place.

For a start, the Board of Directors sets the overall strategy; they determine the asset allocation framework, investment guidelines (which include exposure limits for markets, currencies and modified duration); they also determine performance benchmarks. There is also an in-house Investment Committee, which is responsible for strategic decisions against established benchmarks and periodic portfolio rebalancing (between the Liquidity Portfolio and the Pula Fund). The Committee meets monthly to review developments in the international financial and capital markets, and broad currency and duration decisions are made for each market for implementation by the Department responsible for reserve management.

The Department is organised in a manner that facilitates market monitoring and analysis, dealing

and trading, settlement of deals, verification of transactions and risk management. The main feature of risk control is the segregation of duties relating to dealing, settlement and risk monitoring. In supporting the activities of the Department, the Bank had to acquire and instal appropriate communication, dealing and portfolio management systems, such as SWIFT, Reuters, Bloomberg and HiPortfolio (which has both front and back office capabilities). The Department's operations are audited by the Bank's internal and external auditors, and comprehensive written procedures are subjected to periodic review and scrutiny. The Board is kept informed about the performance of all mandates and portfolios.

The Bank has considered it important to continue to build in-house capability and to instil a sense of pride in the staff through the allocation of a portfolio whose size is considered of worth, commands sufficient attention and provides professional challenge.

External Management of Reserves

A feature of the Bank's operational strategy for managing the reserves is the use of external fund managers. The Bank has had contractual arrangements with overseas fund managers since 1981. External management of reserves provides an alternative or a fall back position in the absence of relevant skills in the Bank, and in case of a possible brain drain on the Bank's scarce manpower resources, particularly given that central banks are not always in a position to offer competitive remuneration packages. Furthermore, the incremental benefits that accrue to the Bank in terms of the training provided by the fund managers to Bank staff over the years have had a positive impact. External fund managers also provide the Bank with a means of performance comparison for Bank staff given that both the fund managers' and the Bank's performance are measured against common benchmarks. The return derived through the manager's investment activity also adds value to the portfolio.

There are currently nine fund managers managing fixed income and equity portfolios of various sizes under different mandates. This enables the Bank to derive benefit from the diversification inherent in multiple mandates and to capture the effects of different fund manager styles. Combining fund managers with different styles reduces the risk of all the fund managers taking similar bets at the same time. The Bank has developed investment guidelines for each mandate which contain, among others, the benchmarks against which the performance of the respective portfolios and the individual fund managers are measured. The benchmarks reflect an element of discretion in terms of permissible deviations from established market parameters.

The safeguards against the risks of using fund managers include a mandatory requirement for UK based fund managers to be members of the Investment Management Regulatory Organization (IMRO), and for those based in the USA to be members of Security and Exchange Commission (SEC). As a related matter, the Bank has acquired the services of an investment consulting firm, which advises the Bank in three main areas - asset allocation, fund manager search and performance measurement.

Global Custody

The Bank also uses the services of a global custodian. Global custody offers advantages through centralized reporting on portfolio valuation and performance measurement. The custodian provides the Bank with an audit trail of transactions generated by all the fund managers, monitors the fund managers' adherence to their respective mandates and guidelines and provides the necessary third-party "checks and balances".

The custodian has had to obtain adequate insurance cover against, inter alia, failure to account to the Bank for any money as a result of error or omission, wrongful or negligent act, dishonest or fraudulent act of any employee, loss of valuable property on the premises, electronic or computer

crime and related omissions or commissions.

IMF Reserve Management Guidelines

As you are probably aware, over the last two years the International Monetary Fund has undertaken a survey of reserve management practices pursued by a number of central banks and agencies responsible for the management of official reserves. This was in response to a request by the International Monetary and Financial Committee (IMFC) for the IMF to develop broad principles of reserve management which could be used as a template in improving member countries' practices in this area. In developing the guidelines, the IMF worked in close collaboration with reserve management authorities of a group of countries and, as part of the outreach programme, regional meetings were held in six countries including Botswana. On the basis of this research, the IMF produced the Guidelines for Foreign Exchange Reserves Management. The guidelines are intended to assist countries in strengthening policy frameworks for reserves management and help build adequate institutional and operational foundations for good reserves management practices. This is an invaluable aid to central banks and related institutions, particularly those intending to establish or modernise their reserves management structures. I recommend the guidelines to those who may not yet have come across them.

Conclusion

I wish to emphasise that reserves management requires diligence in, among others, establishing investment policies, selecting investment currencies and designing appropriate mandates, investment guidelines and performance benchmarks, and all this requires an appropriate operational infrastructure. The purchasing power that the reserves command should ideally be maintained in real terms, while the reserves have to continue to yield the best possible return, commensurate with acceptable risk levels. Given that risk is unavoidable and frequently unquantifiable, it is necessary to formulate a risk policy so that the investment portfolio can derive value for the risks taken.

I hasten to add that there is no unique set of reserves management practices or institutional arrangements that is best for all countries or situations, as circumstances differ. In the final analysis the best approach is to keep the operations in a simple and systematic sequence and to bear in mind that effective operational procedures and manuals are indispensable.

There is considerable scope for reserves managers to learn from each other and to be exposed to best practice in pursuing their objectives. This two-day conference will play an important part in securing collaboration and cooperation among African countries in this area.

With these remarks, it only remains for me to commend the World Bank, Bank of England and Banque de France for organising this conference on "Strategic Directions in Reserves Management for the North Africa and Sub-saharan Africa Regions," thereby sensitising the African continent of the need to keep up with best international practice in reserves management. There is an enriching agenda before us and I have no doubt that we will share experiences in a frank and open manner during the course of the conference. I wish you fruitful deliberations.

Thank you for your attention.

[1] Pula is also the name of Botswana's national currency. The word means "rain" and is used as a blessing, a toast and a slogan of hope (partly because the country is prone to persistent drought due to the rarity of rain).