Emmanuel Tumusiime-Mutebile: Foreign reserve management

Welcome remarks by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the third BIS Meeting on Reserve Management in Africa co-hosted by the Bank of Uganda, Kampala, 18 March 2010.

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The BIS Meeting Chairman – Mr Louis de Montpellier (Deputy Head of Banking Department, BIS)
Distinguished Resource Persons and ***Participants from Central Banks in Africa***
Ladies and Gentlemen

I would like to begin by extending to you all a very warm welcome to this meeting: the third BIS Meeting on Reserve Management in Africa. I would also like to welcome our foreign guests to Uganda, especially those who are visiting this country for the first time. I hope that this meeting will prove very productive and that your visit to Uganda will be a memorable one. I would also like to thank the Bank for International Settlements for granting Uganda the honour of hosting this meeting.

The Bank of Uganda is very pleased to co-host this meeting with the BIS because it comes at a critical time for central banks in Africa, which are still grappling with the myriad consequences of the global economic crisis.

Foreign reserves management is a core function of central banks all over the world. It is particularly important for developing countries. Many developing countries have suffered balance of payments crises, often as a result of large terms of trade shocks or “sudden stops” in the capital account. Many African countries suffered BOP crises in the 1980s while the 1990s saw BOP crises in emerging market economies; in Latin America, East Asia and the former Soviet Union.

The costs of BOP crises, in terms of lost output, bankrupt firms and foregone budget revenue, are usually very high. The lesson we have learned from past episodes of external shocks is that it makes sense to put in place a strategy to protect our economies from the risk of a BOP crisis. One arm of such a strategy comprises sound macroeconomic policies; including sustainable fiscal, monetary and exchange rate policies.

The other arm is to maintain a substantial buffer of international reserves, which can be used to support the BOP in the event of an adverse external shock. This motivated many developing and emerging market economies to build up their international reserves to record levels in the 2000s. Uganda was part of this trend. Our gross international reserves have increased almost fourfold in the last 10 years: from $760 million at the end of 1999 to nearly $2.8 billion today. The countries of Sub-Saharan Africa increased their reserves on average from 3.8 months of imports of goods and services at the start of the 2000s to 5.5 months in 2009.

The decision by central banks to accumulate reserves has proved farsighted. Many African economies, including Uganda, are weathering the current global crisis with much less damage to their economies than was the case with previous major external shocks, such as the oil crises of the 1970s. One of the reasons for the greater resilience of African economies to external shocks is that they now have much larger buffers of international reserves to support their balance of payments, although the improvement in their macroeconomic management undoubtedly made a more important contribution.

With countries across the continent holding higher levels of international reserves, the management of these reserves to maximize the benefits which can be derived from them becomes ever more important. Traditionally, central bank reserve management has focused on three objectives, commonly referred to as the “classic trilogy of objectives”.

In order of importance, this trilogy of objectives is:

- ***Safety of capital*** – through the prudent management of risks;
- ***Liquidity*** – the availability of reserves at short notice and at minimal cost to meet unforeseen requirements and;
- ***Reasonable consistent rates of financial return*** – this objective is normally subordinated to the safety and liquidity objectives.

In pursuit of this trilogy of objectives, most central banks adopt a conservative approach to the management of their foreign reserves. Like Silas Marner, central banks hoard their gold zealously. I think it is fair to say that this approach, with the attendant governance and risk management frameworks that guide its implementation, has also been vindicated by events arising from the global financial crisis in that central banks have not suffered significant losses of capital despite the dramatic falls in value of many different classes of financial assets on world markets. Nor was the liquidity of central bank reserves impaired even though liquidity dried up in many sections of the financial markets around the world.

The global financial crisis has, however, created new challenges for the management of reserves by central banks, in several important respects. First, interest rates on fixed income securities and in money markets in the industrialised economies have fallen to near record low levels as a result of the extraordinary measures taken by central banks in these countries to inject liquidity in order to bolster financial markets and aggregate demand. A three month United States Treasury Bill currently yields only 0.13 percent and a three year US Treasury bond yields only 1.5 percent.

How long interest rates will remain this low is very difficult to forecast, but I'm sure that you will have noted the statement by the United States Federal Reserve on Tuesday of this week that economic conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

Because of the prevailing low interest rates on the traditional safe assets which dominate the portfolios of central banks, their reserve managers are facing increasing pressure to find ways of enhancing income, not least because the income generated by reserves is the main source of operating revenue for many central banks. As such central banks are starting to examine whether they need to diversify their reserve asset portfolios to embrace types of financial assets which can offer higher yields without impairing the liquidity and safety of their portfolios.

A second consequence of the global financial crisis for reserve management is that it has radically changed our view of risks in financial markets. We now know that transactions with financial institutions and markets which, prior to the crisis, were perceived as being virtually risk free can actually carry very significant counterparty and credit risk, as well as liquidity risk.

One other development which has implications for reserve management bears noting. The long term dominance of the US dollar in global financial markets may wane, raising the issue of whether reserve managers should seek to establish a more balanced currency composition of their asset portfolios, and if so, what criteria should guide this.

To meet the challenges posed by low interest rates and the changing nature of risk, central banks must strengthen the technical capacities of their staff for reserve management. In particular they need to deepen their understanding of the risk/return tradeoff in their asset portfolios and they must develop more sophisticated risk management tools.

This third BIS Meeting on Reserve Management is very timely. It presents a unique opportunity for reserve managers to examine the challenges they face and identify solutions. The agenda for the meeting will cover the issues I have highlighted in my remarks as well as other important issues for reserve management, such as cooperation among central banks in reserve management. I am confident that you will be able to take back to your respective central banks a wealth of new ideas to strengthen your reserve management.

Finally, let me implore you to spare a small part of your precious time to enjoy the beauty of this country, the delicious food and the warmth and hospitability of its people. I have heard that some of you took a trip to the source of the River Nile in Jinja yesterday and others are set to visit Murchison Falls National Park on Saturday. I will be happy to join you later this evening at the dinner which the Bank of Uganda will host.

Ladies and Gentlemen, I wish you a very successful meeting. Thank you for your kind attention.