

Session 5:
Role of Liquidity in the Management of FX Reserves

The Role of Liquidity in the Management of Foreign Exchange Reserves

Ms. Sumila Wanaguru
Central Bank of Sri Lanka

THE ROLE OF LIQUIDITY

in the Management of Foreign Exchange Reserves

Sumila Wanaguru
Director of Investment Management
Central Bank of Sri Lanka

7-9 October
Hanoi, Vietnam

Outline

1. Why does liquidity matter?
2. How much liquidity is enough, and how should reserves be composed?
3. What role should credit ratings play in reserve investment decisions?
4. What can we learn from Sri Lanka's recent foreign exchange liquidity crisis?
5. How can early-warning systems and precautionary measures help us identify and address vulnerabilities before they become crises?

1. Why does liquidity matter?

- **Liquidity:** often described as one of the three fundamental objectives of international reserve management
- But for a central bank, liquidity is more than simply the ability to sell an asset quickly.
 - **It is the ability to mobilise foreign currency when it is needed, in the required currency, within the required time, and without incurring an unacceptable cost or loss.**



Priority is not equal weighting.
Return is pursued subject to liquidity and risk constraints.

1. Why does liquidity matter?

- But reserve managers need to take the concept further
- Liquidity has at least four dimensions.
 - **Availability:** Is the asset actually available to the central bank?
 - **Convertibility:** Can it be converted into usable foreign currency quickly?
 - **Market depth:** Can a sizeable transaction be executed without materially affecting the price?
 - **Liquidity under stress:** Will the asset remain liquid precisely when markets are under pressure?
 - An asset can appear highly liquid during normal market conditions but become considerably less liquid when market participants simultaneously seek safety and liquidity.

1. Why does liquidity matter?

- International reserves may have to perform several functions at the same time: support foreign exchange market operations, meet external debt-service obligations, finance essential imports, provide foreign-currency liquidity to the financial system, preserve confidence.
- The relevant question for a reserve manager is not simply: "What is the return on this asset?"

It is: "Can I mobilize this asset, at the required scale and within the required time, under the conditions in which I am most likely to need it?"

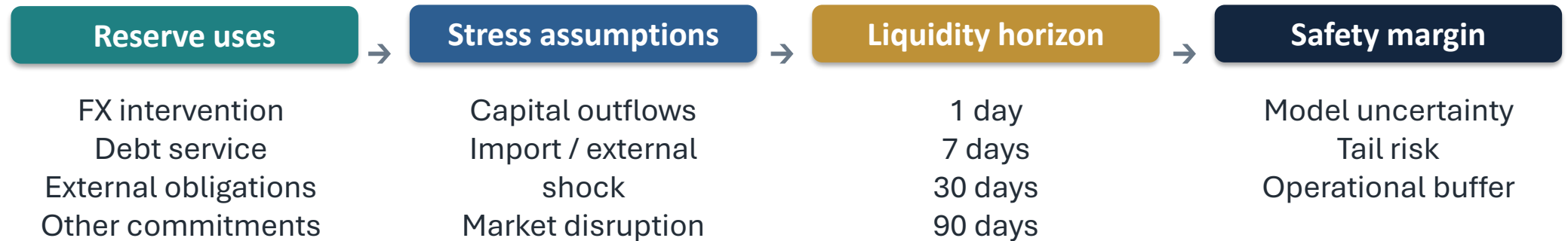
- That is the essence of reserve liquidity - and this explains why central banks are generally prepared to sacrifice some return in exchange for greater liquidity

2. How much liquidity is enough?

- No universal answer
- **Appropriate level** → country's economic structure, exchange-rate regime, financial openness, external debt profile, import dependence, capital-flow volatility and exposure to external shocks
- **Traditional indicators remain useful:** Import cover, Guidotti-Greenspan principle, IMF's reserve adequacy approach
- But even these measures cannot provide the complete answer

2. How much liquidity is enough?

- Reserve managers increasingly need to think in terms of liquidity requirements across different time horizons and under different scenarios



Adequate liquidity = $f(\text{amount, availability, currency, timeliness, marketability})$

Liquidity Target = Stressed Net FX Needs + Safety Buffer

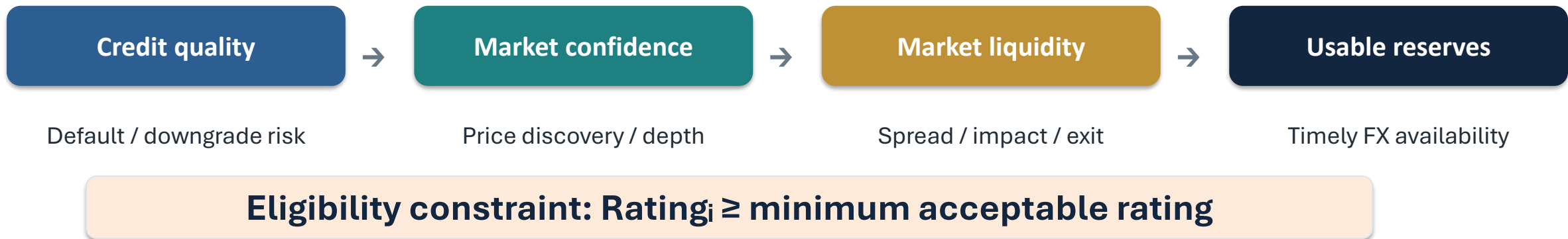
- What happens if several adverse events occur simultaneously? stress testing

Reserve adequacy vs. reserve usability

- Gross reserves are not necessarily the same as usable reserves → need to understand the **liquidity profile of the portfolio, not merely its size**
- One practical approach is a tranche structure → working capital, liquidity and investment tranches
- Precise structure will differ across countries, but the principle is universal:
 - **Not every reserve asset needs to be equally liquid, but **reserve manager must know exactly how much liquidity is available, at what time horizon, and at what potential cost****
 - **Market liquidity can be more valuable than incremental yield**

3. Role of credit rating

- **Credit ratings: necessary, but not sufficient**, as high ratings do not guarantee liquidity under systemic stress
- Question: **how resilient is the asset's credit quality and market liquidity under the scenarios that matter to us?**
- Focus also should be given to- **internal credit assessments, market-based indicators, counterparty surveillance, credit spreads and other market signals, liquidity analysis, stress testing**



4. Sri Lanka: a case study in foreign-exchange liquidity

- **Crisis emerged from the interaction of several vulnerabilities**
 - high external financing requirements, substantial external debt-service obligations, the loss of tourism earnings following the Easter attacks and subsequently the COVID-19 pandemic, reduced access to international capital markets, declining confidence and persistent depletion of reserves to meet external obligations and support exchange-rate stability
- As a result, **usable foreign-currency liquidity became increasingly constrained**
- **Consequences were severe**
 - shortages of fuel and essential imports, significant exchange-rate depreciation, very high inflation, economic contraction, deterioration in confidence and ultimately sovereign debt default followed by restructuring

4. Sri Lanka: a case study in foreign-exchange liquidity

- A reserve crisis does not begin when reserves reach zero
 - when ability to meet future external obligations and shocks becomes increasingly uncertain
- Liquidity requirements should not be based only on the current level of reserves
 - prospective fx obligations, stress scenarios, currency and maturity structure of liabilities, market access, potential speed at which reserves may be required
- **Creates an important trade-off** - holding more highly liquid assets generally improves resilience and reduces the cost of accessing funds during stress
- **Objective is not to maximise liquidity at any cost, but to determine the right level of liquidity for the country's risk profile and external obligations and then optimise the remaining reserves for safety and return**

5. Early warning: moving from monitoring to action

- FX liquidity risk accumulate before the crisis become fully visible – issue is ensuring that warning signs leading to timely decisions
- **Early Warning System: reactive → forward looking**, integrating with directly with the Strategic Asset Allocation, liquidity thresholds and investment guidelines

EWS signal	Possible reserve-management response
Normal conditions	maintain strategic allocation
Emerging liquidity pressure	increase liquidity buffer, reduce new investments with longer maturities
Significant stress	increase share of highly liquid assets, shorten duration
Severe stress	prioritise immediate availability of reserves and minimise market/liquidity risk

Summary

- **True test of international reserves is not how much return they generate - it is whether they are available, usable and credible when country needs them most**
- We need to ask:
 - How much liquidity do we require?
 - At what time horizon and under which stress scenarios?
 - How much of our reserves is genuinely usable?
 - How resilient are our assets to credit and market shocks?
 - How early will we know that our liquidity position is deteriorating?
- **Reserve management is about buying time, confidence and policy space, and liquidity is what makes that possible.**

Thank you.