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BANK OF RUSSIA FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT REPORT

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Bank of Russia foreign
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FOREWORD

This issue of the Bank of Russia Foreign Exchange and Gold Asset Management Report presents the results of asset management in July 2017 – June 2018.

Due to global financial markets' high price sensitivity to the actions of major market participants, including the Bank of Russia, data on Bank of Russia operations on foreign exchange and gold asset management are published at least six months after the end of the reporting period.

Information on Bank of Russia assets is also published in the Bank of Russia Annual Report (managing assets in foreign currency and precious metals) and on the website of the Bank of Russia (data on Russia's international reserves). Please note that any difference in the data provided between the reports is due to data composition and calculation methodologies only.

Terms shown in the text in italics are defined in the glossary.

Please send any feedback, including comments and suggestions regarding the contents of the report and data presentation to reservesmanagement@mail.cbr.ru.

1. PRINCIPLES OF FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT AND FINANCIAL RISK MANAGEMENT

The Bank of Russia's foreign exchange assets include government and non-government bonds of foreign issuers, deposits and nostro accounts balances, reverse repo operations, Russia's net position with the IMF, Russian sovereign Eurobonds and other claims on counterparties. These assets are denominated in US dollars, euros, pounds sterling, Canadian and Australian dollars, yuans, yen, Swiss francs and *Special Drawing Rights* (SDR) (hereinafter, foreign currencies). Foreign securities purchased by the Bank of Russia through reverse repo transactions are excluded from the total volume of foreign exchange assets.

The objective of foreign exchange asset management is to ensure the best balance between the safety, liquidity and profitability of assets.

Bank of Russia assets in precious metals are managed separately from foreign exchange assets. Bank of Russia gold assets comprise monetary gold, stored at vaults within the territory of the Russian Federation.

For the purpose of management, foreign exchange assets are grouped into single-currency portfolios. To assess the efficiency of the management of single-currency portfolios their returns are compared to *benchmark portfolio* returns.

Foreign exchange asset management takes into account the Bank of Russia's liabilities in foreign currencies (balances on foreign currency accounts of clients, mainly *government funds*). Foreign currency holdings expose the Bank of Russia to financial risks, such as credit risk, foreign exchange risk, interest rate risk and liquidity risk.

Credit risk means the risk of counterparties or issuers defaulting on their obligations to the Bank of Russia. Credit risk is constrained by various limits and requirements for the credit quality of counterparties and issuers, which must have a *minimum credit rating* of A under the Fitch Ratings and S&P Global Ratings classifications and a minimum rating of A2 under the Moody's Investors Service classification.

Foreign exchange risk means the probability of a decrease in the value of net foreign currency assets (assets net of liabilities) due to foreign currency exchange rate movements. The Bank of Russia limits the level of foreign exchange risk by specifying a benchmark currency structure of net foreign exchange assets with target weights of eligible currencies and the limits of their deviations.

Interest rate risk is the probability of a decrease in the value of foreign exchange assets due to any unfavourable changes in interest rates. The level of interest rate risk for the Bank of Russia's assets portfolios is measured by duration. The interest rate risk exposure is limited by setting the minimum and maximum *durations* allowed in each of the eligible currency portfolios. Additionally, the maturities of eligible securities, deposits and repo operations are limited.

Liquidity risk means the risk of losses due to insufficient funds to cover Bank of Russia current liabilities in foreign currencies. In order to lower this risk, the volume of liquid assets in each currency is maintained at a level exceeding the volume of liabilities in the same currency. The most liquid assets are government securities, which are the major component of foreign exchange assets. Sources of liquidity also include nostro account balances, credit lines, short-term deposits and repo operations, as well as cash inflows from coupon payments and redemptions of securities denominated in foreign currencies.

The Bank of Russia pays interest on the foreign currency accounts balances equal to the rate of return on indices composed of foreign countries' bonds. The Bank of Russia makes interest payments in rubles. Since the Bank of Russia has the right to issue currency, these obligations don't expose it to interest rate and liquidity risks.

The Bank of Russia has a multilevel collective system for investment decision-making.

The Bank of Russia Board of Directors sets the objectives of foreign exchange asset management, the list of eligible investment instruments, and the target level of foreign exchange risk.

The Bank of Russia collective body, which is in charge of investment strategy and which reports to the Board of Directors, sets the levels of interest rate and credit risks and approves the lists of eligible counterparties and issuers.

The adopted investment decisions are implemented by the authorised divisions of the Bank of Russia. External managers are not involved in foreign exchange and gold asset management.

2. MACROECONOMIC TRENDS IN JULY 2017 – JUNE 2018

Throughout the period under review, the foreign currency exchange rates and government securities yields in major developed economies were primarily driven by the stance of the monetary policy of the Fed and the ECB, as well as by the political and economic events in the USA (the outcome of the US presidential elections and the tax reform) and in Europe (the Brexit process and rising political risks in Italy). Moreover, trade war jitters also affected financial markets, with the USA imposing a broad range of import tariffs.

USA and Canada

With the positive dynamics in the US economy sustained, the Fed commenced with the preannounced unwinding of its balance sheet in October 2017. The tax reform signed into law in late December 2017 gave rise to inflation risks and prompted the Fed to deliver two more rate hikes – in December 2017 and in March 2018 – to 1.50 1.75%. Accelerating inflation coupled with the lowest unemployment rate since 1970 outweighed the risks stemming from escalation of trade wars (the USA imposed import tariffs on steel and aluminum from a number of countries which were followed by more tariffs on various goods from China, triggering symmetrical response) and let the Fed hike the Federal funds rate to 1.75-2.00% in June 2018. In addition to that, the updated Fed's dot plot showed for the first time that in 2018 there may be four rate hikes instead of three.

In 3Q17, the markets continued to reassess the probability of a large fiscal stimulus coming soon. Coupled with an inflation slowdown, it led to a notable correction in long-term yields and weakened the US dollar.

After stabilising in October-December 2017, the US long-term yields blew up in 1Q18 with investors expecting a marked increase in the new issuance from the US Treasury as a result of the tax reform. The yield on the 10-year US Treasury notes surpassed the 3% level in 2Q18 for the first time since 2013. However, the pessimistic rhetoric from the central banks of the euro area, the UK and Japan soured investors' sentiment regarding the speed of global economic recovery and returned the yield below 3%. Political events also put pressure on the long-term yields: the US military operation in Syria, Washington pulling out of the Iran

Chart 1

Changes in exchange rates and gold to the US dollar, as % of start of period

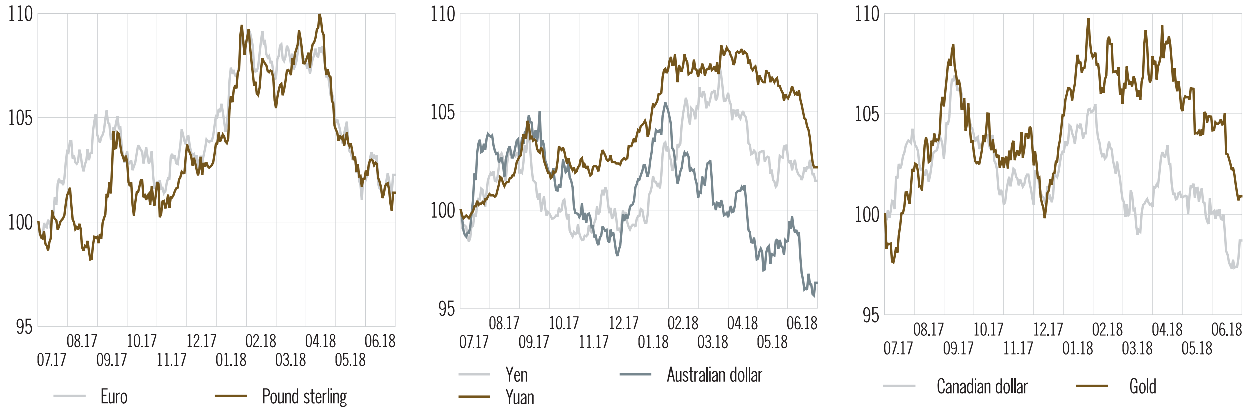
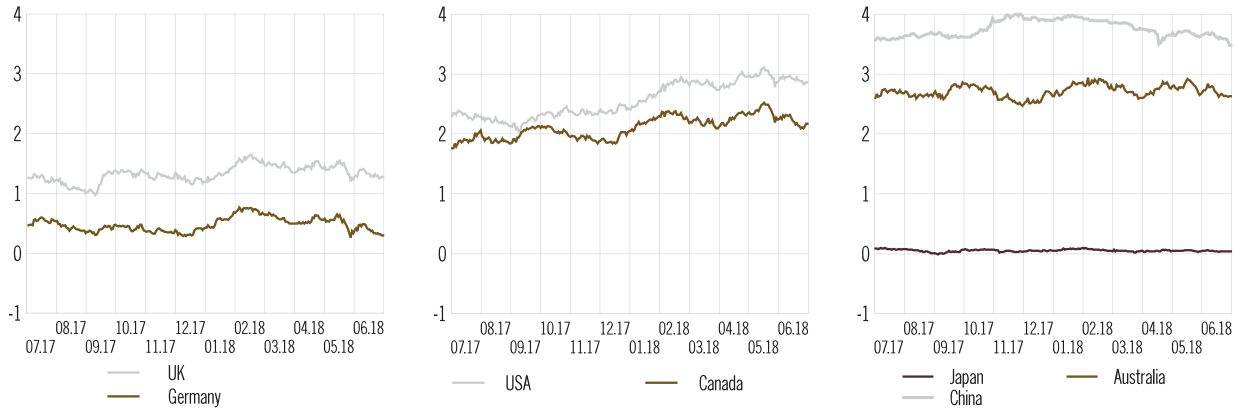


Chart 2

Yields to maturity on 10-year government bonds, % p.a.



nuclear deal and populists coming to power in Italy.

The US dollar continued to weaken in 1Q18, as sustained positive economic dynamics abroad, especially in the euro area and in the UK, led to the expectations of ultra-loose monetary policy there being eventually phased out. Nevertheless, beginning mid-April, the US dollar reversed its down trending path. The deterioration in the euro area macroeconomic outlook and resurfaced political risk stemming from populists coming to power in Italy increased the probability that the spread between the US and European government bonds yields will further widen.

The Canadian dollar started strengthening in mid-2Q17 on the back of increasing expectations of the Bank of Canada to lift the key rate due to rising economic activity and fast disappearing labour market slack. The same narrative supported loonie during July-September. Expectations of monetary policy tightening materialised in July 2017 when the Bank of Canada raised the key rate for the first time in seven years. Positive economic developments led to another rate hike in September 2017, which caught markets by surprise. With this second rate hike, the Bank of Canada returned the key rate to the level last seen at end-2015 thus sending a signal to the markets that the Canadian economy had finally undergone the process of accommodation to the lower oil prices environment.

Shrugging off a substantial rise in oil prices the Canadian dollar underwent a correction in September–December 2017, with the expectations of further monetary policy tightening by the Bank of Canada being stabilised. The yields on long-term Canadian government bonds mostly followed the upward path of US Treasury bonds in 3Q17, with rising probability of a rate hike pushing them even higher.

The oil prices reinstated their influence on the Canadian dollar in January 2018. The loonie also got support from the Bank of Canada, which delivered another rate hike in January 2018, bringing the key rate to 1.25%, its maximum level since 2009. Lingering uncertainties surrounding the future of the NAFTA as well as trade war jitters led to the Canadian dollar's weakness and downward move in the yields on long-term Canadian government bonds in late 1Q18. Despite Canada getting an exclusion till May 2018 from the newly imposed US tariffs on various goods, the persisting probability of new tariffs unnerved the markets and resulted in the Bank of Canada refraining from a rate hike in March 2018.

In April-May 2018, the Canadian dollar and the yields on long-term Canadian government bonds were under the influence of US government bonds yields. That said, rising oil prices, in anticipation of US decision on the Iran nuclear deal, failed to support the loonie and make up for the US dollar broad-based strengthening. However, the rise of political risks in Europe, stemming from populists coming to power in Italy, raised the demand for safe havens and reverted the upward trend in government bonds yields in the second half of May. Weakening macroeconomic data in June 2018 damped expectations of monetary policy tightening by the Bank of Canada and sustained the downward move in yields. The same reason was behind the loonie weakness, which was aggravated by the continuing broad-based US dollar rise.

Europe

Moody's cut the UK sovereign rating by one notch to Aa2 in September 2017 pointing to the uncertainty regarding the Brexit talks and the upcoming budget consolidation. This event did not affect considerably the pound exchange rate and government bond yields since Moody's was the last of the "Big Three" to lower the UK rating after the Brexit referendum.

The pound sterling appreciated in the second half of 2017 due to accelerating inflation and Bank of England rate hike expectations. The rate was raised from 0.25 to 0.5% on 2 November 2017. In December 2017, two months later than originally planned, the UK reached a preliminary agreement on Brexit with the EU.

In 1Q18, high inflation in the UK persisted alongside reports on steady economic growth in the previous period. The political life in the country stabilised, and in March 2018, the government reached a transitionary Brexit agreement regulating the relations with the EU in 2019–2020. It contributed to growing expectations of the Bank of England rate hike and appreciation of the pound sterling against the US dollar.

Yet, in 2Q18, these expectations weakened amid inflation and economic growth deceleration, and the Bank of England rate hike was postponed. The statistical data as well as the Bank's remarks considering the prematureness of a tight monetary policy caused weakening of the pound sterling against the US dollar.

Monetary tightening expectations put upward pressure on the euro in 3Q2017 as well. It was slightly curbed by the growing political uncertainty in Germany where parliamentary elections took place on 24 September 2017. Weakened positions of the German chancellor A. Merkel party urged a major reshuffle of the governing coalition due to significant disagreements on key issues among its member parties.

At the meeting on 26 October 2017, the ECB Governing Council decided to reduce the monthly sovereign bond purchases from 60 to 30 bn euro starting in the beginning of 2018. The duration of the programme with the new amount was set to be nine months with a possibility of further extension. In 4Q, the appreciation of the euro stopped because the ECB actions generally met the market expectations.

In 1Q18, the political climate in Europe was mixed. In Germany mainstream parties formed the government, ending the half-year political instability period, and in Italy populists won the parliamentary election.

In 2Q, the ECB expressed concerns over the deceleration of economic growth in the euro area and the pending threat of trade wars. Nonetheless, in June the ECB Governing Council decided to wind up the quantitative easing programme, as expected, in December 2018 by bringing down the monthly pace of asset purchases from 30 to 15 bl euro in 4Q. At the same time, the regulator announced its plan to maintain its interest rates unchanged at least through the summer of 2019, which came as a surprise for investors and weakened the euro.

In May, a new Italian government whose political programme included an extreme budgetary expansion was formed. Negative news from Italy caused the depreciation of the euro and a flight of capital to German and French sovereign bonds that were considered safer than Italian ones.

Australia and Asia

The Reserve Bank of Australia was keeping its waiting strategy and was holding its key rate unchanged for the whole period under review. Thus, the exchange rate of the Australian dollar and interest rates on government bonds were generally affected not by the RBA's decisions but by macroeconomic data and developments in financial and commodity markets.

During the whole period under review, growth in short-term rates on government bonds was supported by the expectations of the RBA's key rate hike. The growth of expectations was in turn supported by the statistics of unemployment that was declining during 3Q17-4Q17. From the middle of 4Q17, short-term interest rates went down slightly due to weak inflation, which was below the RBA's target again, and due to the regulator's comment that key rate decisions would be determined only by the stance of the Australian economy not by the arising trend of rate hikes in other countries. But in 1Q18, the growth of the interest rates resumed following the path of US rates. The lack of inflation growth toward the RBA's target interval and moderate dynamics of the labour market led to a decline in short-term rates in May 18; however, at the end of period under review, they partially recovered. The long-term rates of Australian sovereign bonds highly correlated with the US ones in 3Q17-4Q17, but at the end of 4Q17–1Q18, the correlation abated and the US rates on 10-year bonds surpassed the Australian ones for the first time in many years. Stable inflation dynamics coupled by the RBA's comment about its refusal to follow the upward trend of policy rated pursued by other central banks led to a decline in long-term rates since the middle of 1Q18. Afterwards, the movements in the Australian long-term rates followed the US ones up to the end of 2Q18.

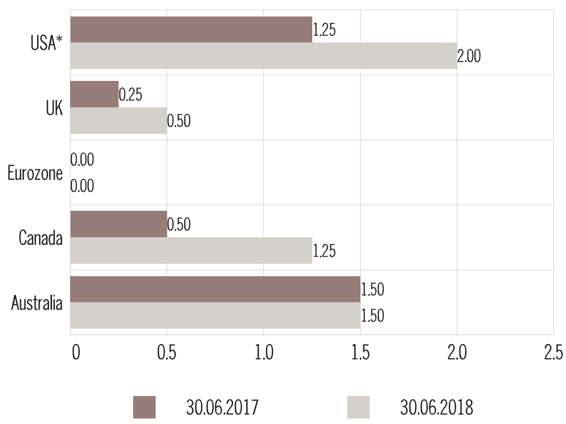
The dynamics of the Australian dollar in 3Q17-4Q17 were mostly determined by iron ore prices. The currency followed the dynamics of iron ore with some lag and, as a result, the Australian dollar appreciated by the end of January 18 to the maximum for the period under review. However, the upward dynamics of US rates and growing concerns about the future of US-China trade relationships resulted in the depreciation of the Australian currency by the end of 2Q18.

After the Bank of Japan (BoJ) announced the policy of targeting of long-term rates on government bonds in September 2016, the rates left negative zone and for the whole period under review stayed within 0-0.1% interval, and turned negative only once in September for a short while. Short-term interest rates were also relatively stable. For the whole period under review, they were fluctuating near -16 bp but several times they went up approaching the maximum point since the BoJ's announcement of the negative rate on its deposits. These periods of approaching the local maximum can be attributed to the growth in expectations of the BoJ's possible tightening following the improving inflation dynamics that accelerated during the period under review. However, each time the BoJ made it clear that the policy of Quantitative and Qualitative Monetary Easing would be stopped only after the inflation reached the BoJ's target (2%).

In in 3Q17-4Q17, the yen followed the dynamics of US long-term interest rates: fall in the US rates led to the yen's depreciation and vice versa. The Japanese currency appreciated in 1Q18 despite the increase of US long-term rates. The appreciation evolved due to the excess demand for the yen as a safe haven asset amid increasing trade tensions between the USA and China. That said, by the end of

Chart 3

Central banks key rates, % p.a.



** The Fed funds target rate was 1.00–1.25% as of 30 June 2017 and 1.75–2.00% as of 30 June 2018.*

2Q18, exchange rate of the Japanese currency declined roughly to the readings observed at the beginning of 1Q18.

Positive statistics on Chinese economy growth in 3Q17-1Q18, which accelerated compared with 2016, supported the appreciation of the Chinese currency up to April 2018. However, elevated tensions in bilateral trade with the USA and the tightening of tariff policy mostly by the USA led to the significant (more than 5%) depreciation of the Chinese currency in 2Q18.

Both the PBoC's policy of monetary tightening that started in 1Q17 with the increase of short-term interest rates on its liquidity provision facilities and the strengthening of control over the banking sector in order to limit lending supported the growth of rates on government bonds over 3Q17-4Q17. Despite the increase in trade tensions between the USA and China, from the beginning of 1Q18, the rates started dropping and this trend continued in 2Q18 supported by the PBoC that introduced some easing measures. The PBoC did not follow the Fed's hike, kept its repo rate unchanged and cut the reserve requirement ratio for banks.

Gold

Gradual escalation of inflation risks stemming from the expected materialisation of massive fiscal stimulus promised by the new US administration as well as the US dollar weakness in 3Q17-1Q18 led to increase in gold prices over this period. In 2Q18, gold prices mirrored the dynamics of the US dollar which started to appreciate.

3. FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT IN JULY 2017 – JUNE 2018

In the period under review, Bank of Russia foreign exchange and gold assets increased by $40.4 billion to reach $458.1 billion (Table 1). Domestic market gold and foreign currency purchases had the greatest positive impact on the value of assets (Charts 1 and 4). The foreign currency purchases were carried out as part of the Federal Treasury's foreign currency acquisitions from the Bank of Russia under the fiscal rule implementation (overshoot of the forecast oil and gas income of the federal budget).

In July 2017 – June 2018, the amount of deposits and nostro account balances with the Bank of Russia significantly increased. The international organisations' securities portfolio and the amount of gold assets also built up. In the period under review, the amount of claims in foreign currency on Russian credit institutions under repo transactions decreased (Table 1).

As of 30 June 2018, the category 'Others' in Chart 5 includes assets in pounds sterling (6.3%), yen (4.5%), the Canadian (2.9%) and Australian (1.0%) dollars, as well as assets in Swiss francs (0.0%).

Chart 6 shows the geographical structure of assets by place of residence of counterparties or issuers of securities.

Chart 7 shows the distribution of assets by credit rating. The Chart is based on Fitch Ratings, S&P Global Ratings and Moody's Investors Service data, with the lowest credit rating grades used.

Data on the return on the actual and benchmark single-currency portfolios of Bank of Russia foreign exchange assets are shown in Table 2.

Table 1

Foreign exchange and gold assets by asset class

Assets	As of 30 June 2017		As of 30 June 2018		Change in July 2017 – June 2018, billions of US dollars
	billions of US dollars	share of assets	billions of US dollars	share of assets	
Government securities of foreign issuers *	218.7	52.3	180.9	39.5	-37.8
Deposits and account balances with foreign counterparties	77.6	18.6	131.1	28.6	53.5
Gold	67.3	16.1	76.7	16.7	9.4
Non-government securities of foreign issuers **	32.3	7.7	38.1	8.3	5.8
International organisations securities	10.7	2.6	22.0	4.8	11.3
Reverse repo operations with foreign counterparties	2.9	0.7	3.8	0.8	0.9
Claims in foreign currency on Russian counterparties and issuers	6.4	1.5	3.6	0.8	-2.8
Net position with the IMF	1.9	0.5	1.9	0.4	0.0
Claims on foreign counterparties on foreign currency supply	0.0	0.0	0.0	0.0	0.0
Total ***	**417.8**	**100.0**	**458.1**	**100.0**	**40.4**

* *Securities issued by a foreign government or foreign issuers with explicit government guarantee.*

** *Securities of foreign issuers that are expected to almost certainly receive government support due to the special role or importance of their organisations in the economy of the country or region (implied guarantee).*

*** *The total value may differ from the sum of asset classes values due to rounding.*

Chart 4

Changes in foreign exchange and gold assets in July 2017 – June 2018, billions of US dollars

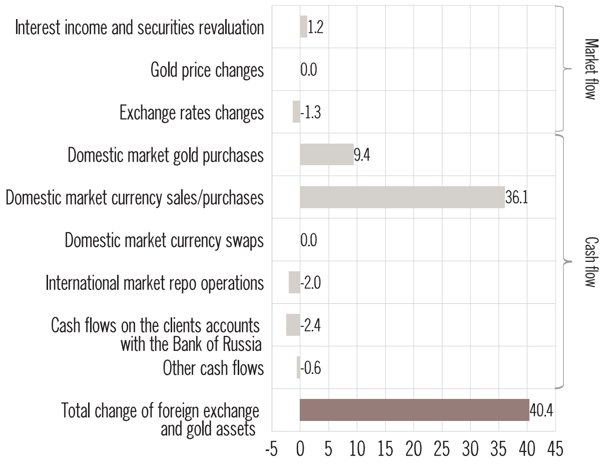


Chart 6

Geographical structure of Bank of Russia foreign exchange and gold assets, %

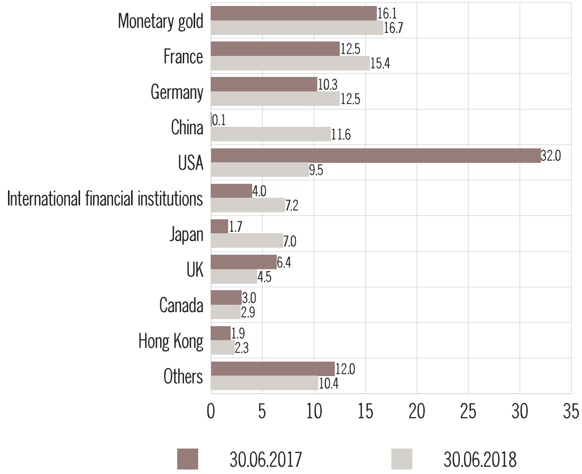
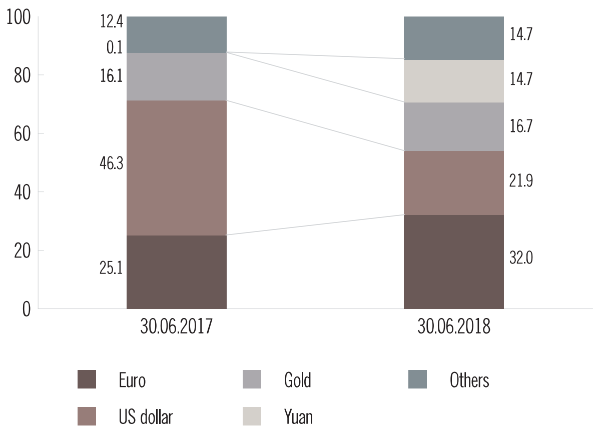


Chart 5

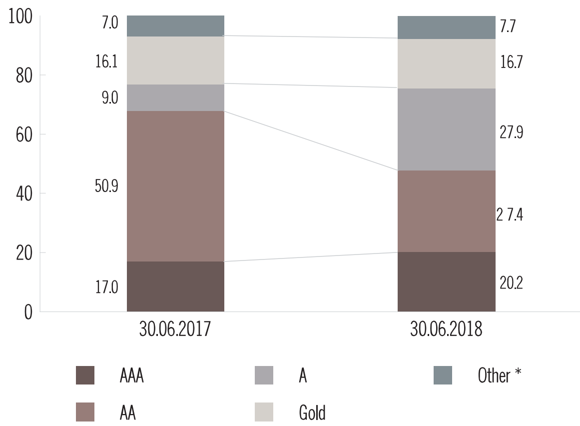
Bank of Russia foreign exchange and gold assets by currency*, % of market value



* *The distribution takes into account unsettled conversion transactions as of 30 June 2017 and 30 June 2018.*

Chart 7

Bank of Russia foreign exchange and gold assets by credit rating, %



* *Mainly claims on Russian counterparties and issuers and Russia's net position with the IMF.*

Table 2

Return on Bank of Russia foreign exchange assets in July 2017 – June 2018, % p.a.

Indicator	US dollar	Euro	pound sterling	Canadian dollar	Australian dollar	Yuan
Return on actual single-currency portfolios of foreign exchange assets	0.35	-0.17	0.23	0.91	1.75	3.20
Return on benchmark single-currency portfolios of foreign exchange assets	0.45	-0.30	0.20	0.81	1.60	3.47*

* *In the previous issues of the Report, the value of the return on the yuan benchmark portfolio (indicated in the Table) included the costs (associated with the settlement procedure in yuan and wide bid-ask spreads) that would arise from making regular rebalancing transactions in an actual portfolio against a corresponding benchmark portfolio.*

GLOSSARY

Benchmark portfolio	A set of financial instruments in each reserve currency taken in appropriate percentage. Benchmark portfolios reflect the target distribution of Bank of Russia assets in each foreign currency.
Central bank key rate	A rate set by a central bank to impact interest rates in the economy. Usually, a change to the key rate is a major monetary policy tool. Examples of key rates used by the leading central banks include: • US Federal Reserve System (Fed) – A target for an interest rate at which depository institutions lend reserve balances to other depository institutions overnight; • European Central Bank (ECB) – A minimum rate at ECB repo auctions; • Bank of England – An interest rate on commercial bank reserves deposited with the Bank of England; • Bank of Canada – A target for an interbank loan rate; • Reserve Bank of Australia – A target for an interbank loan rate; • Bank of Japan (BoJ) – BoJ is targeting an annual amount of asset purchases (since 2013), the level of 10-year JGB yields (since 2016) and is applying a negative interest rate to the reserves of financial institutions held in BoJ accounts (since 2016).
Credit rating	A rating agency's assessment of the creditworthiness of a borrower and its ability to fulfill its financial obligations.
Currency swap	An agreement pursuant to which counterparties exchange payments in different currencies. The Bank of Russia enters into currency swap operations in order to supply Russian credit institutions with ruble funds using foreign currency funds as collateral.
Duration	A measure of the relative sensitivity of the value of a fixed-income instrument or a class of instruments to changes in the corresponding interest rates by one percentage point.
Government funds	The Reserve Fund and the National Wealth Fund of the Russian Federation including their foreign currency deposits with the Bank of Russia (in US dollars, euros and pounds sterling). From 1 January 2018, the Reserve Fund has been discontinued.
Quantitative and qualitative easing (QQE)	A monetary policy used by central banks to stimulate the economy. To carry out quantitative easing, a central bank purchases government securities or other securities from the market or provides funds collateralised by financial assets in order to increase money supply. Qualitative easing refers to the shift in the composition of assets on the central bank's balance sheet to less liquid and more risky assets, given the overall balance of the central bank does not change.
Repo (reverse repo) transactions	Securities sale (purchase) transactions with an obligation of their repurchase (resale) at future date at a stated price. These are mainly executed to borrow money and to simultaneously place corresponding amounts of money at higher interest rates.
Return on Bank of Russia foreign exchange assets	The holding period return is calculated using chain index based on a daily return. Daily return on a single-currency portfolio is calculated as the ratio of aggregate (realised and unrealised) returns on the portfolio to its market value as of the end of the previous day.
SDR (Special Drawing Rights)	An international reserve asset created by the IMF to supplement the existing official reserves of member countries. It is a potential claim on the freely usable currencies of IMF members. The SDR rate is determined based on the dollar value of a five-currency basket made up of the US dollar, euro, yen, pound sterling and yuan (from 1 October 2016).