Bank of Russia

The Central Bank of the Russian Federation

No. 4

2018

BANK OF RUSSIA FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT REPORT

MOSCOW

Bank of Russia foreign
exchange and gold asset
management report
No. 4 (48)
2018

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Contents

FOREWORD

This issue of the Bank of Russia Foreign Exchange and Gold Asset Management Report presents the results of asset management in April 2017 – March 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 (management of reserve assets in foreign currency and gold) 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 APRIL 2017 – MARCH 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 (official start of the Brexit process and presidential elections in France). 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 raised the Federal funds rate in June 2017 to 1.00-1.25%. Moreover, the Fed announced in September 2017 that the unwinding of its balance sheet will start in October. The tax reform signed into law in late December 2017 gave rise to inflation risks and prompted the Fed to deliver two more hikes – in December 2017 and in March 2018 – to 1.50 1.75%. However, the dot plot published along with the hike decision in March unexpectedly revealed unchanged expectations of the future path of the Federal funds rate for 2018. One of the reasons behind this was the build-up of the trade war jitters. The USA imposed import tariffs on steel and aluminum from a number of countries. They were followed by more tariffs on various goods from China, triggering symmetrical response.

In 2Q-3Q17, the markets reassessed 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. The latter also got hit by the political events in Europe with disintegration risk in the euro area diminishing after eurosceptics lost the bid for the French presidency.

After stabilising in October-December 2017, the US long-term yields blew up in 1Q18 with investors expecting a marked increase in new issuance from the US Treasury as a result of the tax reform. 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 expectations

Chart 1

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

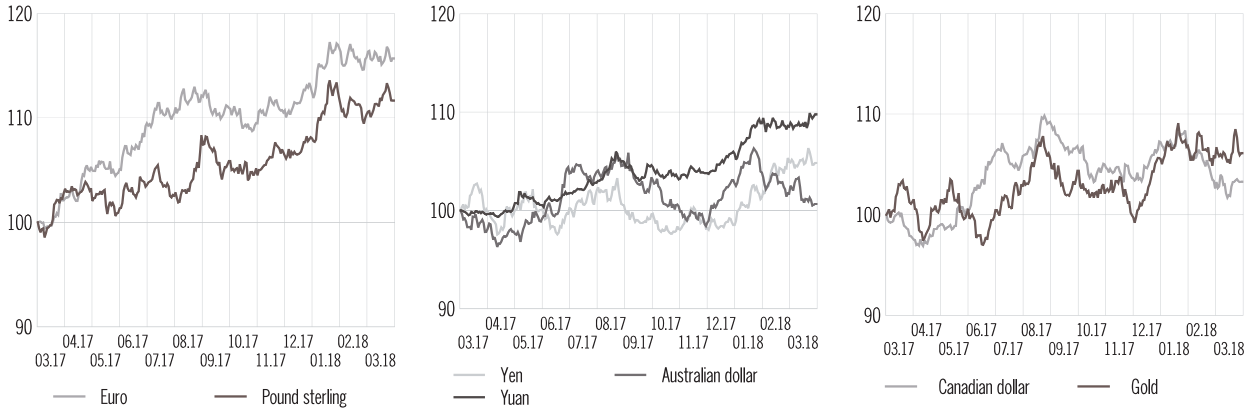


Chart 2

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

of ultra-loose monetary policy there being eventually phased out.

After depreciating gradually since mid-2016 the Canadian dollar reversed its course abruptly in May 2017 when the expectations of the Bank of Canada to lift the key rate started building up on the back of rising economic activity and fast disappearing labour market slack. These expectations materialised in July 2017 when the Bank of Canada raised the key rate for the first time in 7 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 during the period under review, while rising probability of a rate hike pushed them higher in 2Q-3Q17.

The oil prices intensified their influence on the Canadian dollar in 1Q18. 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 a temporary exclusion from the newly imposed US tariffs on various goods, the mere probability of new tariffs unnerved the markets and resulted in the Bank of Canada refraining from a rate hike in March 2018.

Europe

In April 2017, the British parliament approved holding snap parliamentary elections on 8 June. Contrary to the initial forecasts, the elections deprived the ruling party of its parliamentary majority and led to political instability in the country, which caused a brief depreciation of the pound sterling.

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.

In 2Q17, the French presidential election was held which became a major political risk factor for investors. Nevertheless, the risks did not realise and the eurosceptics failed to gain power. This marked the start for the euro appreciation against the US dollar. Strengthening euro and rising government bond yields in the eurozone were further enhanced by growing ECB tightening expectations: despite the fact that the eurozone inflation returned to 1.5% year on year after a brief acceleration in 1Q, the ECB head M. Draghi expressed confidence that inflation would reach its target level and was optimistic regarding further GDP dynamics.

The expectations of monetary tightening by the ECB put upward pressure on the euro in 3Q17 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 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.

Australia and Asia

Since its last decision to cut the key rate by 0.25 pp. in August 2016, the Reserve Bank of Australia was keeping it stable during the whole period under review. Thus, the exchange rate of the Australian dollar and interest rates on government bonds were rather shaped by macroeconomic data and developments in financial and commodity markets than by RBA decisions.

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 2Q17-4Q17 and the RBA's claims that most likely the next policy-rate decision will be hike instead of cut. 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 and 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 long-term rates of Australian sovereign bonds highly correlated with the US ones in 2Q17-4Q17, but at the end of 4Q17–1Q18, the correlation abated and the US rates on 10-year bonds surpassed the Australian rates for the first time in many years.

The lack of positive developments in inflation dynamics coupled by the RBA's comment about its refusal to follow the upward trend of policy rates pursued by other central banks led to a decline in long-term rates in 1Q18.

The dynamics of the Australian dollar in 2Q17-4Q17 were mostly determined by iron ore prices. The currency followed the dynamics of iron ore with some lag but the response to iron ore price movements in 2H17 was stronger than in 2Q17. As a result, the Australian dollar appreciated by the end of January 2018. 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 from the middle of 1Q18.

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 2017 and in 1Q18 stayed within 0-0.1% interval, turned negative briefly only once in September 2017. Short-term interest rates were also relatively stable. For the whole period under review, they were fluctuating near 0.16% 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%).

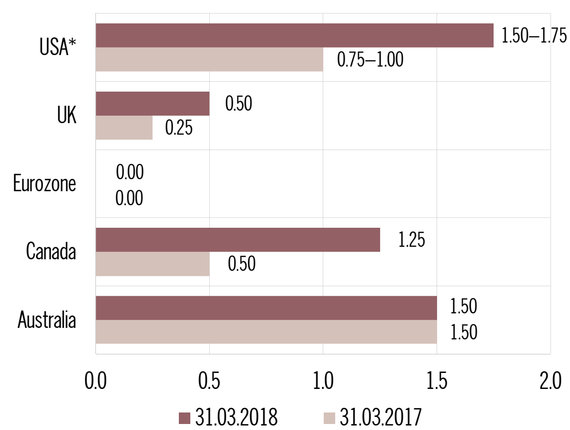
In 2Q17-4Q17, the yen followed the dynamics of US long-term interest rates: fall in US rates led to the yen's depreciation and vice versa. The Japanese currency appreciated in 1Q18 despite the increase of US long-term rates. The appreciation evolved due to the excess demand for the yen as a safe haven asset amid increasing trade tensions between the USA and China.

Positive statistics on Chinese economy growth in 2Q17-4Q17, which accelerated compared with 2016, supported the appreciation of the Chinese currency during the whole period under review. At the end of May 2017, the People's Bank of China (PBoC) announced a modification of its Middle Rate determination mechanism. According to the new rules, significant moves of exchanges rates in the currencies from the SAFE's (State Administration of Foreign Exchange) basket may not be fully passed through to the Middle Rate. The decision led to the appreciation of the yuan against the US dollar. Chinese sovereign rating downgrades in May (by Moody's) and September (by Standard & Poors) to A1 and A+, respectively, did not affect the yuan exchange rate significantly because these decisions were anticipated.

Both the PBoC's policy of monetary tightening that started in 1Q17 from 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 2Q17-4Q17. Nevertheless, in 1Q18, there was little correction of the rates despite the increase in trade tensions between the USA and China.

Chart 3

Central banks key rates, % p.a.



* The Fed funds target rate was 0.75–1.00% as of 31 March 2017 and 1.50–1.75% as of 31 March 2018.

Gold

Gold prices were almost unchanged in 2Q17 due to diminishing expectations of inflation risks stemming from the materialisation of massive fiscal stimulus promised by the new US administration. However, with the above stated risks building up again and the US dollar weakening, gold prices increased in 3Q17-1Q18.

3. FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT IN APRIL 2017 – MARCH 2018

In the period under review, Bank of Russia foreign exchange and gold assets increased by $57.2 billion to reach $460.0 billion (Table 1). Foreign currency exchange rate movements against the US dollar together with domestic market gold and foreign currency purchases and gold price changes had a positive impact on the value of assets (Charts 1 and 4).

In April 2017 – March 2018, the government securities portfolio and the amount of deposits and nostro account balances with the Bank of Russia significantly increased. In the period under review, the amount of claims in foreign currency on Russian credit institutions under repo transactions decreased (Table 1).

As of 31 March 2018, the category 'Others' in Chart 5 includes assets in yuans (5.0%), the Canadian (3.0%) and Australian (1.0%) dollars, as well as assets in yen (0.0%) and 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

Активы	As of 31 March 2017		As of 31 March 2018		Change in April 2017 – March 2018, billions of US dollars
	billions of US dollars	share of assets	billions of US dollars	share of assets	
Government securities of foreign issuers *	209.1	51.9	225.6	49.0	16.5
Deposits and account balances with foreign counterparties	68.6	17.0	93.6	20.3	25.0
Gold	65.9	16.4	79.0	17.2	13.1
Non-government securities of foreign issuers **	33.9	8.4	41.6	9.0	7.7
International organisations' securities	13.0	3.2	12.7	2.8	-0.3
Claims in foreign currency on Russian counterparties and issuers	9.0	2.2	3.6	0.8	-5.5
Reverse repo operations with foreign counterparties	1.4	0.3	2.5	0.5	1.2
Net position with the IMF	1.9	0.5	1.5	0.3	-0.4
Claims on foreign counterparties on currency supply	0.0	0.0	0.0	0.0	0.0
Total * **	**402.8**	**100.0**	**460.0**	**100.0**	**57.2**

* *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 April 2017 – March 2018, billions of US dollars

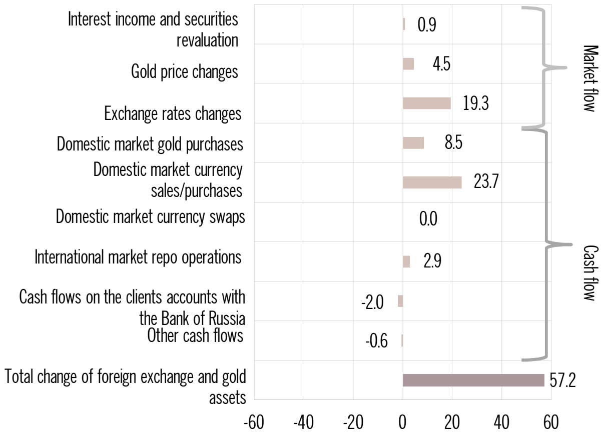


Chart 6

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

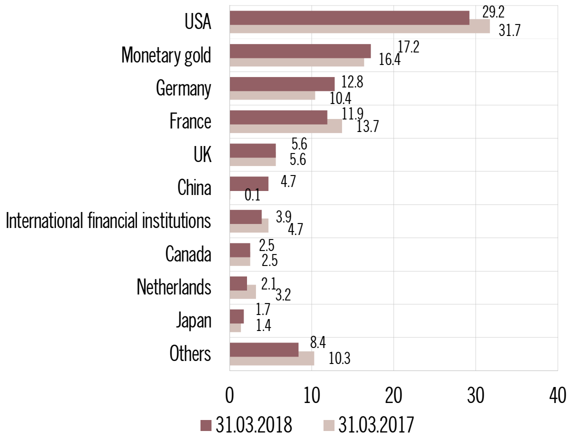
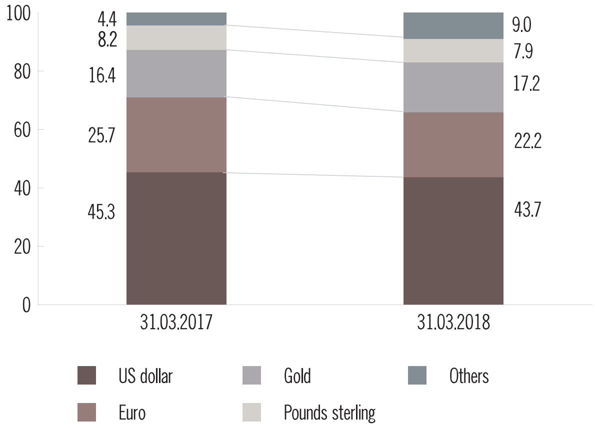


Chart 5

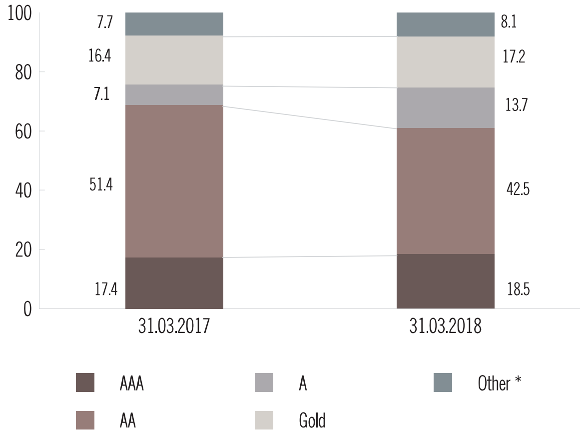
Bank of Russia foreign exchange and gold assets by currency*, % of market value



** The distribution takes into account unsettled conversion transactions as of 31 March 2017 and 31 March 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 April 2017 – March 2018, % p.a.

Indicator	US dollar	Euro	Pound sterling	Canadian dollar	Australian dollar	Yuan
Return on actual single-currency portfolios of foreign exchange assets	0.48	-0.33	-0.20	0.43	1.66	2.17
Return on benchmark single-currency portfolios of foreign exchange assets	0.41	-0.50	-0.23	0.34	1.49	1.76 *

** A valuation is carried out taking into account the costs (associated with the settlement procedure in yuan and wide bid-ask spreads) that would arise from making regular rebalancing transactions in actual portfolio against a corresponding benchmark portfolio. The return on yuan benchmark portfolio excluding these costs was 2.37% p.a.*

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).
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.