THE CENTRAL BANK OF THE RUSSIAN FEDERATION

REVIEW OF BANK OF RUSSIA FOREIGN EXCHANGE ASSET MANAGEMENT

Issue No. 3 (31)

Moscow

2014

12 Neglinnaya St., 107016 Moscow
E-mail: reservesmanagement@mail.cbr.ru

CONTENTS

FOREWORD ....
PRINCIPLES OF FOREIGN EXCHANGE ASSET AND FINANCIAL RISK MANAGEMENT ……………
OVERVIEW OF KEY MACROECONOMIC TRENDS IN JANUARY–DECEMBER 2013…
FOREIGN EXCHANGE ASSET MANAGEMENT IN JANUARY-DECEMBER 2013 …………………………
GLOSSARY ……………………………………………………………………………………………...............

FOREWORD

This issue of the Review of Bank of Russia Foreign Exchange Asset Management presents the findings on foreign exchange asset management in December-January 2013.

Data on Bank of Russia operations on foreign exchange asset management are published at least six months after the end of the period under review due to the high price sensitivity of global financial markets to the actions of major market players, including the Bank of Russia.

Information on Bank of Russia foreign exchange assets is also published in the Bank of Russia Annual Report (data on foreign exchange reserve assets and gold assets) and in several sections of the Bank of Russia site (data on the size of the Russia's international reserves). Variances in the indicators provided in this Review and in the above sources are due to the different composition of constituent data for asset size calculations and calculation methodologies.

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

We would kindly ask you to send comments and suggestions regarding the contents of the Review and the form of data presentation to reservesmanagement@mail.cbr.ru.

PRINCIPLES OF FOREIGN EXCHANGE ASSET AND FINANCIAL RISK MANAGEMENT

The Bank of Russia foreign exchange assets analysed in this Review include government and non-government debt securities of foreign issuers, nostro account deposits and balances, funds used in *reverse repo* transactions, Russia's net position with the IMF, Russian eurobonds, as well as other claims on counterparties. These instruments are denominated in US dollars, euros, pounds sterling, Canadian and Australian dollars, yen, *Special Drawing Rights (SDR)*, and Swiss francs (hereinafter foreign currencies). Foreign securities purchased by the Bank of Russia through reverse repo transactions are excluded from the calculation of the total volume of foreign exchange assets.

The objective of foreign exchange asset management is to ensure an optimum balance between their safety, liquidity and return.

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

Foreign exchange asset management exposes the Bank of Russia to financial risks, such as credit risk, foreign exchange risk, interest rate risk, and liquidity risk.

Credit risk is understood as the risk of counterparties or securities issuers defaulting on their obligations to the Bank of Russia. Credit risk is subject to various limits and requirements for the credit quality of counterparties and foreign issuers, which must have a minimum *credit rating* of 'A' under the Fitch Ratings and Standard & Poor's classifications and a minimum rating of 'A2' under the Moody's Investors Service classification.

Foreign exchange risk is understood as the risk of the erosion of the value of net foreign currency assets (assets net of liabilities) due to foreign currency exchange rate movements. The level of foreign exchange risk assumed by the Bank of Russia is determined by the target weights of different currencies in net foreign exchange assets and is subject to limits on maximum acceptable deviations.

Interest rate risk is understood as the risk of foreign currency asset value erosion due to unfavourable interest rate trends. The level of interest rate risk assumed by the Bank of Russia for each currency is determined by the target asset *duration.* In order to manage interest rate risk, maximum and minimum asset duration values are set for each foreign currency, and limits are fixed for the maturities of securities, and deposit and repo transaction terms.

Liquidity risk is understood as 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 form the bulk of foreign exchange assets. Sources of liquidity also include nostro account balances, credit lines, short-term deposits and repo transactions, as well as cash inflows from coupon payments and redemptions of securities denominated in foreign currencies.

The Bank of Russia has a multi-tier collegiate system for investment decision-making.

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

The Bank of Russia Committee in charge of investment strategy sets the levels of interest rate and credit risks and defines the lists of counterparties and issuers.

The investment decisions taken are implemented by Bank of Russia structural units; third-party services are not used for the management of foreign exchange assets.

OVERVIEW OF KEY MACROECONOMIC TRENDS IN JANUARY–DECEMBER 2013

The key factors influencing the trends of foreign currency exchange rates and government securities yields in major developed countries throughout the period under review included continued debt problems in several eurozone countries, a slowdown of economic growth in China, and the implementation of *quantitative easing* programmes in the USA and Japan.

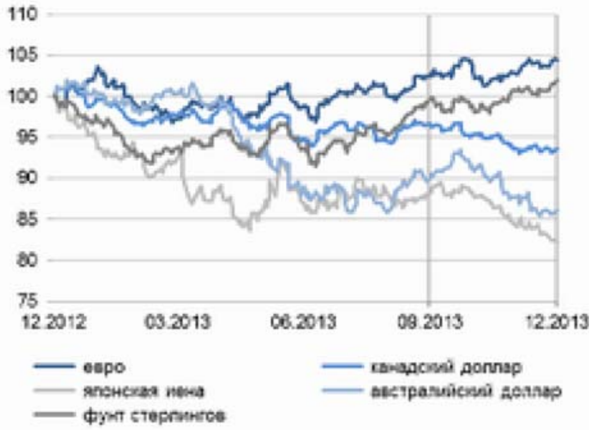
In the first quarter of 2013, US Congress approved a bill envisaging a moderate reduction of the budget deficit without slowing down US economic growth.

In February 2013, Moody's Investors Service cut the UK sovereign rating by one notch, which, coupled with a reduction in previous quarter GDP and worsening economic forecasts, led to a depreciation of the pound sterling against the US dollar.

Market participants' expectations regarding the introduction of a quantitative easing programme in Japan aimed at stopping long-term deflation contributed to the depreciation of the yen against the US dollar (Chart 1) and led to a rise in government bond prices.

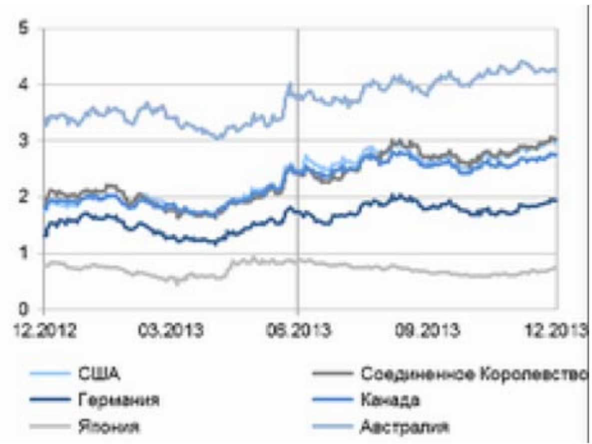
March 2013 saw the completion of a round of negotiations between the troika of international creditors (the ECB, the EU, and the IMF) and Cyprus, which had requested financial aid to rescue its banking sector. As a condition of assistance, the troika demanded that Cyprus transfer part of bank rescue costs from taxpayers to bank depositors. Despite statements by EU officials saying that this approach would not be applied to other EU member countries, investor confidence in peripheral EU countries was shaken, and interest rates on government securities issued by key eurozone countries declined due to widespread *flight to quality* (Chart 2).

Chart 1. Changes in the exchange rates of major developed countries to the US dollar, as % of start of period



euro Canadian dollar
yen Australian dollar
pound sterling

Chart 2. Yields to maturity on 10-year government bonds issued by major developed countries, % p.a.



December 2012 March 2013 June 2013 September 2013 December 2013

USA UK
Germany Canada
Japan Australia

In the second quarter of 2013, US GDP growth accelerated while the eurozone came out of the recession that had continued since 2011. In May, the ECB cut its key rate from 0.75% to 0.5% (Chart 3).

In April 2013, the Bank of Japan announced a large-scale expansion of its quantitative easing programme aimed at reaching an inflation target of 2.0% by 2015; the monthly asset purchase volume increased from ¥3.4 trillion to ¥7 trillion.

At the same time, the Bank of Japan abandoned target interest rate ranges in favour of setting *monetary base* targets. As a result of this policy, the yen depreciated against the US dollar by 7.0% by the end of the quarter, and deflation ended in June.

A slowdown of economic growth in Australia caused its central bank, the Reserve Bank of Australia, to reduce its cash rate from 3.0% to 2.75% in May 2013, which resulted in a decline in the Australian dollar exchange rate.

Market participants' expectations regarding Federal Reserve's early exit from its quantitative easing programme (involving monthly asset purchases in an amount of $85 billion) in the third quarter of 2013 led to the depreciation of most currencies against the US dollar. A Fed meeting in September 2013 left the asset purchase volume unchanged, which resulted in the dollar depreciation.

In July 2013, France lost its top grade assigned by Fitch Ratings (the agency was the last of the three major international rating agencies to have done so) due to high unemployment and government debt. Spain exited the recession in the third quarter of 2013, with GDP growth amounting to 0.1% compared to the previous quarter.

In August 2013, the Reserve Bank of Australia cut its cash rate from 2.75% to 2.5%.

In September 2013, US Congress failed to approve the federal budget for the 2014 fiscal year (starting from 1 October 2013) and to agree on raising the government borrowing ceiling due to political differences. As a consequence, the USA experienced a government shutdown from 1 to 16 October when several government departments suspended operations, raising the threat of a technical default. A day before the borrowing limit was to be reached, on 16 October, US Congress extended government funding until 15 January 2014, and suspended the government borrowing ceiling until 7 February 2014. The period of uncertainty preceding this resolution led to a flight to quality by international investors and to a rise in short-term interest rates.

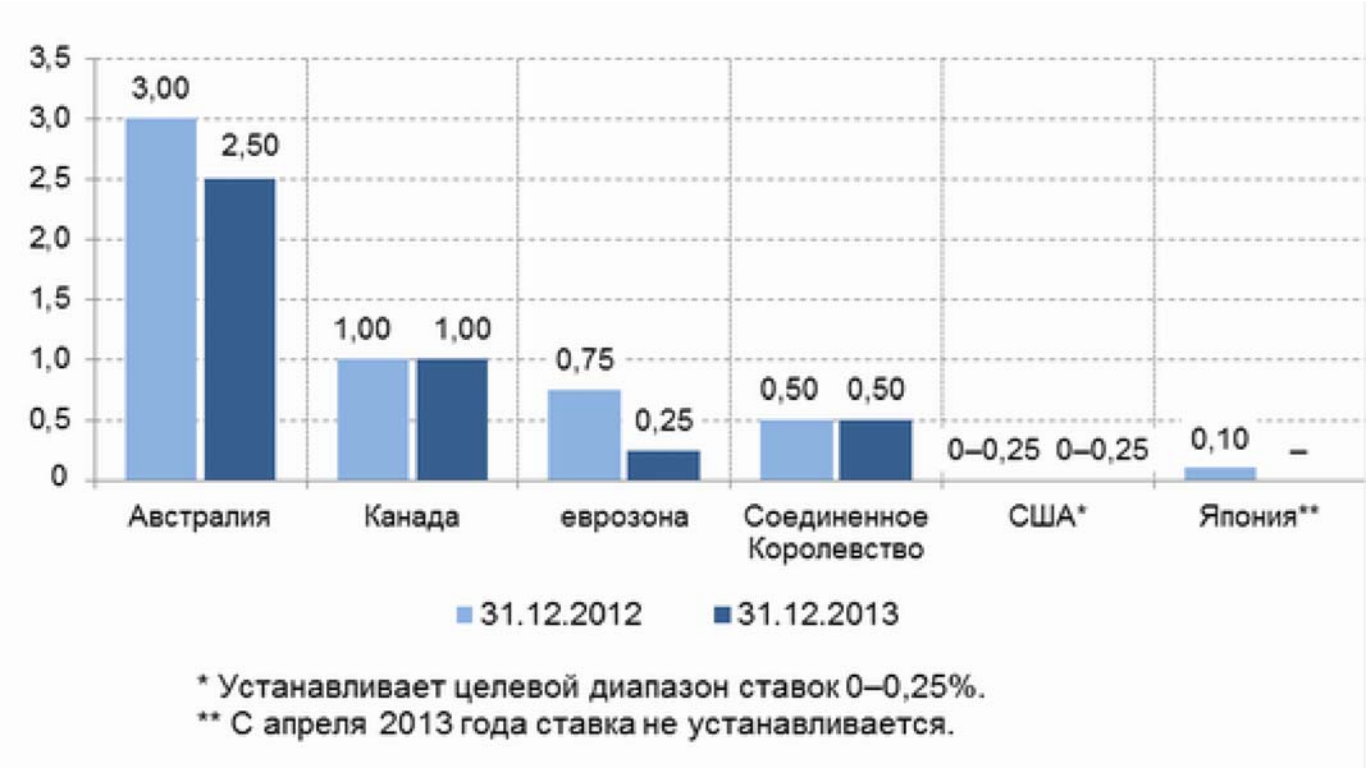
In November 2013, amid weak economic growth and low eurozone inflation, the ECB eased its monetary policy by cutting the key rate from 0.5% to 0.25%. S&P lowered France's rating from 'AA+' to 'AA', noting insufficient labour market reforms and falling competitiveness. The agency's experts also pointed to excessively high budget expenditures coupled with high taxes that do not allow for budget consolidation by means of further tax increases.

In December 2013, the US Federal Open Market Committee resolved to decrease the monthly bond purchases by $10 billion following a significant improvement in the labour market (unemployment reached 7% by November) and the consensus reached in the US Senate regarding the federal budget.

Table 1. Budget balance and government debt in major developed countries (monetary unions) as of 31 December 2013, as % of GDP

Indicator	USA	Eurozone	UK	Canada	Australia	Japan
Budget balance	-7.3	-2.9	-5.8	-3.0	-3.7	-8.4
Government debt	104.5	95.2	90.1	89.1	28.7	243.2

Chart 3. Central bank key rates in major developed countries (monetary unions), % p.a.



3.00 2.50 1.00 0.75

Australia
Canada
Eurozone
UK
USA*
Japan**

31 December 2012 31 December 2013

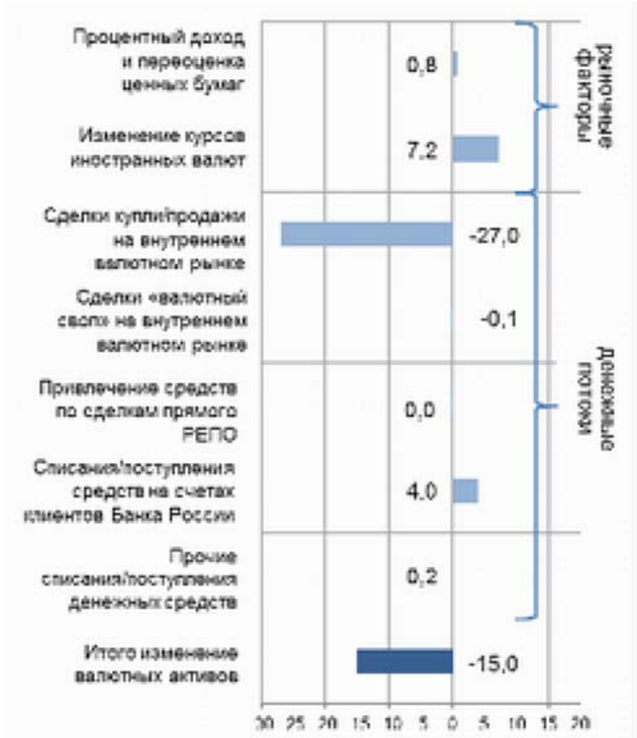
*Sets the target interest rate range of 0-0.25%
** Starting from April 2013, the Bank of Japan does not set the rate.

FOREIGN EXCHANGE ASSET MANAGEMENT IN JANUARY-DECEMBER 2013

In the period under review, Bank of Russia foreign exchange assets decreased by $15 billion to reach $467.6 billion (Table 2). The drivers of the decline included domestic forex market operations, i.e. foreign currency sales for roubles and *currency swap* transactions. The decrease was partially offset by inflows of funds to Federal Treasury accounts with the Bank of Russia, as well as by foreign currency exchange rate movements against the US dollar, and by interest income from Bank of Russia operations (Chart 4).

January-December 2013 saw an increase in the amount of deposits and nostro account balances with the Bank of Russia, against a decrease in the government securities portfolios during the same period (Table 2).

Chart 4. Drivers of foreign exchange asset changes in January–December 2013, billions of US dollars



Interest income and securities revaluation
Foreign exchange rate changes
Sales/purchases in the domestic forex market
Domestic market currency swaps
Raising funds via repo transactions
Funds credited from/debited to customer accounts with the Bank of Russia
Other funds inflows/outflows
Total change in foreign exchange assets

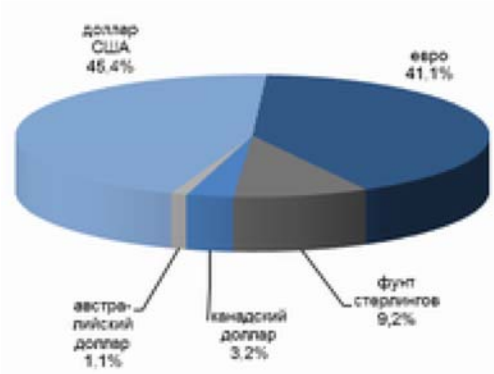
Market drivers
Flows of funds

Table 2. Foreign exchange assets by instrument

Foreign exchange assets	As of 31 December 2012		As of 31 December 2013		Change in January–December 2013, billions of US dollars
	billions of US dollars	Share of foreign exchange assets	billions of US dollars	Share of foreign exchange assets	
Government securities	421.8	87.4%	390.4	83.5%	-31.3
Deposits and cash accounts	51.3	10.6%	63,5	13.6%	12.2
Non-government securities	2.4	0.5%	3.5	0.7%	1.1
Net position with the IMF	4.8	1.0%	4.4	0.9%	-0.3
Reverse repo transactions	2.5	0.5%	5.8	1.2%	3.3
Total	482.6	100%	467.6	100%	-15.0

Chart 5 shows the actual currency breakdown of foreign exchange assets as of 31 December 2013. During the period under review, the share of assets denominated in euros and Canadian dollars expanded with the increased portfolios of bonds issued by the German and Canadian governments. The share of assets denominated in US dollars and in yen declined and that of assets denominated in Swiss francs remained insignificant.

Chart 5. Foreign exchange assets by currency as of 31 December 2013



US dollar 45.4%
euro 41.1%
Australian dollar 1.1%
Canadian dollar 3.2%
Pound sterling 9.2%

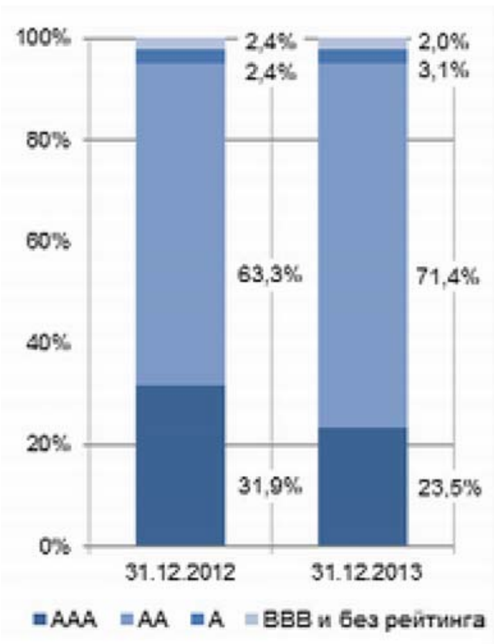
Chart 6. Geographical breakdown of foreign exchange assets as of 31 December 2013

France
USA
Germany
UK
Canada
International financial institutions
Australia
Sweden
Russia
Netherlands
Japan
Norway
Other

Chart 6 shows the geographical breakdown of foreign exchange assets by location (place of registration) of legal entities that are counterparties and issuers of the securities included in foreign exchange assets.

Chart 7 shows the breakdown of foreign exchange assets by credit rating as of 31 December 2012 and 31 December 2013. The Chart is based on information obtained from Fitch Ratings, Standard & Poor's and Moody's Investors Service. The lowest credit rating grades are used.

Chart 7. Foreign exchange assets by credit rating



AAA AA A BBB and unrated

According to the Chart, BBB and unrated assets comprise Russian eurobonds with a rating of 'BBB' and assets that are not rated such as Russia's position with the IMF.

As a result of Moody's Investors Service lowering of the UK long-term credit rating from 'AAA' to 'Aa1' in February 2013, the share of AAA-rated assets decreased while the share of AA-rated assets increased accordingly.

In turn, Fitch Ratings cut the UK rating by one notch, from 'AAA' to 'AA+', in April 2013.

Data on the yields of the actual and benchmark single-currency portfolios of Bank of Russia foreign exchange assets are shown in Table 3.

Table 3. *Yields on Bank of Russia foreign exchange assets* in January–December 2013, % p.a.

Indicator	US dollar	Euro	Pound sterling	Canadian dollar	Australian dollar	Yen
Yields on actual single-currency portfolios of foreign exchange assets	0.17	0.04	0.20	1.20	2.85	0.08
Yields on benchmark single-currency portfolios of foreign exchange assets	0.26	0.03	0.18	1.20	2.82	0.06

GLOSSARY

Benchmark portfolio A set of weighted financial instruments in each reserve currency. Benchmark portfolios reflect the target distribution of Bank of Russia assets in each foreign currency.

Budget balance A difference between the revenue and expenditure of the consolidated budget of all levels of government (federal, regional and municipal).

Central bank key rate A rate set by a central bank to impact interest rates in the economy. As a rule, a change to the key rate is a major monetary policy tool.

Examples of key rates used by the leading central banks include:

- the Bank of England (BoE bank rate or BOEBR): an interest rate on commercial bank reserves deposited with the Bank of England;
- the Bank of Japan: until April 2013, it was an overnight interbank loan rate. Starting from April 2013, the Bank of Japan has been targeting the monetary base instead of the interest rate;
- the European Central Bank (ECB) (an interest rate on main refinancing operations or MRO): a minimum rate at ECB repo auctions;
- the US Federal Reserve System (Fed): a target for an interbank rate on the placement of bank funds with the Federal Reserve;
- the Bank of Canada (overnight rate target): a target for an interbank loan rate;
- the Reserve Bank of Australia (the cash rate): a target for an interbank loan rate.

Credit rating A rating agency's assessment of the ability and willingness of a borrower to timely fulfil its financial obligations in full.

Currency swap An agreement pursuant to which counterparties exchange payments in different currencies. As a rule, the Bank of Russia enters into currency swap transactions in order to supply Russian credit institutions with rouble funds using foreign currency funds as collateral.

Duration A percentage change in the price of a financial instrument or class of instruments relative to a change in the respective interest rates by one percentage point.

Flight to quality Investors' sale of higher-risk assets in favour of purchasing lower-risk ones (predominantly government bonds issued by developed economies) due to a lower risk appetite.

Government debt The value of government outstanding debt in the domestic currency and in foreign currencies. The debt amount is not decreased by the value of government foreign exchange assets.

Monetary base The amount of money in circulation and commercial bank funds deposited with a central bank as required reserves.

Quantitative easing (QE) A monetary policy used by central banks to stimulate the economy. To carry out QE, a central bank buys financial assets or provides funds collateralised by assets in order to increase money supply in the economy.

Repo (reverse repo) transactions	Securities sale (purchase) transactions with an obligation of a subsequent repurchase (resale) during a specified period at a stated price.
SDR (Special Drawing Rights)	A unit of calculation used in IMF operations. The SDR rate is determined based on the dollar value of a four-currency basket made up of the US dollar, euro, yen and pound sterling.
Yields on Bank of Russia foreign exchange assets	Holding period yields are calculated using chain indices based on daily yields for the period. Daily yields on a single-currency portfolio are calculated as the ratio of aggregate (realised and unrealised) yields of the portfolio to its market value as of the end of the previous day.