



Bank of Russia

The Central Bank of the Russian Federation



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BANK OF RUSSIA FOREIGN
EXCHANGE AND GOLD ASSET
MANAGEMENT REPORT

MOSCOW



Bank of Russia foreign
exchange and gold asset
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The reference to the Central Bank of the Russian Federation is mandatory
if you intend to use information from this review

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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 April 2016 – March 2017.

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 re-serves). 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 authorized divisions of the Bank of Russia. External managers are not involved in foreign exchange and gold asset management.

2. MACROECONOMIC TRENDS IN APRIL 2016 – MARCH 2017

The foreign currency exchange rates and government securities yields in major developed economies throughout the period under review were primarily driven by the stance of the Fed monetary policy as well as by the political events in the US (the outcome of the US presidential elections) and in Europe (official start of the Brexit process and looming presidential elections in France). Besides, the financial markets were also affected by the ongoing sovereign debt problems in certain euro area member states, the China slowdown and *quantitative* easing (QE) programmes in euro area and Japan.

USA and Canada

In 2Q-3Q16, the FOMC abstained from raising the Federal funds rate; and a number of FOMC members on several occasions said about the need of a smoother, than previously anticipated, path of the key rate with less hikes in 2017–18 amid the sluggish labour market recovery and unfavourable external factors.

As these factors dissipated by year-end, in December 2016 and in March 2017, the Fed raised the target range for the Federal funds rate by 0.25 pp to 0.75–1.00%. The US yield curve shifted notably upwards after D. Trump's victory in the US presidential elections that led to a spike in expectations of large fiscal stimulus and a substantial rise in government debt levels and inflation. The US dollar appreciated markedly on the back of results of the US presidential elections in 4Q16 with a mild correction in 1Q17.

The Canadian dollar was little changed relative to the US dollar in 2Q-3Q16 with no clear trend in oil prices, while increase in oil prices in 4Q16 was a minor factor for the Canadian dollar – it depreciated to the US dollar following Fed rate hike and returned to muted dynamics in 1Q17. With the Bank of Canada keeping the key rate unchanged and expectations of a stable monetary policy stance over the forecast horizon, the yields on long-term Canadian government bonds mostly followed the path of US Treasury bonds.

Chart 1

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

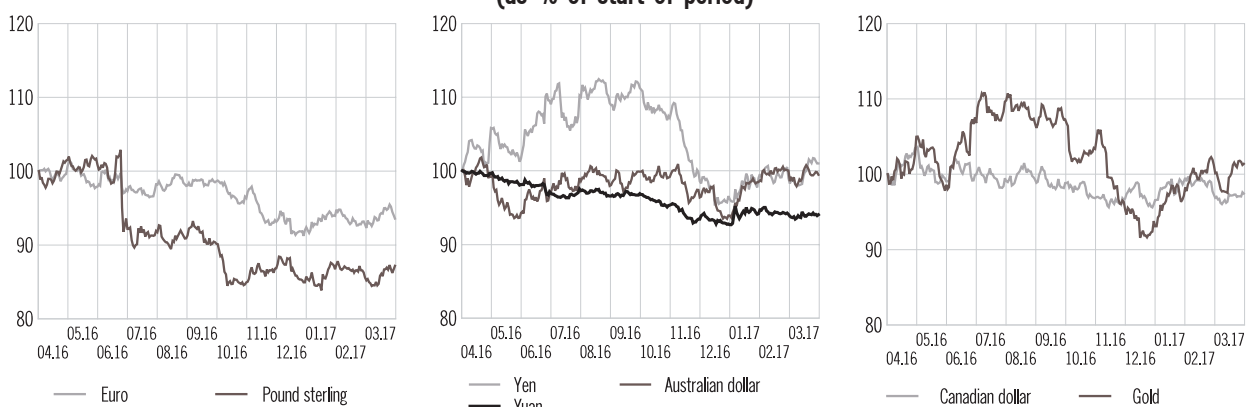
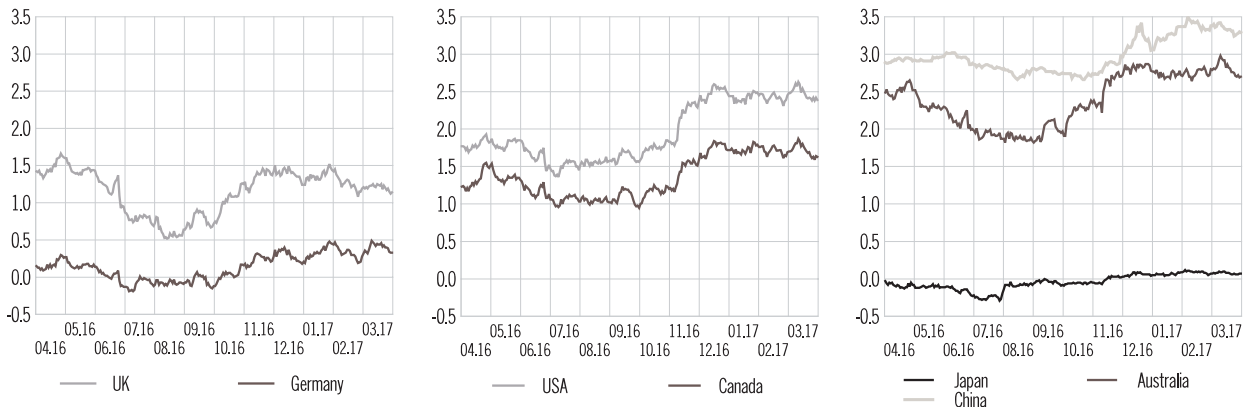


Chart 2

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



Europe

In June 2016, the UK referendum on the European Union membership was held, where the majority of British citizens voted for leaving the EU. This caused a dramatic depreciation of the pound sterling against the US dollar. Amidst higher political uncertainty caused by the referendum results, the Bank of England strengthened its monetary stimulus. In August 2016, it cut the key rate from 0.5% to 0.25% and expanded the quantitative easing programme.

In November, the pound sterling appreciated slightly against the US dollar, as the London High Court ruled that the UK exit from the EU is unlawful without a parliamentary approval. Two months later, the ruling was upheld by the Supreme Court of the UK. Despite of this the Parliament of the UK allowed the British government to invoke the procedure of withdrawal from the EU without any clauses. The government officially notified the EU of the UK's intention to leave it on 29 March 2017.

Following the depreciation of the pound sterling, the UK inflation in February exceeded the target level of 2% for the first time since 2014. But the Bank of England noted in its report that current price trends had not yet been the cause for tightening the monetary policy.

The euro started to decline in 4Q 2016 on the back of weak inflation data and expected

continuation of the loose monetary policy by the ECB. In December 2016, the ECB decided to extend its quantitative easing programme until the end of 2017, while contracting the monthly purchase amount to 60 bn euro since April 2017.

In 1Q 2017, the Eurosceptic threat in the Netherlands and France became the main driver of the exchange rate and government bond yields in the eurozone. The election campaign in France elevated political risks and increased the 10-year sovereign spread between Germany and France. Nevertheless, the Dutch election, which yielded 14% parliamentary seats for the Eurosceptics («Party for Freedom»), moderated political risks in the eurozone.

Australia and Asia

The Reserve Bank of Australia (RBA) cut its key rate twice by 0.25 pp in May and August 2016, thus lowering it to 1.5%. The main reason for the rate cut was low inflation fluctuating below target levels for several quarters. These decisions led to the additional lowering of rates on government bonds in 2Q-3Q16 that started declining before RBA's rate decisions. The US presidential elections and Fed's rate hike in 4Q led to moderate recovery in government bonds' yields. RBA decisions and the above stated events in the US also

affected Australian dollar which depreciated against the US dollar, but substantial growth of exports (mainly to China) in 4Q 2016–1Q 2017 supported appreciation of the Australian currency to the levels observed in the start of period under review.

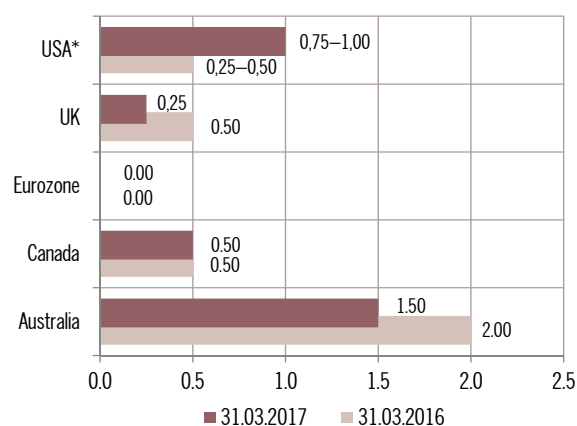
In September 2016, the Bank of Japan (BoJ) announced targeting of long-term rates on government bonds as a new instrument of monetary policy. The reason behind this decision was a significant flattening of sovereign curve and the absence of impact from the *quantitative and qualitative easing* programme on inflation. The decision mostly weighted on long-terms rates of sovereign bonds which became positive in 4Q 2016.

The absence of clear signals from the BoJ on further monetary policy easing, the Fed's postponed rate hike and the result of UK referendum led to substantial yen appreciation in 2Q-3Q16, but events that followed in 4Q16 (results of the US elections and the Fed's rate hike) caused decline in yen to the levels observed in the beginning of the period.

Chinese currency was under pressure during the whole year and depreciated against the US dollar because of vague perspectives of future economic growth in China. But released statistics on GDP growth for 4Q 2016 and 1Q 2017 supported yuan in January-March 2017. The People's Bank of China's (PBoC) policy of liquidity tightening that was applied on the interbank money market to diminish capital flight from yuan also affected sovereign bonds rate in late 2016 – early 2017. Increase in rates was observed across all maturities of sovereign curve. In 1Q17, the PBoC raised short-term

Chart 3

Central banks key rates (% p.a.)



* The Fed funds target rate was 0.25–0.50% as of 31 March 2016 and 0.75–1.00% as of 31 March 2017.

rates on its liquidity facility instruments which added to the growth of sovereign bonds' rates.

Gold

In 2Q16, the increase in the value of gold was caused by both the weakening of the US dollar against other major currencies amid expectations of a slower pace of Fed rate hikes and the *'flight to quality'* effect on the back of the UK opting to leave the EU. In 3Q16, the price of gold was flat, while in October-December 2016 it fell significantly due to more hawkish Fed rhetoric followed by a rate hike and US presidential election results, which were transformed by the market into expectations of accelerating economic growth. In 1Q17, the price of gold moved up, supported by the rising chances of Eurosceptics winning the French presidential elections.

3. FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT IN APRIL 2016 – MARCH 2017

In the period under review, Bank of Russia foreign exchange and gold assets increased by \$2.4 billion to reach \$402.8 billion (Table 1). Domestic market gold purchases had a positive impact on the value of assets, while currency exchange rate changes and cash outflow on the clients' accounts with the Bank of Russia produced a negative effect (Charts 1 and 4).

In April 2016 – March 2017, government securities portfolios and claims in foreign currency on Russian credit institutions under repo transactions significantly decreased. The amount of deposits and nostro account balances with the Bank of Russia and portfolios of securities of foreign issuers that are expected to be supported by governments increased (Table 1).

As of 31 March 2017, assets denominated in US dollars and euros retained the dominant position in the structure of Bank of Russia reserve assets in foreign currency and gold. The category 'Others' includes assets in Canadian (3.3%) and Australian (1.0%) dollars, as well as assets in yuans (0.1%), 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. Russia's location in the geographical structure at the fifth position was a result of Bank of Russia transactions on liquidity provision to Russian credit institutions in foreign currency (repo transactions and loans in foreign currency).

Table 1

Foreign exchange and gold assets by asset class

Foreign exchange assets	As of 31 March 2016		As of 31 March 2017		Change in April 2016 – March 2017, billions of US dollars
	billions of US dollars	share of assets, %	billions of US dollars	share of assets, %	
Government securities of foreign issuers*	233.6	58.3	209.1	51.9	-24.5
Gold	56.8	14.2	65.9	16.4	9.1
Deposits and account balances with foreign counterparties	43.6	10.9	68.6	17.0	25.0
Non-government securities of foreign issuers**	29.3	7.3	33.9	8.4	4.6
Claims in foreign currency on Russian counterparties and issuers	20.7	5.2	9.0	2.2	-11.7
International organizations' securities	13.1	3.3	13.0	3.2	-0.1
Net position with the IMF	2.0	0.5	1.9	0.5	-0.1
Reverse repo operations with foreign counterparties	1.1	0.3	1.4	0.4	0.3
Claims on foreign counterparties on foreign currency supply	0.2	0.0	0.0	0.0	-0.2
Total***	400.4	100.0	402.8	100.0	2.4

* 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

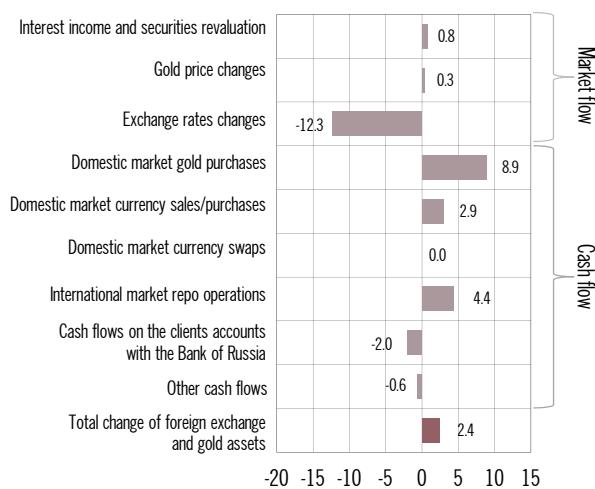
**Changes in foreign exchange and gold assets
in April 2016 – March 2017 (billions of US dollars)**

Chart 6

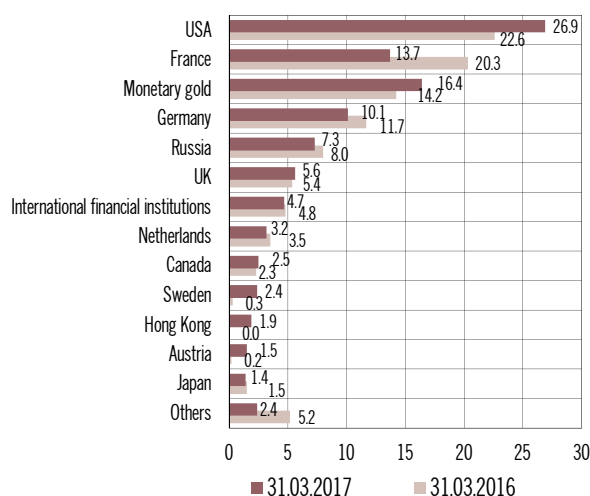
**Geographical structure of Bank of Russia
foreign exchange and gold assets (%)**

Chart 5

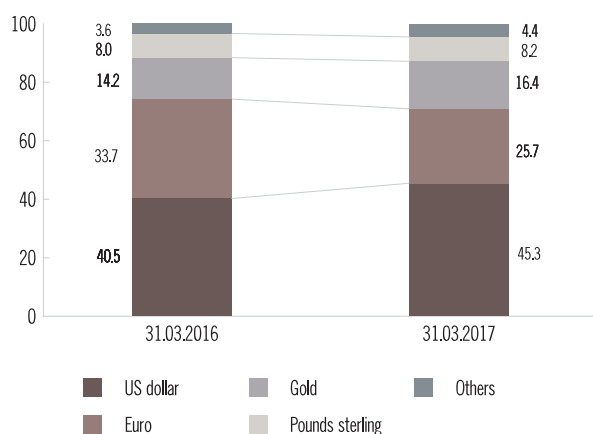
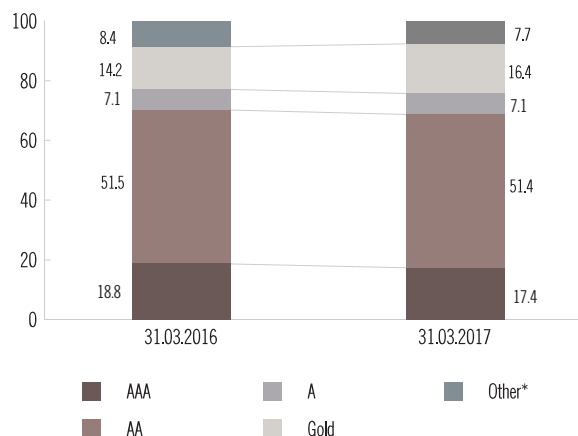
**Bank of Russia foreign exchange and gold assets
by currency* (% of market value)**

Chart 7

**Bank of Russia foreign exchange
and gold assets by credit rating (%)**

* The distribution takes into account unsettled conversion transactions as of 31 March 2016 and 31 March 2017.

* 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 2016 – March 2017 (% p.a.)**

Indicator	US dollar*	Euro	Pound sterling	Canadian dollar	Australian dollar	Yuan
Return on actual single-currency portfolios of foreign exchange assets	0.54	-0.38	0.55	0.63	2.19	1.22
Return on benchmark single-currency portfolios of foreign exchange assets	0.33	-0.46	0.50	0.46	2.03	0.85

* A significant excess of the actual return over benchmark return is due to the fact that the profitability of the instruments included in the actual portfolio (Russian Eurobonds, repo transactions and loans in foreign currency with Russian credit institutions) exceeds the return on the instruments of the corresponding benchmark portfolio.

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.

Decrease in the share of assets with 'Other' rating as of 31 March 2017 was partly due to

the reduction of credit institutions refinancing in foreign currency.

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

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	<p>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.</p> <p>Examples of key rates used by the leading central banks include:</p> <ul style="list-style-type: none"> • 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.
Flight to quality	Investors' sale of more risky assets and purchase of less risky assets (primarily, government bonds of developed economies) caused by a decrease in risk tolerance.
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.
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).

