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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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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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Содержание

FOREWORD

This issue of the Bank of Russia Foreign Exchange and Gold Asset Management Report presents the results of asset management in October 2016 – September 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 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 OCTOBER 2016 – SEPTEMBER 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 USA (the outcome of the US presidential elections) and in Europe (official start of the Brexit process and presidential elections in France). Besides, the financial markets were also affected by the *quantitative easing* (QE) programmes in the euro area and Japan.

USA and Canada

The return to the positive dynamics in the US labour market as well as dissipating expectations of negative spillovers from China slowdown and UK Brexit decision made it possible for the FOMC to raise the target range for the Federal funds rate in December 2016 and in March and 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 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 in 4Q16 on the back of results of the US presidential elections. However, in 1Q-3Q17, the markets reassessed the probability of 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 eurosceptics losing the bid for the French presidency.

The Canadian dollar which depreciated gradually since mid-2016 reversed its course abruptly in May 2017 when the expectations of the Bank of Canada lifting the key rate started building up on the back of rising economic activity and labor market slack disappearing fast. These expectations materialised in July 2017 with the Bank of Canada raising 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.

Chart 1

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

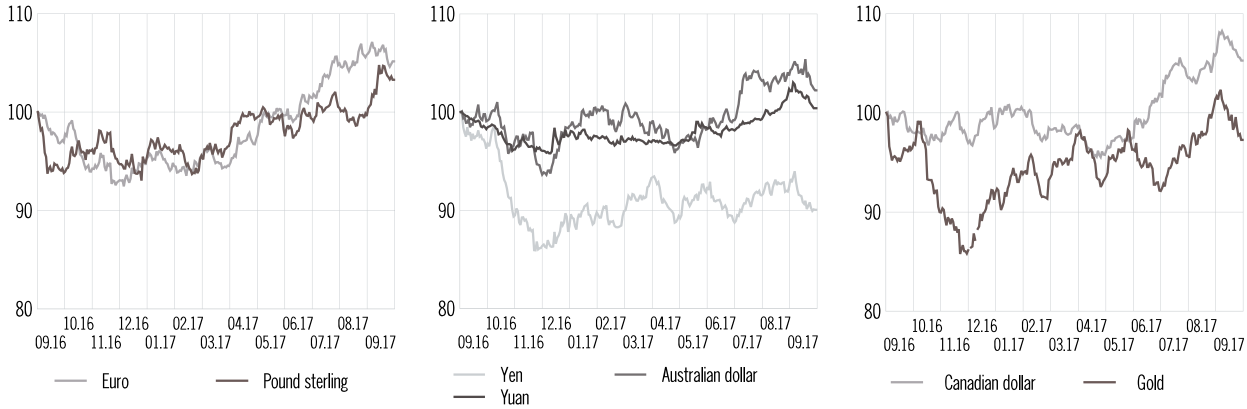


Chart 2

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

The yields on long-term Canadian government bonds mostly followed the path of US Treasury bonds, while rising probability of a rate hike pushed them higher in 2Q-3Q17.

Europe

In November 2016, 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 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 the block 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 didn't support monetary policy tightening.

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 didn't 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 euro started to decline noticeably in 4Q16 on the back of weak inflation data and expected continuation of the accommodative 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 1H 2017, the eurosceptic threat in the Netherlands and France, as well as the expected tightening of the monetary stance by the ECB, became the main driver of the exchange rate. The election campaign in France elevated political risks and widened the 10-year sovereign spread between Germany and France. But the risks didn't 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.

Monetary tightening expectations 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.

Australia and Asia

Following its last decision to cut the key rate by 0.25 pp. in August 2016, the Reserve Bank of Australia was keeping it unchanged 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. The US presidential elections' outcome and Fed's rate hike in 4Q16 led to recovery in government bonds yields and depreciation of the Australian dollar against the US dollar. Substantial growth in exports (mainly to China) and the recovery of iron ore prices provided support to the Australian currency that appreciated in 1Q17. The issued data on inflation in 4Q16 that was below the RBA's target led to decline of interest rates on government bonds in 1Q-2Q17. However, significantly improved unemployment data and the RBA's claims that most likely the next policy-rate decision will be its hike instead of cut, supported the growth of interest rates in 3Q17. Further dynamics of the Australian dollar were mostly determined by iron ore prices and interest rate movements: a short correction in April-June 2017 was followed by the recovery of exchange rate in 3Q17.

After the Bank of Japan (BoJ) announced targeting of long-term rates on government bonds in September 2016, the rates became positive in the middle of 4Q16 and fluctuated within the range 0-0.1% during whole period under review. Short-term interest rates were relatively stable in 4Q16-1Q17 and after that in 2Q17-3Q17 they went up a bit approaching several times the maximum point since the BoJ's announcement of negative rate on its deposits. These periods of approaching the local maximum can be attributed to the growing expectations of the possible tightening of monetary policy following the improving inflation dynamics. 4Q16 events (results of the US presidential elections and the Fed's rate hike) caused decline in the yen. In 1Q-3Q17, Japan's currency appreciated due to improving exports and growing expectations of the possible tightening of monetary stance by the BoJ.

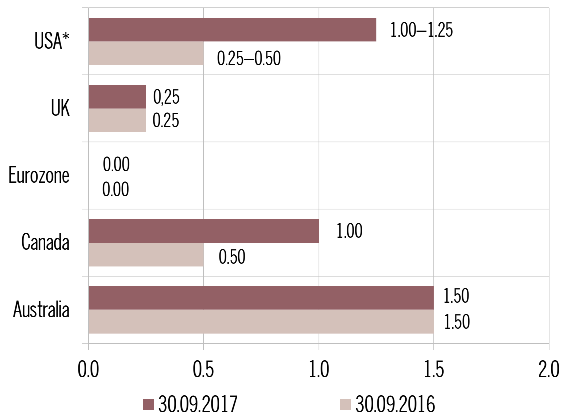
The Chinese currency was under pressure during the whole 2016 and depreciated against the US dollar by the end of 2016 because of vague perspectives of future economic growth in China. However statistics on GDP growth for 4Q16 and 1Q17-2Q17 helped to stabilise yuan in January-March 2017 and strengthened it during further periods. 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. The PBoC's policy of strengthening control over the banking sector in order to limit lending and liquidity tightening also affected sovereign bonds yields in late 2016 – early 2017. In January 2017, the PBoC raised short-term rates on its liquidity provision facilities which added to the growth of sovereign bond yields during 4Q16-2Q17. During 3Q17, the yields remained relatively stable.

Gold

After moving sideways in 4Q16, gold prices dropped markedly on the back of more hawkish Fed rhetoric followed by a rate hike and US presidential elections results, which were transformed by the market into expectations of accelerating economic growth. Correction in gold prices during 1Q17 was supported by the rising chances of eurosceptics winning the French presidential elections. With political risk in Europe abating, gold prices came under pressure from lower expectations of inflation risks stemming from the materialisation of massive fiscal stimulus promised by the new US administration. After neutral dynamics of 2Q17, gold posted substantial gains in 3Q17 on the back of the US dollar's weakness.

Chart 3

Central banks key rates, **% p.a.**



** The Fed funds target rate was 0.25–0.50% as of 30 September 2016 and 1.00–1.25% as of 30 September 2017.*

3. FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT IN OCTOBER 2016 – SEPTEMBER 2017

In the period under review, Bank of Russia foreign exchange and gold assets increased by $27.1 billion to reach $432.8 billion (Table 1). One of the factors underpinning the increase in assets was Bank of Russia repo operations in the international market. These repo operations involve raising funds under a repo transaction and simultaneously investing corresponding amounts at a higher rate on a deposit, reverse repo or placing on a nostro account with a counterparty bank. Foreign currency exchange rate movements against the US dollar together with domestic market gold and foreign currency purchases had a positive impact on the value of assets, while gold price changes and cash outflow on clients' accounts with the Bank of Russia produced a negative effect (Charts 1 and 4).

In October 2016 – September 2017, 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 non-government securities portfolio and the amount of claims in foreign currency on Russian credit institutions under repo transactions decreased (Table 1).

The ultra-loose monetary policy of the ECB with the simultaneous tightening of the monetary policy by the Fed has led to an increase in the interest rate differential between assets denominated in the US dollars and euro. For this period, the Bank of Russia saw it appropriate to change the currency structure of assets by reducing the share of the euro in favour of the US dollar. As of 30 September 2017, the category 'Others' in Chart 5 includes

Table 1

Foreign exchange and gold assets by asset class

Активы	As of 30 September 2016		As of 30 September 2017		Change in October 2016 – September 2017, billions of US dollars
	billions of US dollars	share of assets	billions of US dollars	share of assets	
Government securities of foreign issuers *	208.2	51.3	229.1	52.9	20.9
Deposits and account balances with foreign counterparties	63.6	15.7	82.9	19.1	19.3
Gold	64.8	16.0	70.4	16.3	5.6
Nongovernment securities of foreign issuers **	41.1	10.1	30.1	7.0	-11.0
International organisations securities	8.7	2.2	9.1	2.1	0.4
Claims in foreign currency on Russian counterparties and issuers	15.1	3.7	6.0	1.4	-9.1
Reverse repo operations with foreign counterparties	2.2	0.5	3.4	0.8	1.2
Net position with the IMF	2.0	0.5	1.8	0.4	-0.2
Claims on foreign counterparties on foreign currency supply	0.0	0.0	0.0	0.0	0.0
Total * **	**405.7**	**100.0**	**432.8**	**100.0**	**27.1**

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

** *Securities of foreign issuers with highly expected government support due to the organisation's special role in or importance to the economy of a 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 October 2016 – September 2017, billions of US dollars

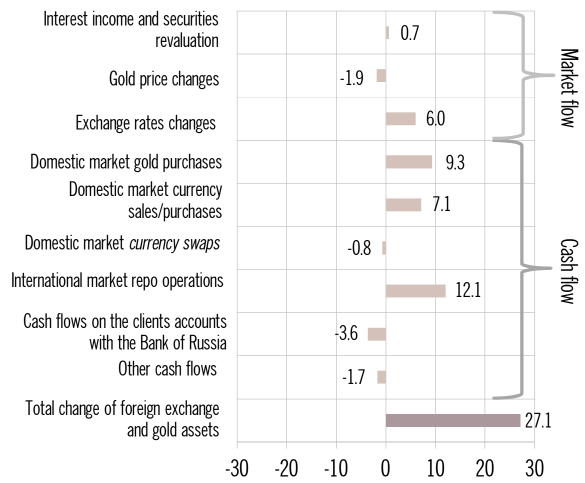


Chart 6

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

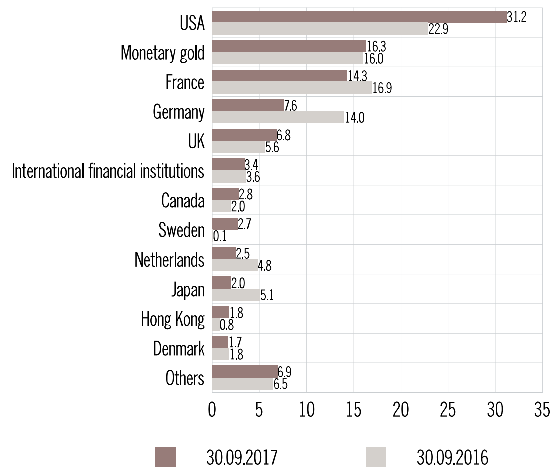
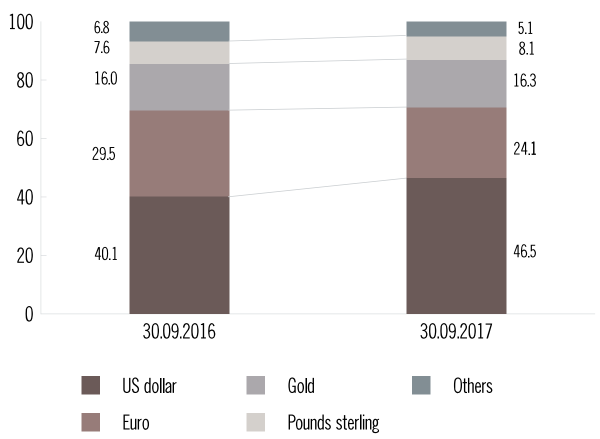


Chart 5

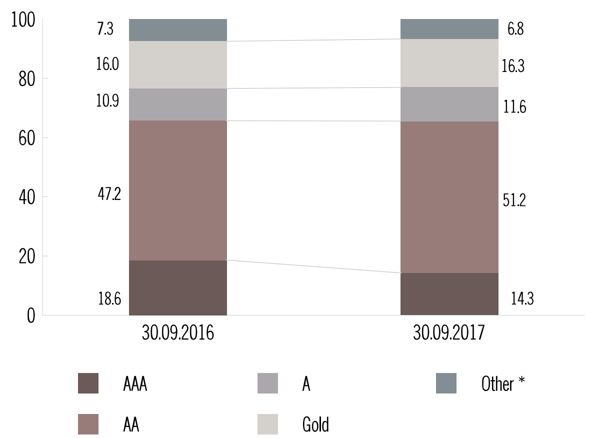
Bank of Russia foreign exchange and gold assets by currency,* % of market value



** The distribution takes into account unsettled conversion transactions as of 30 September 2016 and 30 September 2017.*

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 October 2016 – September 2017, % p.a.**

Indicator	US dollar*	Euro	Pound sterling	Canadian dollar	Australian dollar	Yuan
Return on actual single-currency portfolios of foreign exchange assets	0.64	-0.47	-0.06	0.07	1.70	0.72
Return on benchmark single-currency portfolios of foreign exchange assets	0.56	-0.60	-0.10	-0.05	1.53	-0.03**

** 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.*

*** 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 0.72% p.a.*

assets in the Canadian (3.2%) and Australian (1.0%) dollars, as well as assets in yuans (1.0%), yen (0.0%) and Swiss francs (0.0%).

Decrease in the share of assets with 'Other' rating as of 30 September 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	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 (from 1 October 2016).