Management of gold and foreign-exchange reserves

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Introduction

The South African Reserve Bank (the Bank) is the central bank of the Republic of South Africa. It regards its primary goal in the South African economic system as the achievement and maintenance of price stability.

This fact sheet focuses on one of the functions of the Bank, which is to prudently manage South Africa's official gold and foreign-exchange reserves. However, it is necessary to first describe foreign exchange and an exchange rate briefly, then to consider why central banks hold reserves and what constitutes an appropriate level of such reserves, before discussing the management of these reserves.

What are foreign exchange and the exchange rate?

Foreign exchange may be defined as currency or other financial instruments that allow one country to settle amounts owed to other countries. Amounts owed by South Africans to the United States (US), for example, are settled in foreign exchange, that is, in US dollars. Foreign exchange is earned by residents of a country through the sale of goods and services to the international community (exports) and may also be acquired through foreign investments in South Africa and foreign borrowings. Foreign exchange is used to pay for foreign goods and services bought from other countries (imports). Foreign-currency denominated loans are repaid in foreign currency.

The value of a currency is usually determined by the demand for and supply of that currency. The rand is described as weakening or depreciating against the US dollar when more rands are paid for each US dollar. The rand is described as strengthening or appreciating against the US dollar when fewer rands are paid for each US dollar. A currency therefore depreciates when its supply exceeds its demand, and appreciates when its demand exceeds its supply.

Why do central banks hold foreign-exchange reserves?

Central banks hold reserves – assets denominated in foreign currency – for four main reasons, similar to the reasons why individuals hold money. The most important is to be able to intervene, i.e. buy or sell foreign exchange in the foreign-exchange market to influence the value of the currency. Second, central banks hold foreign reserves for transaction purposes, for example to finance foreseeable foreign-exchange demands from the public sector such as the government wishing to repay a maturing foreign loan.

A third reason for holding reserves is to serve as a buffer against international financial shocks or crises. The fourth reason relates to the portfolio or wealth diversification motive. Most central banks consider safety, liquidity and return, arranged in that order of importance, as their major reserve management objectives. Wealth considerations influence decisions on the composition of reserves and the desired level of reserves. It is worth noting that countries usually diversify their currency portfolio into US dollar, euro, sterling, Japanese yen and Swiss franc. Gold is often also held for reasons of diversification.

It should be noted that an adequate level of reserves is required for almost every country that seeks to employ the savings of other nations to develop its own economy. It is ironic but true that a small country needs foreign reserves earned through its own productive efforts and accumulated through its own virtuous savings before it can gain access to the savings of other countries.

The desired level of reserves

When the Bretton Woods system, essentially a system under which exchange rates were fixed, collapsed in the early 1970s, countries moved towards more flexible exchange rates and it was anticipated that foreign-reserve requirements would be reduced. This has not proved to be the case as many countries have still chosen to intervene in the foreign-exchange market and the increase in exchange rate volatility, moreover, has encouraged countries to hold yet more reserves. (A higher level of reserves is thought to enhance the credibility of the central bank's exchange rate policy.) Other factors that influence the appropriate level of reserves include the openness of the economy, as measured by the ratio of the value of foreign trade to the level of gross domestic product (the total value of final goods and services produced in a country during a year); the flexibility of the economy to adjust to changes in foreign trade and international capital flows; trade and capital market restrictions; the size of its foreign debt obligation; and the cost of holding reserves.

One guideline for an adequate level of reserves is a level which equals the value of three months' imports into the country concerned. Another guideline is that a country's reserves should be at least equal to its short-term foreign debt.

Brief overview of reserve management

Management of the official reserves of a country is similar to the way a prudent individual would manage a portfolio of foreign assets. Consideration has to be given to the appropriate composition of the reserves; decisions have to be taken regarding the currency denomination, the type of instrument and the maturity profile of foreign-currency assets, for example, should United Kingdom (UK) 3-month Treasury bills be preferred to US 10-year Treasury bonds?

The process of reserves management therefore has many ingredients, including specifically the description of subportfolios in which foreign exchange is invested, the definition of clearly defined objectives for these portfolios, the establishment of limits, controls, reporting procedures and the evaluation of foreign-currency investment performance in terms of agreed benchmarks, for example the yield on 90-day US Treasury bills.

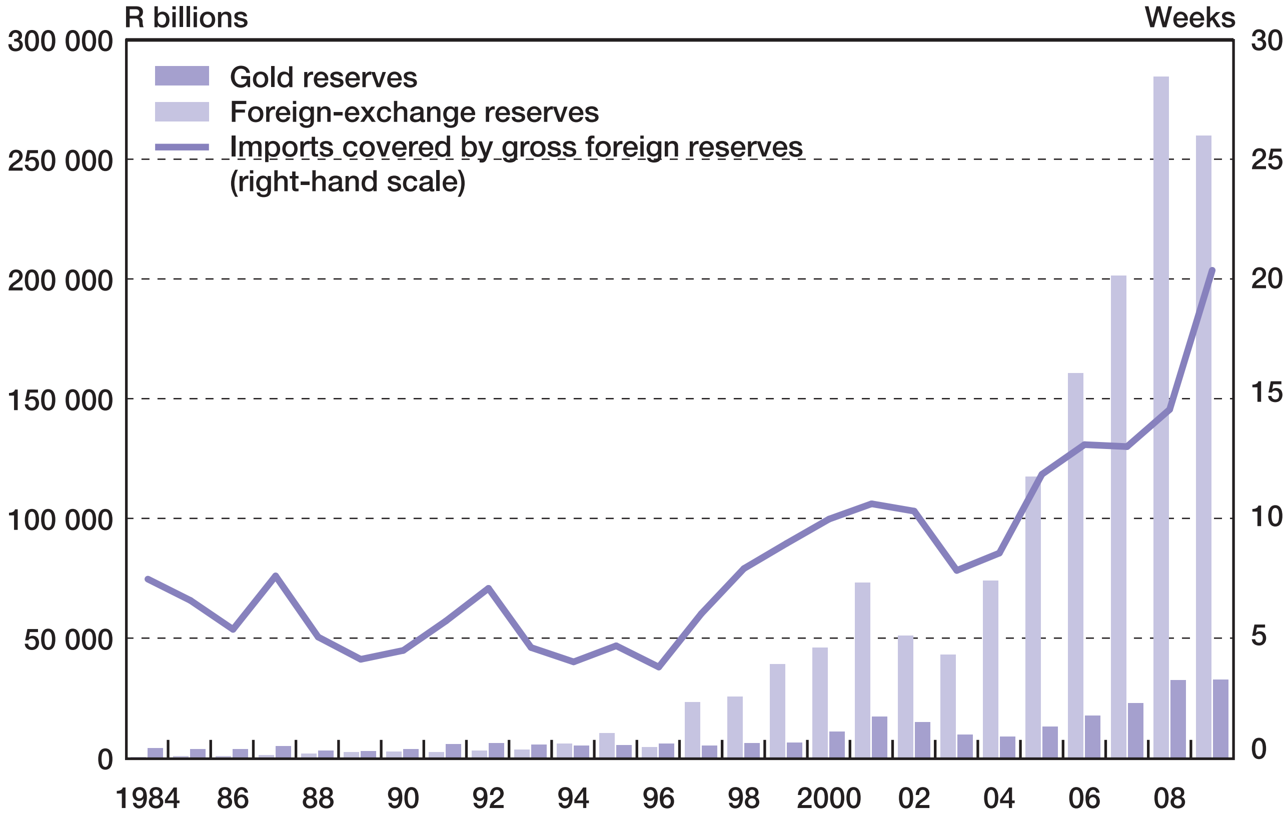
An essential ingredient of this process is a management information system that measures exposure to various risks such as liquidity, interest rate, exchange rate and credit, and ensures that such risks are managed. Performance must also be measured. Almost none of the major central banks around the world have all their reserves managed by an external manager. Of those that do use external managers, the major share of their funds is still managed by the central banks themselves. This suggests that the benefits from the in-house management of reserves, including questions of security, confidentiality, simplicity and costs, as well as development of staff, are substantial.

Reserves management in South Africa

The South African monetary authorities have from time to time endorsed the traditional view that the country should maintain gold and other foreign assets at a level at least equal to three months' imports, as this is deemed prudent and will add credibility to exchange rate policy. In the adverse conditions in the years prior to 1994, when not only the terms of trade and trends in international capital flows moved against developing countries, but internal and external political actions also buffeted the balance of payments, this proved an unattainable target. For most of that time, the country had to contend with a very low level of reserves (see Graph 1) and consequently reserve management focused on the required degree of liquidity and safety of these reserves. The Bank at that time negotiated bilateral short-term standby loan facilities as well as syndicated loan facilities with its overseas correspondent banks, which could be drawn down to supplement the official gross reserves.

Given the continued improvement in both gross and net reserves, the fact that margins on loans have

Graph 1: South Africa's gold and foreign-exchange reserves (1984 to 2009)



widened (sometimes becoming three times more expensive) and that further repayment of borrowed reserves was likely to send a positive message to analysts, the Governor's Executive Committee (GEC) approved the policy of gradually reducing foreign loans, ultimately to zero. On 30 June 2010, the final loan facility was repaid, thus reducing the level of borrowed reserves to zero.

In recent years, however, the country's gold and foreign-exchange reserves have increased significantly, so much so that the efficient management thereof has become a key activity in the Bank, with the view to acquiring a satisfactory return within acceptable risk parameters. That is, a portion of the Bank's foreign-exchange reserves is more actively managed within strict guidelines to achieve this goal, while a portion is also managed by external fund managers.

Most of the Bank's foreign-exchange reserves are still held in very liquid form, either in deposits or in securities that are of a high credit quality and readily marketable in international financial markets. Most of these foreign assets are denominated in US dollars.

The relative importance of dollars in foreign-exchange holdings can be ascribed to a number of factors:

- The foremost factor is the role of the US dollar as an international reserve currency, offering a wide range of market instruments and deep markets in which large transactions may be readily executed.
- Secondly, a large part of South Africa's exports as well as imports are denominated in dollars.
- Thirdly, dollar-denominated commitments form a substantial portion of the country's external debt.
- Fourthly, the level of reserves is reported in US dollars, according to international practice, and keeping a substantial portion in US dollars causes fluctuations due to valuation changes.

As mentioned, decisions are called for on the appropriate composition of the reserves. Matters such as return versus liquidity, risk versus safety, owned reserves versus borrowed reserves and the currency composition of the official reserves must be continuously considered. For most of these decisions, no general rules are available, and the discretion of the central bank in these matters is decisive.

Management of gold reserves

Before December 1997, gold producers in South Africa were obliged to sell the bulk of their gold production to the Bank and were paid in US dollars. The Bank would decide whether to hold such gold in its reserves or whether it would be more appropriate to dispose of the gold to acquire foreign exchange. The Bank could dispose of the gold, if it so desired, in the various gold markets.

In December 1997, the Minister of Finance announced, in a further measure to liberalise exchange controls gradually, that gold producers could apply for exemption from the relevant Exchange Control Regulations if they wished to sell their gold output themselves. The gold producers used this opportunity and consequently started selling their output using the Rand Refinery as their agent.

The Bank may, depending on the prevailing level of the gold interest rate, from time to time place up to 320 000 fine ounces of gold on deposit. This limit restricts the amount of gold on deposit to less than 10 per cent of the current gold holdings which are about 4 million fine ounces.

Conclusion

The prudent management of reserves involves an in-depth understanding of the instruments in which the

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This is the fifth in a series of fact sheets on the South African Reserve Bank, compiled by the Research Department: Information Division and distributed by the Executive Management Department: Communications Unit.

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The content of this fact sheet is subject to change at any time.

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