MANAGEMENT OF GOLD AND FOREIGN EXCHANGE RESERVES

South African Reserve Bank

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Introduction

The official gold and foreign exchange reserves (reserves) of the Republic of South Africa are held and managed by the South African Reserve Bank (SARB). The mission of the Financial Markets Department (FMD), a department within the SARB, is to contribute to the formulation of monetary and financial stability policies, implement monetary policy, manage official reserves and provide treasury services to the SARB's clients.

This fact sheet provides a broad outline of the management of reserves and, in particular, the foreign exchange reserves. It explains what foreign exchange reserves are, the rationale for holding reserves, the pace of accumulation of reserves in recent years, what reserves management entails, the investment objectives and governance of reserves, and broadly outlines the reserves management function at the SARB.

What are foreign exchange reserves?

Foreign exchange reserves are the official public sector foreign assets (currencies) that are readily available and controlled by monetary authorities for the direct financing of payment imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets, and for meeting a defined range of other objectives for a country.

Rationale for holding reserves

Foreign exchange reserves are normally denominated in the major currencies and invested in global bond and money markets. However, there are countries that invest in other asset classes such as real estate, equities and commodities (e.g. oil). The reasons for holding foreign exchange reserves vary from one country to the other, but the most common reasons for holding reserves are:

- to service the country's foreign exchange liabilities;
- to maintain confidence in the country's monetary, financial stability and exchange rate policies; and
- to protect the economic well-being of the country in the event of external shocks.

Accumulation of foreign exchange reserves

Global (international) foreign exchange reserves have continued to increase during the past decade, from US$9.3 trillion in 2011 to around US$12.7 trillion by December 2020, with the US dollar representing approximately 55% of global reserves holdings, followed by 20% in euro, 6% in Japanese yen and 4% in pounds sterling.[1]

Since 2012, South Africa's gross reserves have been little changed, maintaining a level around US$53billion as at March 2021. Central banks generally accumulate foreign exchange reserves through open market purchases, proceeds from foreign direct investments (FDIs) and, in some instances, purchasing proceeds from its government's foreign bond issuance.

Optimal level of reserves

The SARB aims to maintain an adequate level of reserves at all times. This is the amount of reserves a country needs to hold in liquid assets in order to cover known as well as likely trade and debt obligations. It can be viewed as the minimum required reserves holding. The optimal level of reserves includes the provision for unanticipated obligations, taking into account the cost of holding reserves. The difference between adequate and optimal reserves can be viewed as a safety buffer. An optimal range for the level of reserves is calculated by using generally accepted models. The optimal amount of reserves is determined by using various factors that include, among other things, the South African government's short-term external debt, probability of a sudden stop of capital inflows, imports, exports and gross domestic product growth, and the cost and return of holding reserves.

What is reserves management?

Reserves management is the process by which public authority assets are managed such that it provides for the ready availability of funds, the prudent management of risks and the generation of a reasonable return. The management of reserves in the SARB is carried out within a clearly defined investment policy framework which is approved by the Governors' Executive Committee (GEC) of the SARB.

Investment objectives

The SARB's Gold and Foreign Exchange Reserves Management Investment Policy provides the strategic and operational framework, and defines the criteria and objectives for the management of reserves. The management of reserves is guided by the overall risk tolerance of the SARB and implemented through the strategic asset allocation (SAA). The SAA encapsulates the strategic benchmarks for the

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management of the reserves and specifies the target duration for the reserves.

The investment objectives in order of priority are:

Capital preservation

Safety of assets is the foremost investment objective. Investments are undertaken in a manner that seeks to preserve the capital of the overall portfolio over the investment horizon, subject to the appropriate risk constraints.

Liquidity

Investment management seeks to ensure that adequate reserves are available to meet obligations as they fall due. In order to maintain sufficient liquidity, reserves are invested largely in securities with an active secondary market.

Returns

Subject to the capital preservation and liquidity constraints stated above, the reserves are invested with the objective of achieving a competitive market rate of return on the reserves.

Each of these objectives has specific liquidity requirements and investment horizons. Consequently, the reserves are segregated operationally into sub-portfolios, known as tranches, for investment management purposes.

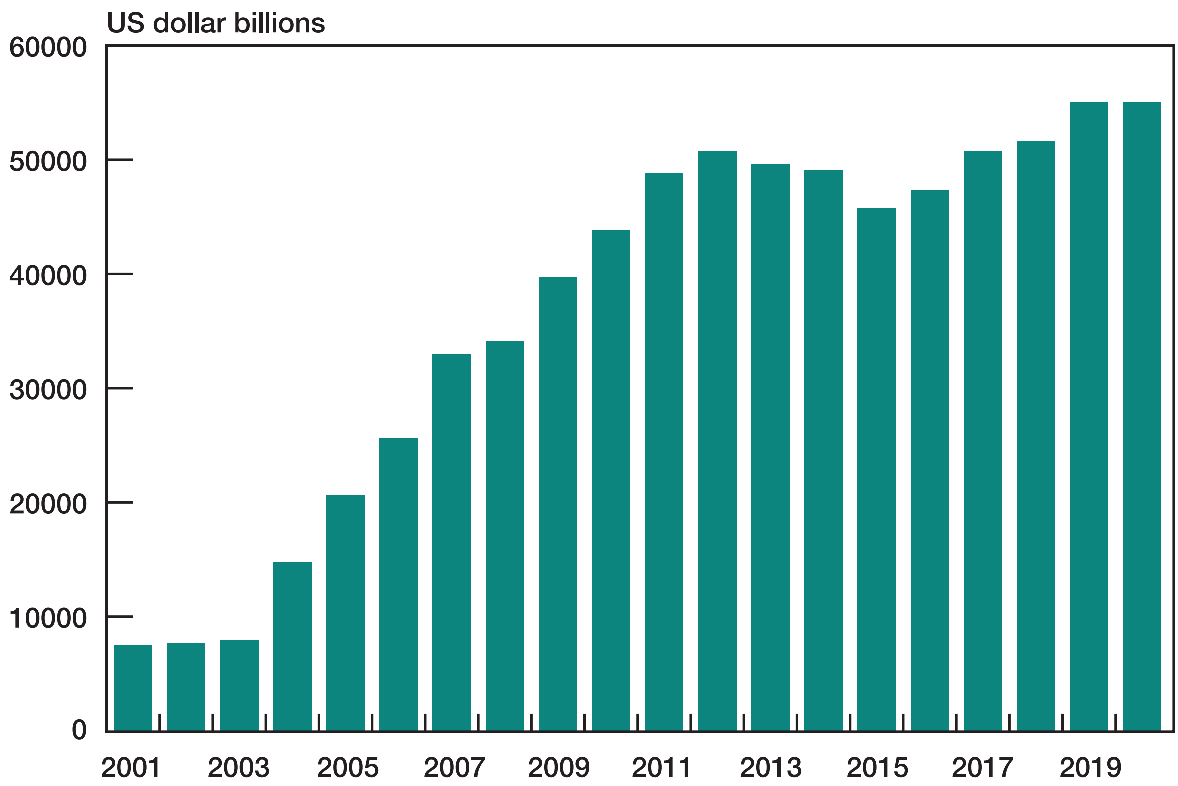
Governance

Good governance and sound functional organisational structures are necessary for the efficient management of reserves. The SARB has a three-tier governance structure where the responsibilities for executive authority, strategic management and portfolio management are clearly segregated.

The Governors' Executive Committee (GEC) is responsible for:

- the Investment Policy;
- the SAA;
- the allocation of the overall active risk budget of the reserves; and
- the target tranche sizes of reserves and the currency composition.

Graph 1: South Africa's gold and foreign exchange reserves (2001 to 2020)



The Reserves Management Committee (Resmanco) is responsible for approving:

- the allocation of the active risk budget to individual portfolios;
- the Investment Guidelines;
- the appointment and removal of external fund managers;
- the appointment and removal of custodian(s); and
- the appointment and removal of security lending agents.

The FMD is responsible for the active management of the reserves via its portfolio and risk management functions.

The reserves management function at the SARB

The prudent management of reserves involves an in-depth understanding of the instruments in which the central bank might invest, including the probable future values of such assets, and a thorough understanding of the inevitable risks that may result from asset allocation decisions. As a result, the portfolio managers tasked with the management of the central bank's foreign reserves should have a comprehensive understanding of internationally acceptable risk management principles and practices, and must remain fully informed of developments in the world economy which may influence their assessment of relative risk/reward trade-offs.

The portfolio managers of the SARB focus on fixed income investment management, with specific emphasis on central bank reserves management. Their key responsibilities entail the management of fixed income portfolios which includes:

- research and analysis;
- view and strategy formulation;
- portfolio construction and trade execution;
- portfolio risk management;
- implementation of the SAA; and
- reporting on reserves management activities.

External fund management

In addition to its internal reserves management activities, the SARB employs the services of external fund managers who manage a portion of the foreign exchange reserves. The rationale for this programme is mainly to diversify the risk/return characteristics of the reserves.

Management of gold reserves

Prior to December 1997, gold producers in South Africa were obliged to sell the bulk of their gold production to the SARB and were paid in US dollars. The SARB would decide whether to hold such production gold in its reserves or whether it would be more appropriate to sell the gold in exchange for US dollars. 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 own gold output themselves. The gold producers have used this opportunity and consequently sell much of their output themselves using the Rand Refinery as their agent. However, the SARB still maintains its level of gold reserves at approximately 4 million fine ounces, which is passively managed.

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

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