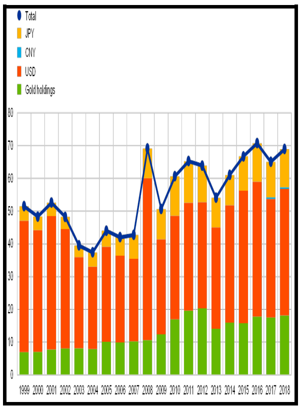
Risk management for Central Bank foreign reserves.

European Central Bank - Central Bank Reserve Management and International Financial Stability—Some Post



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Central Bank Reserve Management and International Financial Stability—Some Post

From a static perspective, central banks tend to take far less equity risk, duration risk and credit risk than private firms, while taking a much higher currency risk exposure. The extent to which central banks hold FX risk in their balance sheets differs substantially from the typically much lower FX exposures of private firms. Finally, the reserve manager would find the portfolio that maximises return subject to these constraints.

Swiss National Bank (SNB)

Borrowing foreign currency generates a hedged foreign exchange position, while outright holdings leave a central bank unhedged. A central bank that borrows to fund reserves may also need to maintain a higher level of gross reserves to guard against this refinancing risk.

Foreign Exchange Reserves and the Reserve Bank's Balance Sheet

Supranationals and advanced economy issuers initially dominated the market. In times of financial distress, gold indeed helps central banks to maintain a solid financial position.

Risk Management in Central Banking

In other words, the central bank is the only financial institution which — by temporarily taking on more risk than it would do in normal conditions — can manage and keep systemic risk in check. As a result, green bonds may not be eligible for the liquidity or working capital tranches of central banks' reserve portfolios.

Foreign Exchange Reserves and the Reserve Bank's Balance Sheet

The measures announced for the Irish banking system are a case in point. We express the relevant trade-offs by way of a 7 x 3 matrix , with different colour codes illustrating the possible weights that reserve managers are likely to give to their various objectives.

Central banks would thus have to limit the size of their allocations. For more information on the relationship between the Australian Government, the Reserve Bank of Australia and the IMF, see Poole 2012.

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