

Foreign exchange reserves and operations of the Eurosystem

The Treaty establishing the European Community (Treaty) and the Statute of the European System of Central Banks and of the European Central Bank (Statute of the ESCB) stipulate that the Eurosystem, comprising the European Central Bank (ECB) and the national central banks (NCBs) of the Member States which have adopted the euro, is responsible for holding and managing the foreign reserves of the Member States. Both the ECB and the NCBs hold foreign reserves. The foreign reserves of the Eurosystem currently amount to around €350 billion, within this total those of the ECB are around €45 billion. There are many reasons for which the Eurosystem holds foreign reserves; one of the most important operations for which the foreign reserves held by the ECB may, in principle, be needed concerns foreign exchange intervention. Against the background of the potential use of foreign reserve holdings, security and liquidity are the basic requirements for their investment. Under these constraints, the ECB's foreign reserves are managed so as to maximise their value. The operational framework for the management of the foreign reserves of the ECB, which is described in this article, reflects these objectives. The ECB's foreign reserves are currently managed in a decentralised manner by the NCBs on behalf of the ECB in accordance with instructions received from the ECB. Although the NCBs manage their own foreign reserves independently, their operations on the foreign exchange market are, above a certain limit, subject to the approval of the ECB, in order to ensure consistency with the single monetary policy of the Eurosystem. The Treaty provides that further transfers of foreign reserve assets from the NCBs to the ECB may take place, should the need arise.

I Introduction: the institutional framework

The foreign exchange reserves of the Eurosystem comprise those of the ECB, which were transferred from the NCBs at the start of Stage Three of Economic and Monetary Union (EMU), and those of the NCBs themselves. The institutional framework within which these foreign exchange reserves are managed and foreign exchange operations are carried out is laid down in the Treaty and in the Statute of the ESCB (see Box 1).

According to the Treaty, the foreign exchange operations of the ECB, if and when they are carried out, would have to be seen as a component of the single monetary policy, bound by the same primary objective: the maintenance of price stability. Accordingly, any foreign exchange intervention and any other foreign exchange operations would have to be seen in the context of the Eurosystem's monetary policy strategy. In particular, as part of the broadly based assessment of the outlook for price developments in the context of the monetary policy strategy, the exchange rate is closely analysed and monitored and is treated as an important indicator.¹

¹ The monetary policy strategy of the Eurosystem was presented in greater detail in an article published in the January 1999 issue of the ECB Monthly Bulletin entitled "The stability-oriented monetary policy strategy of the Eurosystem".

Against this background, the Eurosystem is responsible for the holding and management of the official foreign reserves of the Member States and for all foreign exchange operations, including, in particular, potential intervention.

The Eurosystem may, if and when needed, conduct foreign exchange intervention either on its own (unilateral intervention) or within the framework of co-ordinated intervention involving other central banks (concerted intervention). The foreign currency holdings involved are those pooled at the ECB, but intervention may be carried out either directly by the ECB and/or by NCBs acting on behalf of the ECB, on a disclosed agency basis. Whether the execution of the intervention is centralised or decentralised is irrelevant from the point of view of the ultimate objective of the operation. Finally, it should be noted that the ECB can, if and when needed, also fund intervention through means other than using its foreign reserve assets. The ECB can, for example, use foreign exchange swaps, including swaps with other central banks. Should the need arise, the capacity of the ECB to carry out foreign exchange intervention is not, therefore, restricted to its foreign reserve holdings.

Box I

The institutional framework as laid down in the Treaty establishing the European Community (Treaty) and in the Statute of the European System of Central Banks and of the European Central Bank (Statute of the ESCB)

Article 105 of the Treaty stipulates that one of the basic tasks to be carried out by the Eurosystem is to hold and manage the official foreign reserves of the Member States, without prejudice to the holding and management by the governments of these Member States of foreign exchange working balances. Consequently, there are no official foreign reserves in the euro area apart from those held by the Eurosystem. The Statute of the ESCB governs the holding and management of foreign reserves at the level of both the European Central Bank (ECB) and the national central banks (NCBs).

Both the ECB and the NCBs hold foreign reserves. The Statute of the ESCB provides for an initial transfer of a portion of foreign reserve assets from the NCBs to the ECB and establishes the possibility of additional calls of foreign reserves by the ECB should the need arise (Article 30). The ECB holds and manages the foreign reserves that are transferred to it for the purposes set out in the Statute of the ESCB; the foreign reserves remaining with the NCBs are held and managed by the NCBs in accordance with the provisions of Article 31 of the Statute of the ESCB.

The external operations that may affect the ECB's and NCBs' holdings of reserves are set out in Article 23 of the Statute of the ESCB. First, the ECB and the NCBs may establish relations with central banks and financial institutions in other countries and, where appropriate, with international organisations. Second, they may acquire and sell spot and forward all types of foreign exchange assets and precious metals. Third, they may manage the foreign assets they hold. Finally, they may conduct all types of banking transactions in relations with third countries and international organisations, including borrowing and lending operations.

The foreign reserves of the NCBs are available for the fulfilment of current and prospective obligations, undertaken either by themselves or on behalf of national governments, towards international organisations, such as the BIS and the IMF. NCBs may also conduct other operations when acting as an agent for customers, for example their respective national governments. Finally, portfolio investment transactions may also be conducted by NCBs as part of their general asset management operations and they may change the size of their foreign reserve holdings.

As for the foreign reserves owned by the ECB, the most important type of foreign currency operation that could affect their amount is intervention on foreign exchange markets.

Foreign exchange intervention can, *inter alia*, be conducted in the context of institutional exchange rate relations between the euro and the currencies of countries outside the European Union, e.g. the US dollar and the Japanese yen. With regard to these currencies, Article 111 (ex Article 109) of the Treaty defines two possible alternative institutional procedures. First, the ECOFIN Council can conclude formal agreements on an exchange rate system for the euro. Second, the ECOFIN Council can formulate general orientations for the exchange rate policy. In both cases, the ECB is involved in the institutional procedure by means of either a recommendation to, or a consultation by, the ECOFIN Council. Both these institutional procedures must, however, be without prejudice to the primary objective of maintaining price stability. Neither of the two aforementioned procedures has thus far been initiated. At its meeting in Luxembourg on 13 December 1997, the European Council stressed that the exchange rate of the euro should be seen as the outcome of both economic developments and relevant economic policies, rather than as an objective to be set independently. Following this line of reasoning, the European Council stated that general orientations for the exchange rate policy of the euro area would be formulated only under exceptional circumstances and without prejudice to the independence of the Eurosystem.

Intervention may also take place within the framework of the new exchange rate mechanism, ERM II, which entered into force at the start of Stage Three of EMU. ERM II is based mainly on two legal documents: the European Council Resolution of 16 June 1997 and the Agreement of 1 September 1998 between the ECB and the central banks of the EU Member States outside the euro area. The NCBs of Denmark and Greece currently participate in ERM II. Any intervention in EU currencies would be performed without prejudice to the primary objective of the ECB of maintaining price stability and would be carried out by the Eurosystem in close co-ordination with the relevant non-euro area central bank, in particular with regard to the financing of the intervention. This obviates the need to hold foreign exchange reserves denominated in EU currencies.

2 The ECB's foreign reserves

Size of the foreign reserves

The Governing Council of the ECB decided that the transfer of foreign reserves should take place at the very beginning of 1999 for the maximum amount of €50 billion allowed in accordance with the Treaty, adjusted downwards by deducting the shares in the ECB capital of the NCBs of the countries not participating in the euro area from the outset. The transfer thus amounted to approximately 78.92% of €50 billion, i.e. around €39.46 billion. 15% of this amount was transferred in the form of gold, and the remaining 85% in the two major currencies (the US dollar and the Japanese yen). The foreign exchange reserves represent a very large share of the assets side of the ECB balance sheet. This underlines the importance of a framework which ensures prudent and efficient management of the foreign reserves.

The management of the foreign reserves owned by the ECB

As explained above, the aim of the ECB's foreign reserve management is to ensure that, at any point in time, the ECB has an amount of liquid resources sufficient for any foreign exchange intervention. This implies that liquidity and security are the basic requirements for the investment of the foreign reserves. Under these constraints, the ECB's foreign reserves should be managed in such a way as to maximise their value. The operational framework for the management

of the foreign reserve assets of the ECB reflects these aims.

The ECB's foreign reserves are managed in a decentralised manner. Nevertheless, the strategic and tactical investment framework is determined centrally by the decision-making bodies of the ECB. This framework includes the currency distribution, the trade-off between interest rate risk and return, and the credit risk and liquidity requirements. The investment decisions are then conveyed to the NCBs, in the form of investment benchmarks and limits, to be implemented. When implementing the ECB's investment decisions, NCBs act on behalf of the ECB, on a disclosed agency basis, so that the ECB's counterparties in the international financial markets can distinguish the operations carried out by the NCBs on behalf of the ECB from those carried out by NCBs in the course of managing their own reserves.

The Governing Council has defined the currency distribution of the foreign reserves of the ECB on the basis of prospective operational needs and may change them if this is deemed appropriate. There is, however, no active management of the currency composition of reserves for investment purposes, in order to avoid any interference with the single monetary policy of the Eurosystem.

The ECB defines four key parameters for the investment of its foreign reserves. First, a two-level investment benchmark (i.e. a

strategic and a tactical benchmark) for each currency; second, permitted deviations from these benchmarks in terms of interest rate risk; third, a list of eligible instruments and operations; and, fourth, limits for credit risk exposure. Details of these parameters are not published so as to avoid any unwarranted impact on financial markets.

With regard to the investment benchmarks, the Governing Council first establishes a strategic benchmark for each currency, which constitutes the main guideline for the ECB's investment policy. This benchmark reflects the long-term policy requirements and risk and return preferences of the ECB. Second, the ECB determines a tactical benchmark. This tactical benchmark, which must be kept within pre-set bands around the strategic benchmark, reflects the short to medium-term risk and return preferences of the ECB, in the context of the prevailing market conditions. The information regarding all four characteristics listed above is then communicated to the NCBs, which implement the investment framework of the ECB. Concerning the daily management of foreign reserves, the NCBs have a margin of discretion within the deviation bands and limits defined by the ECB. This aims at maximising the efficiency of the management of the ECB's foreign reserves. Through a portfolio management system which uses a special IT network built for the ESCB, the ECB receives online information on the deals carried out by all NCBs on its behalf.

Since its launch at the beginning of 1999, this framework has proven to function well. However, there is constant consultation between the ECB and all the NCBs to refine and improve it. This is particularly true with regard to the selection of counterparties in operations involving foreign reserve assets, the selection of eligible assets and the introduction of new instruments.

The counterparties and intermediaries used in operations involving foreign reserve assets are selected by the ECB in the light of the experience of NCBs. In making its selection,

the ECB follows a uniform approach, based essentially on two sets of criteria. The first set of criteria includes, notably, an assessment of the creditworthiness of the counterparties. The second set of criteria relates to efficiency considerations and includes, *inter alia*, the research service provided, the competitiveness of prices and the ability of counterparties to handle large volumes in all market conditions. The transactions conducted with the ECB's counterparties are documented under standard market agreements. The ECB has also developed a proprietary master netting agreement which has been accepted by its counterparties. The ECB modifies, from time to time, the list of instruments eligible for use in its foreign reserve management. The choice of such eligible instruments depends upon the general requirements in respect of the management of the ECB's foreign reserves and aims at achieving an increasing degree of sophistication, while meeting the requirements for high levels of security and liquidity.

It should also be noted that the management of the ECB's foreign reserves allows the ECB continuously to update its knowledge of investors' behaviour and market techniques. In particular, beyond the analysis of economic and financial data, this makes it constantly possible to add to a thorough and forward-looking understanding of financial market participants' focus.

The ECB's gold reserves

As a result of the initial transfer of foreign reserves, the ECB holds approximately 750 tonnes of gold. This transfer of gold from the NCBs to the ECB had no implications for the consolidated gold holdings of the entire Eurosystem. The ECB is party to the 1999 Central Bank Gold Agreement, which was signed on 26 September 1999 by 15 central banks, including those belonging to the Eurosystem (see Box 2).

Box 2

1999 Central Bank Gold Agreement

In the interest of clarifying their intention with respect to their gold holdings, the undersigned institutions make the following statement:

1. Gold will remain an important element of global monetary reserves.
2. The undersigned institutions will not enter the market as sellers, with the exception of already decided sales.
3. The gold sales already decided will be achieved through a concerted programme of sales over the next five years. Annual sales will not exceed approximately 400 tons and total sales over the period will not exceed 2,000 tons.
4. The signatories to this agreement have agreed not to expand their gold leasings and their use of gold futures and options over this period.
5. This agreement will be reviewed after five years.

European Central Bank
Oesterreichische Nationalbank
Nationale Bank van België/Banque Nationale de Belgique
Suomen Pankki
Banque de France
Deutsche Bundesbank
Central Bank of Ireland
Banca d'Italia
Banque centrale du Luxembourg
De Nederlandsche Bank
Banco de Portugal
Banco de España
Sveriges Riksbank
Schweizerische Nationalbank
Bank of England

3 The NCBs' foreign reserves

According to the Treaty, as seen above, the foreign reserves which were not transferred to the ECB at the start of Stage Three of EMU are held and managed by the NCBs. NCBs conduct many operations with their foreign reserves and numerous foreign exchange transactions, but most do not substantially affect their total holdings of reserves. In practice, NCBs' transactions are mostly related to the portfolio management of their own foreign reserves and to

customer transactions (e.g. operations for national treasuries or international institutions). The latter might include the management of public debt denominated in foreign currencies (e.g. purchases of foreign exchange by a central bank for the servicing of government foreign debt). In addition, some of the NCBs' operations are aimed at adjusting the size of their foreign reserve holdings.

At the end of November 1999 the foreign reserves held by NCBs amounted to €307.5 billion. Table I illustrates the development of the ECB's and the NCBs' holdings since the beginning of this year. The total amount of the NCBs' foreign reserves expressed in euro has increased thus far in 1999, mainly as a result of revaluations and the accrual of income from their own foreign reserve management, but it was also affected by operations carried out by some NCBs to reduce the proportion of foreign reserves on their balance sheets. The ECB's foreign reserves have increased in euro terms primarily as a result of revaluations, but they also reflect the accrual of income from reserve management operations. If foreign exchange intervention had been carried out by the Eurosystem, this would have affected the ECB's foreign reserves; however, no foreign exchange intervention has been carried out thus far.

In line with Article 31 of the Statute of the ESCB, operations carried out on the foreign exchange market with the NCBs' foreign reserves, which may affect foreign exchange rates or domestic liquidity conditions, are, above certain limits established within the framework of guidelines issued by the Governing Council, subject to the approval of the ECB, in order to ensure consistency with the single monetary policy of the Eurosystem. Since they do not affect the single monetary policy of the Eurosystem, NCBs' investment operations in foreign financial markets are not subject to the

approval of the ECB. Transactions undertaken by NCBs in fulfilment of their obligations towards international organisations are also exempt from this requirement. An analogous framework applies to Member States' transactions with their foreign currency working balances. Internal ECB guidelines, specifying the aforementioned limits, have been in place since the launch of the euro.

While the Treaty provides for a specific amount of foreign reserves to be transferred from the NCBs to the ECB, as seen above, it also makes explicit reference to additional transfers of foreign reserve assets to the ECB. Indeed, Article 30 of the Statute of the ESCB provides that further calls of foreign reserve assets, beyond the amount of the initial transfer, may take place. In the event of such further calls, the contribution of each NCB would be fixed in proportion to its share in the subscribed capital of the ECB, as was the case for the initial transfer. The Treaty establishes that EC secondary legislation shall be adopted to make such further calls possible. To this end, the ECB has made a Recommendation to the ECOFIN Council, which envisages that further calls may be effected up to the same amount as the initial transfer of foreign reserves from the NCBs to the ECB (i.e. €50 billion). This Recommendation is currently being examined. Additional transfers of foreign reserve assets to the ECB may also, if deemed necessary, take place on the basis of further EC secondary legislation.

Table I
Foreign reserve assets of the Eurosystem (including gold)
(end-of-period in EUR billions; revaluations are carried out at the end of each quarter)

1999	ECB	All NCBs	Eurosystem
January	39.2	289.1	328.3
February	39.4	285.4	324.8
March	42.3	302.1	344.4
April	42.4	300.4	342.8
May	42.5	297.1	339.6
June	43.6	299.2	342.8
July	43.5	298.7	342.2
August	43.7	299.8	343.5
September	44.1	307.4	351.5
October	44.1	307.3	351.4
November	44.3	307.5	351.8

4 The presentation of foreign reserves in the consolidated weekly financial statement of the Eurosystem

A consolidated weekly financial statement of the Eurosystem, reflecting the financial position at the close of business each Friday, is published on the ECB's Web site the following Tuesday (or, at the quarter-end, the following Wednesday). The consolidated weekly financial statements are accompanied by a press release indicating the major changes in the various items. In this press release a distinction is made between items related to monetary policy and those not related to monetary policy. In the section on items not related to monetary policy, weekly changes in the net position of the Eurosystem in foreign reserves are

commented upon, in particular. Since these financial statements of the ECB and the 11 euro area NCBs are consolidated, changes in the ECB's foreign reserves cannot be derived from the weekly financial statements. In other words, changes in the Eurosystem's foreign reserves on a weekly basis cannot be attributed to any one of the 12 central banks forming the Eurosystem.

The ECB's foreign reserves will be reported in the ECB Monthly Bulletin on a monthly basis, separately from the position of the entire Eurosystem, as from the beginning of this year.