

The Central Bank of Chile's Management of Foreign Exchange Reserves

Summary

Foreign exchange reserves are liquid assets in foreign currency held by the Central Bank of Chile. They are an instrument supporting monetary and foreign exchange policies, in order to meet the Bank's objective of safeguarding currency stability and the normal functioning of domestic and external payment systems. Within Chile's current floating exchange regime, the main role of reserves is to ensure access to liquidity in foreign currency to permit intervention in the foreign exchange market under exceptional and well defined circumstances.

The purpose of foreign exchange reserves management is to guarantee secure and efficient access to international liquidity, and safeguard Central Bank equity. The management of foreign exchange reserves is defined by the legal framework embedded in the Central Bank's Basic Constitutional Act, and follows best practices and policies in line with international recommendations in this field.

Investment policy governing foreign exchange reserves is restricted by legal and liquidity requirements. The Act establishes that foreign exchange reserves can only be invested in foreign currencies, gold or credit bills, securities or commercial paper issued or guaranteed by foreign States, central banks or foreign or international banks or financial institutions. Moreover, by their nature, foreign exchange reserves can only be invested in liquid financial assets.

Subject to these restrictions, investment policy for foreign exchange reserves is designed taking into account its impact on financial results and associated risks within the Central Bank's balance sheet and potential foreign currency liquidity needs. In practice, this policy is defined using a benchmark or reference structure to guide and evaluate investments and set the parameters for decisions regarding market and credit risk.

Foreign exchange reserves are invested in assets under two portfolios. The Investment Portfolio is the largest, and includes short- and long-term foreign currency assets used to respond to unforeseen contingencies and long-term requirements. The benchmark for this portfolio in terms of currency composition is currently 60% US dollars and 40% euros, and has an average duration of 13 months. The Liquidity Portfolio, meanwhile, is designed to cover requirements foreseeable in the short term. The reference structure for this portfolio corresponds to the currencies and maturities of programmed disbursements.

Risk management policy defines a set of permissible deviations from the reference structure regarding duration, maturity, currency and limits applied to different types of investments. This policy limits liquidity, market and credit risk, including banking, sovereign, supranational, external financial institution and counterparty risk. Operational risk, meanwhile, is controlled by segregating functions and responsibilities, and by internal and external controls and audits, carried out on a regular, ongoing basis.

To complement the internal management of foreign exchange reserves, since 1995 the Bank has also run an external management program for a small portion of reserves. This program provides a benchmark to evaluate internal reserves management, contributes to enhancing returns on the Investment Portfolio, and facilitates the transfer of knowledge and technology. Currently two programs of this nature exist, one involving management of a general fixed income investment portfolio with long-term maturities and the other a special mandate in Mortgage-Backed Securities (MBS), mortgage instruments issued by US financial agencies.

As of 30 June 2006, total foreign exchange reserves stood at US\$17,570 million, of which US\$12,873 million were held in the Investment Portfolio and US\$4,479 million in the Liquidity Portfolio. Of total foreign exchange reserves, 67.2% were held in US dollar instruments, 25.5% in euros and 7.3% in other foreign currencies (table 1).

Table 1: Composition of foreign exchange reserves by portfolio and currency

Type of portfolio	US\$ million	Percent
Investment Portfolio	12,872.6	73.3
Dollar	8,214.4	46.8
Euro	4,484.2	25.5
Other	174.0	1.0
Liquidity Portfolio	4,479.4	25.5
Dollar	3,579.5	20.4
Euro	0.0	0.0
Other	899.8	5.1
Other assets	218.1	1.2
Total foreign exchange reserves	17,570.0	100.0
Dollar	11,805.4	67.2
Euro	4,484.2	25.5
Other	1,280.4	7.3

Source: Central Bank of Chile.

Similarly, as of 30 June 2006, 45.3% of reserves were invested in securities with AAA credit rating, issued by sovereigns, US financial agencies or supranational agencies. The remaining 54.7% was invested in securities with an A to AA+ rating, mainly in the banking sector (table 2).

Table 2: Composition of foreign exchange reserves by credit risk (percent)

Type of credit risk (1)	Credit rating (2)						Total
	AAA	AA+	AA	AA-	A+	A	
Bank	0.0	0.0	9.8	30.3	5.6	6.6	52.3
Sovereign	33.9	0.6	1.4	0.0	0.0	0.4	36.3
Agency	8.8	0.0	0.0	0.0	0.0	0.0	8.8
Supranational	2.6	0.0	0.0	0.0	0.0	0.0	2.6
Total	45.3	0.6	11.2	30.3	5.6	7.0	100.0

(1) Credit risk associated with investment in bank financial instruments (deposits, forex -spot/forward, pfandbriefes); sovereign states (deposits, bills, floating rate notes, nominal and indexed bonds); US financial agencies (bills, nominal bonds, mortgage-backed securities); and official multilateral issuers (deposits, bills, floating rate notes, nominal bonds), respectively.

(2) Based on ratings from Fitch, Moody's and Standard and Poor's.

Source: Central Bank of Chile.

In 2000-2005, annual average returns obtained from foreign exchange reserves management was 4.12% measured in foreign currency, that is, using the currency reference basket for the Investment Portfolio, evolving in line with relevant external interest rates. Measured in pesos, this average was 3.96%, taking into account shifts in foreign currency parities against the Chilean peso. The differential returns relative to the benchmark used to evaluate reserves investment management averaged 0.26% or 26 basis point per year (table 3).

Table 3: Total return and differential on foreign exchange reserves (percent)

Year	Measured in foreign currency*		In pesos		Differential return (a)-(b) = (c)-(d)
	Total return	Benchmark	Total return	Benchmark	
	Foreign exchange reserves (a)	return (b)	Foreign exchange reserves (c)	return (d)	
2000	6.88	6.65	12.92	12.70	0.22
2001	5.57	5.27	18.08	17.78	0.30
2002	5.25	4.69	17.89	17.32	0.57
2003	2.31	1.78	-12.84	-13.37	0.53
2004	1.84	1.95	-2.36	-2.25	-0.11
2005	2.90	2.85	-9.92	-9.97	0.05
Annual average 2000-2005	4.12	3.87	3.96	3.70	0.26

* Reference currency basket for the Investment Portfolio, 60% US dollars and 40% euros.
Source: Central Bank of Chile.

The Central Bank's Board recently established as an institutional policy the disclosure of information on foreign exchange reserves management to the President of the Republic, the Senate and the general public, through the Bank's website. This decision consolidates current Central Bank practices, which are consistent with transparency guidelines issued by the International Monetary Fund to ensure clarity and accountability of activities and results from foreign exchange reserves management.