

Foreign Currency Department

Investment of the Foreign Exchange Reserves and Developments in the Foreign Currency Market

Abstracts

The management of the foreign exchange reserves portfolio, whose average level in 2002 was \$ 24 billion, is subject to the Bank of Israel Law 5714–1954 and the relevant legal interpretations which have been added over the years, together with a set of rules which reflect the Bank's responsibility for the reserves. Against the background of the changes in macroeconomic policy and exchange-rate policy, the role played by the reserves has also changed: currently, their main functions are to support financial stability in the economy, to provide a safety net for emergency situations, and to afford the government flexibility in dividing its liabilities between NIS and foreign currency. These aspects of the role of the foreign reserves are similar to those of the reserves of other countries that are comparable to Israel with regard to their macroeconomic policy and their exchange-rate regimes. Studies of the levels of the reserves held by those countries suggest that the level of Israel's reserves is not very different from its expected level.

The holding-period rate of return on the foreign exchange reserves in 2002 was 5.2 percent, down from 6.4 percent in 2001. This reflected the reduction in yield to maturity in capital markets which resulted from the persistent worldwide slowdown in economic activity and the worsening stock market crisis on the one hand, and the low yield to maturity, mainly in the US market, on the other. In NIS terms the holding-period rate of return in 2002 was 17.8 percent, compared to 14.9 percent in 2001, a rise that reflected the weakness in these years of the NIS against the currencies in which the reserves are invested.

The yield on the reserves is greatly affected by the composition of the neutral benchmark, due to the relatively low risk taken in the portfolio, a risk that derives from deviations from the benchmark. Much effort has been invested in the last few years in the area of asset allocation (securities not in the benchmark), while on the other hand the scope of positions in the areas of duration and currency management has declined, in accordance with the policy of reducing exposure in these fields. In 2002 the holding-period rate of return was 20 basis points higher than that on the benchmark; this yield differential reflects the contribution of portfolio asset management.

Asset-selection decisions contributed 20 basis points to the yield differential in 2002. This derived from investment in Treasury Inflation-Protected Securities (TIPS) (6 basis points), in Eurobonds (6 basis points), in mortgage-backed securities issued by the Government National Mortgage Association (GNMAs) (5 basis points), and securities-lending activities (3 basis points). Currency management contributed 3 basis points, while the duration management contribution was a negative 2 basis points.

The exposure of the reserves to the banking system is limited to 25 percent of the value of the portfolio. In 2002 the exposure averaged 20 percent, about half of which was used in securities-lending activities, which have a very short investment horizon. The exposure is managed under a system of quotas and rules which plays a central role in the credit-risk management of the portfolio.

The liquidity of the reserves, that estimates the proportion of the portfolio that can be realized quickly without reducing its value, is very high: 90 percent of the reserves portfolio is invested in very liquid assets, and the rest in assets with lower liquidity. Bearing in mind the high level of the reserves, it seems that the level of liquidity is satisfactory. The high liquidity of the reserves is due on the one hand to the Bank of Israel Law and to the investment policy derived from the spirit of the Law that requires conservative management of financial risks, and on the other hand to considerations of profitability that in the last few years have led to only partial use of the degrees of freedom to invest in assets with low liquidity.