BanRep Blog: Global Trends in Foreign Reserves Management

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In a recently published blog on *Banco de la República's* profits, it was shown that in 2023 these mainly came from the yield of foreign reserves, which in the last 10 years reached an average share of 84% of the Bank's assets. The importance of foreign reserves in the Bank's equity and origin of its profits and their function as a support for the country's balance of payments, require that their administration meet strict criteria of security, liquidity, and profitability. The security criterion refers to maintaining adequate control over the risks to which investments are exposed. Liquidity is the possibility of converting the invested resources into cash quickly and at low cost. Profitability is the ability of financial assets to increase their value over time. In addition to meeting these requirements, as explicitly mandated by Law 31 of 1992, reserve management requires a modern and dynamic approach, evolving with changes in the global economic and geopolitical landscape. In this regard, this blog highlights some of the trends in foreign reserves management by central banks in various economies around the world in response to the recent economic and geopolitical context. Likewise, it shows how Banco de la República is adapting to such trends. This analysis is based on the results of a survey of 91 central banks conducted by Central Banking, an international specialized publication1.

The main global trend in the management of foreign reserves concerns the duration of the investment portfolio. This concept refers to the average term of flows of fixed-rate securities at which resources are invested or, in the case of variable-rate securities, to the average term over which the benchmark rate changes. This approach is important because a longer portfolio could make valuation profits when the market interest rate decreases or incur losses if it increases. The survey shows that just over half of the central banks surveyed (52.9%) increased the duration of their portfolios in 2023. This is largely explained by the expectation that the tight monetary policy cycle in major economies is coming to an end, raising the outlook for interest rate reductions in global capital markets.

On the other hand, in relation to the foreign exchange composition of portfolios, there is an interesting trend towards an increased weighting of the euro, to the point that 87.3% of the central banks surveyed mentioned that this currency is now more attractive than before 2023. The institutions surveyed also reported that the dollar has been gradually reducing its share of reserves. In line with this, central banks have increased their investment in the renminbi, for which more than half of respondents stated that the percentage of their reserves in the Chinese currency is in the range of 1.0% to 3.0%. It should be noted that the vast majority of respondents (81.3%) believe that, by the end of 2035, the percentage of renminbi's share could be in the range of 4.0% to 12% of total reserves. In addition to interest in the Chinese currency, central banks indicated that the Canadian dollar, the Swedish krona, and the Australian dollar stand out among the currencies in which they invest or are considering investing.

Banco de la República's portfolio is in line with the global trend in terms of currency distribution. As shown in Table 1, the current foreign reserves investment portfolio contains 83% in US dollars, about 5.6% in Australian dollars, 5.3% in euros, and 5.2% in Canadian dollars. The implementation of these strategies explains, to a considerable degree, the high profitability of foreign reserves, whose yields reached the equivalent of 8.7 trillion Colombian pesos in 2023. This gave rise to most of the profits obtained in that year by Banco de la República, which reached a historically high level of 9.2 trillion Colombian pesos.

Table 1.
Foreign Exchange Exposure of Banco de la República's Foreign Reserves Investment Portfolio

Currency**Share**U.S. dollar83.30%Australian dollar5.66%Euro5.35%Canadian dollar5.21%Renminbi0.49%Other0.00%

Sorce: *Banco de la República*

For investment assets eligible for foreign reserves other than more traditional ones, such as sovereign and quasi-sovereign bonds, the survey highlights the increasing use of Exchange Traded Funds. These financial instruments, commonly referred to as ETFs, are investment vehicles that allow for diversification by holding different types of assets as backstops, but are traded as a unit, as if they were a stock, making trading easy and low-cost. Thirty-seven percent of central banks surveyed mentioned that they invest in or are considering investing in these instruments, usually with exposure to shares and credit to highly rated private corporations. Banco de la República has made progress on this matter, and since 2016, investment is allowed in some specific ETFs, which generate exposures to previously permitted assets in the investment guidelines.

Regarding direct investment in equities, about 70% of the central banks surveyed stated they do not invest in them. Those that do invest directly in this asset for higher returns do so in low percentages: 16% of the central banks invest between 1.0% and 10% of their portfolios in equities; only 6.0% of the banks invest between 11% and 25% of their resources in equities; and just 3.0% of the respondents invest between 26% and 50% of their foreign reserves in equities.

Moreover, the survey shows that all central banks have been reluctant to invest their foreign reserves in crypto assets or other digital assets backed by mathematical algorithms.

There have been two issues of growing importance globally: the discussion in foreign reserves management of the use of artificial intelligence (AI) and the implementation of environmental, social, and corporate governance (ESG2) factors in mandates. Most respondents (93.2%) view AI deployment positively to optimize their operations. The potential use for defining optimal investment portfolios, rebalancing strategies, and improved decision-making through data analysis is highlighted. Banco de la República is currently examining the advances and uses of AI in reserve management.

In terms of sustainability, half of the central banks surveyed now incorporate these criteria in one way or another. It should be noted that central banks in developed economies have incorporated them the most (82.1% of institutions in these economies implement them), compared to 36.1% of central banks in emerging economies that claim to implement some sustainability criteria. The most widely used strategy in this regard is the purchase of ESG bonds, followed by integration into the investment process and filters to prohibit investments in financial assets considered unsustainable. In line with this trend, discussions have been held at Banco de la República regarding the use of ESG factors within the criteria for foreign reserves management, and these factors have been measured and monitored in the portfolio3.

In summary, the composition of foreign reserves in Colombia, as well as the criteria for their administration and management by Banco de la República, are in line with best practices worldwide. The adoption of new investment strategies, the consideration of geopolitical and economic risks, and the incorporation of ESG factors and advanced technologies such as AI demonstrate a constant evolution and adaptation to an increasingly complex and dynamic global environment. All these elements follow the established criteria of security, liquidity, and profitability.

1 ? "Trends in Reserve Management 2024 Survey". 20th Annual HSBC Reserves Management Trends Report. May 2024

2 ? *ESG:* Environmental, Social, and Governance, refers to a set of investment standards used by socially conscious investors in sustainability issues.

3 ? Further details on progress in this area are provided in Box 4 of the 2023 Foreign Reserves Management Report.

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