ASSET ALLOCATION

Modelling the Asset-Allocation and Liability Strategy for Canada's Foreign Exchange Reserves

April 2, 2013

The 2007–2009 global financial crisis led to rapid accumulation of foreign reserves in both developed and emerging countries and triggered discussions of how these reserves should be managed. While efforts to reassess and improve the management of Canada's reserves date back to before the crisis, recent events have highlighted the need for appropriate tools to aid policy-makers in their management of the reserves.

Canada's foreign exchange reserves help to promote orderly conditions for the Canadian dollar in foreign exchange markets, if required, and provide foreign currency liquidity to the federal government. These reserves are not included on the balance sheet of the central bank; instead, they belong to the federal government and are held primarily in the Exchange Fund Account (EFA). Unlike many other countries, the assets held in the EFA are funded by Government of Canada liabilities denominated in, or converted to, foreign currencies. The Bank of Canada acts as the fiscal agent for the government in the management of the EFA and works with the Department of Finance to advise the Minister of Finance on the funding and investment of Canada's foreign exchange reserves.

This article describes an analytical tool recently developed at the Bank, which, combined with other information, guides policy advice on the management of Canada's foreign exchange reserves and the liabilities used to finance them. The authors begin by discussing the objectives of the EFA, its governance framework and its investment principles. They then examine the portfolio-management model developed to help policy-makers achieve the EFA's objectives in an efficient and fiscally responsible manner. Finally, they present some of the insights gained from this tool.