May 11, 2012
Bank of Japan

Revisions to the Management of Foreign Currency Assets

The Bank of Japan (Bank), as the central bank of Japan, holds foreign currency assets in preparation for the smooth and flexible conduct of its policies and related operations. The Bank has considered a high degree of safety and liquidity to be essential when managing its foreign currency assets, and, provided this condition is met, return shall also be taken into consideration.

The Bank believes that the basic principle described above continues to be appropriate. In the light of recent changes in international financial and capital market conditions, the Bank has reexamined the underlying operational needs for holding foreign currency assets and the risks associated with holding such assets. As a result, the Bank has concluded that it is appropriate to place increased emphasis on safety and liquidity when managing its foreign currency assets. The Bank has therefore decided to establish the "Principal Terms and Conditions for the Management of Foreign Currency Assets" (Annex), which will replace the current "Guidelines for the Management of External Assets Held by the Bank." The principles guiding the revision are as follows.

1. Recent Changes in International Financial Markets

International financial and capital markets have shown increasing volatility in the wake of the global financial crisis. There have been situations where the market liquidity of assets once considered as relatively safe has deteriorated, accompanied by, in some cases, increased credit risk. In the closely interconnected global financial and capital markets, there has been a growing tendency for a financial shock in one corner of the world to spill over into other markets, and the speed of such spillovers has accelerated.

Amid ongoing economic globalization, it is essential for Japanese firms to take advantage of expanding global demand in order to strengthen further the foundations for Japan's economic growth.

2. Purposes of Holding Foreign Currency Assets

Considering the recent changes in the environment as mentioned above, the Bank believes that the following purposes would result in the effective use of its foreign currency assets.

(1) International financial cooperation

In the face of turmoil in the international financial and capital markets, time may be necessary before international organizations and other relevant institutions are able to take necessary measures. In such types of situations, from the perspective of international cooperation, the Bank, as the central bank of Japan, would be prepared to provide foreign currency until international support is provided.

(2) Emergency liquidity provision in foreign currency to Japanese financial institutions

Currently, Japanese financial institutions do not face any problems with their foreign currency funding. However, should an extraordinary situation occur, where Japanese financial institutions face serious trouble in foreign currency settlements and are unable to resolve the situation by themselves, and if the Bank judges that it is urgent and there is no alternative in order to ensure the stability of Japan's financial system, the Bank would be prepared to provide liquidity in foreign currency.

(3) Fund-provisioning measure to support strengthening the foundations for economic growth

The Bank is prepared for the smooth implementation of the U.S. dollar lending arrangement for investments and loans denominated in foreign currency which contribute to strengthening the foundations for Japan's economic growth.

3. Control of Risks Associated with Holding of Foreign Currency Assets

Given the increased volatility of asset prices brought about by recent changes in international financial market conditions, there is a growing need to contain the potential risks of financial loss associated with holding foreign currency assets.

4. Principles of the Management of Foreign Currency Assets

The Bank considers it appropriate to place increased emphasis on a greater degree of safety and liquidity when managing its foreign currency assets. This would be consistent with the preparation for conducting operations in accordance with the purposes of holding foreign currency assets, and with the need to contain risks from holding such assets. Specifically, the Bank shall hold foreign currency assets primarily in deposits with foreign central banks and government securities with a high degree of liquidity and creditworthiness. For the time being, the government securities shall mainly be those issued by the United States and major European countries. This will enable the Bank to encash foreign currency assets smoothly and promptly as needed for conducting its operations, and also to reduce to a minimum the financial risks associated with holding foreign currency assets.

The Bank will continue to utilize its foreign currency assets effectively and to endeavor to manage risks appropriately in response to changes in financial and economic circumstances.

(Annex)

Principal Terms and Conditions for the Management of Foreign Currency Assets

1. Objective

These Terms and Conditions prescribe the requisite principles for the management of the Bank of Japan's foreign currency assets (foreign currency and assets denominated in foreign currency as defined in Article 9, Paragraph 2 of the Ordinance for Enforcement of the Bank of Japan Act, Ordinance No.3, 1998, excluding assets used in operations [as defined in Chapter 4 of the Bank of Japan Act, Act No. 89, 1997], hereafter "foreign currency assets") with an emphasis on safety and liquidity.

2. Holding Purpose and Management Principle

The Bank of Japan (Bank) holds foreign currency assets in preparation to conduct the following operations, defined in Chapter 4 of the Bank of Japan Act, while ensuring a high degree of safety and liquidity.

(1) International financial cooperation;

(2) Emergency liquidity provision in foreign currency to Japanese financial institutions;

(3) Loans in the U.S. dollar as a fund-provisioning measure to support strengthening the foundations for economic growth.

3. Composition of Foreign Currency Assets

Foreign currency assets can be composed of the following financial assets denominated in U.S. dollars, euros, and pounds sterling (confined exclusively to those considered appropriate in the light of the principles described in 2, above).

(1) Deposits with central banks and other institutions of foreign countries;

(2) Securities issued by governments and other institutions of foreign countries with maturity not exceeding 5 years.

4. Management Practices of Foreign Currency Assets

(1) Financial assets which the Bank holds in preparation for immediate use can be held in the form of deposits with central banks and other institutions of

foreign countries and securities denominated in U.S. dollars with maturity not exceeding 1 year.

(2) Foreign currency assets excluding those described in (1) are composed of the financial assets defined in 3, and their composition is managed in the following manner.

(a) The currency composition is adjusted so that it tracks the benchmark currency composition, which is calculated based on the market capitalizations of the government securities with maturity of 1-5 years (1 year or more, and less than 5 years) defined in 3 (2).

(b) The composition is adjusted so that the price volatilities caused by interest rate fluctuations track those of the government securities markets with maturity of 1-5 years (1 year or more, and less than 5 years) defined in 3 (2).

(c) When the Bank adjusts the composition as necessary to accomplish (a) and (b), it shall make transactions with care to avoid disrupting financial and foreign exchange markets.