

Strategic Asset Allocation for Central Bank's Reserve Management

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Central banks play a vital role in shaping global financial flows and real interest rate. They choose an appropriate strategic asset allocation of the foreign exchange reserves in agreement with the overall policy and corporate objectives. Strategic asset allocation is defined as the long-term allocation of capital to different asset classes such as bonds, equity, real estate and other investment opportunities with an aim of increasing the capital and making an appreciable and optimum return. The main objective of this paper is to propose a possible tranching methodology for the Central Bank for the purpose of working capital, liquidity and investment based on the concepts of Mean-variance portfolio theory, Behavioral portfolio theory, Portfolio optimization with mental accounts and the theory of the Utility. This study has two sub objectives to support the main objective of the study. A descriptive statistic model was built to propose the need of foreign reserves based on the external debt condition of the country and developed a hypothetical equation to allocate foreign reserves in different currencies. The study was based on the secondary data. This study built a mathematical model for the Central Bank to find out the future requirement of the assets based on external debt of the country because debt has a proportional relationship with debt payments (Capitol + Interest). Results were found as Sri Lanka should keep foreign reserves in four types of currencies according to the past currency composition data of Sri Lanka to pay off the debt with an interest in the future. The study developed a way to allocate foreign reserves in different currencies according to the hypothetical equation as $A \times (\text{USD}) + B \times (\text{SDR}) + C \times (\text{YEN}) + D \times (\text{EURO})$. Here A, B, C and D denote the percentage values. Thereafter, the study developed a possible tranching methodology for of working capital, liquidity and investment.

Keywords: Foreign reserves, Reserve management, Strategic asset allocation