Bangko Sentral ng Pilipinas
ECONOMIC Newsletter

No. 10-06
Nov-Dec 2010

Some Thoughts on Diversifying International Reserves

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Background

Investors' search for higher returns supported the steady increase of foreign exchange inflows in emerging market (EM) economies. The dramatic drop in EM asset valuations following the Lehman crisis provided a strong rationale for global portfolios to reallocate into emerging markets in 2009.[2] HSBC Holdings Plc argued that yield advantages will continue to attract capital inflows into the bond markets of Indonesia, Malaysia and the Philippines.[3] In addition, EMs are beneficiaries of capital inflows owing to their upbeat economic prospects while, in contrast, advanced economies continue to face a fragile economic growth constrained by higher unemployment rate and/or sovereign debt problems. Finally, a healthier external sector among the EMs is expected to generate improved foreign exchange receipts as the exports sector rebounds from the slump it experienced during the global financial turmoil.

GDP Forecast (%)

	IMF		Credit Agricole		BNP Paribas		HSBC	
	2010	2011	2010	2011	2010	2011	2010	2011
World	**4.8**	**4.2**	**4.6**	**3.9**	**4.6**	**3.7**	**3.5**	**2.9**
Advanced	**2.7**	**2.2**	**2.4**	**1.8**	**2.8**	**1.7**	**2.4**	**1.8**
US	2.6	2.3	2.7	2.0	2.6	1.6	2.8	2.5
Eurozone	1.7	1.5	1.6	1.2	1.7	1.1	1.6	1.3
Japan	2.8	1.5	3.1	1.5	3.2	1.6	3.0	0.7
UK	1.7	2.0	1.5	1.4	1.5	0.6	1.4	1.4
Emerging Market	**7.0**	**6.4**	**7.3**	**6.4**	**6.8**	**6.1**	**7.2**	**6.2**
China	10.5	9.6	10.0	9.0	9.8	8.4	10.0	8.9
Indonesia	6.0	6.2	5.8	5.7	6.2	6.5	6.1	6.4
Malaysia	6.7	5.3	7.0	5.5	8.2	7.0	7.3	5.2
Thailand	7.5	4.0	7.0	4.3	8.4	5.3	7.9	5.3
Philippines	7.0	4.5	7.5	5.0	6.5	4.9	5.9	4.6

Sources: Various publications

These positive factors resulted in a dramatic rise in EMs' international reserve holdings in recent years.

International Reserves: Selected Asian Countries (in billion US$)

	2005	2006	2007	2008	2009	2010
China	818.9	1,066.3	1,528.3	1,946.0	2,273.0	2,648.0
Taiwan	253.3	266.2	270.3	291.7	348.2	379.3
Korea	210.4	239.0	262.2	201.2	270.0	290.2
Hong Kong	124.3	133.2	152.7	182.5	255.8	266.1
India	131.0	170.2	266.8	245.9	258.7	265.3
Singapore	116.2	136.3	163.0	174.2	187.8	217.6
Thailand	50.5	65.1	85.1	108.3	133.6	164.8
Malaysia	69.4	81.7	100.6	90.6	92.4	101.2
Indonesia	36.3	34.7	42.8	51.6	65.8	92.8
Philippines	18.5	23.0	33.8	37.6	45.0	60.6

Note: Numbers for Taiwan, S. Korea, India, Hong Kong, India, Singapore, Indonesia and the Philippines are as of end-November 2010; those for Thailand and Malaysia are as of end-October 2010; and for China is as of end-September 2010
Sources: Bloomberg, BSP

Motivations for Holding International Reserves

The motivations of central banks in holding reserves include the following:

a. Transaction motive. Maintain international stability and convertibility of the domestic currency and help meet FX liquidity requirements of the country;

b. Precautionary motive. Serve as contingency buffer in instances of insufficient domestic FX supply (crisis prevention);

c. Insurance motive. Fund FX shortages during market stresses (crisis mitigation);

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[2] Barclays Bank Plc, Emerging Market Flows, 5 July 2010
[3] Bloomberg news, 24 August 2010

d. Investment motive. Generate returns; and

e. Other motivations such as the establishment of endowment funds for future generations (e.g., to fund future liabilities, especially in countries with growing aging populations); acceleration of repayment of external or domestic liabilities; recapitalization of state-owned financial institutions; and financing public-sector investment projects.

Asian central banks' purchases of foreign exchange reserves as a form of insurance against and precaution from unexpected shortages of foreign exchange were, in part, a response to the 1997-98 Asian financial crisis. During that period, Asian countries suffered severe foreign exchange liquidity crunch, as foreign investors took their funds out of the region. Borrowings from multilateral institutions, particularly the IMF, were punctuated by too many conditionalities indicative of their reluctance to lend to the weakened economies in the region. Thus, the lesson learned from this episode was that the country's international reserves are the first line of defense in times of extreme stress in the foreign exchange market.

According to Goldman Sachs, such reserve buffer did moderate the rise in the country risk premium and the extent of exchange rate falls during the recent global financial turmoil. This may have, in part, forestalled full-blown crises in some countries and, more generally, it may have allowed EM policymakers to support their local economies in ways that they were possibly unable to in previous crisis episodes. The increased reserves complemented appropriate policy frameworks and macroeconomic fundamentals of EM economies that enabled them to withstand the negative repercussions of the global financial crunch.[4]

Issues on Reserve Currency

The emergence of large and growing EM reserves has led to widespread calls for more active reserve management, such as the establishment of sovereign wealth funds that shift the objective of holding additional reserves from liquidity management toward profit-seeking investment.[5] In addition, focus has been given on revisiting the appropriate reserve currencies and their respective weights in the reserve portfolio.

The IMF's Q1 2010 data on the currency composition of global central bank reserves[6] show that total reserves for Q1 2010 rose by 16 percent year-on-year to US$8.3 trillion from the previous year's US$7.1 trillion, with allocated reserves[7] accounting for 56 percent of total. With respect to allocated reserves, the US dollar share of reserves continued to decline, dipping to 62 percent in Q1 2010 from the previous year's share of 65.2 percent. It may be noted that the US$ share to total reserves was 71 percent in Q1 2000.

This reflects partly the emergence of new economic powers such as the BRICs[8] and the introduction of a single monetary unit in the Eurozone in 1999.[9] The fragilities in the US economy highlighted by the recent crisis have created significant interest in diversifying reserve assets further into the future.[10] Reserve managers have acknowledged the growing systemic risk associated with holding the bulk of reserve assets in one currency.

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[4] Goldman Sachs, Global Economics Weekly, 10 March 2010

[5] Park, Donghyun, Developing Asia's New Sovereign Wealth Funds and Global Financial Stability, ADB Briefs, October 2008

[6] Unfortunately, the IMF data has one major flaw: the IMF publishes the currency allocation of reserves in US dollar amounts, i.e. it states the amount of EUR reserves in US$s rather than EURs, The disadvantage of this is that valuation effects (i.e. changes in the exchange rate from quarter to quarter) distort the result. A sharp EUR/US$ appreciation will, for example, create an upside bias in the share of EUR reserves, while a depreciation would result in a downside bias. In addition, central bank reserves whose currency composition were not identified comprised 44 percent of total reserves for Q1 2010, and 60 percent for emerging market economies.

[7] Reserves whose currency composition has been identified

[8] Brazil, Russia, India and China

[9] The euro was introduced to world financial markets as an accounting currency on 1 January 1999, replacing the former European Currency Unit (ECU) at a ratio of 1:1. Euro coins and banknotes entered circulation on 1 January 2002

[10] Goldman Sachs, Global Economic Papers No. 196, 26 May 2010

The BRICs are a driving force behind the ongoing process of transforming the international monetary system toward one that is more regionally based and in which developing countries have a major say.[11] Over the past 10 years they have contributed over a third of world GDP growth and have expanded from one-sixth of the world economy to almost a quarter (in PPP terms). Prospects for the group for the coming decade remain positive. Goldman Sachs envisages the BRICs, as an aggregate, will overtake the US by 2018. In terms of economic size, Brazil's economy will be larger than Italy's by 2020. India and Russia will individually be larger than Spain, Canada or Italy by 2020.[12]

The BRIC summit on 16 June 2009 called for a "more diversified" monetary system to reduce dependency on the greenback. It was announced after the summit that China and Russia agreed to use each other's currencies in bilateral trade to lessen dependence on the USD. Russia also announced its objective to diversify its reserves, increase gold holdings and promote regional currencies in trade and finance to reduce risks posed by the greenback's dominance. In light of this, it was reported in November 2009 that Russia's central bank added Canadian dollars to its reserves. There were also reports that China has been diversifying its foreign exchange reserves from the USD into the euro (EUR) and the yen (JPY).[13] As of end-July 2010, it was reported that China's reserve holdings were composed of roughly 65 percent in USD, 26 percent in EUR, 5 percent in UK pound (GBP) and 3 percent in JPY.[14]

The introduction of a single European currency among the Eurozone member-countries also offers reserve managers a way to diversify their USD-centered reserves towards alternative currencies. However, the structural issues that have emerged recently within the Euro-zone periphery (over their respective sizeable public debts) may have served to weigh down on the attractiveness of the euro as an alternative reserve asset.[15]

While there is no internationally accepted or standardized list of criteria that qualify a currency as a potential reserve currency, several factors are generally accepted as important:[16]

1. **Liquidity/convertibility.** Given the motivations of holding reserves, it is self-evident that convertibility is a necessary condition and that depth of liquidity is important.

2. **Breadth/depth of financial markets.** As the size of overall reserves has grown rapidly in recent years, the focus has increasingly been on the returns generated by reserve managers and the risks taken in the process. In this context, larger, more liquid and more diverse financial markets add to a currency's attractiveness as a reserve asset.

3. **Widely used/low transaction costs.** The more widely a currency is used as a medium of exchange in international transactions, the lower the transactions costs are likely to be.

4. **Macroeconomic stability/store of value.** This is another aspect of reserve holding that has increased in importance as the level of reserves grows. Diversification of risks is also a major driver for the diversification of reserve holdings that has emerged in the last decade.

The SDR as an Alternative Reserve Asset?

The recent expansionary fiscal and monetary policy strategies adopted by US authorities in response to the global financial crunch have put a strain on the stability of the "safe-haven" status of the USD. This prompted countries to make pronouncements about searching for

[11] Dailami, Mansoor, et al. The New Multi-polar International Monetary System, The World Bank Development Economics, Development Prospect Groups, December 2009
[12] Goldman Sachs, Is this the BRIC Decade?, 21 May 2010
[13] Natixis, Flash Economics, 24 August 2010
[14] Bloomberg News, 3 September 2010

[15] Goldman Sachs, Global Economic Papers No. 196, 26 May 2010
[16] RBC Capital Markets, Currency Report Card, 9 July 2009

alternative financial instruments that could serve as an international reserve asset apart from the USD. People's Bank of China (PBC) Governor Zhou Xiaochuan suggested that the USD could eventually be replaced by the IMF's Special Drawing Rights (SDR) as the main global reserve currency.[17] However, it was noted that the value of the SDR is determined by making a reference to a currency basket composed of the USD (with a weight of about 44 percent at current exchange rates), EUR (34 percent), JPY (11 percent) and GBP (11 percent). If a central bank wishes to have this allocation, it can achieve it without holding SDRs.[18]

The SDR has only limited use as a reserve asset, and its main function is to serve as the unit of account of the IMF (used for the IMF's asset and lending programs). Moreover, the SDR has no current role as a medium of exchange (asking for settlement in SDRs would thus require agents to settle in all four currencies that make up the SDR basket) and its use as a store of value is questionable (considering that there is no SDR debt market). Thus, generating widespread acceptance of the SDR in preference over the USD would entail extreme difficulty and would require the creation of SDR capital markets and a change in the structure and function of the IMF (from lender of last resort in cases of balance of payments difficulties to an international clearing house for foreign exchange reserves transactions).[19] There may be a need for the SDR to be adjusted not just in its currency weights but also in its currency components to be economically representative. For instance, China's importance in global trade, along with the sheer size of its GDP, actually raises the question of whether future SDR revisions should consider including the CNY.[20] Further, the IMF may also consider the reserve holdings of member-countries as a criterion for determining currency weights and currency components of the SDR.

Should the SDR become an alternative reserve asset, Stiglitz (2010) argued that the issuance of the SDR, as a new reserve currency, could (a) serve as an active instrument of global macroeconomic stabilization policies; (b) be used for the pursuit of global public goods, like development and climate change; and (c) provide economic incentives for countries not to maintain high levels of surpluses, recognizing that persistent surpluses could generate global imbalances.[21]

Conclusion

The continued increase in international reserves of EMs has prompted policymakers to consider further strategies for the diversification of their reserve assets. The decision to hold higher reserves has highlighted the need of central banks to diversify their reserve portfolios to earn additional returns. The USD remains the dominant reserve currency, although its share to total reserve holdings has diminished over time, as central banks attempt to embark on less traditional and previously-uncharted active investment policies such as expanding their reserve currency portfolios. The recent expansionary monetary policy stance adopted by the US Federal Reserve has reduced the stability of the greenback as a "safe-haven" reserve currency, thereby (re)igniting the debate about alternative global reserve currencies such as the SDR.

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[17] Zhou Xiaochuan, Reform the international monetary system, BIS Review 41/2009.

[18] Commerzbank, FX Hotspot, 9 July 2009

[19] Yap, Agnes, Challenging the US Dollar's Role as a Reserve Currency: Is the SDR a Credible Alternative?, BSP Newsletter, October 2009

[20] Goldman Sachs, Global Economic Papers No. 196, 26 May 2010

[21] Stiglititz, Joseph, Towards a New Global Reserve System, http://aric.adb.org/grs/papers/Stiglitz.pdf

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