Growth of global FX reserves begins to show signs of wilting

News Analysis

Slowing economies and a rebalance in Asian trade has led to a rethink by central banks, says **Peter Garnham**

One of the defining trends in markets this decade has been the extraordinary growth in global central banks' foreign exchange reserves.

Much of this money was channelled into western bond markets, helping to keep global interest rates lower than they would otherwise have been, fuelling investor confidence and boosting risk appetite and asset prices.

Now, however, the trend of rising reserve accumulation appears to be peaking, amid increasing signs of a global slowdown. This, analysts say, could add further fuel to the dollar's recent sharp rise. "This is a major shift in the markets," says Bilal Hafeez, global head of FX strategy at Deutsche Bank. "Central banks are drawing down their reserves."

Global central bank reserves now stand at \$7,000bn, a record high, up from \$2,000bn at the start of the decade. In contrast, it took all of the 1990s for global FX reserves to double from \$1,000bn to \$2,000bn.

The reserves are concentrated in Asia and oil-producing countries, with nearly 60 per cent of the total held by just six nations. China, with \$1,808bn, has the world's largest stockpiles, followed by Japan with \$973bn and Russia with \$581bn. Taiwan, India and South Korea have reserves of \$291bn, 283bn and 243bn, respectively.

Data from the International Monetary Fund show developing countries' central banks hold about 60 per cent of their reserves in dollars. The remainder is held in euros, sterling and yen.

By diversifying some of their new reserves into other currencies, rather than keeping all their intervention proceeds in dollars, central banks have compounded the weakness in the US currency in recent years. Indeed, the fall in the dollar from 2001 was accompanied by an

\$7,000bn

Global central bank reserves have hit a record high

unprecedented build-up in global foreign exchange reserves as emerging market central banks intervened in the markets to stop their currencies appreciating too quickly.

However, analysts say growth in FX reserves has stalled as the dollar has staged a broad-based rally since hitting a record low against the euro on July 15.

Indeed, since mid-July, the dollar has soared nearly 9 per cent higher against the euro, risen more than 11 per cent against the pound and climbed 4 per cent against the yen. One factor reducing the build-up of global FX reserves and supporting the dollar has been the decline in the US current account deficit.

Since peaking at 6.6 per cent of US gross domestic product in the last quarter of 2005, the US current account deficit has embarked on a down trend that has seen it fall to 5 per cent in the first quarter of this year.

This has been triggered as the US economic slowdown lowers demand for imports, while US exports are still benefiting from the relative cheapness of the dollar.

"The trend decline in the US external imbalance already suggests that last year's \$1,200bn jump in global FX reserves is unlikely to be sustained," says Mansoor Mohi-uddin, head of FX strategy at UBS.

In addition, oil prices have fallen sharply from their highs, reducing the inflows of dollars into the coffers of the oil-producing nations.

Meanwhile, trade balances in Asia have come under pressure as the effects of the credit crisis spread across the globe. Foreign investors are now pulling money out of the region, putting pressure on local currencies.

Analysts say Asia is experiencing a significant downward adjustment of growth expectations, triggering a wave of capital flight from the region.

Callum Henderson, head of FX strategy at Standard Chartered, says he remains bearish on Asian currencies outside of Japan given the prospect of slowing global growth. "Asia has the highest exposure to global trade of any emerging market region," he says.

"Inflationary concerns and resulting tight monetary policy kept Asian currencies supported in the first half of the year, but the economic baton is being passed from inflation to growth."

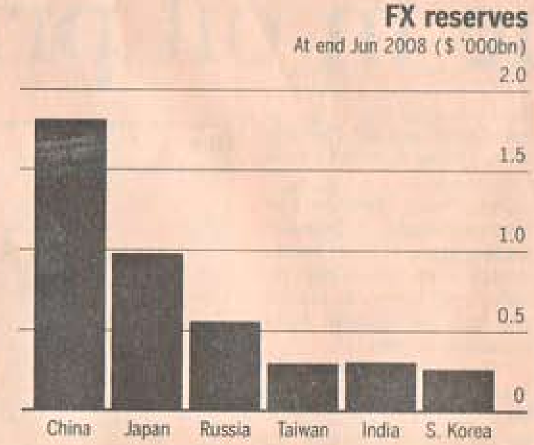
Indeed, instead of intervening to stem the rise of their currencies against the dollar, authorities in South Korea, India, the Philippines are now reducing their dollar reserves to support their weakening currencies.

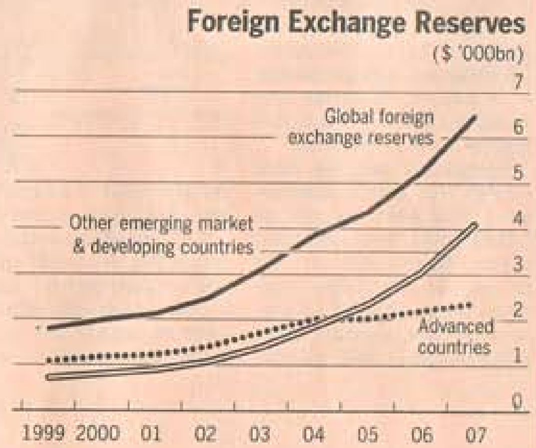
Meanwhile, political concerns in Georgia and Thailand have seen both the Russian Central Bank and the Bank of Thailand dip into their coffers to support their currencies

"FX reserve growth is slowing sharply," says Mr Mohi-uddin. "The counterpoint of slower reserve accumulation is less reserve diversification activity away from the dollar in favour of other major currencies."

He says in those economies where FX reserves are now being run down to support domestic currencies, the dollar is benefiting from "reverse diversification", in which reserve managers have to sell euros, sterling and major currencies in order to rebalance their reduced FX reserves.

"If the growth of FX reserves has indeed peaked globally, the dollar will benefit further against the rest of the major currencies," says Mr Mohi-uddin.





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