Falling global FX reserves: the end of an era?

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Shift in Global Financial Governance and China's Financial Reform
Shanghai 31 October – 1 November 2015

The rapid accumulation of foreign exchange (FX) reserves has been a distinctive feature of the global economy over the last fifteen years. Since the early 2000s, sovereign wealth – which is the sum of the reserves held by Central Banks and the assets managed by so-called Sovereign Wealth Funds (SWFs) - increased several times over. By the end of 2014 it had reached more than USD 18 trillion.

The accumulation of sovereign wealth primarily in emerging countries – but also in some developed countries such as Norway or Switzerland – was propelled essentially by three intertwined phenomena:

– The advent of China and other Asian countries as an increasingly vast part of the global manufacturing value chain translating into large and persistent current account surpluses;

– An upsurge in the demand for commodities in order to build the infrastructure and housing for the new urban middle class, which in turn translated into soaring commodity prices, leading to a rapid accumulation of wealth in commodity-exporting economies;

– And last but not least, an unprecedented rise in capital inflows into emerging markets which received further impetus following the launch of quantitative easing in post-2008 developed economies.

The unprecedented rise in the assets managed by Central Banks and SWFs have had profound implications for global markets. The rapid accumulation of reserves managed by Central Banks and largely invested into fixed income assets from developed economies have – according to some - contributed to lower long-term interest rates, the so-called global savings glut.

Facing historically low yields and anemic growth in the developed world, sovereign institutions have, over the last decade, diversified their assets across regions and asset classes with an increasing share going into equities and emerging assets. The proliferation in the number of SWFs, and the rapid growth in assets managed by these institutions, has increased the flow of funds into alternative asset classes such as private equity, real estate and infrastructure. SWFs are increasingly partnering with pension funds and other institutional investors to undertake strategic investments in listed and unlisted corporations or major infrastructure projects.

FX reserves' growth has slowed down sharply in 2014-15

The growth in global FX reserves has largely been an emerging markets (EM) story. At the end of 2014, EM economies accounted for USD 7.7 trillion of FX reserves, nearly 70 % of the total. China alone accounted for almost USD 4 trillion and the oil-exporting emerging markets for another USD 1.6 trillion. Within SWFs, with the exception of the Norwegian pension fund (the largest SWF in the world) and a few others in New Zealand, Australia and the US, the majority of these institutions have come from EMs. The growth in FX reserves managed by EMs started early in the last decade with the rise of emerging markets and the commodity price boom. It continued uninterrupted after the financial crisis of 2008 - albeit at a slower rate - as growth in EMs remained resilient, despite the slowdown in advanced economies. Oil prices were quick to recover from the temporary drop experienced during the most acute phase of the global crisis.

In 2014, for the first time since the early 2000's, growth in FX reserves turned negative: according to IMF data, during 2014 total FX reserves, excluding gold, fell by around USD 100bn, largely reflecting a drop in reserves held by EMs. The fall in EM reserves continued and accelerated in the first few quarters of 2015 with a further drop of about USD 400 billion, corresponding to a decrease of 5 % when compared to 2014-end levels. Based on current trends, we expect FX reserves to fall

by around USD 800bn in 2015 – a sharp reversal of the secular growth trend experienced over the last fifteen years.

This decline in FX reserves is partly due to valuation effects. The recent rise of the USD against all other currencies, including the euro, has led to a drop in the value of FX reserves which are largely accounted for in USD. This valuation effect is probably the primary factor contributing to the fall in FX reserves witnessed during the last part of 2014 and early 2015. However, other factors have a part to play in this reversal, factors which are rooted far more deeply in recent developments within the global economy. In actual fact, what we are experiencing is a weakening, and in some cases a reversal, of the three fundamental drivers behind the secular growth in FX reserves experienced so far.

First and foremost, the economic outlook for EMs has worsened significantly over the last few quarters. The powerful force of catching-up, which has propelled the growth differential between EM economies and advanced economies to historical highs, appears to have lost some of its vigor. Some EMs, such as Brazil, are paying for an excessive increase in debt and the lack of structural reforms during the boom years, while others (i.e. Russia) are suffering from the drop in commodity prices. The worsened growth outlook of EMs translates into a lower current account surplus: according to the IMF during 2014 the current account surplus in EMs fell by about two thirds from the peaks touched in 2008 (USD 684 billion). The IMF forecasts EM current account surplus remaining at this level for the next few years as imports from advanced economies remain subdued due to slow growth.

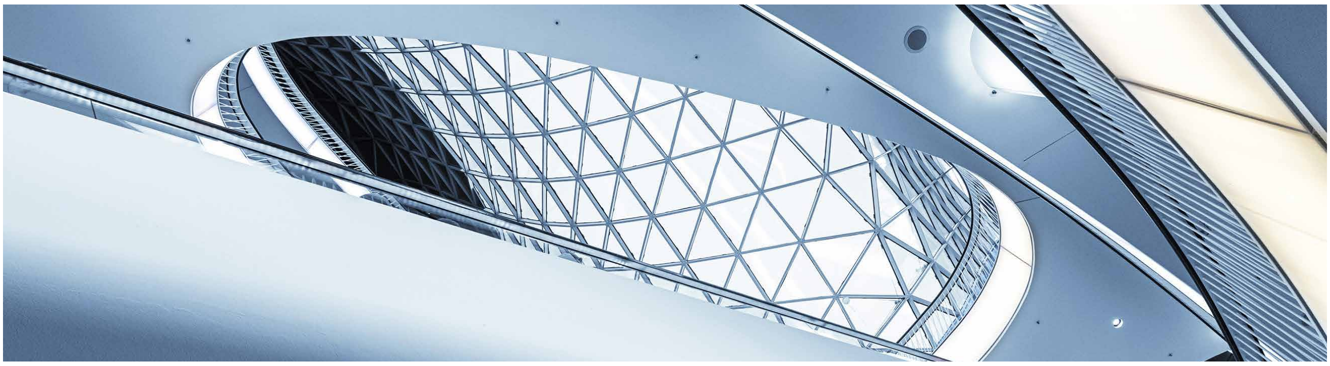
Secondly, China and other emerging markets are engaged in a transition whereby export-led growth is giving way to a domestic driven services sector, which is far less energy intensive than manufacturing. As a consequence the commodities cycle has gone into reverse, with the prices of raw materials and hydrocarbons falling from the highs touched up to 2014. An excess in oil supply appears to be the main driver behind the recent fall - barring disruptive events oil prices are likely to fluctuate for the rest of the decade around a mildly upward trend until this supply excess is worked out.

Lower oil prices translate into lower current account surpluses for oil exporting economies. According to the IMF, with oil prices averaging current levels or slightly higher, Middle Eastern oil-exporting economies will have an almost balanced current account up to 2020, a dramatic reversal from the massive surpluses experienced in the previous decade. Some countries will have to tap into accumulated wealth in order to fill the gap in their budgets, as currently being shown by the rapid depletion of reserves accumulated by Russia and the already visible drop in Saudi FX reserves.

With regard to capital flows into emerging markets, these have been on a secular upward trend since the early 2000s. From that date the distribution of global wealth started to shift in favor of EMs, enjoying as they did, favorable demographics and better returns on capital.

> Private inflows into EM economies increased five-fold in a decade to reach USD 1.3 trillion in 2007. After a pause between 2008-09 whilst the global economy flirted with financial market meltdown, these inflows resumed pretty strongly. Such rapid resumption reflected their better macroeconomic fundamentals, an improved governance framework and credit expansion. This allowed EM economies to recover faster than advanced economies, thereby attracting funds from those advanced economies, who found themselves trapped in a spiral of anemic growth and fiscal restructuring.

A further, powerful, force behind the rapid growth of capital flows into EMs in the aftermath of the financial crisis has been the loose monetary policies of mature economies which have been "pushing" portfolio funds into EM assets. Nearly USD 1 trillion of portfolio funds flowed into EM stocks and bonds over 2010-13 and, in selected countries, portfolio flows actually surpassed Foreign Direct Investment (FDI) for the first time in many years. The reversal of this trend is now unfolding. The worsened economic outlook for EMs has reduced the attractiveness of these economies for investors. The most benign scenario of a soft landing for China as it



re-engineers its economic model away from investment and towards consumption now appears increasingly doubtful, while countries such as Brazil and Russia face recessions and growing political uncertainty. More importantly - at least from a purely portfolio point of view - the expected normalization in US interest rates is reducing the "push" factor in portfolio flows to these economies, leading to a spiral of currency devaluation and capital outflows. The reversal in the secular revaluation trend experienced by EMs over the last decade – with China in the lead – will lead to slower growth or a fall in FX reserve accumulation as Central Banks are forced to intervene in the FX market to support their currencies in the face of falling investor confidence and capital flight.

What happens in China remains key for FX reserve accumulation

Alongside oil prices and the pace of accumulation (or reduction) in foreign assets accumulated by Middle Eastern exporters, future growth in sovereign wealth depends, to a large extent, on what happens in China. According to latest official data, Chinese FX reserves fell by nearly USD 300bn in the first eight months of 2015, having peaked at USD 3.99 trillion during the course of 2014. The drop in FX reserves accelerated over the summer following the largely unexpected devaluation in the RMB. This forced the Chinese Central Bank to intervene in the FX market to support the currency as the outflow of capital accelerated in the face of growing uncertainty over exchange rate policy and the economic outlook.

When talking about capital outflows in China it is easy to get carried away by the news headlines. In fact, this was not the first time that the Chinese balance of payments had swung into deficit over the last few years. Given the uncertainty surrounding the Chinese macroeconomic adjustment and the exchange rate policy, increased volatility in capital flows should come as no surprise.

> However, there are some important policy changes being implemented by the Chinese authorities, notably the gradual liberalization of the capital account and the lifting of capital controls, which point to a future of slower growth or even a fall in FX reserves.

The increasing flexibility given to Chinese firms and households to hold FX they earn abroad in fact translates into lower FX reserves. As a result, the composition of the International Investment Position of the country is changing, with a fall in reserves held by the Central Bank and a rise in direct investment abroad, alongside portfolio investment by corporates and individuals. Such a change is actually what the Chinese authorities would expect as a result of increased diversification into foreign assets by Chinese savers, rather than a sign of panic about China's slowing economy.

Eventually, and in line with the gradual opening up of the Chinese financial sector, the share of FX reserves in China's International Net Investment Position is expected to converge towards that prevailing in other Asian exporters: for instance, in Japan FX reserves represent about 17% of total external assets as the bulk is held by corporates and individuals. In China FX reserves are still two-thirds of its International Net Investment Position. Overall, should the pace of financial liberalization continue as expected, Chinese FX reserves will continue falling over the next few years. This process could be further reinforced by the "going out" policy being pursued by the government, reflected in the FDI deficit experienced in 2014 (the first since 2004) and the recent initiatives launched by China to diversify FX reserves such as the Asian Infrastructure Investment Bank (AIIB) and the so-called Silk Road Fund.

Will lower reserve accumulation lead to higher long-term interest rates?

The saving glut has been a popular theory behind the historical decline in long-term bond yields. And, as we experience a weakening in the current and capital accounts of emerging markets, resulting in slower growth or even falling FX reserves, many are arguing for an increase in long-term interest rates as Central Banks sell US and other advanced economies' bonds. According to some, this effect would be so significant as to eventually wipe out the impact of quantitative easing on long-term interest rates being undertaken in Europe and Japan. Some have already labelled this new trend as "quantitative tightening".

In reality, the savings glut is only one of many factors behind the historical decline in long-term interest rates, and not necessarily the most important one. This is partly proven by the fact that despite the decline in

account balances of emerging nations over the last two years, long-term investment rates have continued to fall. Other factors, such as ageing populations, falling productivity, falling investment and banks deleveraging, appear to be playing an important role as well. Most of these factors are structural rather cyclical and some of them were already at play well before the launch of quantitative easing. It is, in particular, the combination of lower productivity and lower population growth which points to a lowering of the equilibrium interest rate: this would be happening regardless of quantitative easing.

A further important factor pointing to a relatively low impact of falling FX reserves on long-term interest rates in advanced economies concerns the composition of those FX reserves. While it is true that over the last decade FX reserves have been diversified across a wider range of asset classes and regions, the bulk of the reserves are still invested in cash or short-duration government bonds from advanced economies: the sale of these holdings by Central Banks is therefore unlikely to impact bonds with longer maturity.

When it comes to the impact on EM interest rates, it is true that each time an emerging market Central Bank sells US dollar-denominated holdings for local currency, money supply in local currency shrinks. This is a problematic effect in the current environment and one which has been highlighted as a significant risk attached to the large-scale sales of FX reserves. However, this "quantitative tightening" effect is probably much less dramatic than thought and can be countered with various tools, e.g. a reduction of the reserve requirement ratio in the case of the PBoC to keep banking sector liquidity unaffected.

Will falling FX reserves be bullish or bearish for the USD?

Over the last fifteen years, as FX reserves grew at double digit growth rates, Central Banks have not only increased diversification across asset classes but also across currencies. Most of the export receipts of Asian manufactured goods exporters or oil-commodity exporters are accounted for in USD and large current account surpluses have translated into a growing USD share in their reserves. Central Banks have been diversifying USD reserves into other currencies such as Euro, Australian dollar, Norwegian Krone and a few other secondary reserve currencies in order to prevent the USD share of total reserves from rising too much. Historically, through this recycling of USD reserves, rising FX reserves have often been associated with a weakening USD, as has indeed been the case for the greenback for many years before the change in this trend started in the middle of last year.

The ongoing reversal of years of QE-related inflows into EM as well as uncertainties about EM growth and EM currency weakening, coupled with expectations of raising interest rates in the US are now pushing EM FX reserves down. Central Banks are selling USD denominated bonds to support their currencies and this translates into a falling share of USD assets in their reserves. In terms of flows, therefore, falling FX reserves are often associated with a rising USD or, with a lower demand by Central Banks for non-USD reserves, as the previous need for reserve diversification away from the USD is weakened. We are already seeing some evidence that the weaker demand for secondary reserve currencies is exercising further pressure e.g. on the Australian dollar or the Norwegian krone.

A further implication of the slowing down in FX reserve currency diversification away from the USD as FX reserve fall could be a lower demand for RMB and other EM currencies. Over the last few years we witnessed a growing demand by Central Banks for exposure to EM currencies reflecting both economic (i.e. having a currency composition of FX reserves more in line with the trade composition of these economies) and investment factors (i.e. taking advantage of higher interest rates in local currency emerging market debt and the secular appreciating trends in their respective currencies). This has been particularly true for the RMB which has been gradually rising to reserve currency status thanks to the growing share of its use as a trade currency and its possible inclusion in the SDR basket following IMF review. The summer's unexpected devaluation has made the investment case for the RMB weaker because the Chinese exchange rate is no longer a one way bet. It will be interesting to see whether the growing demand for RMB exposure by official institutions will eventually weaken as a result of recent events or whether it will remain unaffected should the uncertainty over the RMB exchange rate policy dissipate in the future.

Will the asset diversification trend among SWFs continue?

Diversification of reserves held by Central Banks has been a powerful trend over the last decade as the size of those reserves has increased and yields on fixed income assets have continued to fall. Early in the last decade Central Banks used to invest only in cash, bank deposits and highly rated government bonds of the US and a few other advanced economies. Nowadays, it is not unusual for Central Banks to invest in a wider range of fixed income asset classes including corporate bonds and emerging market bonds. More recently, Central Banks have also started to invest in equities, an asset class which was almost non-existent in the investment universe of these institutions just a few years back. The proliferation of SWFs is also a reflection of this diversification trend. The establishment of a SWF is often meant to accelerate the diversification of accumulated wealth into asset classes in which Central Banks do not generally invest, such as private equity, infrastructure and strategic investments in listed or unlisted companies. Will the investment behavior of Central Banks and SWFs change as a result of the slowdown, or even reversal, in asset accumulation? Will SWFs eventually reduce their exposure to risky assets as a result? For instance, by increasing exposure to more liquid and less volatile asset classes such as fixed income?

As we have discussed, so far, a fall in FX reserves has been the main impact of lower commodity prices and capital outflows from EMs being felt by Central Banks. As domestic liquidity is reduced as a result of capital outflows, Central Banks are likely to react by reducing the exposure to less liquid and more volatile asset classes, such as corporate bonds, emerging market bonds and eventually equity. However, one should consider that the portfolios of the majority of Central Banks – despite increased diversification - still largely consist of cash and short-duration highly rated bonds. Therefore, the eventual sale of the most risky assets held by Central Banks is unlikely to have a major impact on the market. However, should the FX reserve continue falling, it is reasonable to expect that in the future the appetite for more volatile or less liquid asset classes, such as equity and corporate bonds, will eventually be reduced.

So, what about SWFs? First of all, while it is true that assets held by SWFs are likely to grow more slowly than in the past, SWFs still sit on large amounts of wealth accumulated during the boom time. For most countries with SWFs, this level of assets is well in excess of what might be considered necessary for precautionary motives (i.e. fiscal stabilization), thus leaving ample room for an asset allocation more skewed towards risky assets with the potential of providing higher returns over the medium to long-term.

Secondly, whilst the era of ultra-low yields might end with the expected rise in US interest rates, globally, monetary conditions are likely to remain very loose for a prolonged period of time, and quantitative easing in Europe has only just started. Furthermore, the recent postponement of the expected lift in US interest rate linked to the spillover effects of the growing uncertainty surrounding emerging markets has increased the likelihood of a prolongation of zero interest rates in the US as well. Therefore, the search for yield among SWFs is likely to continue as these institutions try to protect the real value of their accumulated wealth.

Thirdly, in a scenario of rising interest rates, the losses experienced on fixed income assets could be substantial. Assuming a gentle increase in global interest rates over the next five years – a mild tightening according to historical standards – the return on global government bonds of advanced economies will be close to zero or slightly negative over that period. From a portfolio point of view, the best allocation to protect the value of a portfolio in such an environment is to diversify away from fixed income assets towards equities and, more importantly, illiquid asset classes such as private real estate, private equity and infrastructure. Indeed, according to the latest data available on SWFs investment, during 2014 SWFs increased their levels of direct investment, despite the sharp drop in oil prices, indicating that the appetite for these types of investments is unlikely to be reduced as a result of slowing fund inflows.

Finally, the changed conditions in the global financial sector, with commercial banks less willing to take long-term risk because of more stringent regulations, is opening up new investment opportunities for long-term investors such as SWFs. For instance, the infrastructure sector is evolving fast under the impulse of policy makers eager to attract more non-public funds into this sector. Given the right conditions, SWFs are likely to embrace these opportunities by pouring money into real assets, which have the capacity to deliver returns above those achievable in public markets, such as fixed income

and equity. SWFs have established themselves as highly active investors in global capital markets over the last decade; this is unlikely to change as a result of the slow-down in the growth of their assets.

However, should the oil price remain at the current level for a prolonged period of time SWFs might be forced in the future to dispose some of their illiquid investments into alternative asset classes and direct investments into listed and unlisted equities as political pressure from their sponsoring governments increase. This could reduce the future flow of SWFs investments into advanced economies which have been the major beneficiaries of this investment.

All data referred to in this article has been drawn from the public websites of the International Monetary Fund and Central Banks referred to therein.

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