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Leveraging FX Reserves, Spillbacks, and the Prospective Role of the RMB

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Introduction

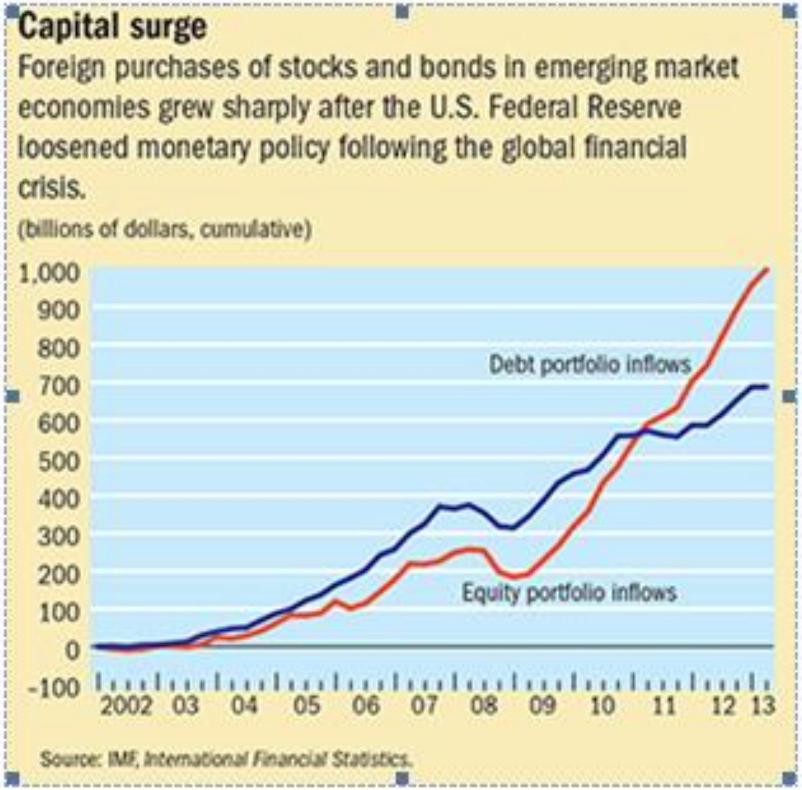
UMPs of core central banks have generated fallout far beyond their jurisdictions. The US Fed's zero-bound rate and swelling liquidity (UMPs) have pushed forth and back capital markets in search for higher return causing valuation effects on exchange rate and equities in EMEs as well in Open Developed Economies.

FX Reserves policies implemented to cope with core spillovers have triggered from the periphery negative feedbacks, or spillbacks, which have the potential of setting off a fresh two-way dynamics between core and periphery.

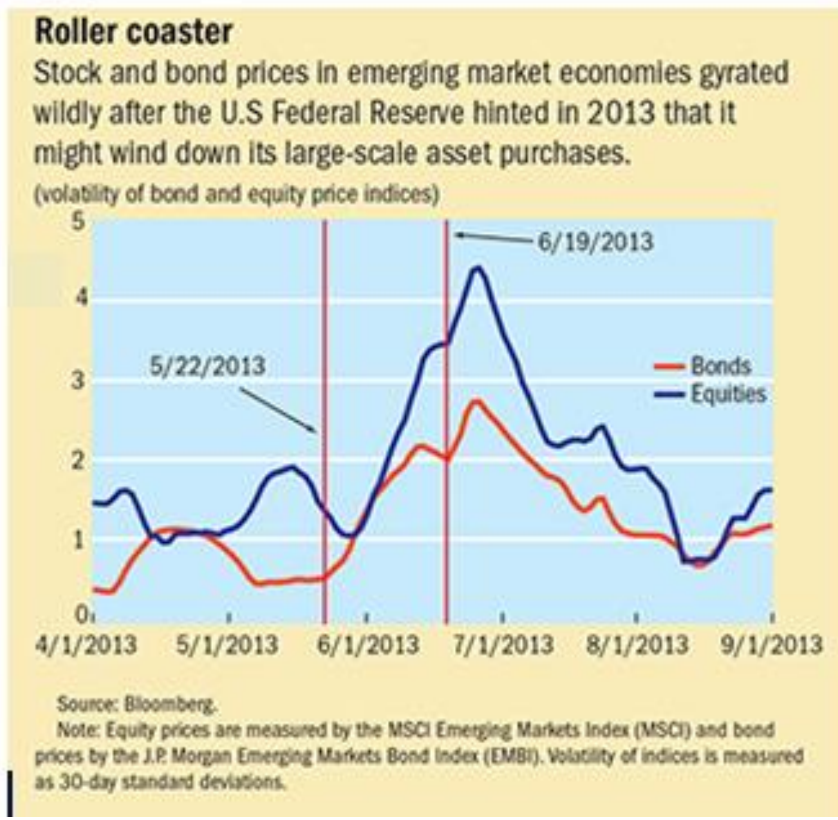
A major thesis of this Presentation assumes that defensive policies adopted by central banks' FX Reserves managers have leveraged inactive resources, kicking off spillbacks, which have the potential to act a game-changer in the current lopsided monetary regime.

Section 1
Fed's Spillovers on EMEs: Capital Inflows

Capital Surge



Taper Tantrum 2013: Capital Outflows

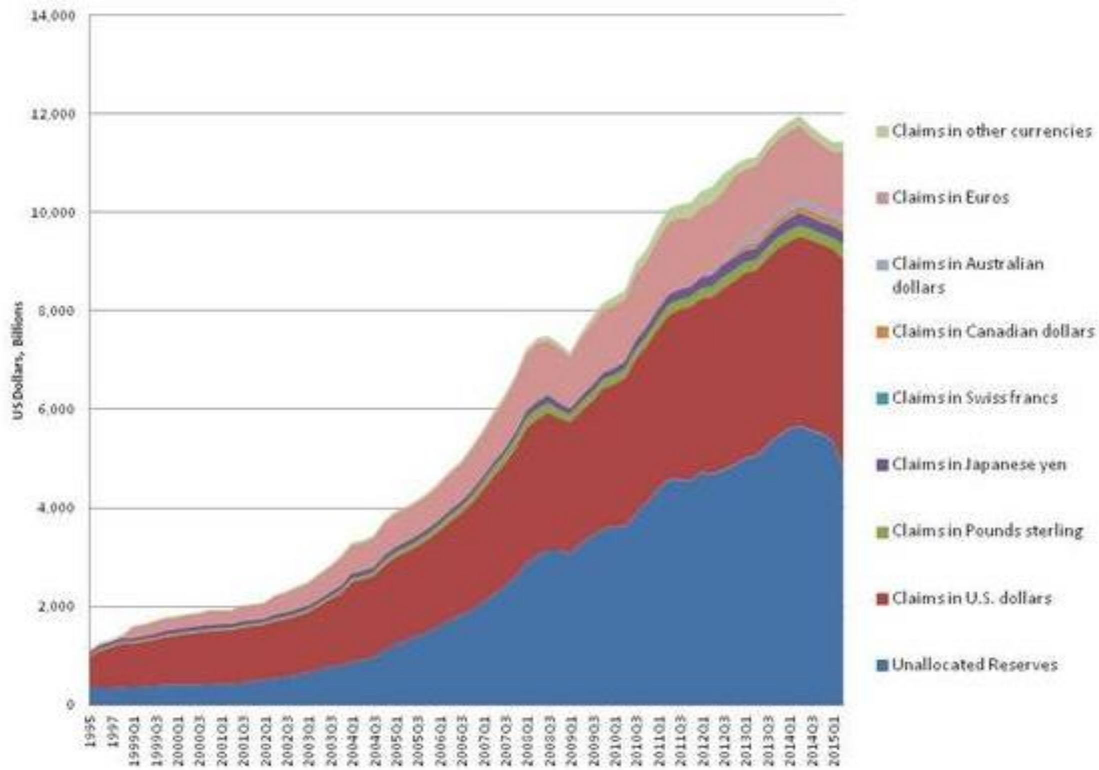


Response of EM central banks: interventionist measures, and the IMF's conceptual shift.

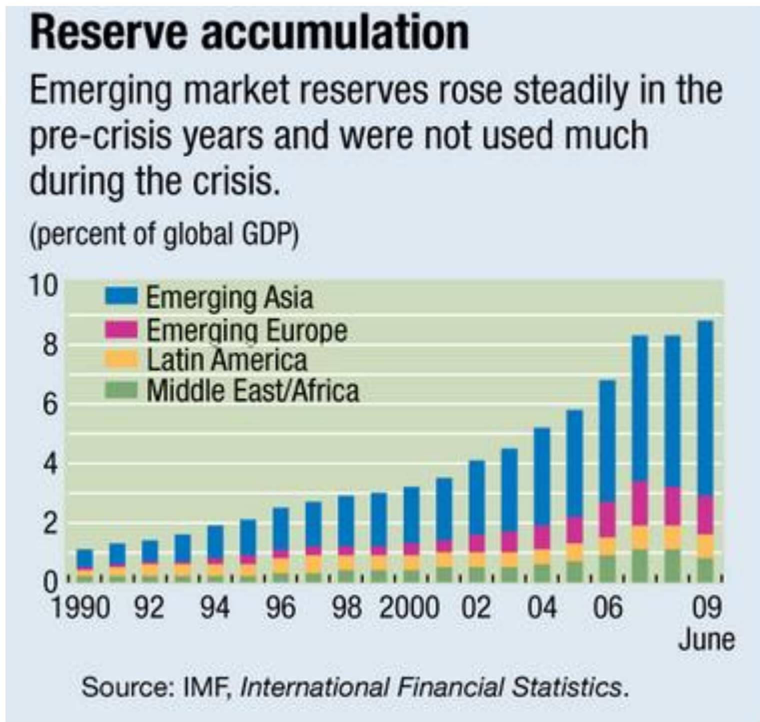
In the wake of spillovers from Fed's UMPs, EM central banks' adoption of intervenionist policies - capital controls and forex reserves sellout - has gathered consensus in IMF and economics community.

The use of FX intervention alongside monetary policy is now included in the IMF tool- kit in situations of financial turbulence.

Dollar Dominance in the World Currency Composition of Official Foreign Exchange Reserves (Figure below from Otaviano Canuto 2016)



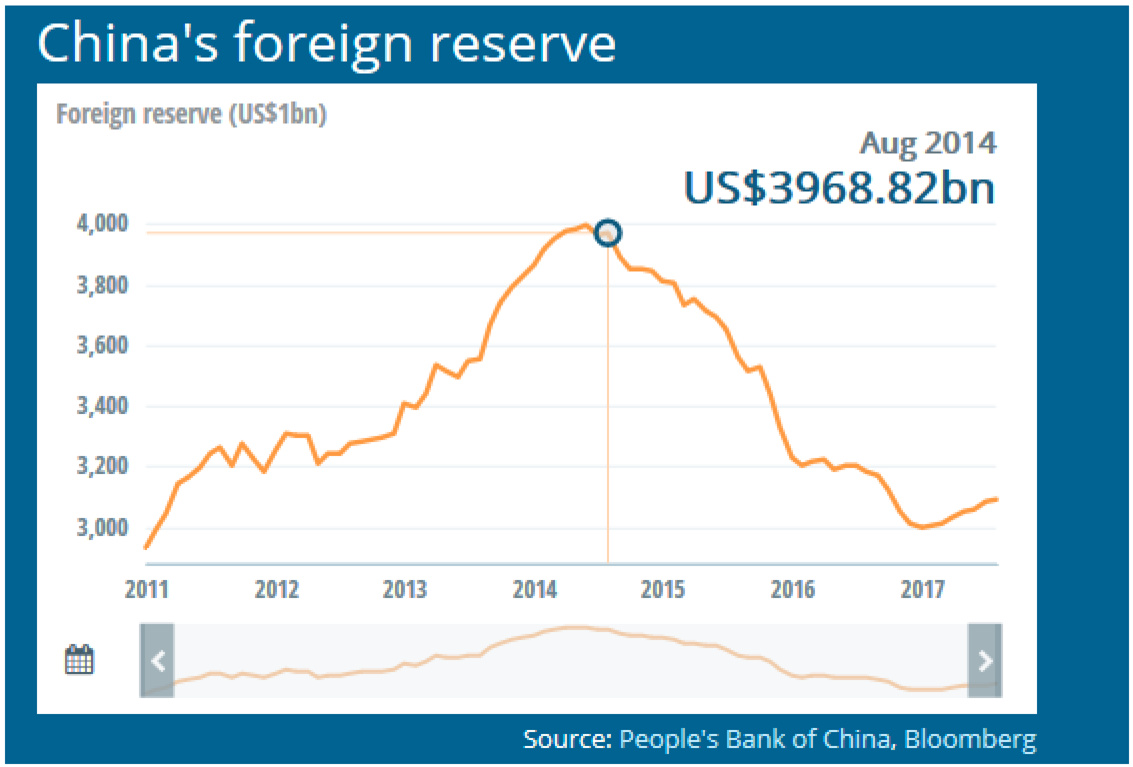
EM Forex Reserves before the crisis



EM Forex Reserves Selloff 2013 (excluding China)

	Monetary policy		Fiscal policy	Macroprudential Policy	CFMs	FX intervention	Liquidity provision measures
	Tight	Loose	Tight	Tight	Removal		
Brazil	✓		✓		✓	✓	✓
India	✓		✓	✓	✓	✓	✓
Indonesia	✓			✓	✓	✓	✓
Russia	✓					✓	
S Africa	✓						
Thailand		✓					
Turkey	✓			✓		✓	✓
Poland		✓				✓	

China’s Forex Reserves Plummeting



Section 2
Leveraging Forex Reserves
Definition

In general terms leverage stands for "the ability to influence a system, or an environment, in a way that multiplies the outcome of one's efforts without a corresponding increase in the consumption of resources".

In the current financial jargon leverage has assumed a more restricted meaning, and it's referred to the use of debt to acquire additional assets.

In this Presentation the notion of leverage describes the policies adopted by periphery's central banks to insulate national currencies from exchange pressures stemming from international financial shocks.

Leveraging Forex Reserves
Rationale and Outcome

EM central banks have often been cuffed for excessive accumulation of foreign exchange as a means to manipulating exchange rate.

Indeed, manipulating reserve levels can allow central bank to intervene against volatile fluctuations in currency by affecting the exchange rate and increasing the demand for and value of the country's currency. Reserves act as a shock absorber against factors that can negatively affect a country's exchange rates and, therefore, the central bank uses reserves to help maintain a steady rate, and financial stability (Aizeman 2011 , Blanchard et Alii 2015)

Spillbacks' Two-Way Dynamics, and their After-Shocks.

From a defensive move of exchange rate, these policies have revealed a higher potential vis-à-vis core bond assets. Almost synchronized large sell off have cause bond yields spike of US T-Bonds and German Bund by …

Though, these spillbacks, as they are dubbed, are still tiny and erratic, they signal a two-way dynamics between core spillovers-and-periphery spillbacks has set in, which is there to stay.

The consequences of this new-born two-way spillovers-spillback dynamics are potentially huge stretching to constraints on core central banks monetary policies, and shifts in reserves portfolio of central banks

Gauging Spillback' Metrics

Actually, FX Reserves sales have had a small effect. Since March 2015 these actions have added 0.3 percentage point to yields on 10-year Treasuries, which ended at 2.05 percent in 2016.

Though these flash rises on T-Bonds and German Bund are still tiny, they could turn higher, rising to about 100 basis points.

Foot Note:

Since the start of the century, EM central banks have **10 trillion US dollar foreign exchange reserves** , which have helped reduce Bund and US Treasury Bonds' yields by more than 100 basis points. Consequently, in the reverse cycle, EM central banks will cumulate a comparable tightening.

Spillbacks.
Is there a new core-periphery's dynamics?

By engineering an almost synchronized sellout at the Fed's tapering of bond purchasing (QE), EM central banks have put in motion reverse spillovers, dubbed spillbacks, resulted in flash rise on the yields of the dollar T-Bonds and German Bund.

The new dynamics calls into questions the dollar global financial cycle, and signals the emergence of a negative feedback loop between periphery and core central banks , which will make core central banks feel some constraints on monetary policy.

Section 3.

Redeployment of Forex Reserves .

The Gold Job.

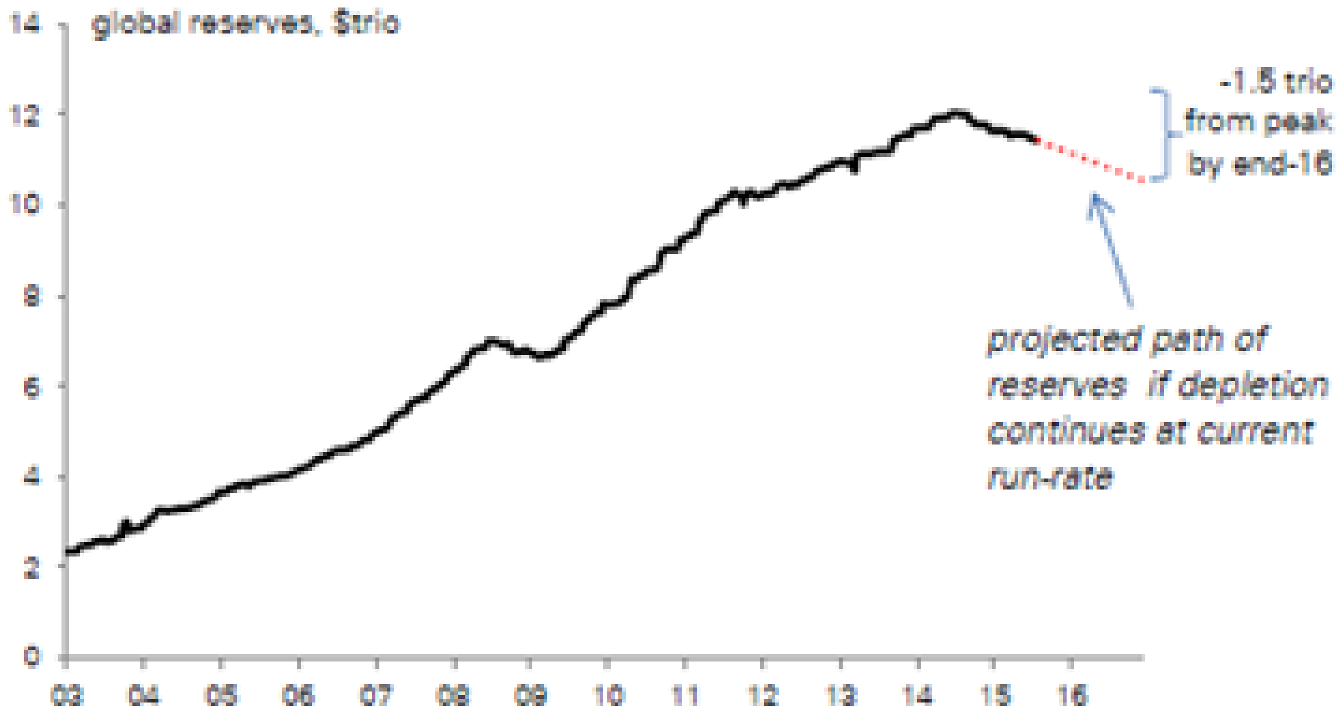
Spillbacks on core sovereign debt are just a fraction of the Forex Reserves' leverage. Alternative redeployment in gold and de-dollarization should not be underplayed.

China’s Gold Job.

In 2014 Alan Greenspan warned. “Redeployment of even a relatively modest part of China's foreign exchange reserves into gold, [Chinese] RMB could take on unexpected strength in today's international currency system. Buying gold bullion to displace the U.S. from its position as the world's largest holder of monetary gold, China would likely incur a penalty for being wrong, in terms of lost interest and the cost of storage. Yet it would be a modest cost, if in the end this clears the way to a multiple and more balanced international monetary regime, less at the mercy of U.S. domestic objectives” (Alan Greenspan, 2014).

Plunging Global FX Reserves' Accumulation

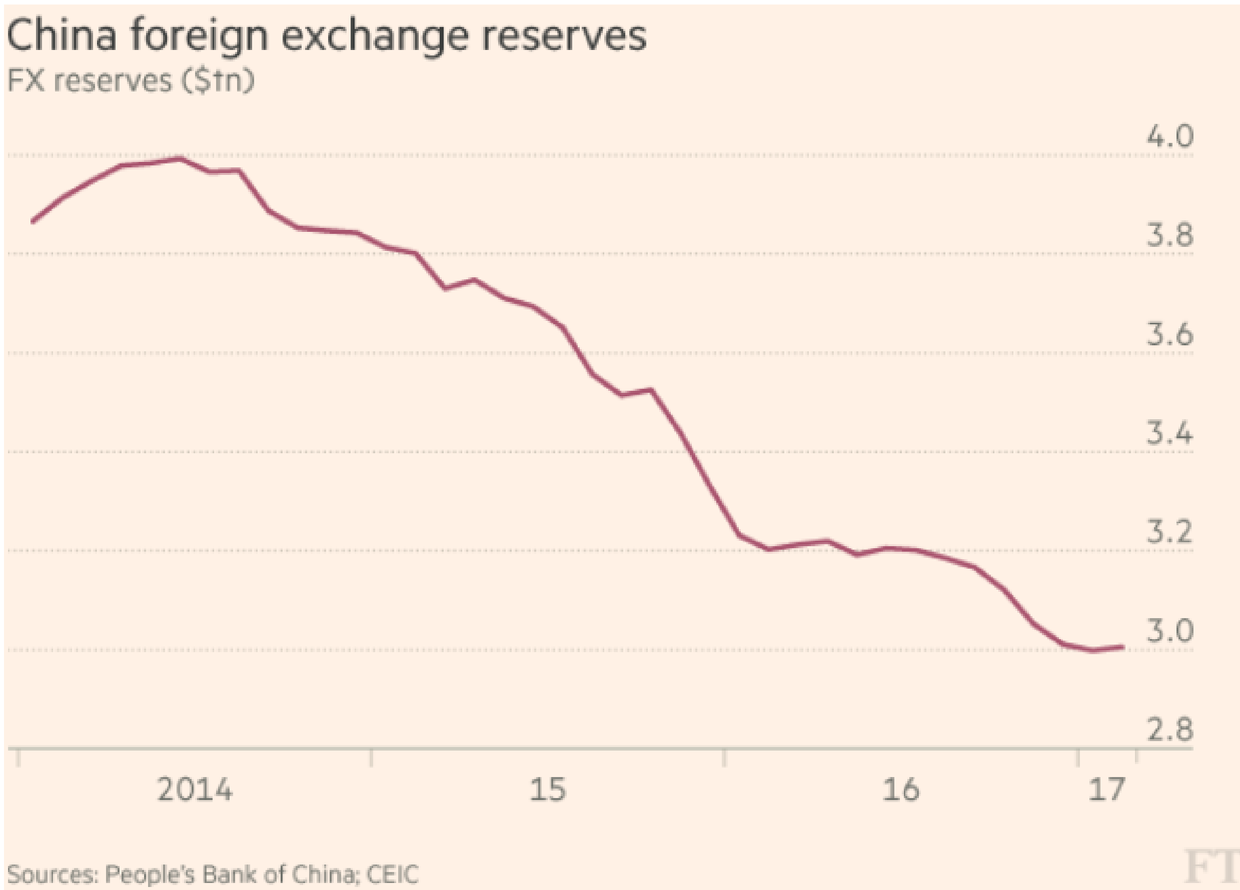
The end of an era: declining central bank reserves



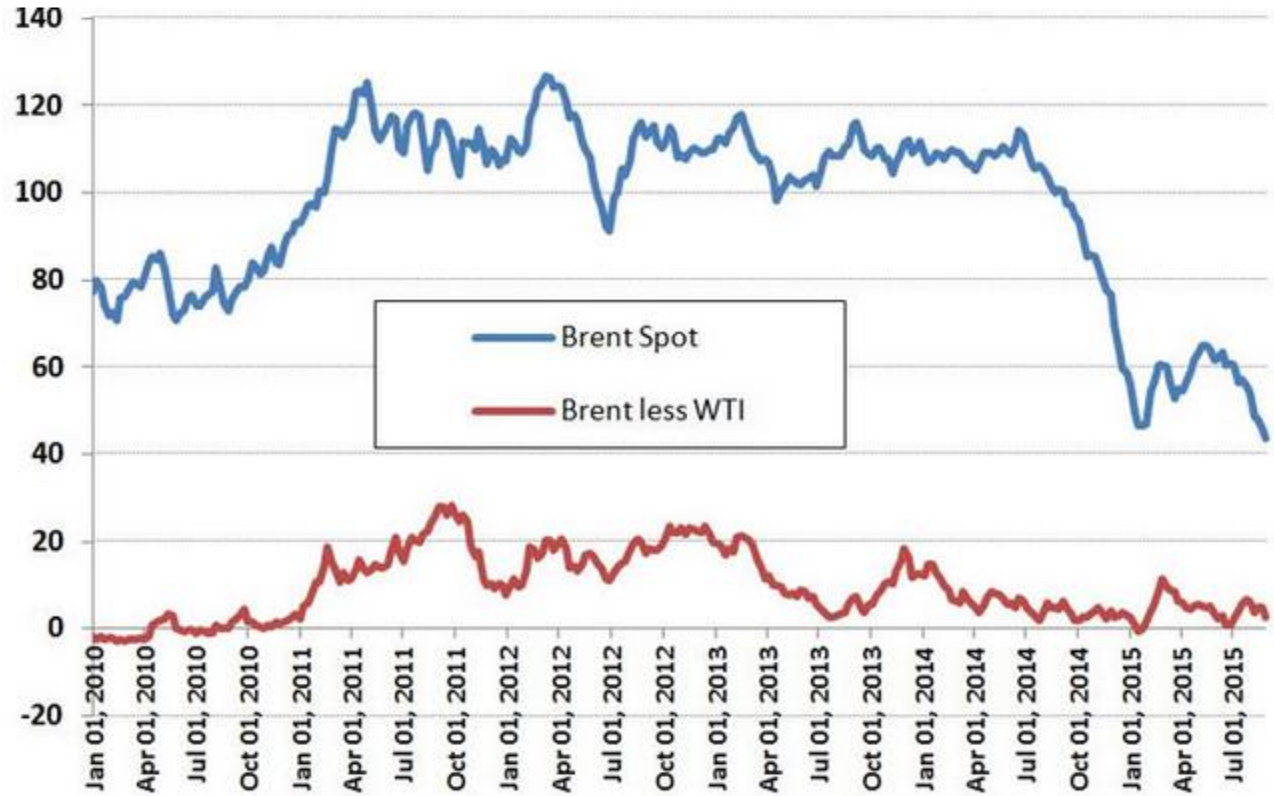
Source: Deutsche Bank, IMF

Trends set dowsizing FX Reserves' Build-up1.

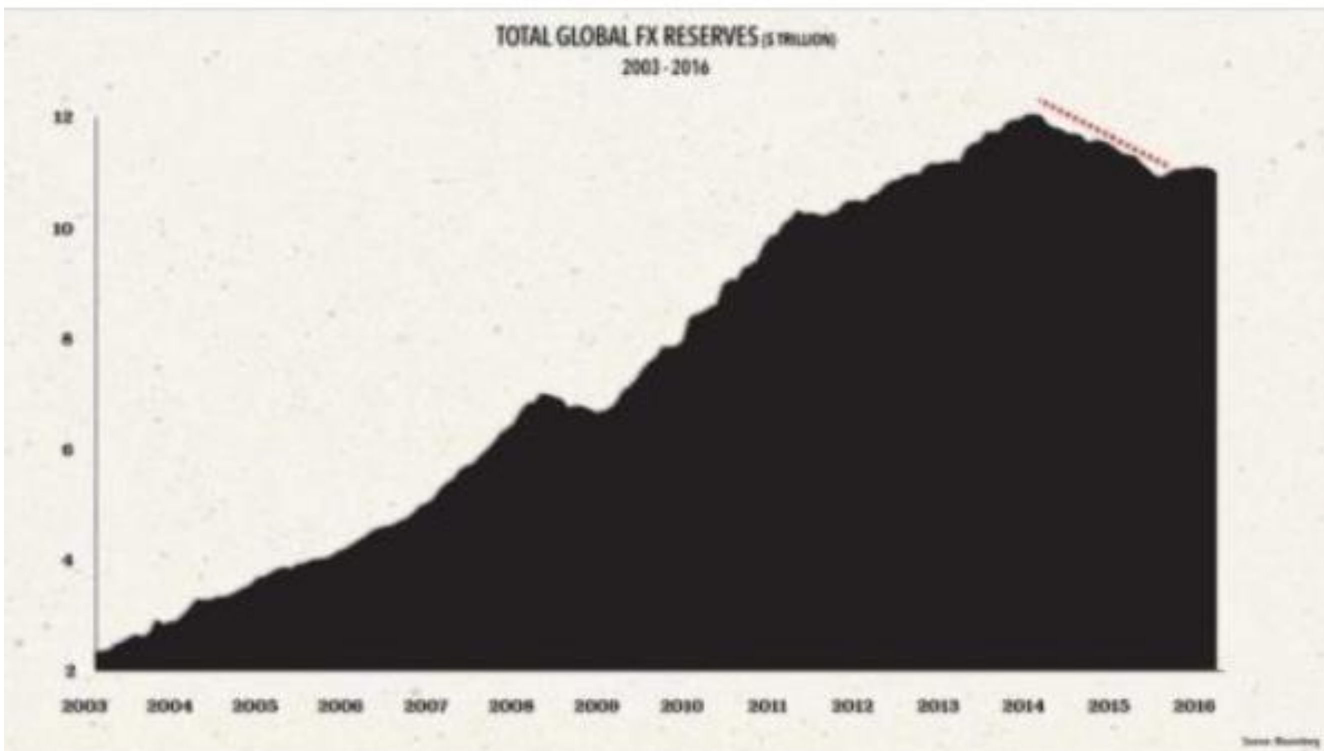
China's Forex Reserves 2010-2017



Trend 2.
Collapsing oil price



And declining Forex reserves.
Is the petrodollar story facing its end?



Trend 3.
De-dollarization In Latin America?

Concluding Remarks:
Is the RMB Ready to Play the Great Game?

In China, external pressures to let the RMB free-floating are leading to higher RMB volatility, which implies a sharp reduction of FX reserves holdings, especially in US dollar, and higher share in RMB.

So that a critical shift in EM central banks' reserves policy is likely to come from a full market valued RMB, as it implies a higher volatile RMB.

China's trade partners, especially those in emerging economies, should be prepared to a paradigm shift in FX reserves reallocation policy. For the "thick economic networks of Asia economies, and the role of China, [EM] central banks in order to smooth out exchange rate volatility vis-à-vis the Chinese RMB need to hold RMB's rather than US dollars" (Winkler et Alii 2015: 1-2).

A Blue Sky scenario?

- The consolidation of the spillover-spillback dynamics through the redeployment of FX reserves will eventually defy the current financial markets' inertia, centered on the dollar.
- These actions are set to constrain the Fed and other core central banks to run excessive accommodative policies, and will act the like of self-organizing forces in complex systems.
- In Asia, if China's policymakers allow a full-fledged liberalized RMB, this will accelerate the shift to a further diversification into the RMB.

These developments will lead to reduce the dollar share in the central bank portfolio , and eventually allow the current international monetary arrangements expand into a multi-polar currency system.

Thank You for the Attention!