Rumours continue about the diversification of central banks’ reserves
Does Canada benefit?

Since the end of the financial crisis, the U.S. dollar as a safe-haven currency has lost some of its appeal and rumours about portfolio diversification are spreading at a time when market concerns about financing the U.S. government’s astronomic debt are resurfacing. While foreigners continue to buy Treasuries in very high numbers, it looks as though the inclination toward diversification of central banks in emerging countries is now a boon to other currencies.

To verify this, COFER (Currency Composition of Official Foreign Exchange Reserves), the database used by the International Monetary Fund (IMF) to track major currencies, is particularly useful. COFER is divided into two parts: industrialized economies (33 countries) and emerging nations (107 countries). The allocation of currencies in the portfolios of emerging countries is clearly the more interesting of the two. Japan, of course, continues to be a major player since it holds one of the highest levels of Treasuries, but emerging countries hold the biggest currency reserves by far and they continue to accumulate them at a frenetic pace (graph 1).

From 2002 to 2008, central banks in emerging countries partly countered the greenback’s depreciation by consistently boosting their purchases of U.S. assets. Therefore, despite a 37% drop in the trade-weighted U.S. dollar index in that period, the value of their portfolio held in U.S. dollars—after declining slightly from 2002 to 2004—has stabilized, on average, to close to 61% of total reserves in the four years that followed (graph 2).

Recently, despite the greenback’s appreciation, the value of U.S. assets held by central banks in emerging countries has plummeted to below 60%, meaning that portfolio diversification is on the rise. The euro, the only real alternative to the greenback, continues to reap the rewards of this situation but, unlike previous years, it is no longer alone. This situation, which is consistent with a growing inclination for portfolio diversification, was a boon to “other currencies” whose share has climbed from 1.5% of total reserves at the end of 2007 to 3.2% during the summer of 2009 (graph 3 on page 2).
The IMF does not define currencies that fall in the “other currencies” category in COFER, but it is widely perceived that the recent craze for commodities and quality credit (AAA ratings) have pushed Canadian and Australian dollars to the top of the list of coveted marginal currencies (graph 4).

With the recently announced diversification needs of some central banks, the appetite shown by foreigners for Canadian securities could continue to grow (graph 5). This would no doubt have a major impact on Canada’s bond market and exchange rate.

It would be surprising to see central banks in emerging countries liquidate their inventories of U.S. securities. Most of these central banks, and especially Asian countries, still depend on international trade and they continue to count on mercantilist policies that are tilted toward weak exchange rates to increase their market share. It would clearly not be in their best interest to provoke the greenback’s depreciation. However, if only a portion of future capital flows, say only 1% or 2% more, were invested in Canada, the impact would be substantial.

The inventory of aggregate reserves in emerging countries grew by about US$600B in 2009, to close in on US$5,000B (graph 6). With the exception of 2008, when international trade plummeted, the inventory of reserves has grown year after year. As a result, an additional increase of US$600B in reserves, to US$5,600B in 2010, looks like a conservative estimate.

Under these circumstances, and if no diversification takes place, the anticipated increase in reserves of emerging countries in 2010 will translate into a US$21B jump in securities falling under the “other currencies” category, that is from US$175B in 2009 to US$196B in 2010. If we further assume that the share of securities held in U.S. dollars will fall by one percentage point, i.e. from 57.5% in the third quarter of 2009 to 56.5% at the end of this year, we would have to add a marginal amount of US$4.5B, for a total of US$25.5B in 2010 (table 1 on page 3). And yet, the total amounts could even be higher. Other than our conservative estimates (including that the 1% drop in U.S. securities purchases is allocated to all non-USD currencies tracked in COFER), other entities in addition to central banks are interested in buying Canadian securities. Some big private managers, among others, have already
announced their strategies for 2010, and Canada is in their sights.

Of course, the bulk of these amounts will not be invested solely in Canada, and cash flows will take place gradually over the course of the year. That said, it is difficult to say with any degree of certainty what the impact or net result will be. Foreign exchange traders generally agree that each net inflow of one billion dollars is equal to a minimum of 50 points on the Canadian exchange rate. Accordingly, if the central banks in emerging countries invest US$5B of their reserves in Canada, the USD/CAD could fall by 250 points, from C$1.0642 today to C$1.0392 sometime during the year.

The problem is that the effect could be either fleeting or transitional. The balance of payments identity stipulates that, in a floating exchange rate system, any increase in the capital account balance (including foreign capital inflows) must be offset by an equivalent reduction in the current account balance. This can be done two different ways: on one hand, a rising Canadian dollar should lead to higher imports through Canadians’ increased purchasing power, or by a drop in exports. On the other, net investment income will deteriorate further due to the interest paid to foreigners on their Canadian investments. Capital outflows would drive the loonie downward.

In the short term, beyond the potential impacts on the loonie, increased diversification of central banks’ reserves would likely lead to downward pressures on interest rates. Canada’s government and provinces will still be grappling with substantial financing needs in 2010 (graph 7). The arrival of new players could in fact limit the crowding-out effect on corporate issues.

Already at an advantage due to less aggressive monetary easing policies than in the U.S., Canada’s bond market will benefit from strong demand for Canadian securities and will continue to outpace its U.S. counterpart (graph 8). In a few years, we may even be discussing the conundrum facing Canada’s bond market.

*Excludes the share held by the Bank of Canada and the share of the federal government.
Sources: Statistics Canada and Desjardins, Economic Studies

Table 1
COFER* emerging countries

<table>
<thead>
<tr>
<th>2009**</th>
<th>2010</th>
<th>2010 (assuming a 1% drop in USD share)</th>
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<tbody>
<tr>
<td></td>
<td>In US$B</td>
<td>In %</td>
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<tr>
<td>USD</td>
<td>2,875</td>
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<td>EUR</td>
<td>1,570</td>
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<td>GBP</td>
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<td>JPY</td>
<td>80</td>
<td>1.6</td>
</tr>
<tr>
<td>Others</td>
<td>175</td>
<td>3.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5,000</td>
<td>5,600</td>
</tr>
</tbody>
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* Currency composition of foreign exchange reserves; ** Based on COFER data from Q3 2009.
Sources: International Monetary Fund and Desjardins, Economic Studies

Graph 7 – The Canadian government’s financing needs have increased substantially throughout this crisis

Graph 8 – The relative performance of the Canadian market will remain high

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