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Should we be worried about the decrease in official international reserves?

After several years of strong increases, official international reserves in emerging countries are starting a new trend. These reserves, mainly comprised of foreign currency assets, have stabilized or even started to diminish in certain countries. They are often considered an insurance policy for difficult times, but is it a bad omen if they decrease?

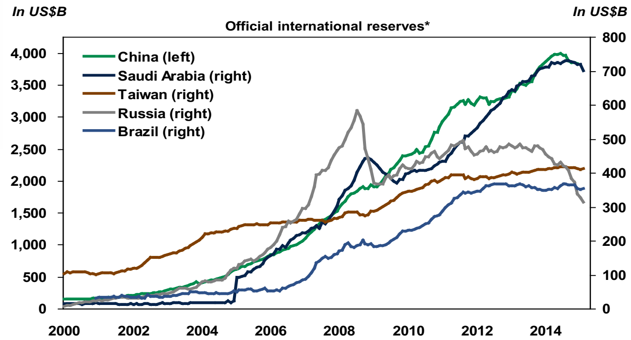
It should be made clear that countries with significant reserves did not amass them solely as rainy day savings. Many countries purchase foreign currency as part of a strategy to maintain a competitive exchange rate, especially with the United States, to support exports. The amounts at play were particularly sizeable in China, where reserves went from below US$200B in 2000 to close to US$4,000B in 2014. This strategy has been much less relevant for the last few quarters, as the strong U.S. dollar was doing the job on its own.

Another explanation for the rapid expansion of official reserves during the 2000s was the explosion in oil prices. Major oil exporting countries took advantage of the situation to rack up a portion of their surplus income in their official reserves. With the drop in oil prices, it should not be a surprise that these countries are now seeing their reserves dwindle as they offset their weaker income inflows.

The situation in oil exporting countries could become problematic if the price of crude stays low for several years. Russia is particularly worrisome, as its reserves are falling significantly. At the current pace, Russian reserves could be wiped out by the end of 2016.

Based on our forecasts, oil prices should start to rise in the second half of 2015, a situation that should reduce pressure on the reserves in oil producing countries. Russia could still be stuck as it continues to suffer the effects of the sanctions imposed by the West due to the conflict in Ukraine.

Many emerging countries are seeing the start of a downward trend in official international reserves



* Excluding gold reserves, except for China.
Sources: Datastream and Desjardins, Economic Studies

Accumulation of reserves to control exchange rates should remain weak, however. We call for the U.S. dollar to retain its strength thanks to diverging monetary policies.

Implications: Except for Russia, falling reserves in emerging countries do not appear to be a concern for financial stability. The situation should improve somewhat in the coming quarters as oil prices increase, but not to the extent of what prevailed previously.

This still raises an issue as to future demand for U.S. bonds, which make up a large portion of reserves. If continued weak demand, particularly in China, is not offset by other factors, there could eventually be a quicker rise in interest rates.

Hendrix Vachon
Senior Economist

François Dupuis
Vice-President and Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Mathieu D'Anjou Senior Economist
Benoit P. Durocher Senior Economist
Francis Généreux Senior Economist
Jimmy Jean Senior Economist
Hendrix Vachon Senior Economist