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Asian Reserve Diversification: Does It Threaten the Pegs?

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- Our bottom line is that any important change in the investment choices across currencies would likely:

  -Threaten their USD pegs.

  -Require an even higher rate of accumulation of total gross reserves in the future.

  -Increase pressure on the ECB to intervene to support the USD against the euro.

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Is Asian Reserve Diversification a Threat to the Dollar Pegs?

Asian central bankers have been incessantly peppered with advice to diversify their fx reserves. Early on, such advice was based on the soundest of textbook risk-return optimization concepts, notably to diversify from the predominant USD share. As if this were not enough, in recent months the obvious trend strengthening of the euro and the lack of sufficient yield spread vs. the dollar has intensified such advice. As a last straw, international financial experts, eyeing the huge U.S. imbalances on current and fiscal accounts, are nearly screaming at the Asian central banks to sell off dollar reserves, before they have to absorb what the experts forecast as an ever larger disaster. Even if they may be talking their own book, such advice follows from conventional analysis of international macroeconomics, especially as it has been applied to small emerging market economies in recent years.

It is useful, therefore, to evaluate the likely effects of a rebalancing of these important asset portfolios away from USD and toward the euro or other currencies. The problem is that these official sector investors are much too large now to be price takers in foreign exchange and fixed income markets. Moreover, changes in the allocation of existing holdings will clearly influence market expectations about future flows of investments by these central banks and governments.

Our bottom line is that any important change in the investment choices across currencies would likely:

- Threaten their USD peg.
- Require an even higher rate of accumulation of total gross reserves in the future.
- Increase pressure on the ECB to intervene to support the USD against the euro.

The first two seem inconsistent with the revealed interests of the Asian governments. So an application of the most basic principles of portfolio management would require a fundamental change in basic macro and development policy. The third cannot be ruled out: it would represent a major shift in ECB policy, but it is now being widely signaled by statements from EU finance ministries and by ECB board members.

Analysis

First, let us note what amounts to an accounting identity. Suppose Asia significantly reallocates existing reserve portfolios away from USD to euros. This is equivalent in impact on private holdings of base currencies and securities to sterilized intervention in support of the euro by either the US or Europe. That is, there is no change in monetary conditions, i.e. monetary base, in any of the three countries due to the reallocation alone. It follows that private investors will have to adjust to the mirror image change in their asset allocation, that is more USD-denominated assets and fewer euro-denominated assets. For private investors to accept this portfolio shift, the USD should weaken against the euro, a result of the standard portfolio balance view.

The less transparent issue is what happens next? Intuition suggests that the dollar should weaken against the Asian currencies while the Euro firms against Asia. Indeed, both standard portfolio theory and historical evidence suggest this is the case. Starting from a mix of Asian currencies, USD, and euros in their portfolios, global private investors are suddenly confronted with fewer euros and more USD. At old exchange rates, they would want to get rid of USD and get more euros. This would tend to bid up the price of Asian currencies and the euro vs. USD, with the euro rising more. The case study on European interventions during the 1970s described in the included box provides the historical color.

The Snake in the Tunnel

The evidence comes from the common practice in the 1970s of European central banks buying and selling dollars to influence their cross exchange rates during the "snake in the tunnel" period. The European cross-currency bilateral rates were supposed to be maintained in a band by the individual central banks, and the whole array was to be maintained in a band against the USD. But interventions to maintain cross rates within the snake were often done with the USD. For example, to support the franc against the DM, the Bank of France would sell USD to buy francs. Private investors, who for the usual portfolio reasons desired a mix of USD and DM but who received only dollars from the Bank of France, would then offer USD for DM. The DM then tended to appreciate against USD. When the DM was pushed to its intervention limit against the dollar the Bundesbank would then buy USD against DM. The net effect was an appreciation of the franc against the DM with both currencies moving up relative to USD. See Michael Dooley "Note on Key Currency Intervention Systems," Board of Governors of the Federal Reserve, IFDP #79 (February 1976).

The important lesson from the 1970's is that portfolio diversification will have first order implications for exchange market intervention by both the ECB and Asian central banks. If Asian central banks rebalance their portfolios away for dollars, private investors will require a fall in the dollar against the euro and the ECB may be politically forced to stabilize the dollar euro rate. In effect the ECB would play the same roll as the Bundesbank in the 1970's except that there is no formal obligation to limit the euro's appreciation against the dollar. Statements currently coming from European finance ministries and ECB board members indicate the potential for intervention in order to preserve cyclical recovery even without the added pressure of Asian buying of euros.

Perhaps more important, pressure from portfolio diversification on the USD/Asian currency cross rate would generate new intervention by Asian central banks to preserve the current dollar rate. Even if this new intervention is less concentrated in dollars than in the past, it can still eventually stabilize the dollar Asian currency cross rate. But this implies even more rapid growth of gross reserve assets in Asian central banks and larger gross private capital inflow to these countries.

It most likely that in trying to keep the old peg against dollar rate, Asian central banks would invest all the new intervention proceeds in dollars. This would avoid the juggling among the currencies and the large gross acquisition of reserves. It would thereby largely offset the initial portfolio adjustment, leaving only an additional acquisition of euros, the same amount of dollars, and more monetary base to sterilize.

In the end it comes back to the question we explored at length in "An Essay on the Revived Bretton Woods System" Deutsche Bank, September, 2003. If the dollar peg and export led growth are the dominant policy considerations for Asia, it makes little sense to threaten the peg with a portfolio adjustment that may have solid micro-finance grounds, but undermines the broader policy framework.

Our guess is that even if such a portfolio adjustment is attempted it will be cautious, small and quickly reversed. Even this could initially shake the market badly given the strong weight of opinion that it is only a matter of time before Asian governments abandon their basic policy stance of export led growth. By jarring expectations, it might even trigger a buying-in attack on Asian currencies that would be counter-productive if Asian governments really intend to maintain their pegs to the dollar.

Adoption of a basket peg would certainly allow diversification away for dollars without requiring intervention since the decline of the dollar against the domestic currency would be (depending of weights assigned to different currencies) offset by appreciation against the Euro. This of course does not eliminate the problem faced by central banks and governments that want to underwrite their access to US import markets. If basket pegs are in the works it is more likely to signal a cautious and gradual move away from strict dollar pegs than a move to facilitate reserve diversification.

References

Michael Dooley "Note on Key Currency Intervention Systems," Board of Governors of the Federal Reserve, IFDP #79 (February 1976).

Michael Dooley, David Folkerts-Landau, Peter Garber, "An Essay on the Revived Bretton Woods System" Deutsche Bank, September, 2003

Certifications

The views expressed in this report accurately reflect the relevant quantitative research model(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. (Peter Garber, Michael Dooley]

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