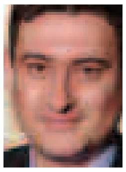
PARIS-BASED **HERVÉ LIÉVORE** AND **ALEXANDRE BOURGEOIS** ASSESS THE GLOBAL AND EUROPEAN ECONOMIES.

Asia's FX mountain rises even higher



HERVÉ LIÉVORE CONSIDERS THE RAPID INCREASE IN THE WORLD'S FOREIGN EXCHANGE RESERVES, ESPECIALLY IN CHINA, AND EXPLAINS WHY THE CREDITORS OF THE US WON'T PULL THE PLUG JUST YET.

Excluding gold, the world has $4,335bn in foreign exchange reserves, according to the latest IMF report. A year earlier, the figure was $3,837bn, so that's a rise of 13%. Over 40% of the total is held by just two countries – China ($875bn) and Japan ($833bn). Taiwan and South Korea's reserves constitute another 10%. Asia (excluding the Middle East) now holds two-thirds of the world's total and its share is on the increase.

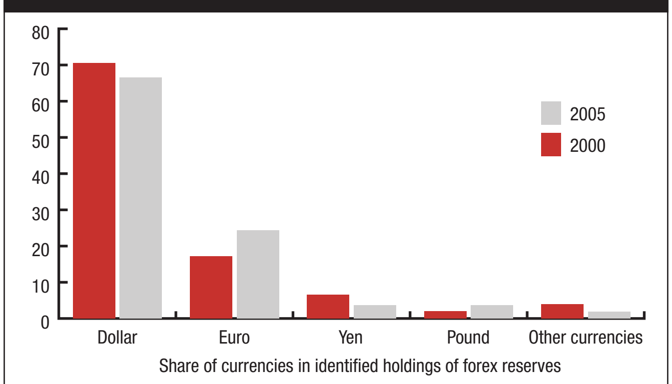
Two countries, in particular, have contributed to the rise in FX reserves over the last year – China and Russia. Although together they hold a quarter of the total share, they accounted for 59% of the increase. Russia benefits from oil, while China gains from robust foreign-trade revenues and foreign direct investment.

In currency terms, the lion's share of securities are dollar-denominated. In Q4 2005, of the countries consenting to disclose the breakdown of their reserves (one-third do not), 66.5% of reserves are dollar-denominated (versus 65.9% at end-2004) and 24.4% were in euros (24.9% a year earlier). Sterling's share of reserves was 3.7% (3.3% at end-2004) while the yen accounted for 3.6% (3.9 the preceding year).

LOGICAL PREDOMINANCE The dollar's predominance is logical given that the US has 65.1% of the world's total financing requirements. The country's need for financing stems from its yawning current account balance deficit ($805bn in 2005).

We are unlikely to see any rapid or significant change in the currency breakdown of forex reserves insofar as the ensuing dollar depreciation would generate capital losses for reserve holders. Although in recent years central banks in Russia, China, the UAE, South Korea and elsewhere have stated that greater asset diversification would be desirable, such a move is not necessarily synonymous with a massive

Chart 1. Share of currencies in FX reserves



Executive summary

- Despite the modest yields on foreign currency, Asia-Pacific, principally China, has amassed a vast chest of mainly dollar-denominated FX reserves. At this point, the only events capable of curbing this hoarding look very unlikely to happen.

purchase of euros. For example, China has underscored its modest gold stocks, which amount to less than 1% of reserves. Diversification could also take the shape of a different issuer rather than a change in currency. For a comparable risk, for instance, yields on securities issued by semi-public US agencies outweigh the US Treasury's.

Whatever the case, it is clearly not in the interests of a country such as China to shy away from the dollar, thereby risking a sharp slowdown in US GDP growth from a rise in long-term interest rates, which would halt US imports – and leave China to deal with its own production overcapacity, the fruit of a massive investment drive over the last 10 years.

The question is, are China's currency reserves excessive? The amount at China's disposal is equivalent to around 15 months of imports compared to 13 months one year ago and under 10 months at the start of 2001. This virtually wipes out the risk of a crisis in its balance of payments. The prudential function of these FX reserves is therefore amply met. However, one can question the strategy of investing in dollar-denominated securities – or in euros, as the same logic applies – as a part of the national savings.

MODEST YIELDS Yields on foreign currency-denominated assets are modest compared with the benefits of using such funds domestically via, notably, the recapitalisation of state commercial banks. To some extent, Chinese currency reserves are a form of money hoarding.

It is difficult to see what could temporarily curb the rapid accumulation of China's FX reserves. At this stage, two factors could contribute to such a scenario. The first is true flexibility in the Chinese exchange rate regime – in other words, net appreciation of the yuan – but the Chinese government has made it abundantly clear that it does not plan to roll out such a measure. The second entails a massive reduction in the US current account deficit. This, though, implies a hike in the US savings rate, which would clearly take time to achieve.

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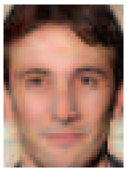
Communication good, diagnostics fair



ALEXANDRE BOURGEOIS APPLAUDS THE EUROPEAN CENTRAL BANK'S NEW-FOUND ENTHUSIASM FOR CLARITY, BUT CRITICISES ITS ALARMISM ON INFLATIONARY RISKS.

Everyone knows that the banking system is based on confidence. A central bank, more than any other, must inspire the trust of economic and banking players alike. More than ever before, the art of communication has become an indispensable tool for any respectable central banker.

It must be said that Jean-Claude Trichet is making clear progress in this area, particularly compared with his predecessor, Wim Duisenberg. Since taking over the reins at the European Central Bank (ECB) two and a half years ago, Trichet has striven to make the ECB's monetary policy clearer. It is now unnecessary to read between the lines of its communiqués to anticipate with any acceptable room for error the future actions that the ECB may take.

Moreover, so that market watchers do not take too great notice of the opinions presented by the 17 other members of the ECB's monetary policy committee and do not overinterpret the statements of the ECB president by systematically searching out certain words or expressions, the recent rate-hiking cycle has been so far relatively well anticipated. The forecast still holds of a scenario whereby the ECB gradually hikes its rates during the coming winter at an average pace of 25bp per quarter.

DEBATABLE ECONOMIC ANALYSIS However, while the ECB President's recent statements should be applauded for their clarity, his economic analysis is more debatable. At the press conference following the monetary policy committee meeting held on 4 May, during which the ECB decided (unsurprisingly) to maintain its refinance rate at its current level of 2.50%, Trichet reiterated and underscored his fears of inflationary risks. Two factors underpinned his rationale: surging oil prices and the analysis of monetary data.

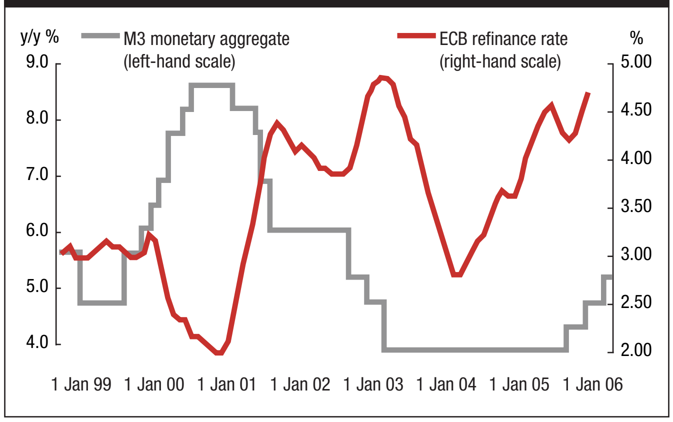
The observation holds true in both cases. Oil prices, the M3 monetary aggregate and loans have risen in recent months at sustained rates. However, and with all due respect, to conclude that these elements prompt the need for monetary tightening is a mistake.

While it is undeniable that surging oil prices will trigger an increase in inflation[1] – it has already contributed more than a third to current inflation – the much vaunted second-round effects cited by the ECB remain, and would appear set to remain, non-existent. In the Eurozone, wages are still rising by only around 2% a year.

An imbalance of power also continues to hinder employees from claiming higher wages that could be judged excessive from the economic standpoint.

Nor does the rise in the M3 money aggregate (8.1% year-on-year three-month moving average) and the ready supply of credit to the private sector (10.6% year-on-year in Q1, which constitutes a high since the ECB began to monitor this index) present enough of a risk to warrant the ECB tightening its monetary policy. In fact, the rise in market rates[2] observed since the beginning of this year should take care of slowing down the increase in loans.

Chart 2. Euro Money Supply



This trend should not be reversed, but, at most, merely slowed down. These loans are helping to sustain growth by offsetting weak household purchasing power.

All told, the ECB should not focus excessively on inflationary risks. On the one hand, because growth, in contrast to what published EU data purports, remains fragile. The Eurozone's retail sales are increasing by just 0.8% year-on-year, which indicates that the region's growth engine and the current situation for households remain a challenge. On the other hand, by taking an expressly alarmist stance on inflationary risks, the ECB president is encouraging the markets to ramp up euro appreciation. It is precisely the rise in the euro that constitutes the main threat to an extension in the Eurozone's economic recovery.

The ECB would be wise to wait a few months more before continuing to tighten its monetary policy. Unfortunately, preoccupied by the risk of inflation, the ECB board members are ignoring the risks to growth and will probably do nothing. In all likelihood, the ECB will probably raise the refinance rate to 2.75% next month and a further 25bp hike should be implemented before the autumn.

[1] Although monetary policy has no effect on this mechanism.

[2] In the period between September 2005 and today, the Eurozone 10-year rate has gained 100bp and currently stands at 4.05% – its highest level in a year and a half.

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