COURTING THE EURO ZONE

SIMON DERRICK OF THE BANK OF NEW YORK LOOKS AT HOW THE INCREASING IMPORTANCE OF THE EURO AS A RESERVE CURRENCY AND HOW IT IS INFLUENCING GLOBAL MARKETS.

Despite the continued outperformance of the US economy over those of core Europe, the dollar has nevertheless consistently underperformed the euro. While many have focused upon the growing US trade deficit as being the driving force behind this move, the evidence suggests that another (albeit related) factor has been behind the euro's strong performance.

ASIAN CENTRAL BANKS. While there has been a growing debate this year over currency management within Asia, a less mentioned aspect of the policies being followed has been the rapid growth of the region's foreign exchange reserves. According to *The Economist*, Asia's reserves have swollen from less than $800bn at the start of 1999 to more than $1.5 trillion by mid-2003 (almost two-thirds of the global total).

The rate of growth of these reserves has accelerated rapidly this year as international investors have looked to place fresh capital into the region's equity markets (to take advantage of the expected recovery in the global economy and the artificial weakness of the currencies) and because of an equally rapid rise in the pace of central bank intervention as they have fought to keep their currencies from appreciating.

As a result of these flows Japan's official reserves jumped by 15% from the start of the year to stand (by the end of June) at $545.618bn (the largest in the world). Similarly, the *Financial Times* reported in July that China's central bank was being forced to buy an average of $600m a day to steady the exchange rate. This helped to drive China's foreign currency reserves (the second largest in the world) above $340bn by the end of June, up from $316bn at the end of March. Taiwan and South Korea's foreign exchange (FX) reserves have also been growing rapidly and stood well north of $100bn apiece by the end of the first half year. Meanwhile, India's reserves had reached $84bn by mid-year and were increasing at a rate of more than $2bn a month (they have doubled in the past two years). This money needed to be invested somewhere.

INVESTMENT CHOICES. When investing FX reserves, the assets of choice for the region's central banks (for reasons of safety and liquidity) have typically been treasury or government agency bonds. Given that the currency intervention by the Asian central banks that has taken place has largely been conducted in US dollars, the most natural home for this money should have been the US Treasury market. Indeed, Federal Reserve custody data revealed a $933bn surge in foreign central bank holdings of US government and agency debt, over the first half of the year. But the story has proved to be slightly more complex than this. China, at least, had made no secret in recent years of its interest in diversifying its FX holdings away from the dollar. The euro zone was the most logical place to diversify these reserves into, given the substantial size of the E-12s debt markets relative to the rest of the world (excluding the US and Japan).

In early 2002, China's then-Finance Minister, Xiang Huaicheng, told German finance minister Hans Eichel that the People's Bank of China wanted to increase holdings of the euro. More recently, speaking in Basle at the end of June, China's central bank Governor Zhou Xiaochuan (commenting on China's FX reserves) noted: "We are determined to have a quite significant portion of euros as our reserves." Although China does not disclose the composition of its portfolio, it has been suggested that the percentage of euros held by the central bank could have risen this year to as high as 20% of its overall holdings.

China has not been alone in its desire to diversify its currency reserves away from the US dollar. In a speech given in March, Lim Hng Kiang, the Deputy Chairman of the Monetary Authority of Singapore (and Second Minister of Finance) noted: "I think there is considerable room for several Asian countries to diversify their reserve holdings into higher-yielding assets. Asian FX reserves have climbed to some $1.3 trillion at the end of 2002. The bulk of these reserves are passively invested in US government securities. The reserve holdings far exceed the requirements for exchange rate management or import coverage. Dedicating a small fraction of the reserves to a wider selection of sovereign and corporate bonds, Asia included, would diversify risks and enhance yields."

There have also been reports that the central bank of Taiwan has been actively shifting its portfolio towards the European currency, while both the Philippines and Indonesia have announced their intention to increase the share of euros in their reserves. As the former Finance Minister of Indonesia, Rizal Ramli, noted: "We are strongly tied to the US dollar, but with its decline, it is wise for Indonesia to diversify its reserves into euros."

Outside of Asia, Russia's central bank has also been diversifying its reserves. Prior to 1991, it held up to 90% of its FX reserves in US Treasury bills or dollar-denominated cash. By the end of 2002, this number had fallen to below 75%, while the euro has gone from less than 10% of the $48bn of reserves to more than 20%. Again, this intention has been well signalled. The central bank's First Deputy

'CHINA HAS MADE NO SECRET IN RECENT YEARS OF ITS INTEREST IN DIVERSIFYING ITS FX HOLDINGS AWAY FROM THE DOLLAR. THE EURO ZONE WAS THE MOST LOGICAL PLACE TO DIVERSIFY'

Chairman, Oleg Vyugin, said in February: "We reconsidered our investments at the end of last year [2002] in favour of other currencies. We are diversifying. Returns on US dollar instruments are very low now. Other currency instruments pay more." Similarly, both the Bank of Canada and Saudi Arabia have also been reported to be shifting their portfolios towards Europe, as well as all of the eastern European states that are looking to join the European Union (EU).

All this indicates that this year has seen a dramatic rise in the role of the euro as a reserve currency. According to the International Monetary Fund (IMF), the euro represented about 13% of official holdings of FX reserves at the end of 2001 (the US dollar represented 68.3% of holdings). *BusinessWeek* reported in February that the holdings of euro had risen to 15% of all holdings by the end of last year. Given the reports from the various central banks, it would seem reasonable to assume that the euro will come to represent 20% of the $2.4 trillion global foreign currency reserves by the end of this year. This, in turn, would imply purchases of euros this year by the world's central banks of around €135bn.

FLOW DATA. The released data from the first half of the year certainly supports the view that the main driving force behind the euro's appreciation has been investment inflows into the region's capital markets. According to the European Central Bank (ECB), the combined net direct and portfolio investment into the euro zone recorded an inflow of €6.7bn in May (the euro zone's broad basic balance stood at €6.2bn) entirely as a result of portfolio investment inflows of some €7bn (direct investment posted a net €0.3bn outflow). Moreover, over the six months to April, the euro zone averaged a monthly €0.7bn in combined investment inflows, and the cumulative total inflow over the 12 months ending May was €57.6bn

THE EURO ZONE. Over and above the natural desire of central banks to diversify their currency reserves, there have been good reasons for fixed income investors favouring the euro zone over the US. The ECB's pursuit of 'monetarism' has entailed that it will only adjust nominal interest rates to fine-tune prices (as monetary policy is deemed an ineffective tool with which to influence economic activity over anything but the short term). However, to say that monetary conditions are not ideal for the euro zone's largest economies would seem to be something of an understatement. There are widespread fears that the German economy will succumb to a fall in prices in the not too distant future and, for proponents of output gap analysis, current projections for euro zone growth this year (in the region of 0.1%-0.5%) mean that downward pressure on prices can only grow from hereon.

Moreover, many observers now feel that the euro zone may be paying the price for the ECB's relaxed stance on this year's sharp appreciation of the euro. Using a rule of thumb – a 5% rise in the euro equates to a 1% increase in interest rates – it could easily be argued that monetary policy has actually been tightened considerably in the euro zone this year.

However, the ECB has proved reluctant to implement further rate cuts without what former ECB President Wim Duisenberg called "urgently-needed reforms" – the absence of which he deemed would ensure that any further stimulus to monetary growth would simply engender a rise in inflation and no net stimulus to growth over the longer term. Given this essentially deflationary environment, it was hardly surprising that fixed income investors were naturally attracted to the euro zone.

LEARNING TO LET GO. As long as the Asian central banks continue to actively manage their currencies to keep them artificially weak against the US dollar, then they will continue to see a sharp accumulation in their FX reserves. Given their avowed aim to increase the holdings of euro-denominated instruments within their portfolios, this indicates that they will continue to need to purchase the single currency out of their US dollar holdings. Unless this process is broken (by, say, China agreeing to revalue the renminbi or loosening the currency's trading band), it seems likely that the underlying demand for the euro from the Asian authorities will remain a key force within the currency markets.

Simon Derrick is Head of Currency Research at The Bank of New York.
sderrick@bankofny.com
sderrick@bankofny.com
www.globalmarkets.bankofny.com