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CAUTION AND FLIGHT IN GLOBAL CURRENCY FLOWS

The dollar looks set to benefit from global uncertainty while reserves managers weigh the pros and cons of allocating more to the renminbi. By Julian Jacobs.

MOVEMENTS in central bank reserve currencies mirror many of the trends revealed in the asset allocation findings of OMFIF's reserves manager survey (see Chapter 2). Central banks are navigating an increasingly uncertain and volatile macroeconomic environment through their currency allocations. Among the elements impacting reserves managers' decision-making, historically high inflation, Russia's war on Ukraine and the lingering effects of Covid-19 lockdowns appear pronounced.

This year's GPI findings suggest that global flows movement has become more static amid significant uncertainty among reserves managers. And yet, there appears to be movement towards the dollar and, in particular, the renminbi. Within these trends, central banks are attempting to avoid the volatility, uncertainty and elevated inflation of the euro and sterling as a consequence of the Russo-Ukrainian war. While the movement towards the dollar this year represents a slight reversal of findings in our 2021 survey, there is a hastened continuation of previous actual and planned flows towards China.

AVERSION TO SHIFTING CURRENCY HOLDINGS

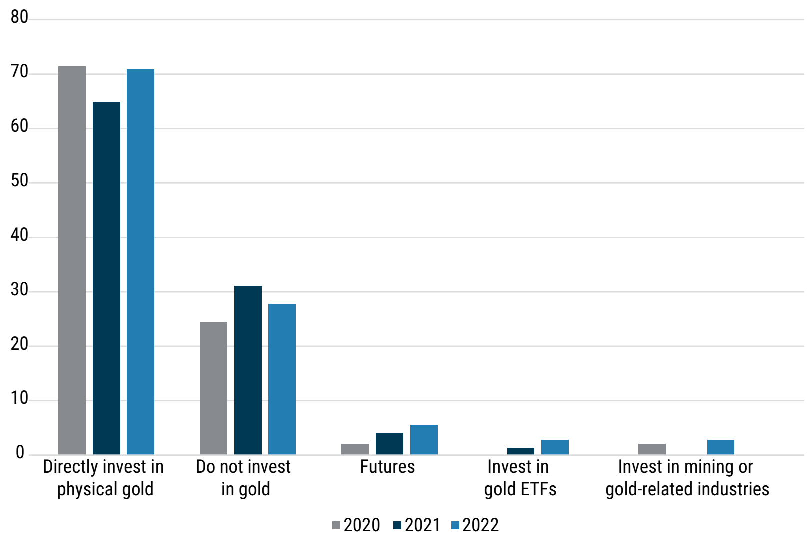
In such a turbulent time for global financial markets, the relative stability of currency reserves flows from 2021-22 may appear surprising. This is particularly true given the inflationary context, where the economic shock of sanctions on Russia is having a varied impact on currency values. Reserves managers might be expected to shift their currency holdings towards denominations experiencing less inflationary pressure.

Instead, central bank reserves managers have generally kept currency holdings consistent. Net planned movement towards or away from currencies has fallen for every single denomination. In total, the share of reserves managers stating they would plan to move currency holdings averaged 14.1% in 2022 compared with 19.4% in 2021. This decrease was particularly pronounced for the euro and dollar, which have seen 18% and 17.3% reductions in planned movement from 2021-22, respectively.

The causes of this slowed movement are likely

1. CENTRAL BANKS MOVING TOWARDS GOLD

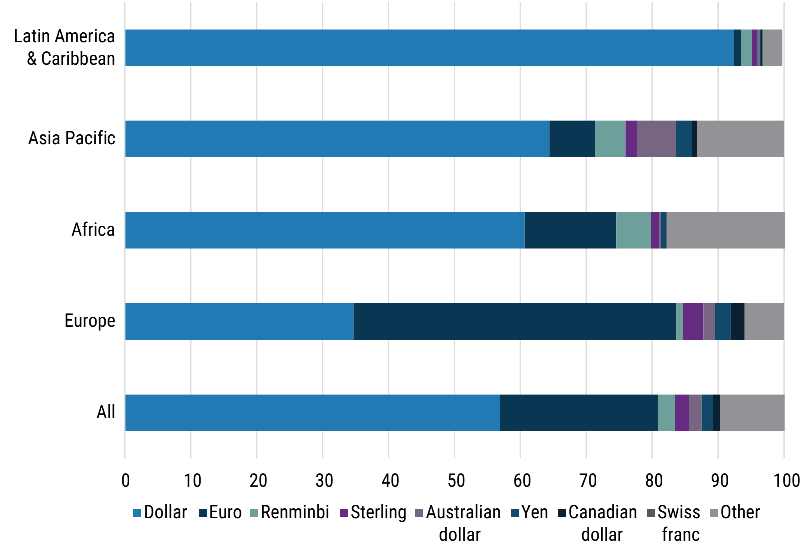
Do you invest in gold, and if so, how? Share of respondents, %



Source: OMFIF GPI survey 2020-22

2. DOLLAR REMAINS DOMINANT

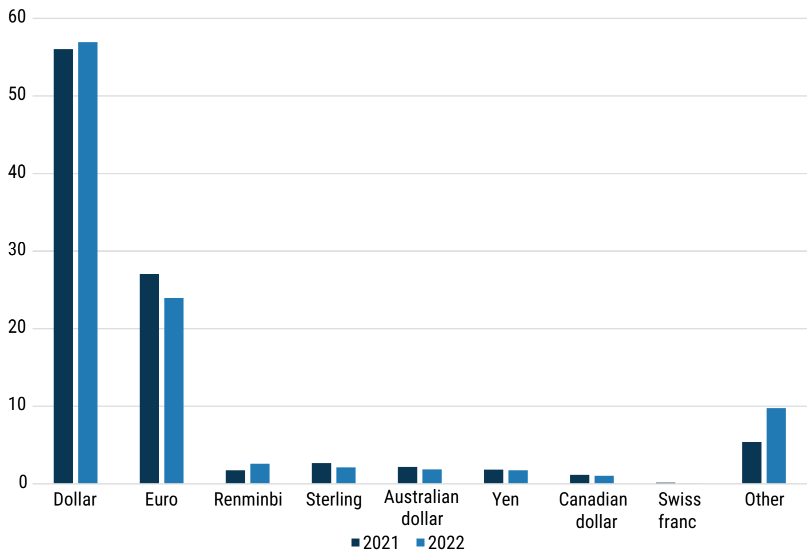
What percentage of your portfolio is allocated to the following currencies? Average response by region, %



Source: OMFIF GPI survey 2022

3. DOLLAR HOLDINGS RISE, WHILE EURO ALLOCATIONS FALL

What percentage of your portfolio is allocated to the following currencies? Average response, %



Source: OMFIF GPI survey 2021-22

> **THE DOLLAR, FOR AT LEAST THE FORESEEABLE FUTURE, WILL CONTINUE TO DOMINATE AS THE GLOBAL RESERVE CURRENCY.**

to be a consequence of both prudence and fear in a volatile global economy. Johanna Lasker, chief executive officer for North America at BNP Paribas Asset Management, points out that this static behaviour is most likely a result of a pervasive sense that doing nothing is better than making potentially hasty manoeuvres in a rapidly changing climate. Yet this sluggishness may also be a matter of policy.

As Juliusz Jablecki, head of risk management and strategic allocation at the National Bank of Poland, put it at an OMFIF event in March: 'While we are experiencing transitory valuation shocks that are not pleasant… we needn't worry too much about these valuation changes.' This is because the National Bank of Poland is a long-term investor, and so central bank reserves managers are loath to shift their currency holdings on account of short-term economic shocks.

This longer-term strategy, however, is exactly why the movements that are occurring are worth paying attention to. Given the unwillingness of central banks to generally move their holdings on account of economic shocks, the movement that does happen can be a strong indication of concern about today's crises as well as the future of the global macroeconomy.

This caution about the global economy and currencies losing their value may partially explain the slight growth in gold purchases in 2022. Figure 1 shows that central banks directed their holdings towards gold in 2020 and 2022 – two periods of significant economic tumult. Such a flight towards the safety of gold mirrors the flight towards government bonds and corporate bonds as a means to slightly move away from cash holdings (see Chapter 2). This shift away from cash, says Massimiliano Castelli, head of strategy for global sovereign markets at UBS Asset Management, is a consequence of an 'emotional response to the current environment,' in which central banks are potentially missing out on 'good medium- to long-run returns on cash.'

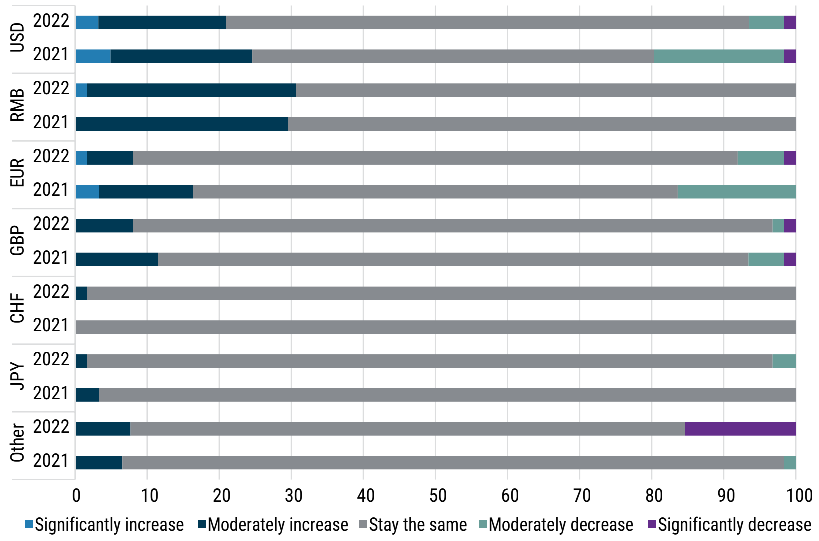
REVERSING PREVIOUS TRENDS

Amid the slowdown of currency movements, there are indications that central banks are planning to move towards the dollar. Given the geographically uneven impact of the Russo-Ukraine war, such movement towards US currency markets – less exposed to war in Europe – is expected. These results are part of broader trends that see a growing US-based asset allocation among global central banks. And the dominance of US financial markets in recent years is likely to further encourage this movement.

Figure 2 shows that central banks hold an average of 57% of their portfolio in dollars. The second largest share is the euro at 24%. However, its presence is highly concentrated among European central banks. Among surveyed central banks in Latin America, there is an average of 92% dollar exposure compared with just 1% for the euro.

4. BIGGER ALLOCATIONS PLANNED IN DOLLAR AND RENMINBI

Over the next 12-24 months, are you planning to increase, reduce or maintain your exposure to the following currencies? Share of respondents, %



Source: OMFIF GPI survey 2021-22

Given this continued dominance of the dollar, it is important that all movements of currency flows are contextualised. As Figure 3 shows, although growth in renminbi holding has been rising alongside movement towards the dollar, it is starting from a significantly lower point.

These results are significant given the considerable speculation about the future of the dollar as the global reserve currency. Figure 4 highlights central banks' planned movement in currency holdings. After a period of roughly +5% planned net movement towards the dollar in 2021 (with 20% of central banks intending to move away), there is planned net movement of +12% towards the dollar in 2022 (with under 7% moving away). Such shifts suggest that, at least for a period, the status of the dollar as a global reserve is not at high risk.

Yet, as some reserves managers commented, these short-run shifts towards the dollar are not necessarily indicative of long-term strategy. Jablecki remarks that the National Bank of Poland's movement towards the dollar is 'strategic rather than tactical'. In other words, such shifts towards the dollar are indicative of immediate-term movement to preserve capital and avoid volatility, as opposed to a revaluation of long-term currency allocation strategy.

SHIFT TOWARDS RENMINBI GROWS

There is continued growth in planned movement to holding renminbi. And unlike the movement towards the dollar, central banks' planned increase in renminbi holding appears to be largely a case of long-term strategy, rather than short-run prudence to avert volatility in European markets.

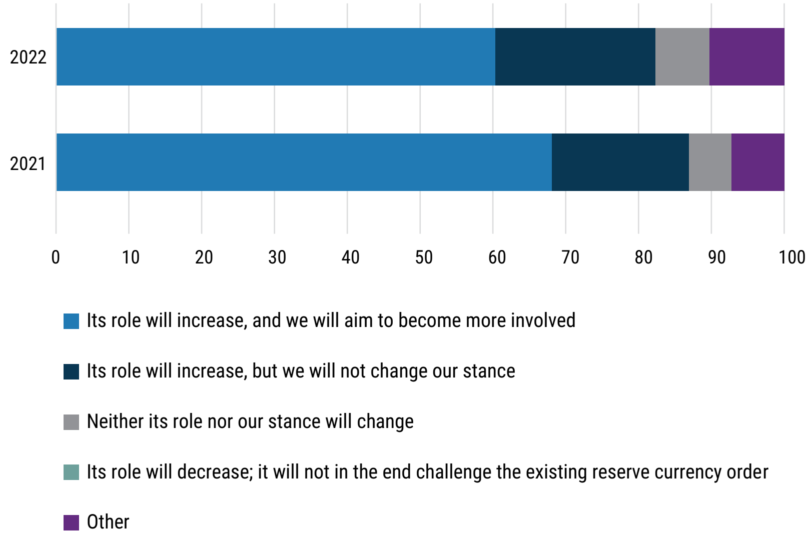
Figure 4 also captures net planned increases of

↓14.1%

In total, the share of reserves managers stating they would plan to move currency holdings averaged 14.1% in 2022 compared with 19.4% in 2021.

5. CENTRAL BANKS ANTICIPATE A GREATER ROLE FOR THE RENMINBI

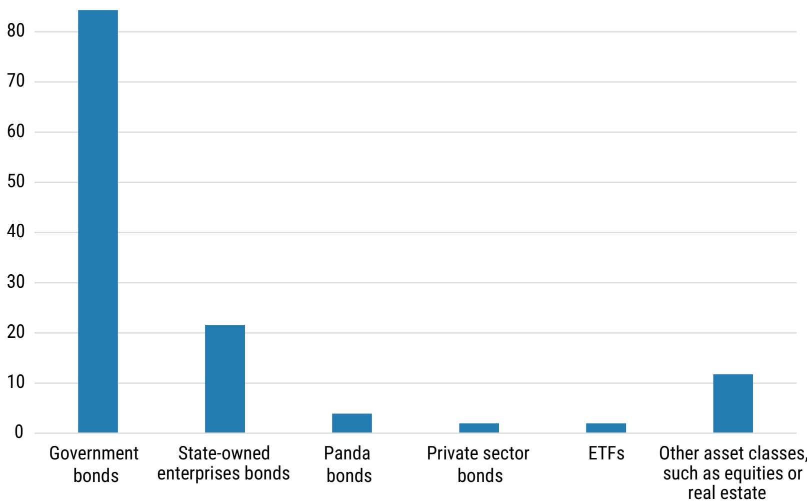
How do you see the role of the renminbi as a reserve currency developing over the next 10 years, and how will you respond? Share of respondents, %



Source: OMFIF GPI survey 2021-22

6. GOVERNMENT BONDS MOST WIDELY OWNED CHINESE ASSET

What kind of Chinese assets do you own? Share of respondents, %



Source: OMFIF GPI survey 2022

renminbi allocation among central banks of roughly +30% in both 2021 and 2022, with zero planned reductions in either year. Given the considerable volatility and economic shocks that have occurred throughout 2022, the consistency of this move towards the renminbi is notable. Figure 5 shows that 82% of surveyed central bankers expect a greater role for the renminbi, with 60% stating that they will aim to be more involved.

The movement towards the renminbi is part of a broader shift towards Chinese assets (see Chapter 2). Figure 6 shows that reserves managers are overwhelmingly choosing Chinese government bonds (84%). An additional 22% of central banks invested in Chinese assets opt for state-owned enterprise bonds. Just 2% of reserves managers with allocation to Chinese assets were invested in exchange-traded funds or private sector bonds.

Central bank respondents' chief reasons for the movement towards renminbi is shown in Figure 7. Among them, diversification (81%), the increasing importance of renminbi to the global economy (73%) and the possibility for higher yields (61%) were most significant. However, an average of just 2% of global currency allocations are directed to the renminbi. And this figure is even lower for Latin American, European and North American central banks. By contrast, the orientation towards the renminbi is primarily concentrated in Asia and Africa.

Central bank survey respondents also revealed the concerns that limit their plans to increase exposure to the renminbi and assets (Figure 8). For 71% of respondents, geopolitical concerns were discouraging them from investing in renminbi assets, and 63% and 62% respectively cited poor market infrastructure and a market not sufficiently open to investors. The presence of such concerns is why our findings do not suggest an imminent sea change in global reserves management strategy, with a widespread shift to the renminbi.

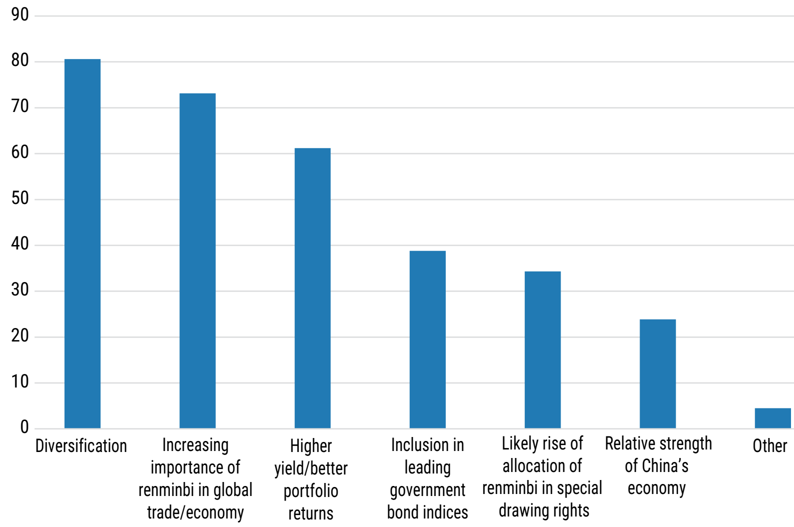
Lasker remarks that it is all too common for central banks to indicate 'planned' movement towards China, only to eventually become discouraged by geopolitical friction and weaker market infrastructure. Our survey results were also captured before the bout of Covid-19 lockdowns in

82%

of surveyed central bankers expect a greater role for the renminbi

7. DIVERSIFICATION AND GLOBAL ECONOMY IMPORTANCE KEY TO RENMINBI GROWTH

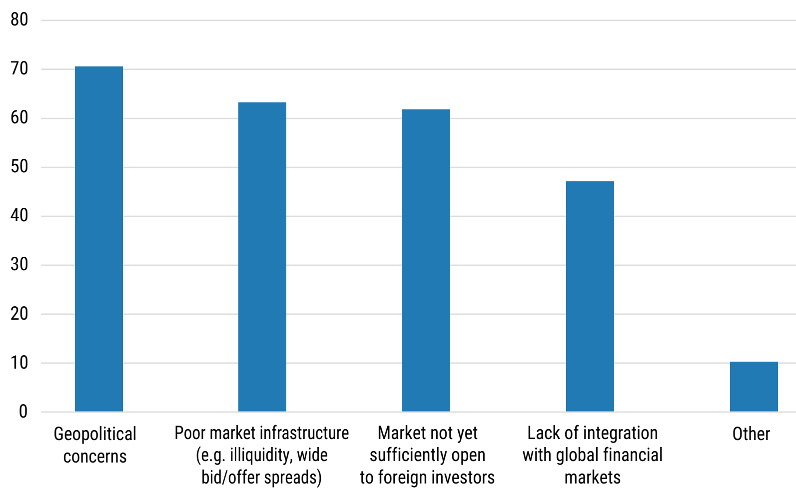
Which of the following reasons might encourage you to invest more in renminbi assets? Share of respondents, %



Source: OMFIF GPI survey 2022

8. GEOPOLITICAL CONCERNS AND MARKET INFRASTRUCTURE DISCOURAGE RENMINBI GROWTH

Which of the following reasons might discourage you from investing in renminbi assets? Share of respondents, %



Source: OMFIF GPI survey 2022

China earlier this year, which may be truncating the country's growth picture for some time.

These findings suggest that many countries around the world, particularly in developing regions, are keen to diversify and shift holdings from dollar to renminbi, not because of the renminbi's suitability as a reserve currency, but in spite of its many flaws. This encapsulates the geopolitical aspect of the drive towards reserves diversification, made more pressing by the freezing of Russian reserve assets through western sanctions.

SHORT-TERM PRUDENCE VERSUS LONG-TERM STRATEGY

The results of this year's GPI survey tell a clear story about how central bank reserves managers are proceeding with their currency delineations. First, central bank reserves managers are generally keeping things static, although there is some indication of a flight to safety. Planned movement of currency flows fell from 2021-22. However, the movement that is occurring generally takes the form of flight. This includes shifting towards gold to avert some of the impacts of a historically inflationary moment.

Moreover, as part of a flight to safety, many central banks are increasing their reserves allocation to the dollar. Though this may not be an indication of a long-run strategy, such planned movement seems to stem partially from a recognition that the US is better insulated from the macroeconomic shocks of the Russo-Ukrainian war and turmoil in European and British financial markets. The dollar, for at least the foreseeable future, will continue to dominate as the global reserve currency.

Against these dynamics, China's growing importance to the global economy is encouraging many central bank reserves managers to increase their renminbi allocation. Despite considerable geopolitical challenges and issues of limited market infrastructure, a movement towards renminbi can offer useful opportunities for higher yield and more diversified portfolios. Such movement towards the renminbi remains primarily abstract, however, given the limited global allocation to the renminbi as well as the significant challenges central banks face in moving towards China. •

71%

of respondents said geopolitical concerns were discouraging them from investing in renminbi assets