

High vaultage

By Alice Ross and Claire Jones

Central banks have become crucial but controversial participants in currency markets



Traders of Japan's currency became unusually fond of the Tokyo night air last year. Long after their colleagues had gone home, the traders left the grand investment houses that dominate the skyline of the Marunouchi financial district and strolled north for a block or two.

Once they reached the Beaux-Arts style Bank of Japan building, they would count the taxis parked outside. A lot of cabs meant the officials were working late. This, the traders speculated, meant they were planning an intervention in the currency market.

To aid Japan's exporters, the central bank has loaded up on foreign currency in recent years to lower the yen's value against the dollar. Although these interventions are not known in advance, the BoJ declares its foreign exchange purchases soon after making them.

What happens next with the money, however, is shrouded in secrecy. Little is known about what the reserve managers at the BoJ, and their counterparts in central banks around the world, buy.

Trying to fathom what secretive central banks do with their huge forex reserves – Japan, the second-largest reserves holder, had \$1.28tn at the end of last year – has long been a headache for traders and investors.

But the influence of central banks has now grown to critical levels. Currency wars and global monetary easing have filled the vaults of the world's central banks with record amounts of

reserves. Since 2006, those have doubled, making central banks crucial participants in markets. Yet there is little accountability or transparency over their holdings.

With fears of currency wars on the rise and no end to monetary easing, the reserves could swell even further.

The \$4tn-a-day forex market is the largest in the world but covert activities by central bank reserve managers have the clout to move it.

“They pose a lot of distortions in the market,” says one hedge fund investor who asked not to be named. “As an investor I can find out what Pimco is doing in the bond markets. But we’re made to feel we can’t ask what central banks are doing and there’s something uncomfortable about that. I’m afraid that this may lead to more volatility in the global economy in the years ahead.”

Many acknowledge the immediate effect that currency interventions have on financial markets. The G20 group of nations said in February that “excessive volatility” of financial flows and disorderly movements in exchange rates had “adverse implications for economic and financial stability”. Yet there is far less focus on the longer term impact of the surge in foreign exchange reserves.

The International Monetary Fund estimates that central banks held \$10.8tn in assets at the end of September, more than four times as much as global hedge funds. China alone holds \$3.32tn – the largest reserves of any central bank. After Japan come Saudi Arabia and Russia. In fifth place is the Swiss National Bank, which has amassed reserves worth \$468bn, mostly in the past year as it has sought to cap the Swiss franc’s gains against the euro after its currency became a haven for investors fleeing the eurozone crisis. With the threat of more currency wars looming, other central banks could follow the SNB’s lead.

Central banks’ newly found riches are pushing them towards adventurous diversification into more unusual currencies. Unknown to many, they often use third parties, such as BlackRock and other private-sector companies, to manage their assets and conduct transactions. The SNB last year outfoxed markets by buying euros through a prime brokerage service at Rabobank.

“‘Safety, liquidity, return’ has long been the traditional mantra of central bank reserve managers,” says Terrence Keeley, global head of BlackRock’s Official Institutions Group. “But today that’s an oxymoron. Not even the safest assets are that safe.”

Reserve managers have traditionally held low-yielding assets that can be sold easily if a central bank suddenly needs to counter moves in the currency, which can dent export trade, stymie inward investment and spark banking crises.

Both US Treasuries and eurozone government debt allow ready access to dollars and euros and are the two most popular reserve currencies. But their allure is fading. While the Federal Reserve still holds close to a record \$3.25tn-worth of Treasuries on behalf of foreign central banks, the figure represents a shrinking proportion of such banks’ portfolios. In 2000, the dollar made up 71 per cent of reserves. Today it accounts for just 62 per cent. The euro’s sheen has, understandably, faded; the currency’s share of reserves has fallen from 28 per cent in 2009 to 24 per cent today.

With interest rates at or close to zero, reserve managers have been feeling the pinch. Central bankers have never been driven primarily by rates of return. But there are costs associated with maintaining a large reserves stockpile – and yields of just 0.14 per cent on one-year US Treasuries do not cover them.

The problems of the advanced economies have pushed reserve managers to search for higher-yielding assets, often denominated in more exotic currencies. That means fresh reserves – gained through interventions or trade – are increasingly likely to be diversified out of dollars and euros.

John Normand, head of forex strategy at JPMorgan, estimates that 50 per cent of central banks now have exposure to emerging currencies, up from 25 per cent two years ago. “The eurozone crisis has made central banks more sensitive to the quality of what they buy,” he says. “This year is when the reserve story could start to get more interesting – even if the eurozone crisis has abated, we may still see more flows into alternative currencies.”

Switzerland is a case in point. Last summer the SNB was a key mover of the global forex market. It was known to be buying tens of billions of euros each month, hoping to keep the franc weak to protect its exporters in the face of inflows from spooked overseas investors at the height of the eurozone crisis in May. But the Swiss, wary of getting stuck with huge amounts of euros, decided to exchange them.

Rumours abounded among forex investors that the SNB was buying Swedish krona and the Australian dollar. The currencies became widely sought after by other investors seeking to follow or even front-run the central bank. Bankers said there had been days when the SNB was the biggest single buyer of Australian debt. Figures released by the SNB later in the year confirmed the rumours; the proportion of “other” currencies on its balance sheet – the Australian dollar, Swedish krona, Danish krone, Singapore dollar and Korean won – rose.

This level of transparency from a central bank is rare. Many monetary authorities in Asia and the Middle East refuse to declare the currency composition of their reserves even to the IMF, which compiles data on the holdings. And it is reserve managers in these regions that have seen their portfolios expand the most in recent years.

Clues to the behaviour of these central banks can, however, to some degree be gleaned from disclosures of the SNB, and others, such as the Bank of Israel, that are less opaque. Like any other investors, central bankers can succumb to herd-like behaviour. Anecdotal and empirical evidence indicates Switzerland’s appetite for currency diversification is matched elsewhere. Of those that do declare the currency composition of their reserves to the IMF, the proportion of assets invested in currencies other than the dollar, yen, euro or pound rose from less than 2 per cent in 2006 to nearly 6 per cent last year.

With their relatively high interest rates and cherished triple A sovereign debt rating, interest in the past two years has focused chiefly on the Canadian dollar and the Australian dollar; so much so that the IMF is considering switching both out of the “other” category and listing them as reserve currencies in their own right. Analysts point to a rise in foreign ownership of these nations’ debt as evidence that central banks are buying in force. The portion of foreign-owned Canadian government debt rose from 12 per cent in 2007 to 28 per cent today, according to Nomura, while the bank calculates foreign ownership of Australian government debt rose from 58 per cent to 72 per cent.

Many central banks trade in foreign exchange, and other markets, themselves. But traders say such banks increasingly rely on third parties to cover their tracks, as Switzerland's use of Rabobank demonstrates. Other banks are looking at using automated systems, or algorithms, to drip-feed purchases through the market.

Given the size of central banks' portfolios, other investors are concerned by what they view as the banks' secrecy. "Central banks are becoming both players and referees," says one investor. "They don't have to report to regulators and when there's a crisis yes, they can control it. But they also distort markets. They have way too many 'official' reserves."

A report from Standard & Poor's, the rating agency, last year argued that the SNB's hefty purchases of euros had played a large role in reducing the spread between peripheral and core government bond yields in Europe, which global investors used as a barometer of the eurozone crisis. The SNB said the rating agency had overestimated the size of its footprint in the market. Some central banks have been keen to demonstrate awareness of the dangers of wading into new and smaller bond and currency markets; the SNB said recently that it was in constant discussion with other central banks about how to diversify its reserves without causing price distortions. However, others do not make these courtesy calls. And some have become fed up with what they feel is other investors' scaremongering.

Those managing central banks' assets play down fears that the banks' rapid accumulation of reserves could be a destabilising force. David Smart of Franklin Templeton says investors are unlikely to gain more transparency. He believes markets' ability to weather changes in reserve managers' behaviour in recent years suggests there is little cause for concern.

"Diversification has been going on for a few years now and we haven't encountered any big problems," he says. "Central banks don't hold a particular advantage over other investors. They're very conscious of how much they can do in these markets without distorting them."

Back in Tokyo, yen traders no longer need to count cabs. Investors have relieved the BoJ of its need to intervene. Selling the yen has been one of the most popular trades this year among hedge funds amid expectations that a new BoJ governor will take unorthodox measures to fight deflation. Yet unlike Switzerland, Japan has pulled back from earlier suggestions it might buy foreign currency. The move, which would further build up reserves, is viewed by other central banks as potentially destabilising to global markets. For now, Japan is keeping its powder dry.