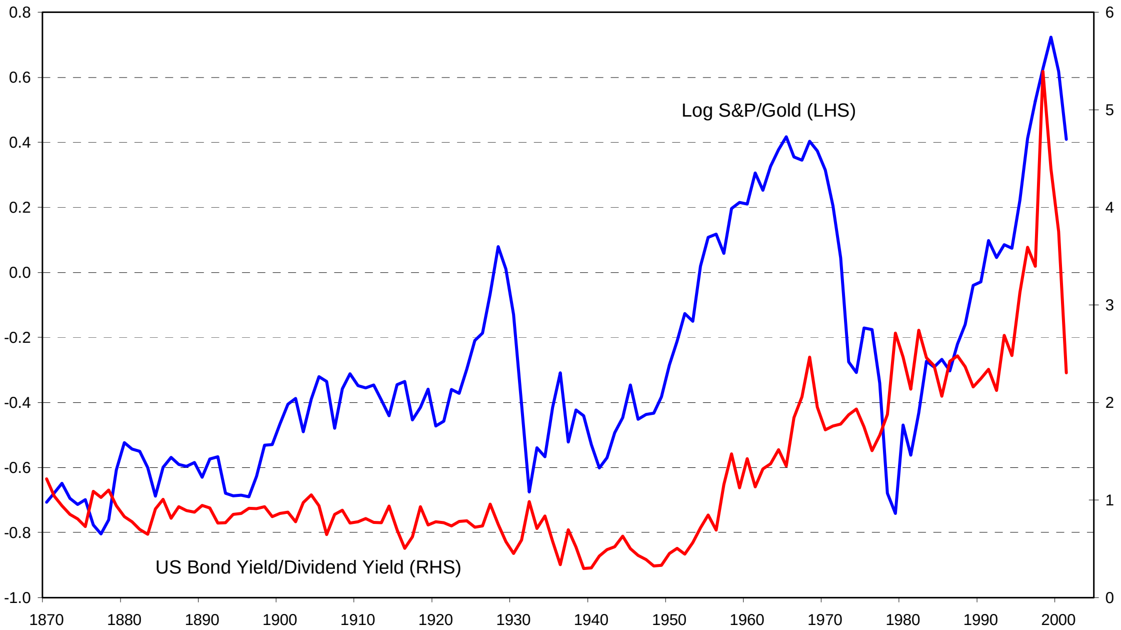
A Golden Moment for Asian Reserve Management?

DSG*Asia* has been bullish on gold since the middle of 2001.[1] In fact, we love gold so much we have sometimes seemed in danger of succumbing to a rather nasty schmelting accident. Current fears about global conflict have served to accelerate the rise in the price of the yellow metal, and there is certainly a risk that some of these gains may be surrendered should love, peace and harmony break out across the world. However, we believe that the longer-term thesis for continued strength in precious metals, and by implication commodity currencies, remains valid. In short, the ongoing debasement by the world's major central banks, particularly the Fed, should drive a revaluation of hard assets relative to paper, and of commodity currencies relative to fiat.

We have been bullish on gold since the middle of 2001

Stocks, Gold & Yields



[1] See: "Australia – Digger's Revenge", June 4th 2001 published when the gold price was around USD266 an oz, and "Commodity Prices, Gold and the Aussie Dollar", May 13th 2002. Note that our gold recommendation has not been included when totting up the returns on our notional portfolio recommendations since we confine the calculation to only include Asia-specific trades.

The chart above shows how much further these trends can potentially go. We still view US stocks on such measures as wildly overvalued, and believe that we are still in the midst of a long-term reversion to more sensible relative valuations between different asset classes. Bond yield-dividend yield ratios are further along the adjustment path, and this normalisation should be given another boost by recent changes to the US tax code. However, we contend that the transmission mechanism from central bank liquidity creation to broader economic activity is going to continue to sputter, while balance sheets adjust to the realities of over-leverage and excess capacity. Hence, we expect to see a prolonged period of poor profitability and weakness in the dollar, which will further pull down the ratio between stocks and gold.

We expect to see continued strength in precious metals, and by implication commodity currencies

Foreign Exchange Reserves, USD billion

	FX Reserves ex Gold		Share in Global Total		Gold as % FX Reserves	
	1992	2002	1992	2002	1992	2002
USA	60.3	56.5	6%	3%	16%	16%
Major EU[1]	204.2	151.9	21%	7%	27%	39%
Switzerland	33.3	32.1	3%	1%	20%	39%
Saudi Arabia	5.9	17.6	1%	1%	4%	1%
Japan	71.6	394.1	8%	18%	2%	0%
Korea	17.1	106.0	2%	5%	0%	0%
Taiwan	82.3	128.0	9%	6%	n/a	n/a
China	20.6	230.9	2%	11%	3%	1%
Hong Kong	35.2	110.2	4%	5%	0%	0%
Singapore	40.0	75.9	4%	4%	0%	0%
Malaysia	17.2	32.4	2%	2%	1%	0%
Thailand	20.4	32.9	2%	2%	4%	2%
Indonesia	10.4	27.2	1%	1%	8%	3%
Philippines	4.4	15.0	0%	1%	18%	14%
India	5.8	51.7	1%	2%	34%	5%
Asia Total	**325.0**	**1204.2**	**34%**	**56%**	**2%**	**1%**
Others	322.6	690.9	34%	32%	47%	16%
Global Total	**951.3**	**2153.2**	**100%**	**100%**	**29%**	**12%**

Source: IMF except Taiwan, government statistics; 2002 Totals as at March 31st

[1] Germany, France, Netherlands, Italy and the UK

An additional driver of the gold price could well be changes in patterns of central bank reserve management – particularly in Asia. The table above, sourced from IMF data, shows that at the end of March 2002, the major Asian countries held around USD1.2 trillion of foreign exchange reserves, compared to USD325 billion at the end of 1992. (The total had risen to USD1.38 trillion by the end of 2002.) This represented around 56% of the world total compared to 34% a decade earlier. Interestingly though, Asian central banks hold an almost insignificant proportion of their reserves in gold – around 1% compared to a global average of 12% and a European average of nearer 40%.

An additional driver of the gold price could be changes in patterns of central bank reserve management

Furthermore, unlike in the foreign exchange markets where central banks are, in reality, only minor, albeit periodically influential players (more on this later), central banks remain dominant players in the bullion markets. The world's stock of gold is estimated at around 145,000 tonnes of which central banks hold around 30,000 tonnes or a fifth. Global production is currently running at around 2,500 tonnes per annum, but has also been supplemented in recent years by active forward selling by central banks and mining companies that has exceeded annual demand (estimates of annual demand range from 3,500-4,000 tonnes). As a result, prices were under downward pressure until recently. This had caused much stress in various developing countries that rely heavily on gold exports and was one of the drivers behind the Washington Accord signed in 1999, under which European central banks committed themselves to selling only 2,000 tonnes in the five-year period to September 2004.

Central banks remain dominant players in the bullion markets

The bear case is, of course, that come September of next year, European central bank sales will resume and the gold price will be capped or could resume its downward trend. This is certainly a plausible scenario if we are wrong about the traction of monetary policy. If global growth is recovering nicely by then, allowing central banks, especially the Fed, to 'normalise' their liquidity provisions, the dollar would find its reserve currency reputation enhanced once again. However, we suspect that we are in for a prolonged period of very easy money as imbalances are worked out of the global economy and financial system, and that come 2004, the European central banks will have less compunction to be selling. In fact, it may be the

The bear case is peace and a nicely recovering global economy

case that their Asian counterparts could be looking to raise their gold holdings.[2]

Much has been said about the potential for central banks, especially Asian ones, to diversify their reserve holdings into the euro. However, the evidence suggests that to date, little such diversification has taken place. Given the sorry record of the euro until recently, this can be seen as a prudent reserve management decision but with the dollar now on the slide, the cacophony has started to build again.

Asian central banks have not diversified FX reserves greatly

Currency Composition of Foreign Reserves

	1992	1997	1999	2001
US Dollars	55.3%	62.4%	68.4%	68.3%
Japanese Yen	7.6%	5.2%	5.5%	4.9%
Pounds Sterling	3.1%	3.7%	4.0%	4.0%
Swiss Franc	1.0%	0.7%	0.7%	0.7%
Euro	-	-	12.7%	13.0%
European Currencies[1]	26.4%	19.7%	-	-
Others Unspecified	6.6%	8.3%	8.7%	9.1%

Source: IMF
[1] DEM, FFC, NLG and ECU

As can be seen from the table above, according to IMF data,[3] the share of the dollar in the currency composition of global foreign exchange reserves has barely changed since 1999, though it has risen steadily since the early 1990s. Unfortunately, the Fund does not provide individual country breakdowns since the data is supplied on the strict understanding of confidentiality. However, a few countries give occasional snapshots or

The currency composition of global foreign exchange reserves has barely changed since 1999

[2] At this stage, we are not building in expectations of an explosion of interest in the Gold Dinar as proposed by Malaysia's Dr. Mahathir, late last year. Mahathir has suggested reintroducing this ancient unit of Islamic commerce to diminish the Muslim world's dependence on the US dollar. For further details see Tom Holland's article of December 19th 2002 in "The Far Eastern Economic Review".

[3] See: http://www.imf.org/external/pubs/ft/ar/2002/eng/index.htm

indications of their currency allocations. For example, according Taiwan's Central Bank of China website:[4] "The bulk of… foreign exchange reserves are deposited in overseas correspondent banks with excellent ratings. Foreign exchange reserves in the US dollar account for a major share of total reserves, followed by the euro and the Japanese Yen. This composition is similar to those of other major central banks around the world." We recall seeing more specific numbers in the mid-1990s though in recent years these releases seem to have dried up.

Few central banks reveal their currency breakdowns

Top of the class for transparency is the HKMA,[5] which has published a table of its reserves currency composition in its annual report every year since 1997. As can be seen, the HKMA has been an exception to the global trend in reducing its dollar holdings during the late 1990s, albeit they were exceptionally high in the past reflecting the peculiarities of a currency board system granting itself greater discretionary powers. From a Hong Kong taxpayers' perspective, 2002 would have been a good year (final data is not yet available) and made up somewhat for losses caused by being early in the switch.

Currency Composition HKMA Foreign Assets

	1997	1999	2000	2001
US Dollars	90.7%	78.9%	80.7%	78.4%
Japanese Yen	1.0%	5.7%	4.9%	3.8%
European Currencies	7.1%	14.8%	14.1%	17.5%
Others Unspecified	1.2%	0.6%	0.3%	0.3%

The HKMA is a notable exception

Our guess, based on various discussions with various central bankers across the region over the years, would be that the reserve management behaviour of the HKMA has been an exception rather than the rule. Hitherto, most would appear to have been highly suspicious about the claims of the euro as an alternative global reserve currency. Certainly we recall speaking at a seminar in 1998 entitled something like "the role of the euro in Asia" and being scolded by a French Treasury Official for stating that the single

[4] http://www.cbc.gov.tw/

[5] http://www.info.gov.hk/hkma/

currency would be weak after its launch and would be best avoided.[6] Most local officials we spoke with after seemed to have sympathy with our sentiments, and suggested that they would be taking a wait-and-see attitude.

The lack of diversification makes inherent sense from a prudent reserve management perspective

But we digress. Leaving aside currency punting predilections, the lack of diversification makes inherent sense from a prudent reserve management perspective. In the early 1990s, Bank Negara Malaysia's *raison-d'être* of foreign reserves management appeared to be to maximise returns by aggressively throwing its weight around in the FX markets. In a slightly different vein, the Bank of Thailand committed virtually all of its reserves forward in its unsuccessful defence of the THB. However, these episodes can be viewed as an aberration in the staid world of central bank reserve management, and most countries choose to manage their portfolios with reference to the currency composition of their external debts and imports.

Debt and trade remain overwhelmingly dollar denominated

Turning first to foreign borrowings, as can be seen in the table over, the share of US dollar-denominated debts rose sharply over the 1990s while Yen loans remained stable and European currency borrowings shrank from not very much to not very much at all. There was little reason to buy the euro here. As for imports, the shares of goods sourced from the US and the EU have remained relatively stable or have fallen slightly over 1990-2001. The biggest changes have been the reduction in imports from Japan and the counterpart rise in imports from other countries, predominantly regional neighbours. However, we view these imports as predominantly US dollar surrogates. The vast majority of this intra-regional trade is denominated in US dollars, is between countries who manage their currencies pretty tightly against the dollar, and reflects shipments of sub-components for manufactured goods destined to be exported back out to the major developed nations. We would refer you to our November 2002 "Trade Winds" article where we discussed this phenomenon in greater detail.[7] Even allowing for say 5% of this intra-regional trade share to be euro-denominated or Europe-related (assuming a 15% share in the intra-regional pie, roughly equivalent to the European share in the total), this would imply a maximum rise in the share of European currency holdings in foreign

[6] She got most upset when we gave a presentation pointing out the inherent contradictions in the design of the system as she had thought that the representative of a European investment bank would be compelled to give the Rah! Rah! euro line.

[7] November 4th 2002.

exchange of 20%. And note this figure would include Sterling and the Swiss Franc, which (thankfully) are unlikely to be entering any time soon.

Asian Foreign Debt Currency Composition and Imports by Country

	Japan		Korea		Taiwan		China		Hong Kong		Singapore	
	1990	**1998**	**1990**	**1998**	**1990**	**1998**	**1990**	**1998**	**1990**	**1998**	**1990**	**1998**
Foreign Debt Currency Composition												
US dollars	n/a	n/a	33%	74%	n/a	n/a	29%	72%	n/a	n/a	n/a	n/a
Japanese Yen	n/a	n/a	32%	17%	n/a	n/a	30%	15%	n/a	n/a	n/a	n/a
French Franc and Deutschemark	n/a	n/a	13%	3%	n/a	n/a	4%	5%	n/a	n/a	n/a	n/a
Others	n/a	n/a	23%	6%	n/a	n/a	37%	8%	n/a	n/a	n/a	n/a
	1990	**2001**	**1990**	**2001**	**1990**	**2001**	**1990**	**2001**	**1992**	**2001**	**1995**	**2001**
Import Shares by Country												
USA	22%	18%	24%	16%	23%	17%	10%	11%	7%	7%	15%	16%
Japan	n/a	n/a	27%	19%	29%	24%	22%	18%	17%	11%	21%	14%
EU	15%	13%	12%	9%	18%	14%	16%	15%	10%	10%	13%	12%
Others	63%	69%	37%	56%	30%	45%	51%	57%	66%	72%	51%	58%
	Malaysia		**Thailand**		**Indonesia**		**Philippines**		**India**		**East Asia**	
	1990	**1998**	**1990**	**1998**	**1990**	**1998**	**1990**	**1998**	**1990**	**1998**	**1990**	**2000**
Foreign Debt Currency Composition												
US dollars	32%	59%	28%	49%	21%	47%	36%	34%	61%	60%	**24%**	**58%**
Japanese Yen	37%	30%	43%	40%	35%	33%	31%	39%	10%	13%	**29%**	**26%**
French Franc and Deutschemark	9%	1%	5%	2%	8%	7%	3%	2%	8%	8%	**6%**	**3%**
Others	23%	11%	24%	9%	36%	13%	30%	25%	22%	19%	**41%**	**13%**
	1990	**2001**	**1990**	**2001**	**1990**	**2001**	**1990**	**2001**	**1990**	**2001**		
Import Shares by Country												
USA	17%	16%	11%	12%	12%	10%	19%	18%	12%	6%		
Japan	24%	19%	31%	22%	24%	15%	18%	23%	8%	4%		
EU	16%	13%	14%	12%	22%	14%	9%	7%	29%	21%		
Others	43%	52%	44%	54%	43%	61%	54%	53%	51%	70%		

Foreign debt data from World Bank; other data from CEIC

Let us assume that Asian central banks are currently holding euro-denominated FX reserves in similar ratios to the global norm, and that they decide to raise their holdings around four percentage points towards HKMA levels. This would imply marginal euro buying of around USD48 billion. This is a big number, no? Well yes, but as the table over shows, it is merely drop in the ocean compared to daily global foreign exchange market turnover of USD1.2 trillion, or even the daily turnover in euro-denominated transactions of USD420 billion.[8]

Global Foreign Exchange Market Turnover

Daily Averages in April, USD billion

	1989	1992	1995	1998	2001
Spot	317	394	494	568	387
Forward Outrights	27	58	97	128	131
FX Swaps	190	324	546	734	656
Unclassified	56	44	53	60	26
Total	**590**	**820**	**1190**	**1490**	**1200**
Memo: Interest Rate Derivatives			151	265	489
Volumes by currency[1]					
USD/EUR		192	254	290	354
USD/JPY		155	242	256	231
USD/GBP		77	78	117	125
USD/CHF		49	61	79	57
USD Total		**473**	**635**	**742**	**767**
EUR/JPY		18	24	24	30
EUR/GBP		23	21	31	24
EUR/CHF		13	18	18	12
EUR Total		**246**	**317**	**363**	**420**

Source: BIS

[1] DEM prior to 1999

This is not to say that if the major central banks were to stand up tomorrow and declare to the world that they were going to buy euros, or indeed carry out sustained intervention in any of the major currencies, that the parities

[8] All of the numbers quoted are taken from the Bank for International Settlements' "Triennial Central Bank Survey", March 2002, available at http://www.bis.org/publ/rpfx02t.pdf

would not move. However, we continue to believe that coordinated, ongoing central bank intervention in the manor of the Plaza and Louvre accords of the 1980s, is an unlikely event at this juncture. And in the absence of such coordination, fundamentals do not suggest that euroland needs a hugely strong currency – machismo concerns aside. Indeed, the recent strength of the currency post the ECB's belated December cut in interest rates, has more than offset any stimulus provided. Sooner or later, it will twig with the euro-protagonists that a strong euro is a recipe for even deeper economic stagnation. In our opinion, the ECB should be cutting rates aggressively now.

Asian central bank currency diversification will be carried out gradually and quietly

We come to the conclusion that while there is some justification for Asian central banks to be raising their euro holdings at the margin, if this occurs in isolation from coordinated and sustained global currency pacts, and if we assume that such diversification will be carried out gradually and quietly, it should not meaningfully impact on the value of the single currency. However, in a world of ongoing currency debasement, there is an equally strong if not more powerful argument for Asian central banks to raise their holdings of gold.