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Daiwa's View

World's foreign exchange reserves continuing to shift out of the US dollar

- According to COFER data announced by the IMF, the share of US dollar reserves held throughout the world fell to 58.8%, a new low
- While the share of US dollar reserves is dropping, the share of Chinese yuan reserves is rising; possible major background factor is influence from asset diversification by Russia
- There are limits to shifting currency composition of foreign exchange reserves in order to avoid the impact of trade friction or international sanctions

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World's foreign exchange reserves continuing to shift out of the US dollar

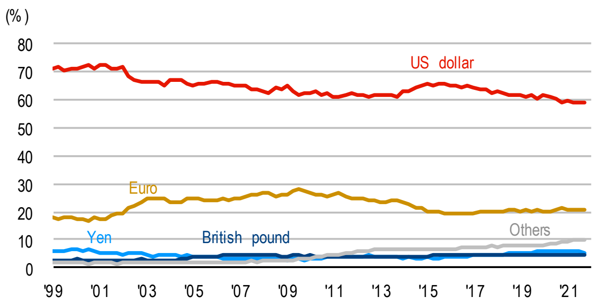
Share of US dollar reserves held throughout the world fell to new low; possible major background factor behind rising share of Chinese yuan reserves is influence from asset diversification by Russia

According to the data regarding the currency composition of official foreign exchange reserves (COFER) announced by the IMF on 31 March, the world's foreign exchange (forex) reserves came in at $12.9373tn as of end-December 2021 ($12.8312tn as of end-Sep), increasing for three consecutive quarters.

Looking at the composition ratios of each currency (share of allocated forex reserves), the share of US dollar reserves was 58.8%, falling below the 58.9% at end-December 2020, marking a new low (Chart 1). While the share of US dollar reserves dropped, the share of reserves in other currencies (Australian dollar, Canadian dollar, Swiss franc, Chinese yuan, and other unspecified currencies) rose, finally hitting the double digit level, at 10.2%. The second largest share after the US dollar was held by the euro, which has been roughly flat at around 20% since 2015. Looking at other currencies, the share held by the yen was 5.6%, the lowest ratio since September 2019, while that of the British pound was 4.8%, the highest ratio since June 2008. That said, the decline in the share held by the yen is the result of the continuing depreciation of the yen, and the quantity of yen-denominated reserves has increased after adjusting for the impact of the exchange rates.

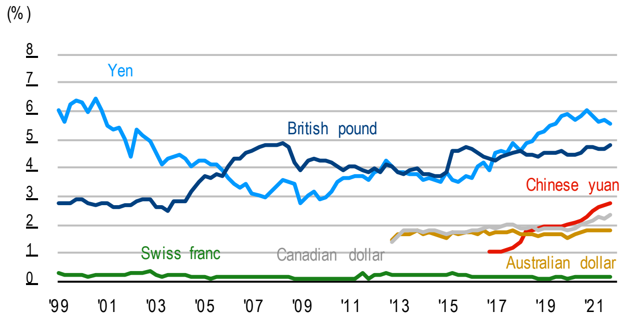
Among other currencies, the share of the Chinese yuan has been rising year by year. When this report started at end-December 2016, its share stood at 1.1%. But, it had risen to 2.8% at end-December 2021 (Chart 2). At end-December 2018, the share of the Chinese yuan exceeded that of the Canadian dollar, and ranked fifth following the US dollar, the euro, the yen, and British pound. The rise in the share of the Chinese yuan appears to be largely influenced by diversification of forex reserve assets by Russia, about which we will explain later in this report.

Chart 1: Composition Ratios of World's Forex Reserves by Currency



Source: IMF; compiled by Daiwa Securities.
Note: Others include Australian dollar, Canadian dollar, Swiss franc, Chinese yuan, and other unspecified currencies.

Chart 2: Composition Ratios of World's Forex Reserves by Currency (details of other currencies)



Source: IMF; compiled by Daiwa Securities.

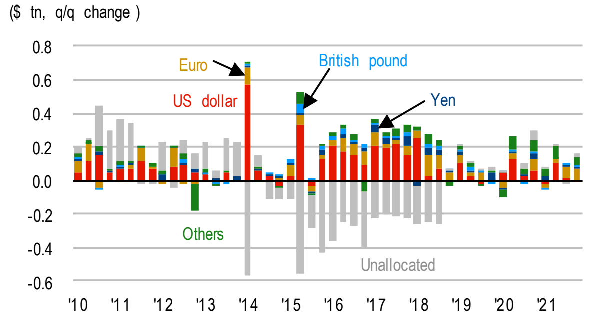
As COFER forex reserve data is reported on a US dollar basis, currency market fluctuations have a major impact on the currency composition ratios of forex reserves. For example, during times when the US dollar weakens against major currencies, the share of the US dollar declines because there is a rise in the US dollar-converted price of forex reserves denominated in other currencies. Meanwhile, during times when the US dollar strengthens, the opposite phenomenon occurs. Accordingly, in order to trace time-series changes in forex reserves, we need to adjust increases/decreases due to changes in exchange rates. In addition, changes in the relative price of various government bonds also have an impact on the composition ratios, but the impact tends to be relatively small as sovereign bond yields in major nations show similar movements in many cases.

Moreover, we need to pay attention to the impact from Chinese factors during the last several years since 2015. Since June 2015, China has started to disclose its currency composition of forex reserves to the IMF in stages. Therefore, the status of its forex reserves has shifted from 'unallocated' to 'allocated.' Looking at quarterly changes in forex reserves (after adjusting currency valuations), there appears to have been an impact from Chinese factors from June 2015 to around September 2018. Therefore, we are unable to determine whether the change in currency composition during this period was a reflection of the authorities' intentions or was caused by the impact from Chinese factors (Chart 3).

Looking at the data while paying close attention to the two points mentioned above, the US dollar's exchange rates against major currencies have not changed substantially over the past 20 years (Chart 4). On the other hand, the share of US dollar reserves in forex reserves has declined over the medium/long term. That said, during the period from the collapse of the tech bubble to the Global Financial Crisis, the impact of the weak dollar on the currency market was large, and, therefore, the drop in the share of US dollar reserves was not as big as indicated by the COFER data. Conversely, the share of US dollar reserves has declined since 2014, despite further appreciation of the dollar. While Chinese factors need to be discounted, this suggests that central banks have been shifting out of the US dollar at a faster pace than before.

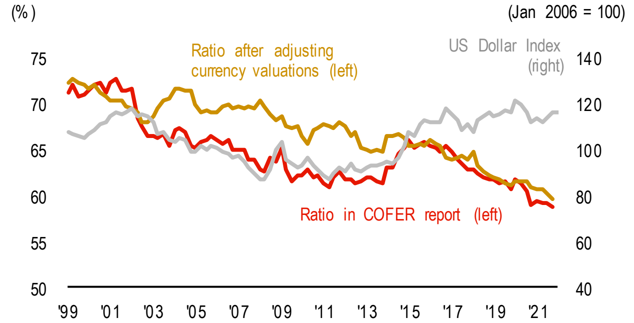
When discussing forex reserves in the currency market, a continual topic is the demand to buy the euro associated with flows related to forex reserves. Since its introduction in January 1999, the euro was expected to become an international currency that could rival the US dollar. Until the European debt crisis occurred in the 2010s, the share of euro reserves did in fact rise (while the share of US dollar reserves dropped), and the euro continued to appreciate (Chart 5). Since then, euro-denominated forex reserves have certainly increased on a value basis, but we haven't seen the kind of euro appreciation coupled with a rise in the share of euro reserves that was seen in the 2000s. In recent years, with the emergence of EU skepticism, particularly in Southern European nations, people have been casting doubt on the ability of the euro to continue serving as the single currency. As such, movements to shift forex reserves to the euro have been limited.

Chart 3: Changes in Forex Reserves by Currency (after adjusting currency valuations)



Source: IMF, Bloomberg; compiled by Daiwa Securities.
Note: Currency valuations not adjusted for unspecified currencies and unallocated amounts.

Chart 4: Share of US Dollar-denominated Forex Reserves, US Dollar Index



Source: IMF; Fed; compiled by Daiwa Securities.

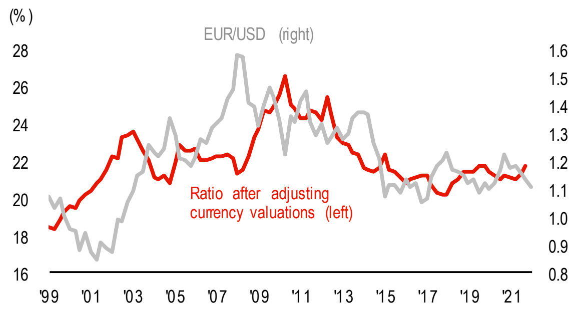
In addition, what has been recently attracting attention as a topic surrounding forex reserves is the possibility that nations will shift out of US dollar-denominated forex reserves at an accelerated pace, due to the impact from sanctions against Russia. As of end-2021, the Central Bank of the Russian Federation had forex reserves worth about $630.0bn, the fifth largest reserves in the world. Since the annexation of Crimea in 2014, Russia has accumulated foreign currencies mainly via the export of resources, and increased its forex reserves by 1.8 times what it held in April 2015, which was $356.0bn.

Russia has diversified its assets in addition to accumulating forex reserves. Looking at the breakdown of Russian forex reserves at end-June 2021, the shares held by the US dollar, the euro, and the British pound were 16.4%, 32.3%, and 6.5%, respectively (Chart 6). Regarding other assets, the Chinese yuan and gold accounted for 13.1% and 21.7%, respectively, which is very different from the currency composition ratios in the COFER data. In addition, looking at time-series changes, we can confirm that Russia has substantially decreased its share of US dollar reserves since 2018, and shifted funds to the Chinese yuan and gold. Using the aforementioned ratios, it is calculated that Russia has Chinese yuan reserves worth $82.5bn. According to COFER, the Chinese yuan increased by $169.1bn from end-March 2018 to end-June 2021, about half of which appears to have been attributed to Russia. Accordingly, while the share of Chinese yuan reserves throughout the world has been steadily rising, movements by Russia may be exaggerating the overall picture.

As mentioned above, in addition to accumulating forex reserves, Russia has shifted its assets from US dollars to the Chinese yuan and gold, as if it anticipated that it would be subject to financial sanctions from advanced nations. As advanced nations have frozen Russian forex reserves, it is reported that Russia is now unable to use its gold and forex reserves worth about $300bn among its holdings. This means that the nation has suddenly lost about 48% of its forex reserves. Russia may not have expected that central banks in major nations other than the US would freeze Russian forex reserves. In any case, sanctions are having a serious impact on the Russian economy.

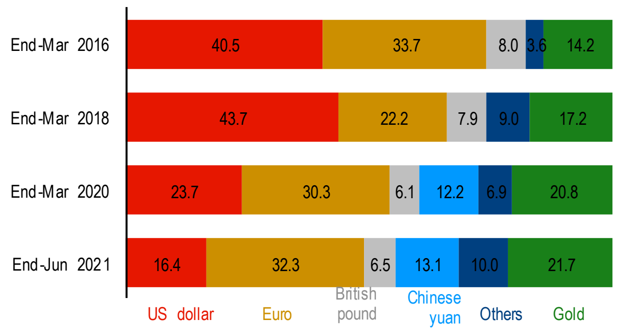
While frozen forex reserves may be having an impact on Russia, people are pointing out that the fact that the US, Europe, and Japan have decided to exact economic sanctions against Russia by freezing its forex reserves may lead emerging nations (such as China) to rethink using forex reserves as an investment method. IMF First Deputy Managing Director Gita Gopinat stated that sanctions against Russia could hurt the dominant position of the US dollar and some nations were already renegotiating settlement currencies for trade. As central banks hold foreign currencies in order to support international transactions, such as trade and financing, forex reserves tend to consist of currencies used in trade settlement and the issuance of foreign currency-denominated debt. Accordingly, once the use of non-US dollar currencies increases in international trade, central banks are expected to further diversify the currencies in their forex reserves.

Chart 5: Share of Euro-denominated Forex Reserves, EUR/USD



Source: IMF, Bloomberg; compiled by Daiwa Securities.

Chart 6: Breakdown of Russian Forex Reserve Assets (%)



Source: Central Bank of the Russian Federation; compiled by Daiwa Securities.

However, it is true that there is no currency alternative to the US dollar. In addition to the US, Europe, the UK, and Japan are also participating in the current sanctions. Therefore, it is obvious that major effects are not expected even if Russia shifts its reserves to major currencies other than the US dollar (such as the euro, the British pound, or the yen) for the purpose of avoiding sanctions. Moreover, Russia has increased its holdings of gold, but the nation has been locked out of the London market, the world's leading gold market. Therefore, it would be difficult for the nation to convert gold to cash.

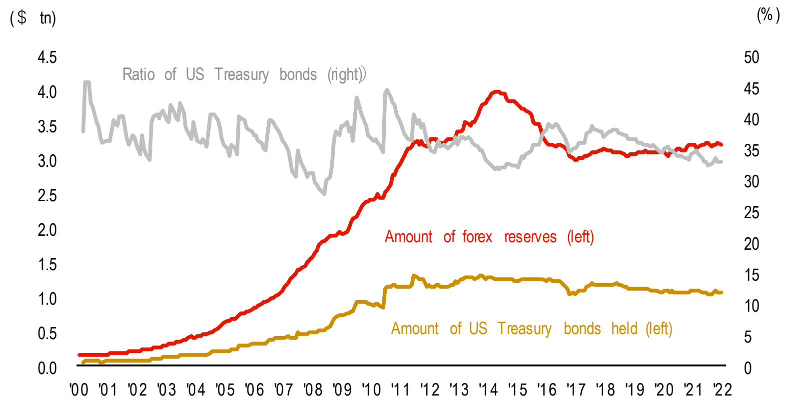
Regarding the Chinese yuan, some nations that have been deepening their geopolitical relationships with China, like Russia, may increase their holdings in the Chinese yuan. However, its use is limited in international transactions, such as trade settlement and the issuance of foreign currency-denominated debt. In the end, unless nations can change the currencies used in trade and financial transactions, there are limits to shifting the currency composition of their forex reserves in order to avoid the impact of trade friction or international sanctions.

Furthermore, there is a quantitative issue regarding the impact on the currency composition of the world's forex reserves. As of end-2021, the share of the world's forex reserves (incl. gold) held by various countries was: 21.0% held by China, 8.3% by Japan, 6.8% by Switzerland, 3.8% each by India and Russia, 3.4% by Taiwan, and 3.1% by Hong Kong. Since 2018, Russia has reduced its share of US dollar reserves by more than 50%, and reallocated it to the Chinese yuan and gold. However, these movements account for only several percentage points of the total change in the US dollar and the Chinese yuan in the COFER data during this period.

Even though Russia's forex reserves rank fifth in the world, the impact they have is limited in this way. The only nation that could bring about drastic change is China. We are not able to get time-series data for the currency compositions of Chinese forex reserves. However, in an annual report announced by the State Administration of Foreign Exchange in 2019, it was disclosed that its ratio of US dollar reserves declined from 79% in 1995 to 58% in 2014. We haven't been able to confirm what the situation has been since then. However, looking at trends in Chinese forex reserves and its share of US Treasury bond holdings, no major changes have been observed during 2014-2021 (Chart 7).

The position of the US dollar has moderately declined over the past 20 years. Still, as long as the US dollar continues to have an overwhelming position in global financing and trade, the composition ratios of forex reserves are unlikely to change substantially. Emerging nations are shifting to "dollar-based" economies, as shown by the fact that they are holding large amounts of US dollars as a safe asset in line with increased US-dollar denominated debt. This is increasing the position of the US dollar as a key currency. That said, just because there are no indications of change at the moment doesn't necessarily mean that current circumstances will continue going forward. Historically, this system of concentrating only on the US dollar is unusual, so it is possible that, over a time span of several decades, the currency market could move towards a system that has multiple key currencies.

Chart 7: Forex Reserves and US Treasury Bonds Held by China



Source: IMF, US Treasury Department; compiled by Daiwa Securities.

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