Preface

This book, the third in an annual series reporting and commenting on trends in reserve management, begins with a new survey of reserve managers.

The survey shows reserve managers' concerns with global imbalances and the risks of economic slowdown looking forward as well as heightened concern about geopolitical and security risks. In response they are actively managing the duration of their reserves and have diversified in terms of instruments, currencies and markets. An executive summary is on page 1–2.

How will China's reserve management change as the country adjusts to being the world's largest holder of reserves? This is the question Hui Feng asks in his chapter. He takes readers behind the scenes to show the new organisation that is emerging to manage the world's first trillion dollar reserve – and reveals for the first time how policy is really made in China.

Political and economic forces pull the authorities in different directions. Reserve accumulation underpins the renminbi's peg to the dollar. For an economy like China, highly dependent on export-led growth, a stronger renminbi could adversely affect the economy and ultimately social cohesion. This is a scenario Beijing has been fighting hard to avoid, the author observes. The flip side of this is of course the anger that the peg evokes in US policymakers who regard it as a subsidy to China's exporters. Yet this is still outweighed by other pressures. Above all, the crises in East Asia in 1997 provide a lesson no policymaker in China dares to forget: countries must insure themselves.

Radical change is not on the agenda. China's ability to move is constrained by its reserve's size and importance: it is hard for the authorities to do anything without moving markets. A gradual strategy may be employed, Hui Feng suggests, in the short to medium term, to defuse the pressures from the country's gigantic reserve holdings. What should markets expect?

China's new moves

First, the People's Bank of China and SAFE will be forces that push for changes. Zhou Xiaochuan and Hu Xiaolian, the heads of the two institutions, are part of a new generation of technocrats in China's financial management. "The Zhou-Hu alliance is set to inject new ideas, style and approaches into Beijing's reserve management," writes the author. Second, there will be a slow but steady increase in the amount and proportion of euro and yen assets, given the rapid growth of trade with these currency areas, especially the European Union. Third, a gradual relaxation of Beijing's foreign exchange system may follow. This will allow wider ownership of foreign exchange, instead of it all funnelling into the central reserves, taking pressure of the authorities. Four, despite the government having its fingers burnt over the attempted purchase of Unocal, an American oil company, a move into "strategic" investments remains an option. The vehicle for this could be Central SAFE Investments Ltd, known as Central Huijin, and a possible model that of Singapore's Temasek. It is no accident that senior officials from the People's Bank of China have paid several visits to Singapore recently.

The authorities are already building the institutions. SAFE enters 2007 with an expanding staff, which now totals 160, and new offices. The central bank is growing: setting up its second centre in Shanghai, home to the Shanghai Gold Exchange, which is China's only gold market. The centre is expected to provide the platform to facilitate China's gold trading and reserve management, and could be an indication of an emerging interest in bullion playing a more substantial role in the country's reserve portfolio, the author suggests. A large number of SAFE staff is being trained in financial centres abroad.

The strategic objectives will be to reduce dependence on the dollar, which Professor Fan Gang, a prominent member of the central bank's monetary policy committee, says is no longer reliable as the anchor of the monetary system, and to improve the yield or performance.

Misleading results

Performance, or more properly, the interplay between performance and presentation of results, is the subject of a chapter from Roberts Grava, a former head of reserve management at the Bank of Latvia. Many central banks' financial statements avoid reporting all mark-to-market gains and losses from reserve management, he says. While they have their reasons for this, with central banks under more scrutiny, this attitude is clearly running against the trend, which is towards mark-to-market accounting. Yet there is far more at risk here than being out of kilter with fashion, as he skilfully demonstrates.

For if a central bank's reserve management is judged by the results it presents it may be tempted to switch strategy to maximise the chances that those results look good. Taking this "presentational" approach has its attractions. Board, management, and politicians will be content with results that are easy on the eye.

But as this presentational accounting does not provide a true picture of profits and losses or the economic risks it faces, the central bank's strategy may start to diverge from the one that would give the best results from an economic perspective. Were such a strategy to deliver poorer results in economic terms – however good it looked in the annual report – it would imply that the central bank is sacrificing opportunities for real gains. Using data from the last 20 years the author puts a figure on what costs could be for a "hypothetical" central bank, which chooses to maximise returns to suit the way results are presented as opposed to maximising economic returns. While tactfully calling this a "hypothetical" exercise, the author leaves no doubt that this is close to the way many central banks behave in the real world.

2006 in review

What major central banks have actually been doing in the past year is the subject of Malan Rietveld's overview in Chapter 4. First he picks out the major trends in policy and then he shines a spotlight on the activities of each of the world's largest holders. Four themes stand out: China's dominance of reserve accumulation, the renewed importance of oil-exporting countries as reserve holders, the rapid growth of national wealth funds, and the new willingness of a number of large reserve holders not only to alter the currency composition of their reserves but also to disclose publicly what they have done and why.

A feature of the last three years, which continued in 2006, was the rapid increase of reserves in oil-exporting countries. Central banks and political authorities are clearly employing different strategies from the two previous rounds of petrodollar "recycling" seen in the 1970s to manage this "windfall". These include: repaying debt; placing of reserves with intermediaries; diversifying into "real" assets, such as property; and the use of national wealth funds to manage a portion of the money. Revenue invested in these funds has thus moved away from what could be considered "traditional" reserves, which makes it harder to monitor the investment of these surpluses.

Turning to currencies, it is true that the dollar remains undisputed as world's number-one reserve currency, with an estimated 66% of global reserves. While a number of central banks reduced their dollar exposure in 2006, largely in favour of the euro and sterling, the large-scale shift out of the dollar in reserve portfolios predicted by some has yet to materialise.

After seeing its status as a reserve currency dwindle for several decades, sterling has made something of a comeback in recent years. According to IMF, it surpassed the yen as the third-placed reserve currency in 2006. While these two currencies are of course nowhere near the dollar or euro in terms of popularity, the holdings and in particular recent *shifts* in holdings (see especially Italy's entry), show that it is not exclusively a bipolar world.

Interestingly, there seems to be a growing willingness by large and influential central banks to make and disclose significant changes in their currency and or asset mixes. Several countries, Russia, Sweden and Switzerland as well as Italy, announced major adjustments in their reserve portfolios, largely in favour of the euro and sterling at the expense of the dollar (for details see appropriate country entries). Many central banks openly discuss instrument or asset diversification and all believe that this process still has a long way to go.

Demystifying ABS

One asset that has attracted considerable interest in central banks is asset-backed securities, as the survey chapters of the two previous books in the *RBS Reserve Management Trends* series show. In the fifth chapter, Peter DiMartino, Mat Knowles and Ronald Thompson, Jr of The Royal Bank of Scotland set out to demystify this asset class and explain how, with a central bank's point of view firmly in mind, the addition of ABS can improve the performance of the portfolio in terms of both returns as well as risk.

The chapter concentrates on the US ABS market, as this is typically the first market investors look to, and offers a snapshot of its composition and growth. The authors examine the risk profile both in "normal" market conditions as well as under "stress", and importantly the time it takes for the markets to return to the former conditions from the latter. Performance is compared with that of more "traditional" instruments. Low ratings volatility is emphasised and, as the authors note, studies show that ABS ratings have held up better than corporate ratings over the ABS market's 20-year history.

An understanding of the context in which ABS exist and what influences the prices of the assets is essential for those looking to incorporate them into their portfolio. The authors look at who issues these securities and how they are structured, as well as highlighting the main macroeconomic forces which