BLUEGOLD

Central Banks' Losses from EURUSD this Year: USD300 Billion and Counting

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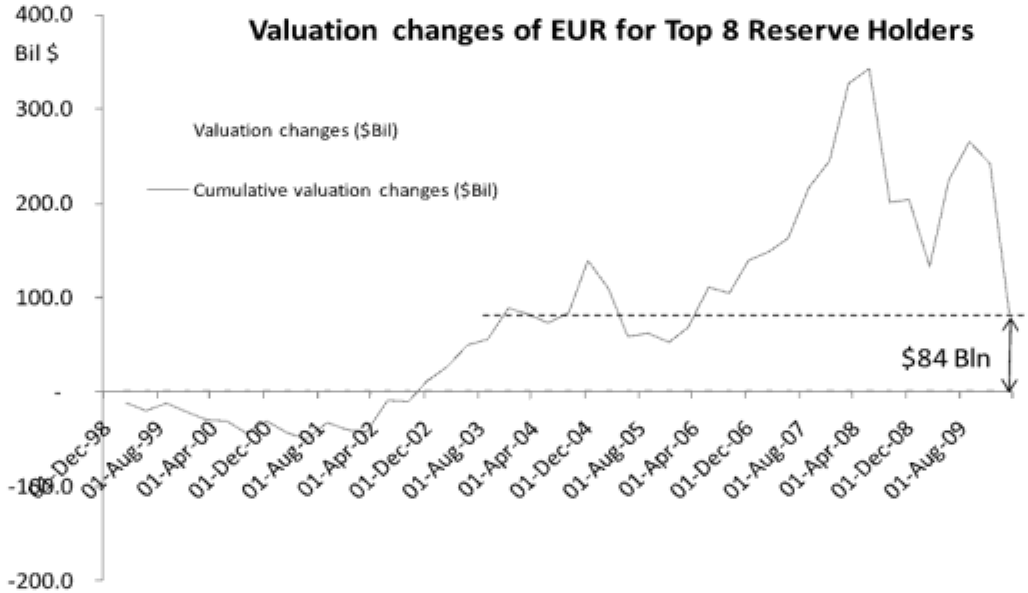
***Bottom line**: Central banks have sustained USD300 billion in valuation losses (YTD) from the depreciating euro. The level of angst at these central banks may be elevated now and the risks are rising that some of these central banks de-rate the euro. Total foreign currency reserves held by all central bank have reached USD9.0 trillion, with the top-8 reserve holders managing some US$5.3 trillion. Of this latter amount, US$1.55 trillion (or 30% of the total) is held in euros. Corresponding to the 10% depreciation in EURUSD year-to-date, the top-8 reserve holders may have suffered close to USD200 billion in valuation losses, and for all central banks the total valuation loss has been around USD300 billion. We guesstimate that China (SAFE) may have suffered a US$80 billion in EUR valuation losses, US$14 billion for Russia, and US$7 billion for Korea. These figures do not include actual and potential further losses on their underlying holdings of European bonds. If EURUSD trades down to 1.2150, all of the monetary gains from the dollar-to-euro diversification in the past decade will be lost. (1) Central banks' reserve managers are presumably reconsidering their dollar-diversification strategy, now that the euro is also found to be less than a perfect 'anti-dollar'. (2) The risks of further declines in the euro and a possible debt rescheduling in Europe are likely to be sources of additional worries for central banks with large exposures to the euro. (3) In addition to central banks being concerned about the euro, the euro-selling process has only just begun for the large real money institutional funds, and the potential for much larger funds to reduce their euro exposures is significant. Since January, my mental target for EURUSD has been 1.20. However, I now think the risk to EURUSD is heavily biased to the downside relative to this figure.*

Central bank reserves. In the past decade, the top 8 reserve holders in the world bought close to US$1.5 trillion worth of EURs. This 'dollar diversification' became particularly aggressive since 2002. The thesis, presumably, was that the dollar was losing its hegemonic reserve currency status in an increasingly globalised world. Not only were the US economic and social fundamentals deteriorating, but the rise of Europe and Asia would ultimately supplant the dollar and the US' dominance in the world, so the argument went. Since the EUR offered most liquidity - among the alternative reserve currencies to the dollar, an aggressive dollar diversification campaign by global central banks has helped propel EURUSD higher during most of the 2000s.



Valuation losses from the EUR weakness. As the EUR weakens, however, these central banks have suffered very large valuation losses. The exhibit above shows the quarterly EURUSD valuation changes (the bars in the chart) and the cumulative valuation changes since 1999 (the line in the chart), which is a proxy for the monetary value of USD diversification into the EUR. The episodes of USD strength in 2005 and 2008 are visible in the chart, so is the latest sell-off in the EUR. In fact, the cumulative benefits of dollar-to-euro diversification since end-1999 for the top-8 reserve holders are US$84 billion, down from a peak of US$343 in mid-2008. In other words, the cumulative benefits of dollar diversification since 1998 are a modest 5.6% of the total reserve holdings, and the same level of gains were reached in 2003, i.e., <u>there has been no net change in the benefits from diversification in close to eight years</u>.

If EURUSD trades down to 1.2150, the cumulative benefits from dollar-to-euro diversification since the launch of the euro would be nil.

Being the largest foreign currency reserve holder in the world, China has suffered EURUSD valuation losses of about US$80 billion so far this year. This is a large amount even for SAFE. To put this figure into perspective, US$80 billion is equivalent to 5 months of China's trade surplus in 2009, or 80 million-worker-years, i.e., this is equivalent to the total annual wages of 80 million workers.

Potential losses on European bond holdings. The managers of large EUR reserves are likely to be worried about the euro, but are also likely to be uncomfortable with the potential losses from potential defaults or debt rescheduling. My own view is that an eventual debt rescheduling is probable for Greece and Portugal, and will inflict further losses on central banks.

The table below shows the relative size of the government debt for selected European countries. Since we do not have information on the specific breakdown, by country, of the European bond holdings by central banks, we have had to come up with some guesstimates. We made the conservative assumption that central banks have a disproportionately high exposure to German bunds and low exposure to the PIIGS bonds. But even with our conservative assumption, we find that it is possible that global central banks have close to a third of their EUR holdings in PIIGS bonds, and possibly 5% (about USD140 billion) or so in Greek and Portuguese bonds. A 30% haircut, which I think is likely, would imply a USD42 billion potential loss for the world's central banks, or USD22 billion or so in losses for the top-8 reserve holders. These figures are for indicative purposes only. Clearly if the size of the haircut is larger than 30% or if other countries also reschedule their debt, the losses would be much bigger.

(US$ Blns)	Gov't Debt 1/	% of Total	Possible 2/ CB Portfolio	CB Reserves 3/ Top-8	CB Reserves 3/ All
EUR Total	**11,321**	**100%**		**1,550**	**3,000**
GER	1,508	13.3%	35.0%	543	1,050
PIIGS Total	3,909	34.5%	30.0%	465	900
POR	182	1.6%	1.4%	22	42
IRE	135	1.2%	1.0%	16	31
ITA	2,567	22.7%	19.7%	305	591
GRE	428	3.8%	3.3%	51	99
SPA	597	5.3%	4.6%	71	138

Sources : Haver, Bluegold

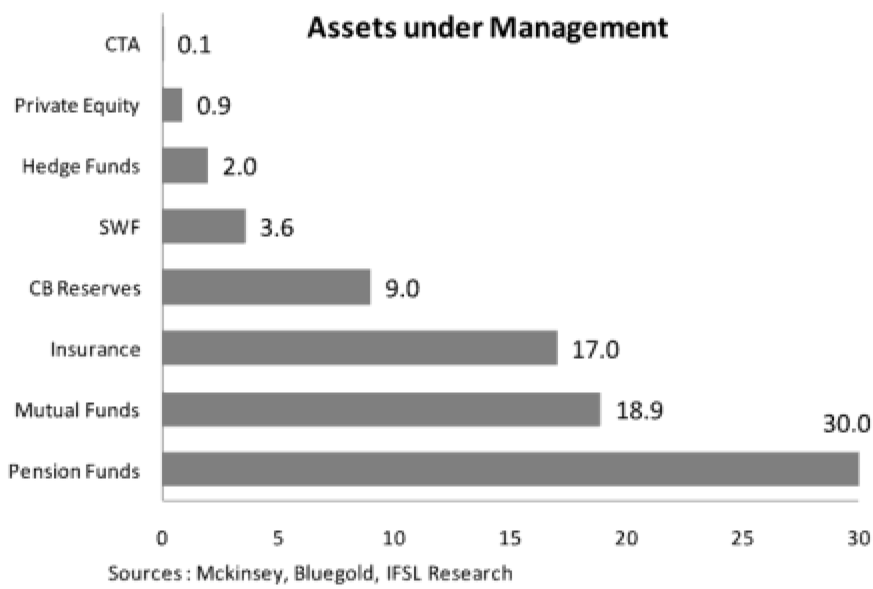
1/ Gov't Debt also includes local central bank's holdings of its own debt and other forms of non-bond debt.

2/ These are our guestimates of the portfolio allocation of reserves in the European sovereign bond markets.

3/ Total central bank reserves held in Euros, by the top 8 reserves holders, and by all central banks;
In billions of dollars.

An expanding universe of EUR sellers. Back in February, I wrote a note[1] arguing that the fixation on the IMM/CFTC short positions in EURUSD was misplaced, and that there would likely be different and bigger waves of new sellers of euros that would push EURUSD lower. Short-squeezes, despite the large reported EUR-shorts, will be more modest and more temporary than many may think, because of the expanding universe of potential EUR sellers:

> *There has been a curious amount of attention paid to the IMM/CFTC position in EURUSD, which shows a 'record short' of around USD 9 billion. Both foreign exchange professionals and those outside the trade seem to be convinced that investors are very short the EUR. We believe this fixation on such a narrow measure of market position is mis-leading. First, the IMM/CFTC data captures trades by CTAs, which have only USD70 billion under management, equivalent to around 0.09% of the global managed asset universe. Second, the absolute size of the EUR short is equivalent to around 1.3% of the daily turnover in EURUSD. Third, the big issue here is whether real money accounts (pension funds and life insurance companies) and central banks may de-rate their opinions of the EUR, just as they de-rated their views on the dollar in 2002-08. In my opinion, an 'expanding universe' of EUR-sellers will likely keep these 'short-squeezes' small in size, and help power a protracted downward trend in EURUSD.*



Sources : Mckinsey, Bluegold, IFSL Research

The big sellers of EURs so far have been the CTAs and hedge funds, which, as the chart above shows, together control 'only' US$2.1 trillion in AUM. Central

[1] 'An Expanding Universe of EUR Sellers,' (February 24, 2010).

bank reserve managers – who have US$9.0 trillion in AUM - have not yet, as far as I can tell, materially altered their reserve management strategy, but may be on the verge of doing so. However, the large valuation losses sustained by central banks, as discussed above, will likely compel some central banks to at least curtail their diversification program and possibly even liquidate some of their exposures to the PIIGS bonds.

Similarly, the real money accounts (insurance companies, mutual funds, and pension funds) which have an aggregate US$66 trillion in AUM may also be on the verge of de-rating the euro. My own guess is that, while the US real money accounts have already started de-rating the EUR, the European counterparts have by and large not commenced this process, as most of their overseas investments are still fully hedged back into the EUR. As it becomes clear to these portfolio managers that the structural problems in the EMU will not be resolved in the short-term, it is likely that these hedge ratios be reduced.

In sum, there is potentially much larger EUR selling in the weeks ahead than what has already taken place so far.

Bottom line. In this sell-off in EURUSD, central banks have sustained large valuation losses. In fact, the cumulative benefits of diversifying from the dollar to the euro in the past decade have dwindled significantly, and would completely evaporate if EURUSD trades down to 1.2150. In my view, it is likely that some central banks may be contemplating reducing their exposure to the EUR and European bonds. Real money accounts (e.g., pension funds, insurance companies) are likely to be going through the same EUR de-rating process.

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