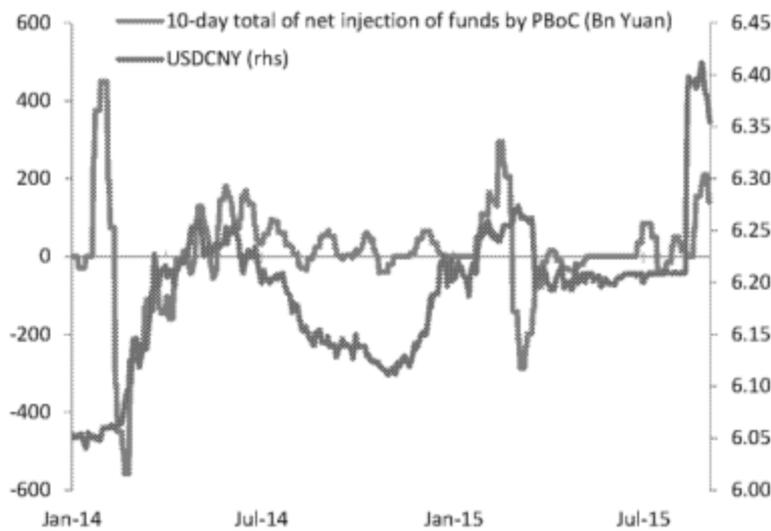




needs to be offset and recently in the case of China the PBOC has acted to reinstate domestic liquidity and also has cut reserve requirements. However as we demonstrated above this component of liquidity seems to have a lagged impact on say (equity) financial assets relative to either the Fed or FX reserves themselves. This is actually quite intuitive. The liquidation of FX reserve holdings reflects forced redemptions of domestic currency holdings. Simply forcing currency back into the system to satisfy those redemptions shouldn't be associated with restoring asset prices to where they were before. Ultimately in a fiat money system asset prices reflect "outside" i.e. central bank money and the extent to which it multiplied through the banking system. The loss of reserves represents not just a direct loss of outside money but also a reduction in the multiplier. There should be no expectation that the multiplier is quickly restored through offsetting central bank operations.

PBOC injection of funds vs. CNY



Source: Bloomberg Finance LP and Deutsche Bank

We now move on to interest rates. If equities have a negative correlation with liquidity, it is not surprising to find that interest rates have a positive correlation at least since the crisis. Again in line with the above analysis regarding equities, the correlation in contemporaneous time is better if we focus on Fed and FX reserves. However even then we notice the correlation is a little loose at times. This raises an obvious issue in terms of how one thinks about nominal yields in terms of additional central bank liquidity and FX reserve accumulation. On the one hand the more Fed may help lower real yields but raise inflation expectations; more FX reserve accumulation may be just lower nominal yields and if anything real yields to the extent that by accommodating Fed monetary policy expansion the US "exports" inflation risk. Running across everything is the problem that equities are generally stronger (weaker) of liquidity is expanding (falling).