



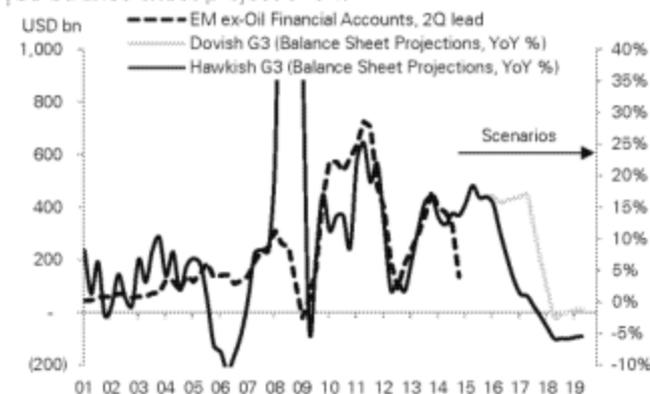
The long-term prospect of a more flexible RMB also raises the question of what the PBoC would do with the reserves left over from the current drain. Reserves could be used increasingly as sovereign wealth rather than for currency managements. The FX impact of such a shift in investment objective would likely be bearish EUR/USD. The reason is that the transition from liquidity management to the risk/reward optimization would likely lead to a rebalancing towards equities which, if market caps were replicated, would imply a greater portfolio weight on USD.

The other implication is that greater volatility in the RMB would reinforce the need for Asian central banks in particular to hold RMBs to smooth out exchange rate volatility vis-à-vis China. Taiwan is just one example of a regional central bank with deep pockets. So far, buffer stocks were best invested in USD assets without much loss in firepower. As China's dollar peg weakens, USD investments pose an increasing misallocation risk. As we have argued before, an Asian reallocation toward the RMB would threaten the dollar more than the euro, which accounts for negligible shares in Asian reserves. US Treasury yields would rise relative to other G5 yields, which could raise private sector inflows to the US helping support the USD.

Current draw-down shouldn't mask excessive EM reserves

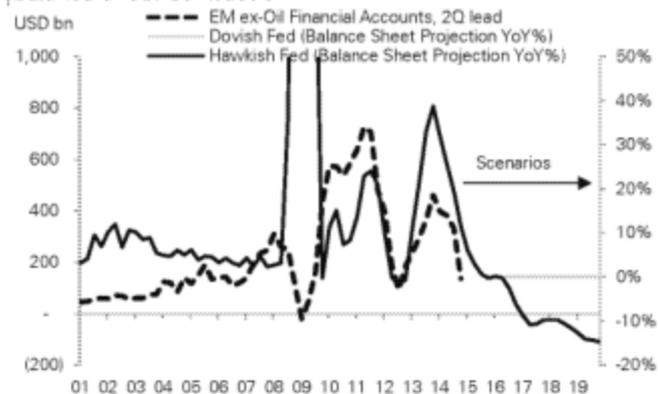
As noted above, a traditional reason to build a war chest of reserves is the prospect of excessive capital flight leading to a currency crisis. The expediency of holding reserves as a developing country could not be clearer than at present. The force of the underlying pressure has so far been understated by official reserve draw-down, as central banks' forward books have served as the first line of defense. Yet these should soon be depleted, and continuing outflows would become an even bigger drain in the coming weeks.

Figure 15: EM financial flows are undershooting relative to G3 balance sheet projections ..



Source: Deutsche Bank

Figure 16: ...and are likely responding more to potential Fed balance sheet contraction



Source: Deutsche Bank

Given the reliance of EM reserves on QE-enabled financial flows since the 2008 crisis, the speed of reversal should be a key driver of reserves trends going forward. EM capital flows have indeed had a strong relationship with G3 central bank balance sheet growth with a two-quarter lead (Figure 15), given that market pricing anticipates shifts in QE. Projecting G3 balance sheet trends thus offers some clues. In our most hawkish scenario, the Fed stops reinvestment by mid-2016 and the ECB and BoJ stop QE by September and December 2016, respectively. A more dovish scenario might see the Fed reinvesting ad infinitum and the ECB and BoJ extending QE purchases until end-2017.

Worryingly, EM capital flows are already significantly undershooting the projection from the hawkish scenario. A constructive take on this would be that EM outflows have overreacted and could give way to inflows again as global liquidity conditions