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REMEMBERING THE FUTURE

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From *Ius Gentium* to *Weiji*: The Charybdis of Currency Crisis

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Introduction

Without a doubt, the title of this month's newsletter might be confusing. So, let's clarify the terms: *Ius Gentium*, *a.k.a.* the law of nations, exemplifies the universality of the Roman laws that applied to citizens and non-citizens alike, due to the emergence of international transactions. *Ius Gentium* embraced the most flexible and commercially significant parts of Roman law, had its basis on natural reason, and corresponded to modern public international law.

Fast forward now 2000 years, and let's view the role that China plays in today's global economy. Our century is about the rise of developing countries to the status of being co-players in growth opportunities and crises. The Chinese have a word for those situations, where crises become opportunities and vice versa. They call them *weiji*.

Finally, let's review Odysseus on his way back to Ithaca. Now, his Trojan horse and the corresponding triumph is a distant memory. In his Odyssey he faced Charybdis, the modern equivalent of a black hole, where everything goes in but nothing comes out. Charybdis was a maelstrom in the straits of Messina, and no ship that was caught in it could escape.

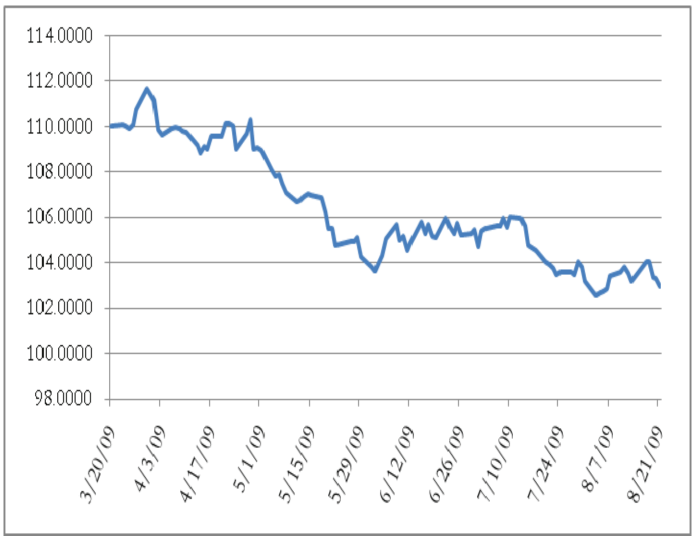
How can we connect the dots? The current crisis has universal repercussions, and has at its roots global imbalances built over a number of years, where surplus and savings-abundant nations such as China, financed the deficit-spending countries by buying their paper assets. Unfortunately, the paper-asset prices were not based on intrinsic historical values, but rather on sophisticated algorithms. One could call that "cash for trash." There are universal "laws" that govern such transactions. One of them is known as bailouts. Another one is known as credit guarantees. Both of these "laws" were applied to institutions like Fannie Mae, Citibank, and AIG. Could you imagine the Chinese waiving the papers sold to them and asking for the collateral that backed their values? What was and is behind those paper-assets is another paper-contract "asset" that is equally illiquid and overvalued as the original one!

Looking at the financial scenery over the last few months, one could have thought that those paper-assets have now become valuable again. Thus, AIG's stock skyrocketed last month by 265% [1]. What has happened to the $300 billion dollars of credit guarantees that our government extended to Citibank last fall? Weren't those for the illiquid paper assets on Citi's balance sheet? Is Citi now out of the woods and no longer needs those guarantees? How in the world has that information been lost? Could the black hole/Charybdis make information disappear? Obviously, information cannot be lost, unless it passes on to a parallel universe!

Twin Crises and the Universe of Currencies

When we look over the global experiences since the breakdown of the Bretton Woods system (August 15, 1971, when the US suspended the USD convertibility into gold), we would conclude that crises come in twins. Thus, the stagflationary period of the 1970s had a twin oil crisis in the mid and late 1970s. The commodities market crash in the 1980s had its twin in the debt crisis in early to mid 1980s, while the stock market crash of 1987 had its twin in the S&L crisis of the late 1980s/early 1990s. Similarly, the Mexican currency crisis of 1995 has its twin in the Asian financial/currency crisis in 1997-98 (while the latter theoretically as well as empirically could be linked to the Chinese devaluation of 1994 that forced counties like Thailand to devalue in order to stay competitive, which in turn brought in the tsunami of beggar-thy-neighbor competitive devaluations in S.E. Asia.) The tech bubble had its twin in the housing bubble, which makes us think that the crisis that started in August 2007 awaits the birth of its twin. The current credit crisis seems to be easing in the last few months, but in the midst of these better times, we believe that another crisis is brewing that will affect currencies, and especially the USD (without the USD losing its reserve-status position). A good measure of the USD value is its trade-weighted strength against currencies of major trading partners of the U.S. Thus, while the equities and other markets celebrated significant gains in the last five months, the relative position of the USD has been weakening constantly since March, as the following graph shows.

Figure 1: The Trade-Weighted Value of the Dollar



Source: US Federal Reserve Bank of St. Louis, MO

We are moving into a world of multiple reserve currencies. Such a move will be gradual and will coincide of course with the rise in importance of other currencies that could serve a reserve currency role. The Euro has been positioning for such a role, and thus central banks keep a rising portion of their foreign reserves in Euros. The Chinese renminbi also will start playing such a role (serving initially as a regional reserve currency) given the rising status and significance that China plays in the global economy. However, for such a multi-reserve currency scenario to arise, those currencies cannot have an anchor-type of relationship, like the renminbi currently has with the USD. Therefore, the first step is to break that relationship, especially if the projected US-deficits prevail over the next 7-10 years. If this is the case, the Chinese cannot afford to stimulate their economy with fiscal measures that finance loans for the stock market (hence the significant increase of approximately 70% in the Chinese stock markets since March)[2].

The current crisis is a *weiji* crisis for China, *i.e.*, an opportunity to change its growth model. The latter – as in most of Asian economies – is characterized by growth based on exports. However, for the latter to be sustainable an undervalued exchange rate is necessary. Thus, the Chinese for years have anchored the renminbi to the USD at an exchange rate below renminbi's potential, based on China's external current account surpluses. Those surpluses are being invested into USD-denominated financial instruments, and thus the fear that if China starts significantly restructuring in its reserve currency holdings (*e.g.*, moving away from USD and into Euros) it will have negative repercussions not only for the US (bond prices would fall significantly, interest rates would rise, the dollar would suffer, to name just a few), but also for China, since their USD portfolio would negatively be impacted.

Let's consider a twin scenario: First, a shift in China's growth model from external to internal, where consumption rather than exports would be the driving force. A revaluation/appreciation of the renminbi against the USD would hurt their exports but would give a boost to local spending, since the renminbi's spending power would increase. At the same time the threat of Congressional action against Chinese exports would diminish, while the imbalances (part of the cause of the current crisis) would shift into an automatic corrective mechanism with US exports rising while US imports drop. The US employment levels would increase, while the spending power of the rising Chinese middle class would enable higher living standards and thus employment via the consumption mechanism. Let's also remember that the current crisis has caused a significant increase in the number of Chinese who lost their jobs. If we also take into account the scenario that the US and the EU economies will only slowly recover, such that the prospects of rising exports are not that encouraging for China, then the choice for the Chinese planners might be more than obvious in terms of shifting growth strategies and models. The second aspect of this scenario is as follows: If the Chinese could balance out the losses of their USD-holdings by a corresponding appreciation in the rest of their reserve holdings (such as gold), then the damage might be minimal, especially if the Charybdis of the USD depreciation is not protracted and the Chinese keep buying USD-denominated paper. It is a fact that the Chinese are buying significant amounts of gold to enhance their reserves (as reported by Bloomberg in late April), thus minimizing the impact of a drop in their paper assets.

The appreciation of the renminbi would put it into the sphere of influence in the international scenery of currencies, would increase its prospects to become the dominant Asian currency, and would cause it to be seriously considered to be an alternative reserve currency in the new model where few currencies share the status of reserve currency, while it would usher the era of global growth that is not based upon western-type asset bubbles/instabilities that are financed by foreigners who are hungry for a single reserve currency. The multiple currency reserve scenario has been tried before and worked. It worked prior to World War I with the British pound dominant but sharing the status with the French franc and the German mark. In the 1920s the pound shared the spotlight with the rising USD. The 1930s currency crisis in Britain (which originated in a banking crisis) diminished the pound's prospects and ushered in the era of the USD. If the US is able to manage the banking crisis, then it should be able to lead rather than follow in the new era of multiple reserve currencies. The adage, keep your friends close and your "enemies" closer applies.

We believe that the twin of the credit crisis will manifest itself as a currency crisis, emanating from the appetite of foreign central banks to reduce their dollar-exposed risk in the face of rising US deficits. This will uplift the prospects of de-linking (see previous issues) between developed and emerging economies. If the process can be contained successfully – the prototype might be the containment of the credit crisis – then, the shocks to trade and financial flows would be minimal, while asset bubbles would be avoided, and global imbalances would be on their way to a corrective path. In the midst of the credit crisis, countries found refuge/safe haven in US bonds. The swap arrangements made between the Fed and other central banks, as well as the reserves (borrowed via the discount window as well as the non-borrowed) circulating in the US banking system, are looking for an exit.
The following figures demonstrate some of the points made earlier.

Figure 2

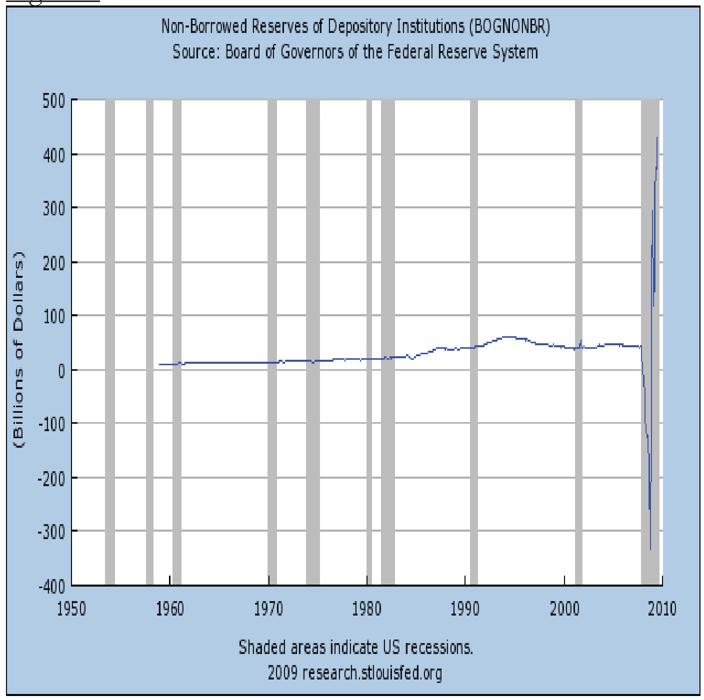
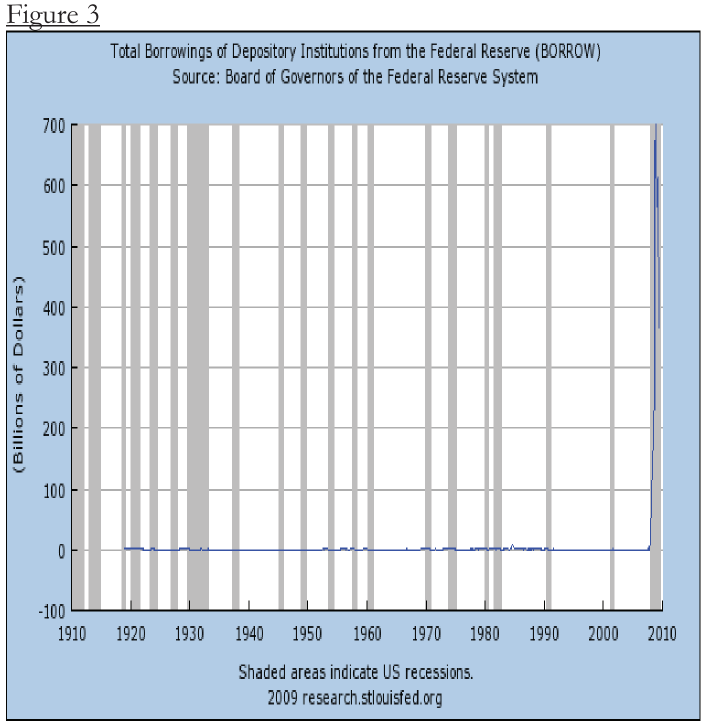


Figure 3



The figures above are revealing in terms of the unprecedented crisis in which we find ourselves. The borrowed reserves (figure 3) skyrocketed due to the Fed's measures to secure liquidity in the markets in the midst of a confidence crisis.

Not even in the 1930s did we see something similar to the above. Now, the question is what do the foreigners do in the midst of the ocean called massive flooding when the sky has been raining dollars?

Figure 4

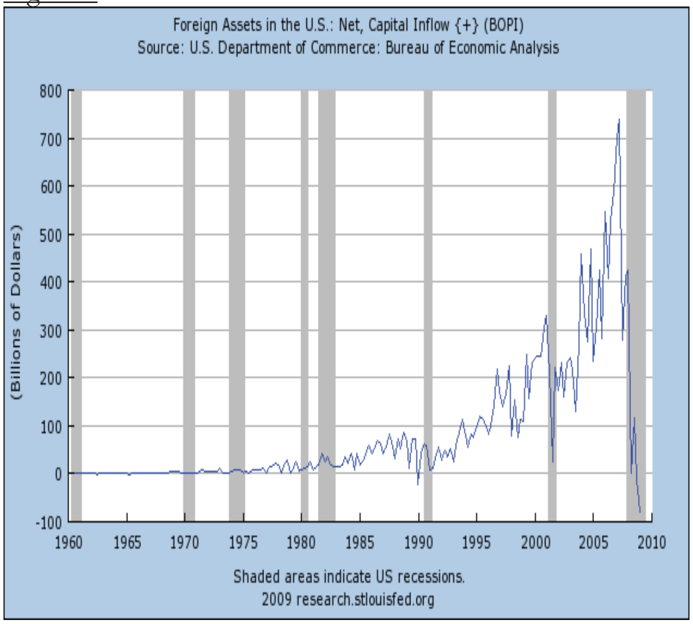


Figure 4, above, shows that they are taking their assets away from the US. Such disinvestment should be understood in terms of changing their holdings away from US-denominated assets and subsequently from the USD. Maybe now, it would be easier to understand Figure 1 where the trade-weighted position of the USD has been constantly deteriorating since March of this year. The more alarming thing is the fact that our net capital position has turned negative, something that the US has never experienced before. Therefore, we are sleepwalking on thin ice while the purchases of US paper backed by the government (such as Fannie Mae) has been declining constantly too, as the following figure reveals.

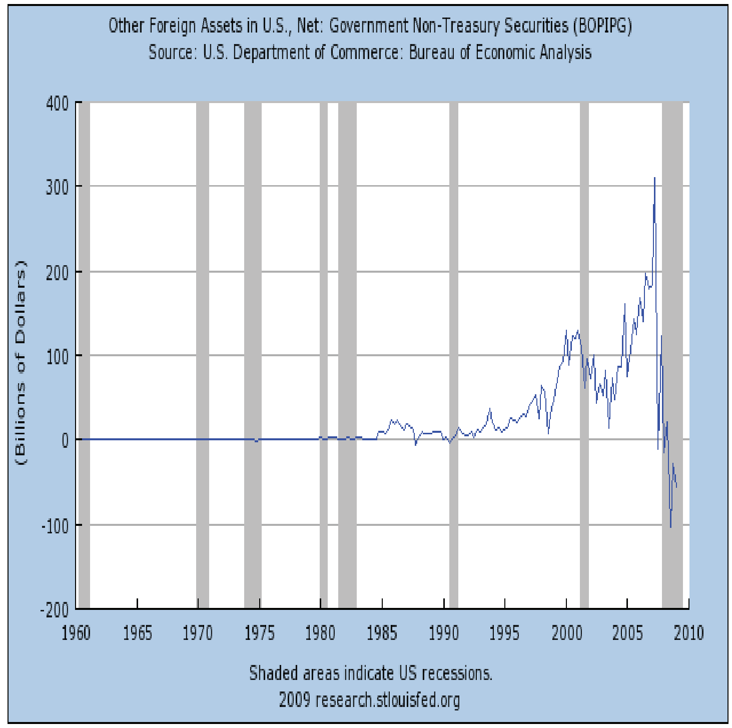
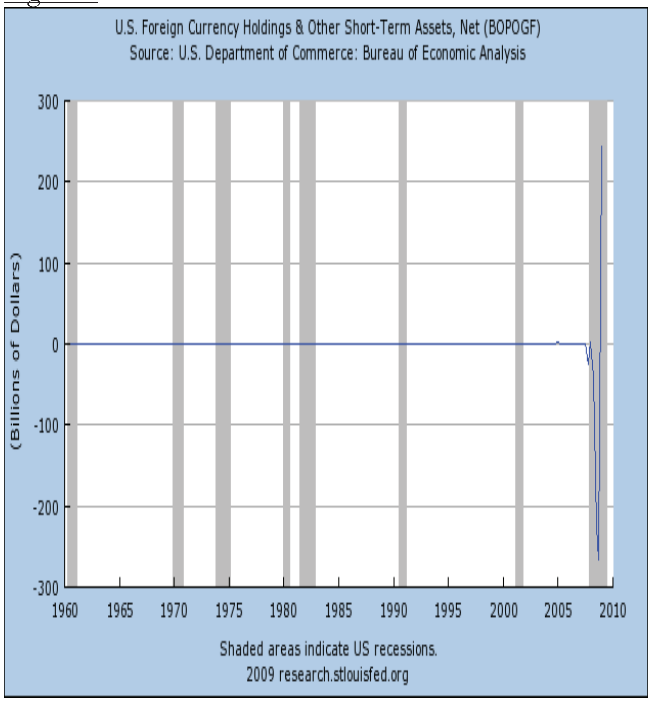


Figure 5

What then, should we expect? Maybe the actions by our own authorities, as shown in Figure 6, should give us a hint. The US holdings of foreign currencies have been increasing. If that were part of Swap agreements with other central banks, we should have seen a cessation and actually a drop in such acquisitions.

The radical shift shown below may be perceived as the seeds for the *weiji*, where a contained dollar depreciation deflates US internal and external imbalances, and becomes the springboard for a multi-polar reserve currency system, where debt instruments will also be traded in multi-currencies. The mixture of exchange rate anchors in association with an elevated metal-based reserve position will advance global liquidity, improve the chances of middle classes everywhere, and will improve transparency and reduce political channeling of funds into favored industries and firms. The latter misallocates capital, while its reduction due to a multi-polar market for debt instruments will usher investments and higher productivity. The multi-polar currency system will remove the asymmetries that have contributed to global imbalances due to accumulations of paper-assets denominated in USD, while it will improve the convertibility among currencies.

Figure 6



The Fed will facilitate such convertibility if it starts accumulating foreign currencies in its reserves holdings, as shown in Figure 6. Of course, the desired convertibility cannot be achieved until China allows its capital account to be fully convertible, something that could start with a contained USD depreciation. Moreover, the fact that HSBC and the Bank of East Asia started selling renminbi-denominated bonds last May, exemplifies the point that we are on our way to a new era in currency valuations. It seems that the lights in the city of London have been dimmed down (the recent talk of a Tobin tax there might not be a coincidence) and the lights in China are turning on in terms of financial center significance.

Conclusion

Odysseus is headed home to Ithaca. There he will throw out the suitors who are after his wife and his estate. However, before he arrives home he has to face the Charybdis of currency crisis. If he succeeds in his efforts to contain the Charybdis, then a better day will arise for him and his people. The road to Ithaca might be long, but Charybdis might just be around the corner. The sooner he faces her and her twin sister Scylla, the sooner he will get home.

Would you ride along with Odysseus?

[1] WSJ historical quotes 8/2009

[2] WSJ Market Data Center 3/2009-8/2009