The New "International Currency System"

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Chinese President Hu Jintao remarks that "the current international currency system is the product of the past." We agree. In fact, market participants including central banks are already building the new international currency system.

Unfortunately, the health of this new system is fraught with the same serious threats as the old system.

- **The Chinese yuan is the most undervalued currency in the world. China's heavy management of the currency creates distortions and obstructs development of a new strong and stable international currency system.**
- **China is reaching limits in its ability to control inflation – due in part to inflows of hot money and trade surpluses.**
- **Fiscal and monetary policies in the US undermine confidence in the dollar.**

Valuations, Distortions, and Currency Reserves

The Chinese yuan is the most undervalued currency in the world – based on Center for Financial Stability calculations of exchange rates across a universe of 34 nations.

Severe undervaluation of a small Emerging economy's exchange rate is hardly noticed. In contrast, meaningful undervaluation in the currency of a major trading nation and industrial power such as China creates substantial distortions. Distortions from an extremely cheap or undervalued yuan result in large subsidies for Chinese exporters as well as foreign companies investing in China. Simultaneously, severe yuan undervaluation acts as a tax on China's imports of foreign products and its companies seeking to invest abroad.

Valuation of the yuan is admittedly a difficult task. Our models result in an unusually wide range of undervaluation – centering around 35%. Although unscientific, *The Economist* magazine corroborates these findings based on comparing the price of a Big Mac across the globe, suggesting the yuan is 40% undervalued.[1]

Despite debate surrounding valuation techniques and results, the consistent and unyielding swell in China's foreign exchange reserves provides concrete evidence of yuan undervaluation. In other words, if a central bank sells its own currency to keep the value of its currency down, it must buy other currencies and accumulate foreign exchange reserves in the process. Over the last ten years, China has accumulated a

[1] "An indigestible problem: Why China needs more expensive burgers" – *The Economist*, October 14, 2010.

whopping $2.7 trillion in foreign exchange reserves through 2010 or roughly 44 times the entire stock of US foreign exchange reserves.

There is no episode in recent economic history stretching back to the late 1950s remotely close to this experience. Japan is a distant second with a reserve build over a decade of less than one-third the recent increase in China. Likewise, Japan's largest 10 year reserve increase ended in 2008. In contrast, China's continues with the period through year-end.

The build in China's reserves is gigantic even when scaled to GDP. The only nation demonstrating a larger sustained increase in reserves relative to GDP back to the late 1950s is Singapore during the 10-year period ending in 1971. Some parallels exist, as Singapore experienced rapid progress and opening during that period.[2] However, Singapore was still extremely small relative to the rest of the world between 1962 and 1971.

Surprisingly, advanced economies demonstrated relatively small reserve builds during the same period dating back to the late 1950s. This is revealing, as the period covers the breakdown of the old international currency system or Bretton Woods. The disintegration of Bretton Woods is similar to the experience today. Surplus countries (Europe) built their reserves via heavy purchases of gold from the deficit nation (the US). The process began in the late 1950s and continued through the close of the US gold window on August 15, 1971 and the Smithsonian Agreement on December 18, 1971.[3]

At present, China gains from preservation of an undervalued exchange rate by the concurrent swell in reserves. In other words, foreign exchange reserves of nearly $3 trillion at the end of December 2010 provide the authorities with the flexibility to purchase a wide range of commercial and financial assets abroad deepening the nation's geostrategic footprint.

The Inflation Threat and PBOC Intervention

The rapid advance of international reserves places inflationary pressure on the local economy. However, the People's Bank of China (PBOC) intervenes heavily in domestic markets to offset price pressures and to restrain yuan appreciation.

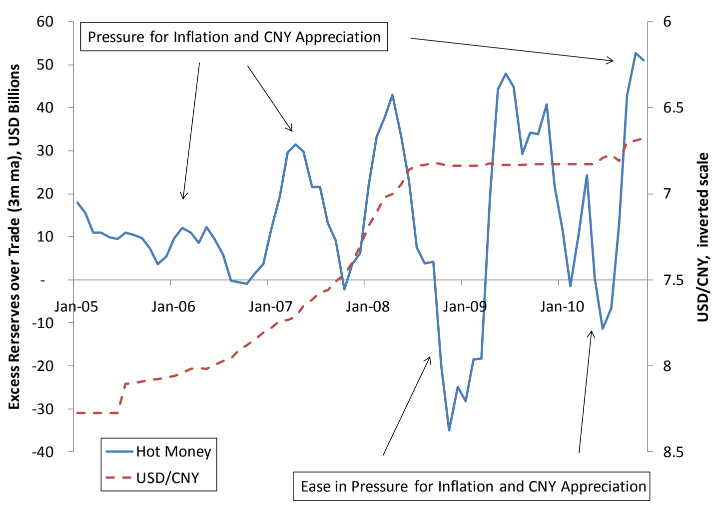
PBOC actively issues zero coupon bonds in local markets and reduces its holdings of domestic assets to dampen inflationary forces or "sterilize" reserve inflows. **The Center for Financial Stability estimates that between 2003 and 2010 the PBOC sterilized over 90% of the foreign exchange inflows via local monetary operations.**

[2] Lee, Kwan Yew, The Singapore Story: From Third World to First, 1965-2000, Times Media Private Limited; 1st. edition (2000).
[3] Odell, John S. US International Monetary Policy: Markets, Power, and Ideas as Sources of Change, Princeton University Press (1982).

We believe that inflation pressures are on the ascent in China and the present policy to sterilize inflows is reaching limits. Although the Fed certainly deserves part of the blame for higher international commodity prices[4] - as President Hu suggests, inflationary pressures stemming from US monetary policy is a relatively late phenomenon. The Fed introduced Quantitative Easing (QE) or the plan to repurchase US Treasury obligations on March 18, 2009.[5] In contrast, China's excessive reserve builds began over a decade ago. Likewise, higher commodity prices are also due to the remarkable success of China and other Emerging economies boosting growth and demand for foodstuffs and raw materials.

Unfortunately, the delay in permitting the exchange rate to adjust creates a challenge for PBOC in managing hot money inflows. Hot money inflows (defined as excess reserves over trade) are largely speculative and designed to benefit from an expected appreciation of the yuan. Postponed currency adjustment simply boosts inflation and appreciation pressures, exacerbating the already strong inflows of hot money in addition to dollars flowing into the country from persistent trade surpluses.

Figure 1. Hot Money Drives Inflation and Pressure on CNY



Source: PBOC and Center for Financial Stability Inc.

The New International Monetary System

The "current international currency system" as described by President Hu is already changing. The US dollar is losing its luster and other currencies are gaining favor. The decline in prominence of the US dollar is a function of lax US fiscal and monetary policy, advent of the euro, as well as the vast opportunities in Emerging Markets.

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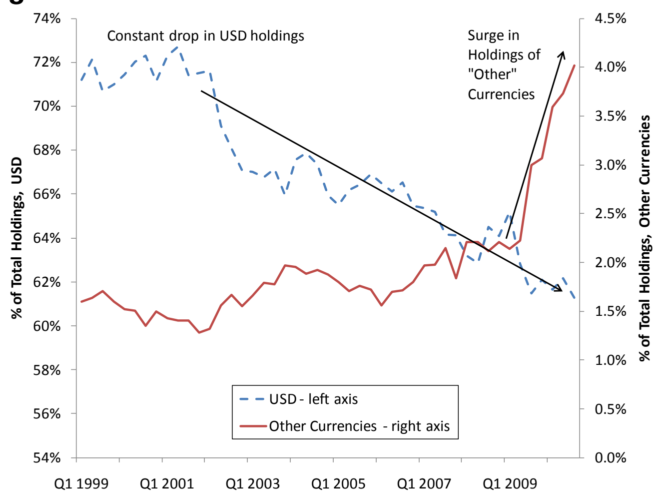
[4] Goodman, Lawrence, "A Strategic Approach to QE: A Bad Trade" – Center for Financial Stability, December 9, 2010.

[5] See "Financial Timeline" at http://www.centerforfinancialstability.org/timeline.php.

The trajectory of central bank currency reserve holdings is highly supportive of the notion that the transition to a new international currency system is already well advanced. For example, the US dollar accounted for 71.2% of central bank international reserve holdings in the first quarter of 1999. As of the latest available data from the IMF, the US dollar accounts for a less substantial 61.3% of central bank reserves (Q3 2010). An undisclosed grouping of "other" countries demonstrates an equally remarkable trend with a jump from 1.6% of all holdings to 4.0%. Most of this gain in "other currencies" corresponds with recent years as well as a pronounced deterioration in the US fiscal accounts and ease in monetary policy.

Figure 2. Remarkable Shift in Central Bank Currency Holdings



Source: International Monetary Fund (COFER) and Center for Financial Stability Inc.

What does this mean?

- **Market participants including central banks are already building the new international currency system.**

- **The new system is under severe strain, as evidenced by China's declining ability to manage domestic inflation and unending borrowing by the US government.**

- **If these macro policies remain seriously distorted, the new international currency system will be destined to fail. Market participants from speculators to central banks will identify weaknesses, seek to avoid losses, and shock the system.**

Conclusion

President Hu's remarks are well timed and on target. However, are governments prepared to strengthen this new system?

- **Will China reduce its intervention in local currency and domestic money markets?**
- **Will China accelerate the pace of promoting yuan denominated capital markets in Hong Kong or the "Dim Sum" market to deepen investment opportunities and diffuse local inflationary pressures?**
- **Will the US create and execute a long-term fiscal plan?**
- **Will the US gracefully exit from QE as soon as possible?**

If officials act swiftly and thoughtfully, the new international currency system will be strong and pass the market test.

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