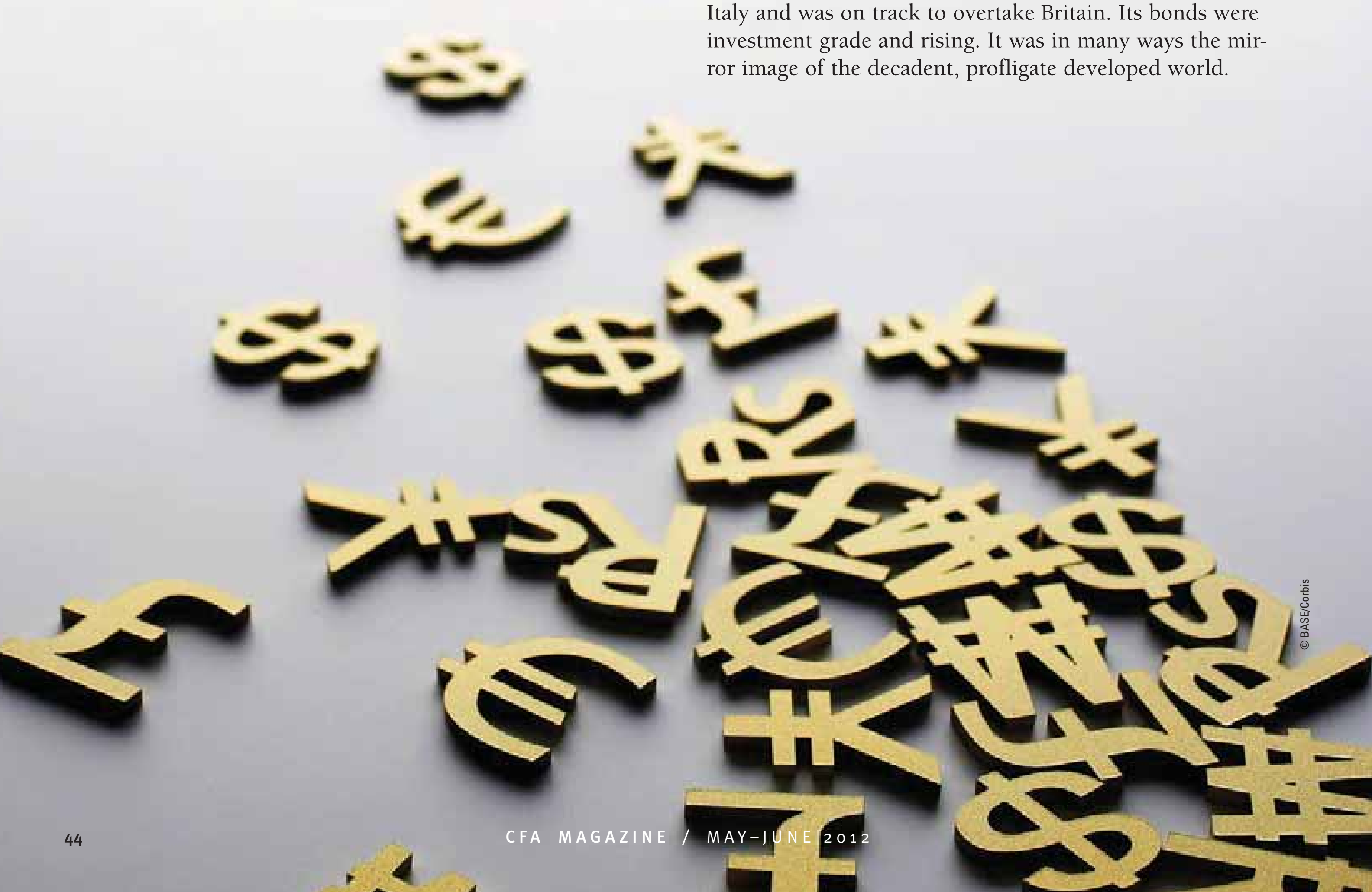
CURRENCY WAR III

Does the world risk "a chaotic, catastrophic collapse of investor confidence"?

BY JOHN RUBINO

"The primacy of politics over markets must be enforced"
—German Chancellor Angela Merkel

For most of the past decade Brazil was the developing country that got it right. By promoting steady, balanced growth and controlling government spending, it generated budget surpluses (remember those?) and paid down debt. Its GDP surpassed that of Italy and was on track to overtake Britain. Its bonds were investment grade and rising. It was in many ways the mirror image of the decadent, profligate developed world.



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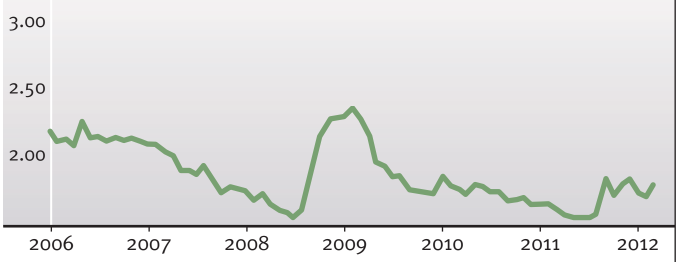
Then the hot money started pouring in, spiking asset prices and forcing Brazil to choose between accelerating inflation and double-digit interest rates. It chose the latter, which led to a soaring currency, which threatened to price its exports out of world markets. Suddenly, the emerging giant began to look quite vulnerable.

Brazilian Real/U.S. Dollar Exchange Rate

(January 2006 – 21 March 2012)



Source: Based on *Financial Times* data.

But this sudden reversal of fortune was not Brazil's fault, declared finance minister Guido Mantega in 2010. His country was the victim of a "currency war" orchestrated by the U.S., China, and Europe as those global powers try to inflate away their debts and/or gain a trade advantage. They were, he said, exporting their problems to the rest of the world via carry trades and commodity speculation.

Mantega was onto something. Since his mention of it, the currency-war meme has entered mainstream economic discourse, being repeated by several other national leaders and spawning a best-selling book of the same name by James Rickards, senior managing director at New York hedge fund Tangent Capital Partners. The belief is now widespread that a currency war has indeed begun.

So what exactly is a currency war? In very general terms, it's a financial competition/conflict that starts when a country accumulates an unwieldy amount of debt and decides that faster growth, a cheaper currency, and rising exports are needed to pay the resulting bills. "The debt can be repaid only with help from inflation and devaluation. When growth falters, taking growth from other countries through currency devaluation is irresistible," says Rickards.

Public policy then shifts towards some combination of higher deficits, lower interest rates, various kinds of trade barriers, and explicit currency devaluation. If it works, the domestic money supply increases, the currency exchange rate falls, exports become cheaper relative to imports, and the country sells more abroad while buying less, generating a trade surplus or reducing the trade deficit. Citizens feel richer and are more open to retaining their current leaders.

But one nation's advantage is another's problem. Victims of the above policies quickly retaliate with their own inflation and protectionism, which prompts a response from other players (including the first mover) and so on. The result is a period of uncertainty at best and monetary chaos at worst.

There have been two previous currency wars—during the Great Depression and the inflationary spiral of the 1970s, according to Rickards. Both conflicts began with too much debt and ended when currencies were cheapened enough to make the debt manageable. While the wars raged, they contributed to some of the worst financial episodes of the past century.

And now it begins again, says Scott Mather, head of global portfolio management for California bond fund manager PIMCO. "Look around the world—is there any country that wants a strong currency? The U.S. is the only country that even says it does, but everything the Fed and Treasury do behind the scenes indicates otherwise."

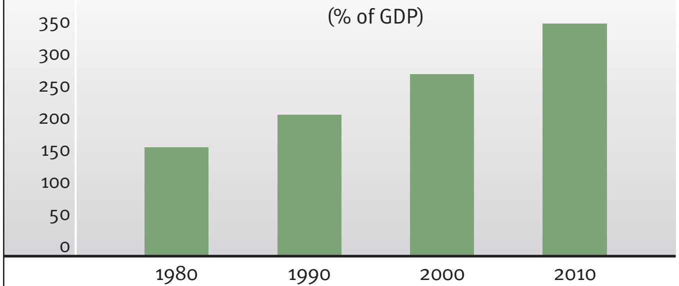
The Combatants

One of the hallmarks of past currency wars is the general lack of enmity between the combatants. Where shooting wars tend to involve serious grudges and existential threats, currency-war opponents are often trading partners given to friendly cooperation in other spheres. Yet when it comes to trade and investment, they're more than happy to steal food from each others' plates and tax revenue from each others' coffers. Here's a quick look at the current war's main antagonists:

United States. Washington has responded in essentially the same way (i.e., with monetary stimulus) to a series of crises dating back to the 1998 collapse of Long-Term Capital Management and continuing through the 2008–2009 real estate bust/Wall Street collapse. The current policy mix now features trillion-dollar deficits, aggressive debt monetization via a series of quantitative easing programs, artificially low interest rates across the yield curve, and pressure on China to revalue its currency (functionally the same as devaluing the dollar versus the yuan).

U.S. Total Debt

(% of GDP)

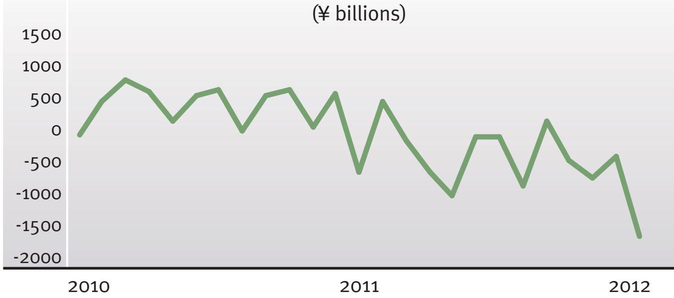


Source: Based on U.S. Federal Reserve data.

Eurozone. The 2002 adoption of the euro failed to harmonize member-state fiscal policies, leading to soaring debt in Portugal, Ireland, Italy, Greece, and Spain (the PIIGS countries as they've come to be known). The European banking system is now so riddled with cross-border obligations that a default by even one small country like Greece might trigger a continent-wide collapse. The only alternative is for Germany and the handful of other relatively sound European countries to bail out the rest, with financing from the European Central Bank. Via its long-term refinancing operation (LTRO), the ECB by early 2012 had accepted about €1 trillion in collateral (mostly sovereign bonds) in return for three-year 1-percent loans to eurozone banks, in effect monetizing a big slice of eurozone debt.

Japan's Balance of Trade

(¥ billions)



Source: Based on data from the Japan External Trade Organization.

Swiss Franc/U.S. Dollar Exchange Rate

(weekly closing, 27 December 2011–3 January 2012)

Source: Based on Rydex CurrencyShares data.

Japan. When its epic 1990s real estate/stock market bubble burst, Japan responded by pumping liquidity into a moribund banking sector via extremely low interest rates and high government deficits (sound familiar?). The result was stagnation (as banks, even with government help, remained saddled with bad loans and reluctant to lend) and ever-expanding deficits. Japan's government debt now exceeds 200 percent of GDP, by far the highest of any major country.

Meanwhile, Japan's population is aging rapidly, savings rates are falling, the yen recently hit a record high versus the dollar, and the perennial trade surplus has become a deficit for the first time since 1980. In response, Japan has begun aggressively loosening its monetary policy by selling yen to buy foreign bonds.

China. For most of the past 20 years, China has pegged the yuan to the U.S. dollar, a policy that, given China's massive labor cost advantage, has produced a trade surplus with the U.S. of several hundred billion dollars annually. The U.S. has demanded a revaluation of the yuan, and China has complied, somewhat, by raising the yuan's dollar peg incrementally over the past few years. But in February 2012, China's trade balance fell to a US$31 billion deficit as a result of slowing sales to Europe, which makes future yuan appreciation less likely.

"If China is going to raise its exchange rates by 20 to 40 percent then many of our export companies will have to close down," Chinese Premier Wen Jiabao told reporters recently. This won't happen because "China fears civil unrest" if it can't find jobs for its millions of workers, says James Turk, director of the GoldMoney Foundation, a free-market sound-money think tank based in the British Channel Islands.

Great Britain. By adopting the borrow-now, pay-later U.S. model of consumer- and real estate-led growth, Britain finds itself in a similar place. The ratio of debt to GDP is now disturbingly close to that of Greece, and the Bank of England is aggressively monetizing debt via its own quantitative easing program.

The Victims

All wars inflict collateral damage, and currency wars are no exception. This one is affecting—and sometimes devastating—a wide variety of innocent bystanders. A few of the most notable are Switzerland, successful developing countries, and savers generally.

Switzerland. A global banking center and traditional bastion of sound money, Switzerland "does not have a public debt problem and its budget is close to balance," says Klaus Wellershoff, former chief economist for Swiss Bank UBS and now CEO of Zurich economic consultancy Wellershoff & Partners. Not surprisingly, capital in search of a safe haven began pouring into Swiss franc accounts in 2010, boosting the franc to record highs and sending the country's exporters into a tailspin. In response, the Swiss did the previously unthinkable, pegging the franc's value at 1.20 to the euro and vowing to sell unlimited amounts of currency to keep it there. The franc plunged 8 percent on the day of the announcement, which is another way of saying the Swiss devalued the franc by that amount.

"This was a case of self-defense for us," says Wellershoff. "But it is very serious. Via the currency link [with the euro] we are forced to create an environment where inflationary expectations will be much closer to European levels than people in this country would have opted for otherwise."

Successful Developing Countries. Pretend for a minute that you're running a global hedge fund. You're being offered virtually unlimited quantities of dollars, euros, and yen for next to nothing. Meanwhile, there are developing countries, such as Brazil, Colombia, and Russia, with prettier balance sheets and bonds yielding far more than U.S. Treasuries. So you borrow dollars, use them to buy Brazilian bonds, and sit back while your fund reaps a wide, lucrative spread.

This is great for you but terrible for Brazil, where an influx of capital causes rising inflation, interest rates, and consumer indebtedness. After raising short-term interest rates to 12 percent to combat inflation, Brazil saw its GDP growth fall from 7.5 percent in 2010 to 2.7 percent in 2011, and the real's exchange rate still rose 10 percent in the first two months of 2012. Brazilian households, fooled by the deluge of easy money, now spend about a quarter of disposable income servicing their debts.

Despite the fact that inflation is still north of 5 percent, Brazil has begun easing aggressively to lower the real's value, selling dollars in the open market and imposing a 6 percent tax on foreign buyers of the currency. Yet long-term Brazilian bonds still yielded nearly 10 percent in March, making them as attractive as ever for the carry trade.

The developing world is strictly collateral damage, of course. "America has no interest in disadvantaging Brazil," says Wellershoff. "This is just a side story." The damage, however, is very real.

Savers. "Financial repression can be thought of as a tax on savers and capital owners," says Mather. A decade ago a retiree in the U.S. or Europe might have reasonably expected to earn 5–7 percent annually on a safe portfolio of bank deposits and high-grade bonds. But now the income from such a mix is half that or less. Meanwhile, a pension fund that was once able to earn a reasonably predictable 8 percent return for its beneficiaries is now lucky to earn 3 percent on its fixed-income investments.

Artificially low interest rates push those who require higher returns further out on the risk curve. A retiree who needs 7 percent to survive can only get there by loading up on junk bonds, equities, and "alternative" (i.e. illiquid and therefore risky) assets. The result is a lower-quality global balance sheet and increasing systemic fragility, as well as a life of extreme financial anxiety for retirees.

Asset Allocation in a Currency War

In a world where politics trumps sound monetary policy and free markets, models based on the latter might need a bit of adjustment. Three approaches have emerged as strategies of choice.

Acknowledge Asymmetry. Interest rates play a key role in calculating net present value for virtually every financial asset. But "Many interest rates are quite close to the zero bound," says Wellershoff. "Interest rate forecasting is imprecise; nobody can tell us whether they'll fall further. But there is a natural lower limit, slightly below zero, which is determined by the cost of holding cash."

In practice, this means that interest rate-dependent expected returns are now asymmetric, with one side limited to a couple of percentage points and the other theoretically unlimited. "If you have different interest rate sensitivities in the asset classes and your expected return for interest rates becomes asymmetric, the correlation structures for the asset classes will be different than you originally assumed," says Wellershoff. The recommended adjustment? "Diversify while avoiding highly interest rate-sensitive assets."

Focus on Balance Sheets. Debt (i.e., financial claims on future wealth production) has grown faster than the overall economy. "There's a limit to how much debt can be accumulated, and clearly, we are hitting that limit," says Mather. Less borrowing means lower future growth and skimpier returns for many assets. As a result, he adds, "Cyclical models that don't account for the massive buildup in debt might be way off the mark."

In coming years, Mather sees a scramble among those with existing claims on wealth, with governments having the upper hand: "Sovereigns can tax and confiscate from others who think they have a claim on economic activity, which means the bottom of the capital structure will be subject to the most volatility." In other words, equities and junk bonds will be squeezed. "P/E models don't account for all the debt that has a higher claim," says Mather. The solution? "Focus on better balance sheets wherever you're investing in the capital structure."

Swap Paper for Gold. In 1971, the U.S. broke the final link between national currencies and gold, which had been humanity's money for millennia. The decades since have seen continuous inflation and a series of ever-larger financial bubbles, culminating in today's epic debt binge.

In response, capital has been flowing back into gold, with individual investors snapping up gold coins and central banks (heavy sellers of gold from their reserves until recently) becoming net buyers. Russia and China in particular have been adding aggressively to their gold stocks.

Why the renewed interest in this older form of money? "The price of gold is the reciprocal of the world's faith in the deeds and words of the likes of Ben Bernanke," James Grant, publisher of *Grant's Interest Rate Observer* newsletter, told *Bloomberg* in March. As the world's central banks increase the supply of paper currency, capital is losing faith in paper promises and gravitating to the one form of money that can't be created out of thin air.

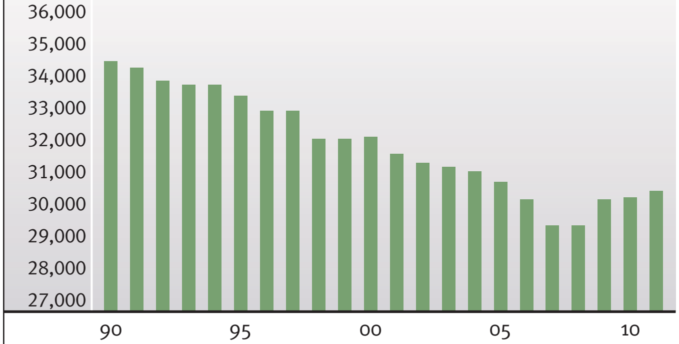
And how does gold fit into the currency-war story? Perhaps as part of the eventual resolution, according to Rickards. "The conflict begins with countries devaluing against each other," he says. "But retaliation comes very quickly, and all you get is inflation and wealth destruction. Then comes the realization that there is something we can all devalue against at once—gold, because gold can't fight back."

The result, in Rickards analysis, will be a re-linking of currencies to gold at a significantly higher gold price, which is the same thing as saying a massive across-the-board devaluation of the world's major currencies. "A world with $5,000 gold is also a world of $300 oil and $100 silver and higher prices for cotton and copper and everything else," he says. "That's the inflation the policy makers want."

Whether gold can or should return to the center of the global monetary system is disputed among economists. But from an asset allocation perspective, the past decade, during which gold rose 400 percent in U.S.-dollar terms, does indicate that the metal offers good protection against monetary debasement, argues Turk. "In a currency war, nobody

Gobal Central Bank Gold Reserves (1990–2011)

(in tons)



Source: Based on World Gold Council data.

wins," he says. "There will be a lot of wealth destruction. The only way to survive is by losing less than the next guy, and the best way to lose less is to own gold. It's been money for the past five thousand years, and the attributes that made it money haven't been lost, only forgotten."

Uncharted Territory

How close is this currency war to resolution? Alas, not close at all. Worldwide, total debt is rising in both nominal and real terms. The U.S. budget deficit will be nearly as large in 2012 than it was in 2011. Most eurozone countries are running deficits of 5 percent or more to GDP. Chinese and Japanese trade deficits are projected to persist in the coming year, and monetary easing is the official policy of every major nation.

Meanwhile, this currency war has at least two unique features that might make its progress and resolution very different from those of the past: alternative currencies and complexity.

Alternatives to the Dollar and Euro. If your opponent has more powerful weapons, you can accept unfavorable odds in a straight-up fight or you can find a different field of battle and/or a different set of weapons.

In currency wars past, such options didn't exist. Gold was the world's money in the first war and the U.S. dollar in the second, so the terms of the conflict were fixed from the start. But in today's world of floating paper currencies with no anchor to gold or anything else—where the dollar, euro, and yen are not the only mediums of exchange or stores of value—switching to other currencies is a viable strategy.

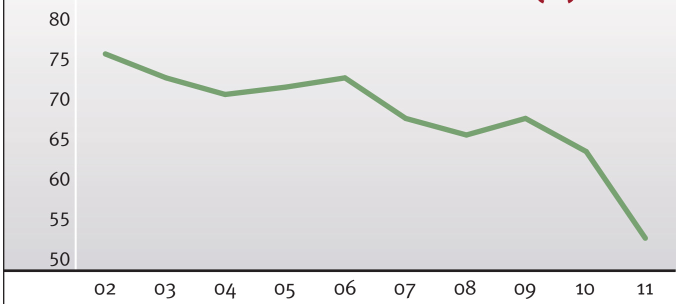
Less than 1 percent of foreign exchange transactions are currently settled in Chinese yuan, a figure which, given China's status as the world's second largest economy, is clearly ripe for an increase. To that end, China recently announced its intention to make the yuan fully convertible and to transact half its foreign trade in its own currency within five years.

Iran recently opened an oil trading bourse that transacts in currencies other than the dollar. India and Iran have agreed to trade oil for rupees, with Iran using the proceeds to pay for imports from India. China, India, Iran, Russia, Japan, and Ecuador were all negotiating (in early 2012) to trade in their own currencies rather than the dollar. China and the Association of Southeast Asian Nations (ASEAN) are discussing the creation of a central bank that would settle in yuan.

Meanwhile, China has been lowering the dollar's role in its foreign exchange reserves by buying relatively fewer Treasury bonds. The portion of China's reserves parked in Treasuries is now 54 percent, down from 65 percent in 2010 and 74 percent in 2006, according to a recent study.

Going forward, such developments mean that the U.S. might get more currency depreciation than it has bargained for. Trillions of dollars worth of dollar-denominated assets are sitting in various central banks, corporate treasuries, and offshore bank accounts. If fewer dollars are needed because more transactions are taking place and more wealth is being stored in yuan, rupees, and real, then a lot of dollars will have to be converted into those other currencies. Which is another way of saying dollars will be dumped on the open market.

Portion of Chinese Foreign Exchange Reserves in Dollar-Denominated Assets (%)



Source: Based on Dow Jones data.

"Dollars are used outside the U.S. for one reason: people's confidence in them. That's why currency collapses usually begin outside of a country, as those who don't need to hold the currency dump it by seeking alternatives," says Turk. The result, he reasons, might be a dramatic fall in the dollar's value, and keeping the fall orderly might be the challenge of the coming decade.

Peak Complexity. Previous currency wars took place in much simpler times, which allowed them to progress in a roughly linear fashion. Today's global financial system is far more complex, and complex systems operate according to less linear (and therefore less predictable) rules. Unlike machines, which are merely complicated, says Rickards, "Complex systems like social networks or weather systems contain parts that communicate with each other and change in response to this communication. Financial markets are complex systems nonpareil."

As complex systems grow, two things happen, according to Rickards. They require exponentially greater amounts of energy to keep operating, and they become vastly more risky and prone to catastrophic failure. "The relationship between catastrophic risk and scale is exponential," he says. "If the size of a system is doubled, the risk does not merely double—it increases by a factor of 10. If the system size is doubled again, the risk increases by a factor of 100."

Today's global financial system is orders of magnitude more complex than it was 30 years ago, especially considering the quadrillion dollars worth of notional value in derivatives that don't show up on national or corporate balance sheets. As a result, "Perhaps the most likely outcome of the currency war is a chaotic, catastrophic collapse of investor confidence," predicts Rickards. "Regulators and market participants think they're dialing a thermostat, but they're actually playing with a nuclear reactor that will prove to be much harder to contain than most people expect."

John Rubino, a former financial analyst, is the author of Clean Money: Picking Winners in the Green Tech Boom *and* The Collapse of the Dollar and How to Profit from It.