Thoughts About FX. USD vs RMB.

The basic and easy stuff

USD will be strong for the foreseeable future.

- USD is a haven currency and as the economic crisis persists or matures, preference for USD will remain.
- USD remains the settlement currency of choice for the vast majority of international trade.
- The US economy is the strongest and is expected to be strong on the rebound, supporting USD.

USD will remain the primary reserve currency for the foreseeable future. RMB will rise to become the number 2 reserve currency over time. EUR has structural issues that threaten its role as current number 2 reserve currency.

- US has deep capital markets to absorb investor demand, satisfying store of value role.
- US has open capital account.
- RMB has semi-open capital account.
- China capital markets not as deep.
- EUR suffers from not having a fiscal union, and thus has break-up risk.

Gold likely to remain strong or strengthen in the near term.

- Record growth in national debts across the world effectively debase currency.

<u>There is always a ‘however’ and these are mine:</u>

I agree that USD will be strong, but consider additional factors. In the final analysis I expect the dollar to be strong.

- Japan's stimulus is the largest at 20% of GDP, US is currently 11% of GDP and China is 2.5% of GDP. Based on marginal impact on budget, RMB should be stronger than USD. I discount this as I think there are other overriding factors.
- If de-globalization and the regression in international trade continues, and I am pretty confident it will, the largest net trade debtor nation, that is the US, will shrink its trade deficit. This implies a reduction in export of USD increasing its scarcity and creating upward pressure.

I also expect that USD will remain primary reserve currency, however, I also think that the role of RMB as reserve currency will rise more quickly than many expect.

- If currencies are claims on goods denominated in that currency then demand for RMB is under-represented. I think this is a choice by China as much as inertia from the rest of the world. The US economy is roughly 20 trillion dollars nominal and the Chinese economy is 13.6 trillion dollars nominal, trade being 12% of the US economy and 19% of the Chinese economy.

I am less certain about the outlook for gold.

- The gold price has risen sharply this year, precisely in response to the large scale fiscal and monetary policies. However, gold is like an insurance policy and the cost of insurance has already risen in response to the event which has already occurred. Therefore I think gold has become an inefficient hedge for future currency debasement.

Other tangential thoughts.

- As every country expands fiscal deficits, instantaneously to deal with the shutdowns of the economy and more deliberately in a Keynesian reflationary effort, the impact on purchasing power internally (inflation) and externally (exchange rate) will become more acute. The risk to the exchange rate may be addressed through temporary currency pegs very much like Bretton Woods. An anchor currency will need to be identified. Even if there is no agreement, any attempt at a Bretton Woods style system will have implications on FX volatility in the interim.

- Inflation is a serious risk. This is a contrarian view. The immediate consequence of the shut downs is deficient demand and thus deflation. This can very quickly reverse.
    - Supply chains may not be restored quickly leading to shortages.
    - In the longer term, more robust supply chains may lead to longer lasting rising costs and thus inflation.
    - More money for a given level of output is inflationary.
    - The deficits will want financing and taxes are almost certain to rise. If the tax codes are more progressive, and I think they will be, this will be more expansionary and thus inflationary.
    - Finally, when national debt to GDP levels rise to acute levels, the risk of loss of confidence in the sovereign and its central bank rises. This type of inflation is the most dangerous, hyperinflation.

Politicization or weaponization of currencies.

- President Trump’s administration has contemplated the weaponization of the USD. US influence over SWIFT has been used against Iran. Most recently, the US has contemplated selective default against China as sanctions for its culpability in spreading COVID19. *The weaponization of the USD would accelerate the search for an alternative reserve currency.*

- The EUR is the second largest reserve currency. However, the break up risk is not zero and handicaps its potential role as lead reserve currency. RMB is 3rd largest in the IMF's SDR and is also a potential candidate.

RMB as a viable primary reserve currency.

- RMB is gradually being internationalized. RMB was officially de-pegged from USD in 2005. CNH (offshore RMB) was introduced 2009. Market forces were introduced in the daily rate setting of RMB in 2016, the same time that RMB was introduced into the IMF's SDR basket. China is a long term player and has been gradually and systematically inserting the RMB into the global financial system.
- The RMB as primary reserve currency is also a choice. To achieve primacy China would have to fully open its capital account, and be fully transparent about its money market and PBOC open market policies and actions. China would lose some control over its currency, just as the US has handed control over the USD entirely to market forces (Plaza Accord excepting).
- The primacy of USD as reserve currency was determined at Bretton Woods. For RMB to achieve the same status as the USD, international and institutional support is necessary. If the COVID19 crisis induces such conditions, and the US flubs its hand, Europe and the rest of the world might rally around the RMB as the new anchor.

I think that USD will remain supported but now have signposts that might herald a change, swift or slow, to a new regime and what that regime might be.