CURRENCY WARS ALERT – interview with Ben Davies (Hinde Capital)

Por Jorge Nascimento Rodrigues em 9 Outubro 2010

In an interview Monday with the Financial Times, Dominique Strauss-Kahn, the head of the International Monetary Fund (IMF), warned of currency wars if the great powers started to use their currencies as a policy tool. He said: “There is clearly the idea beginning to circulate that currencies can be used as a policy weapon”. And last week, it was Guido Mantega, Brazil’s finance minister, to warn that a currency war “just has broken out”.

Suddenly, after the Great Recession and the sovereigns’ debt crisis, competitive currency devaluation appears to be the next name of the game in the long tail for many Treasury ministers and central banks alike. In a period of uncertain global growth, the intensification of this protectionist political discourse and measures is the last thing we need to avoid a double-dip and a new crash in the world trade.

Just recently, Japan and Brazil have both decided to take unilateral actions, intervening to weaken their respective currencies. Brazilia have stepped up the offensive, increasing the tax on capital inflows to 4% and buying billions of dollars in the market in an attempt to devalue the real. Further steps could be taken, including direct capital controls. Switzerland, the “heart” of financial neutrality, attempted to devalue the Swiss franc relative to the euro, and Washington DC has intensified its criticism at China’s renminbi policy, culminating in the passing of Congress legislation.

This beggar-thy-neighbour competitive currency devaluations are “marrying” a second round of quantitative easing policies (QE2 in the parlance of Wall Street) – an indirect manipulation – in the monetary side by the big central banks, as we are seeing now from the American FED and the Japanese BoJ, the forecast will be worse. The IMF, in its recent World Economic Outlook of October, clearly separate inside the advanced economies a group of “monetary easing” (FED, BoJ, ECB and BoE) from another one, of “monetary tightening” that have recently raised policy interest rates (Australia, Canada, Israel, South Korea, New Zealand, Norway and Sweden).

“For every winner there’s a loser in currency wars,” said in an interview **Ben Davies**, CEO and co-founder of Hinde Capital, a London based investment management company established in 2007 that launched its first fund specialising in the precious metals sector, Hinde Gold Fund.

In a certain sense, the recent events are the end of the realpolitik arrangement between China and the US – coined the Bretton Woods-II -, a specific international monetary regime since 1995, distinct from the period of managed floating among the major currency areas after the Nixon shock (1973).

“Do not expect the Chinese government to surrender. If it has to choose between millions of Chinese jobs or pressure from several US politicians, the decision is not difficult. As the world’s leader in the monetary system with the greenback, the global reserve currency, the US is savvy at enforcing exchange rate reforms on other countries. It is natural that China remains suspicious of US demands. It is not a coincidence that many of the advocates of yuan appreciation are also hawkish against China. China has made some compromises over yuan exchange rate reform in the past, but compromising has its limits. China will respond if the US initiates a trade war, but the US may have no chance of complete victory in a Sino-US trade war,” remarked an editorial from the Chinese ‘Global Times’ English edition.

Some analysts refer “hard noise” but a chance of armistice from the secret gatherings of the G20 and G7 in Washington DC last Friday and this weekend at the semi-annual IMF and World Bank meetings.

INTERVIEW *by Jorge Nascimento Rodrigues, Janelanaweb.com, October 2010 ©*

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Q: Do you think we just begin a period of a serial currency manipulation with the recent event you coined *as "the world monetary earthquake" of 2010? There's a risk of currency and trade wars?*

A: If you mean by currency manipulation, countries will embark on competitive currency devaluations, or in the case of China diversification away from the dollar, then YES. We have already seen that type of behaviour. "Buy America" clauses in the Obama bailout packages. Even the Brazilian's and Canadian's who have fantastic growth are intimating at curbing the 'excessive' strength of their currencies. Since the horrendous collapse in output in 2008, countries have experienced anaemic growth particularly in the West. World central banks embarked on a monetarist infusion of currency and governments joined in collaborative Keynesian spending to restore the ailing system to pre-crisis growth levels. The return on their capital outlay has been woeful. The policy prescription of yet more fiscal and monetary imprudence has left the world burdened by vast debts. Debts that have merely added to the potentially crippling structural deficits that exist from unfunded liabilities, such as social security and medical care schemes. These debts are acting as a drag on growth as the government drowns out the energy and vitality of the private sector. Domestic unrest and disquiet are on the rise. European countries are experiencing the brunt of this. Governments face expulsion from power by these maddening citizens. They need to find growth, and fast. Governments are rarely altruistic. They are choosing the shortest, oldest tactic in the book to push for this illusive growth.

P: And what is the consequence?

R: In a free floating monetary system 'beggar-thy-neighbour' or competitive currency devaluations are one way to achieve that. A short-sighted way. They create more currency by which to devalue their currency to gain an advantage in the current account. Simply put they expropriate output from another country by making cheaper goods to sell overseas. Unfortunately this is a zero sum game: for every winner there is a loser. This always causes trade friction as for every country experiencing weakness in their currency another experiences strength. To prevent the flow of goods into their country they either retaliate with their own devaluation or trade barriers (quotas and tariffs) go up on goods imported. The US is looking to put 25% import tariffs on Chinese goods as a notable example. In extremis capital controls will be reintroduced. If nations then fail to communicate on matters of trade, these feelings of resentment can easily spill over into military action.

«The Chinese want to sort out of this relationship [dollar-yuan peg], but on their own terms.»

Q: Is Bretton Woods-II, as you coined the dollar-yuan arrangement, coming to an end? The main reason is economical, strictly speaking, or geoeconomical and geopolitical, due to the reverse of the relationships between great powers, and particularly the emergence of China in geopolitics?

A: Yes, the Chinese want to sort out of this relationship, but on their own terms. Let's be clear China was always going to move towards liberalisation of its currency. It knows that to maintain growth and maintain its growing dominance in world as a superpower it has to have a flexible currency system as well as a developed banking system. Now it is arguable whether fractional reserve banking is a sound system, but that is a debate for another time. China has benefited from this undervalued yuan/dollar peg, as it has been able to export itself to growth and fulfil its commitment to generating gainful employment to its 200 million underemployed. Unfortunately the US 'vendor financing' relationship has created too many dollars in the system. It is too inflationary and they can't easily maintain a stable equilibrium between growth and rising prices. They understand full well that their US dollar holdings of US government bonds is their problem not America's.

«China cannot afford to be an isolationist.»

Q: In what direction are the Chinese moving?

A: They need to diversify and build solid bilateral agreements with other nations, particularly those with large commodity resources. China, sadly for them, cannot be independent, it needs large amounts of resources to survive. It cannot afford to be an isolationist. Perversely China's revaluation is passing the problem of excess dollars onto other nations and causing their currencies to strengthen. Japan is the unhappy recipient. However, because it is assisting the devaluing the dollar it gets them off the hook for *the title of serial currency manipulator. The tag appraised them by US officials. US Officials will be happy if the RMB does revalue substantially. They should be careful what they wish for as we saw in the 1930s, it didn't work out too great.*

«Undoubtedly we are slipping nearer and nearer to full-scale protectionism.»

Q: This beggar-thy-neighbour financial manipulations are "cloning" the 1930s?

A: Undoubtedly we are slipping nearer and nearer to full-scale protectionism, which arises out of such competitive devaluations (manipulations). The US Tariff Act of 1930, known as the Smoot-Hawley Tariff on over 20,000 imported goods from outside US, was disastrous. All nations retaliated with some counter measures, which resulted in global trade falling by half. Unemployment rates in the US rose from 16% to 25% post tariffs. This is pretty damning evidence that this type of behaviour will fail in its primary objective of protecting domestic jobs. Some nations like Germany even became fully autarkical. It was certainly a period of extreme isolationist behaviour, which in many ways helped foster resentment beyond that of even Germany's post-WWI resentment. We know the aftermath. WWII. Let's hope the world is flat as Friedman hopes and we all keep talking. The fiat currency system we live in is so fragile that it doesn't take much to spark an international incident which gives countries excuses to put up barriers. Take the Chinese fisherman who was incacerated by the Japanese. This recent 'fish flap' did not help international relations which were already strained. I would note if a country intervenes to stem the tide of currency appreciation, then it is manipulation. In the case of sterling the market has weakened the currency in response to QE (quantitative easing) or printing money. This is indirect manipulation as it is less overt. The Bank of England (BoE) accepts that it is using the currency to assist its growth stabilisation.

«Countries acted independently in the end on interest rate policy and the free market dictated its response with increasing and more fractious fx volatility.»

Q: The FT reported in Saturday edition that France and China held secret talks about currency co-ordination over the past year. The idea was to draw China into a joint policy, as Sarkozy wants to prioritise this type of coordination during his upcoming G20 presidency. It will work?

A: We will see more of this, but I would say co-ordination attempts never achieve the ultimate aim of a stable FX (foreign exchange) environment. The Louvre Accord signed in 1987 in Paris failed to arrest the slide of the USD, and the Yen collapsed from 250 to 150 yen, with the rear appreciating still further. The Louvre Accord was a response to the Plaza Accord which used trade agreements to take the heat out of the strong dollar. The Louvre accord tried to employ both fiscal and monetary restraints to affect FX movements. But remember the "impossible trinity" – you cannot control all three of these aspects. Countries acted independently in the end on interest rate policy and the free market dictated its response with increasing and more fractious FX volatility. Such coordination heightened balance of payment tensions, and arguably contributed to the 1987 crash…..

«The Euro zone is encumbered with horrendous liabilities which go beyond national debts.»

Q: In this new context, of the day after the monetary earthquake you refer, what's the situation of the Euro? What's your forecast regarding the Euro?

A: The interminable question I am asked most! First off I am not a fan of the Euro. It is too divisive. How can you have a single currency and monetary policy for all whilst maintaining national fiscal independence for each member nation. It's absurd. National identities and languages are a barrier to my mind to a harmonious Euro zone. The US Republic's single currency (the dollar) works across so many states and a wider geographic largely down to a common language and unified patriotism. Now will the euro disappear? Yes in time, like all fiat currencies will, but I don't think it will happen imminently. Still, the Euro zone is encumbered with horrendous liabilities which go beyond national debts. Each country has huge public and corporate unfunded liabilities. Portugal's real debts – the estimate of government [negative] Net worth – are closer to 600% of GDP, when you include these dynamics. Now they are lucky. The Irish or even the Greeks have more than 1500% of GDP.

Q: Do you think the sovereign credit crisis inside the euro zone will aggravate?

A: This is an unsolvable problem. Europe is broken, the world is broken. Each European country does not have the immediate advantage of currency devaluation within the Eurozone to ignite growth. The periphery countries can only undergo an adjustment through lower prices and wages, in order to be competitive. Perhaps they will be the lucky ones.

Q: Lucky ones?

A: The political will to keep the euro going is strong. Recent multilateral fiscal governance calls to reduce debt to GDP exposure. It is too little too late. The question is, will the ECB resort to money creation to devalue the value of their debts vis–a-vis inflation? I bet they are tempted. For now they have pushed back. This is to some extent why the euro is rallying whilst the dollar is falling. Of course Ben Benanke and the US administration are guiding the dollar lower. The issues in Europe are only just beginning. This is not just a euro issue it is a global issue. No one is immune as each nation is undoubtedly as encumbered as each other in the West.

«The ECB is effectively involved in quasi-fiscal subsidies to governments.»

Q: In what conditions do you think the ECB will embark on full Money printing, in a kind of QE2 à la Bernanke?

A: The high concentration of the euro area peripheral sovereign debt in the Northern European banks mean the prevention or mitigation of sovereign debt default is a paramount to the ECB. Social unrest and market response to further deterioration of growth and fiscal imbalances raise the risk of a systemic banking collapse. A Creditanstalt event could be lurking around the corner. Stress tests brushed at the surface. Banks are in a precarious position. The ECB is already making purchases of government bonds, but claims it is sterilizing these purchases. So they say this does not count as full QE. But they neglect to mention the rehypothecation of these purchases The ECB is effectively involved in quasi-fiscal subsidies to governments. They have much ammo left to purchase debt at prices far above fair value much as the FED did with the CDO product. The ECB's balance sheet is being denigrated by such bond purchases. It's a slippery slope to full monetisation. I suspect they will feel have no choice.

«Gold is the currency of first resort.»

Q: Gold ounce is near $1400. Do you think gold and other precious metals will be the main target for financial investments?

A: Gold may be at nominal new highs, but it is as undervalued now as it was in 2001. The amount of debt and money created in response to the ongoing debt collapse has left gold looking extremely cheap. Gold has no liability. It cannot default. It cannot be created out of thin air or printed, like paper money and debts. It is the undeniable store of value or, as we term it at Hinde Capital, it is the currency of first resort. China's need for dollar diversification will see it accumulate more and more gold as a nation. This is being replicated by other developing nations. The ASEAN in particular. On an investment basis gold only comprises 0.8% of global assets (savings). In the 1920s and 1980s this number was nearer 25%. A rise of 1% in gold ownership relative to these global assets would require 85,000 tonnes of gold. At current annual rates this is 34 years worth of mine supply. There just isn't enough gold to go around at these prices. Gold prices will be revalued higher. Remember price is a determinant of exchange, value is whether it is worth making that exchange. Gold is too cheap and underwoned in the world today.

«Once the Chinese feel they have accumulated enough gold and other real assets they can create their own trading currency with their new partners.»

Q: Can gold return to a standard role? The fiat system is coming to an end? A 'bancor', a monetary solution like the one suggested by Keynes at Bretton Woods, is useful, if supported by international organizations and the Chinese?

A: I will be brief. Yes I think we can. I believe the Chinese by calling for a Bancor, or a currency independent of national identity. I think they meant a currency basket that includes gold or silver. Gold is *independent of all nations. The recent announcement by the People's Bank of China in July of this year to open up the precious metals market is part of a plan to encourage gold ownership domestically. They are internationalising the RMB and creating direct currency swaps with Russia and Brazil. They want out of the debasing dollars. They have an affinity for precious metals as a monetary standard in history. There are 1.5 billion Chinese. They require more gold than is available at these prices. So they will strengthen their currency by accumulating more gold. Once they feel they have accumulated enough gold and other real assets they can create their own trading currency with their new partners. I suspect it will be backed with gold. If you do not own gold, it is not only advisable to, it is a must.*

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