

HindeSight



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October 10

The World Monetary Earthquake - The Dash From Cash - 起劲的作...形从...小额货币

The Orient Perspective

Monetary theory is like a Japanese garden, an apparent simplicity conceals a sophisticated reality

Orient TRileMmOR

BW 2 Trilemma

Tragedy of the Commons

Renminbi Rumpunch

YEArNing for More

Tax Dodge & Golden YEN

Yen less

Tael of two Countries

Within a single week 25 nations have deliberately slashed the values of their currencies. Nothing quite comparable with this has ever happened before in the history of the world. This world monetary earthquake will carry many lessons.

Henry Hazlitt 1948 wrote this in a book "From Bretton Woods to World Inflation", which predicted the inevitable collapse of this fixed exchange rate mechanism. It was a compilation of his editorials from both his time at the New York Times and Newsweek, which ridiculed the prevailing economic Keynesian thinking to great effect. A brilliant journalist, economist and liberal philosopher, this man intuitively understood the pernicious nature of the Bretton Woods fixed exchange rate arranged in 1944.

Murmurings of such 'beggar-thy-neighbour' currency devaluations have once again sprung up amongst the financial literati and rightly so. Better late than never. The truth be told is that we have been living in a highly unstable world even more so than under BW I. The dollar pegs, primarily the Asian renminbi dollar semi-fixed exchange rate, what most refer to as Bretton Woods II, have (arguably) been responsible for the financial friction we observe today.

The RMB and US dollar are constantly colliding into each other. The clashing of these two tectonic currency plates has just begun to accelerate at an alarming rate. Ironically the move to greater currency flexibility on the part of the RMB against the dollar stands ready to produce the almighty mother of seismic monetary events - the collapse of the fiat currency system. The implications for government bonds, equities and real assets are profound. Are we being overly sensational? We don't think so.

Orient TRiEMmOR

STOP PRESS: Yomiuri Shimbun:

On the 2nd Sept 2010 the Japanese government conducted the largest ever disaster drill under the scenario in which three massive simultaneous earthquakes struck a wide area along the Pacific coast in central Japan. This was the first of many drills undertaken on Disaster Prevention Day which was established to mark the anniversary of the Great Kanto Earthquake of 1923, when over 100,000 died.

A 'Trilemma' (or the 'Impossible Trinity') refers to a difficult choice from three options, each of which is (or appears) unacceptable or unfavourable. The Japanese TRiEMmOR of a three way earthquake leaves a horribly difficult choice of where to assign resources most effectively. Two is possible three unlikely. But this is not the only trilemma that has besieged the Japanese.

Japan suffers from an International economic trilemma. It is a conundrum that befalls all countries. An economic trilemma (Mundell–Fleming) expresses the logic that there is a choice among three favourable options, only two of which are possible at the same time. It is impossible to have all three of the following at the same time:

- A fixed exchange rate.
- Free capital movement (absence of capital controls).
- An independent monetary policy.

All countries want to achieve the following:

Make the country's economy open to international flows of capital. Capital mobility lets a nation's citizens diversify their holdings by investing abroad. It also encourages foreign investors to bring their resources and expertise into the country.

Use monetary policy as a tool to help stabilize the economy. The central bank can then increase the money supply and reduce interest rates when the economy is depressed, and reduce money growth and raise interest rates or reserve requirements when it is overheated.

Maintain stability in the currency exchange rate. A volatile exchange rate, at times driven by speculation, can be a source of broader economic volatility. Moreover, a stable rate makes it easier for households and businesses to engage in the world economy and plan for the future.

(N. Gregory Mankiw, professor of Harvard)

The Chinese trilemma is a special case in point. A command based economy, China has not necessarily wanted to allow its citizens access to capital mobility, whilst at the same time wishing to participate in the capitalist miracle of industrialisation which could only really be fostered by a monetary credit machine and access to international capital markets, most notably via open trade.

Japan has like the US has adopted a different response to the trilemma. Both US and Japanese citizens can invest abroad, and foreigners are free to purchase stocks and bonds on their domestic exchanges. Monetary policy is implemented by both but at the expense of a more volatile currency. Both are subject to the vagaries of this BWII RMB peg.

Japan had a history of conflict pre-dating this currency arrangement, and their prolonged distrust of each other has been aggravated by China's management of the 'dirty' float. Japan has responded consistently to the China revaluations, which exerts upward pressure on the yen by intervening forcefully in the free floating yen dollar rate. This fractious relationship has helped fuel the global asset boom, by what was termed the 'global carry trade'. Japan exported capital to the world, due to its low interest rates and weak yen, which made it an attractive funding currency.

Bretton Wood II Trilemma

Let me be more positive: if I had an agreement with my tailor that whatever money I pay him returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him.

Jacques Rueff (1965)

Since 1971 we have lived in a world of fiat currencies. We have what many call a Bretton Woods II system (BWII). This is where much of the world, primarily the Asian countries, has more or less informally pegged their currencies to the dollar, without the backing of gold. These countries do this in order to maintain their relative competitive ability to sell their products to the world and more specifically to the US. So the defining nature of this international and financial monetary system is that it finances the United States' enormous external deficit and the associated fiscal deficit at low interest rates.

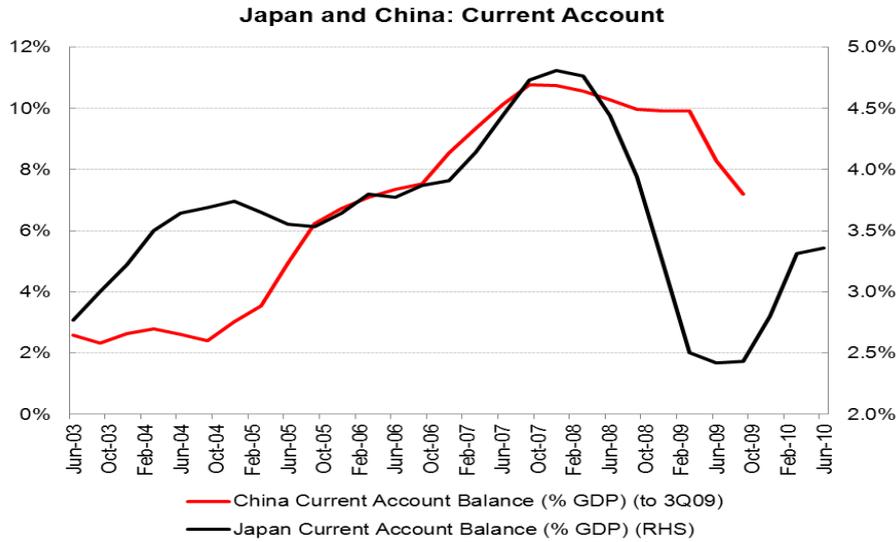
In 2005 we wrote to a prospective seed investor that we felt this new system that was advertised as BWII, a semi-fixed exchange rate system, was inherently more unstable than the Bretton Woods (that Hazlitt feared). It had created greater global imbalances and a much more speculative environment, as excess reserves floated around the globe. Why? Because there was no gold conversion restraint upon the reserve currency, under BW I the natural equilibrating mechanism of trade balance was the transfer of gold from one country to another. Even the BWI was a poor substitute for a true gold standard (but we have covered that elsewhere - see Gold Wars).

China has pursued the classic mercantilist venture of export led growth in order to drive its industrialisation. China has the largest population in Asia and the peg of the RMB to the dollar is the main driver; so how China handles its foreign exchange has a significant impact on all currencies in the region. Most Asian nations, such as Korea, Malaysia, and Japan, for example, have to keep their currencies competitive with that of the RMB. So this RMB/US dollar peg is at the core of the BWII.

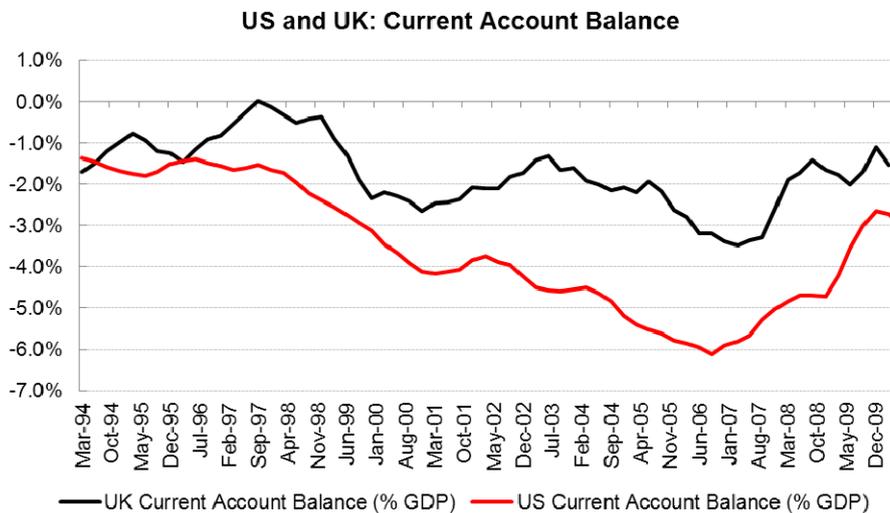
China has maintained a cheaper currency to the West, but to protect their economy from overheating from the flood of dollars in exchange for their goods they have been recycling the dollars back into US assets, namely US government securities. By virtue of buying US government debt they are foreign lenders. They are the financiers of the US economy (and West) via the current account. This recycling allows them to artificially stimulate their manufacturing exports even more as the Chinese are helping to stimulate American demand for Chinese goods.

How come? The purchasing of US debt supports the dollar, maintaining the undervalued RMB. Meanwhile interest rates have been driven lower than otherwise would have been without their purchases of debt. In addition to this the Chinese bought US mortgage backed and US corporate and agency securities. So US rates have been distorted lower than fundamentals would otherwise assume. This whole relationship has been termed vendor financing and resulted in lower rate, more affordable mortgages.

The 2008 and ongoing financial crisis was not caused by excessive mortgage lending to 'ownership' obsessed households in the US (and the rest of World), it was merely the symptom of these global imbalances created by this vendor-financing relationship of the Occident and Orient. This relationship was more instrumental, by far, than the Clinton legislation passed for more affordable rates for less well-off Americans, which some apportion blame to for the subprime mess.



China, Japan and by necessity other Asian nations have been running huge current account surpluses, from the accumulation of vast currency reserves, notably US dollars; whilst the US (and the UK) have suffered from large current account deficits. This bilateral US trade deficit with Asia has been balanced by official bilateral capital inflow to the US from Asia - economic parlance for the 'vendor -financing' relationship explained earlier.



China's trilemma is that its central bank conducts monetary policy and maintains tight control over the exchange value of its currency. But to accomplish these two goals, it has to restrict the international flow of capital, including the ability of Chinese citizens to move their wealth abroad. Without such restrictions, money would flow into and out of the country, forcing the domestic interest rate to match those set by foreign central banks.

However, as one has just read, the nature of this fixed peg has ultimately led to an export of dollars, which fuelled asset prices. The irony today is that as China liberalises its currency peg in an attempt to use a currency revaluation to contract growth*, other countries are having to devalue. *(For it has seen those very same dollars which it has recycled, return home to inflate goods and asset prices, particularly property in Hong Kong and China.)

Tragedy of the Commons

Tinker, Tailor, Soldier, Sailor, Rich Man, Poor Man, Beggar Man.....Thief

Globally GDP has been anaemic since the crisis first arose in 2007.

The inevitable conclusion of most countries today is that the best way to extricate themselves from the current mess is to shift effective demand away from imports onto domestically produced goods. The preferred method is competitive currency devaluations.

Unfortunately this is not possible for all, and leads to friction as countries effectively steal other nations output to bolster their own. Plato and Aristotle referred to this as 'overgrazing', then 'tragedy of the commons' (people). Nothing changes. This always leads to heightened tensions and conditions of capital controls and other protectionist behaviour such as punitive tariffs and quotas on imports often prevail. Friedman's flat world aside - it is already happening.

Variant Perception (formerly part of Hinde Capital) pointed out in a recent piece that the *public* sector and *private* sector in economies cannot deleverage at the same time without running a trade surplus. This is for mathematical reasons that are inescapable.

We know the following national accounting identity in economics:

Domestic Private Sector Financial Balance + Public Sector Balance + Current Account Balance = 0

The changes in one sector's financial balance cannot be viewed in isolation. If a nation wishes to run a persistent fiscal surplus and thereby pay down government debt, it needs to run an even larger trade surplus, or else the domestic private sector will be left stuck in a persistent deficit spending mode.

Currently the private and public sector is highly encumbered with debt. So deleveraging of both can only occur by moving into a large trade surplus. Large because the debts are large in both the public and private sector. So a trade surplus has to be created, which as the US have found, is hard to achieve when confronted by an inflexible currency regime like that with the Chinese. The root of all our problems. Reducing imports and exporting something productive, especially when your main export has been financial services and intellectual capital is hard. The former isn't in such demand anymore.

A country needs to create a competitive advantage. This can be created vis-a-vis increased productivity (output per worker), or by lowering prices. Japan and German seemed to have achieved this whilst the rest of the world (excluding China) does not have any input or labour cost advantages, so devaluing the currency to make their exports look more attractive becomes the most viable option.

To maintain the last decade of prosperity (illusion) countries are systematically hell bent on exporting themselves to economic health. This is a zero sum game. Not all countries can export at the same time by definition that the global balance of payments will not then balance. For one winner there is a loser. The implication on import prices is dramatic. Inflation is imported or exported depending on your view point around the world. Let's rephrase 'inflation' - global citizens will experience a rise in the value of goods due to creation of more money used to devalue their currency.

The pursuit of mercantilist traditions may help alleviate the collapse in output for some, and the ensuing rise in goods prices may help government reduce the value of their debts; but at what costs? Increased international tensions and let's not forget the internal social unrest that is accompanied by citizens whose wages have not kept abreast of these rising prices.

As the traditional English folk tune rhymes *Tinker, Tailor, Soldier, Sailor, Rich Man, Poor Man, Beggar Man.....Thief*. Rich or poor, you beg from your neighbour there is no two ways about it in the world of current accounts - you are a thief.

It is politically more savoury to expropriate the output from another country, unfortunately this will be at the loss of the majority.

RMB Rumpunch

In view of the recent economic situation and financial market developments at home and abroad, and the balance of payments (BOP) situation in China, the People's Bank of China has decided to proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility.

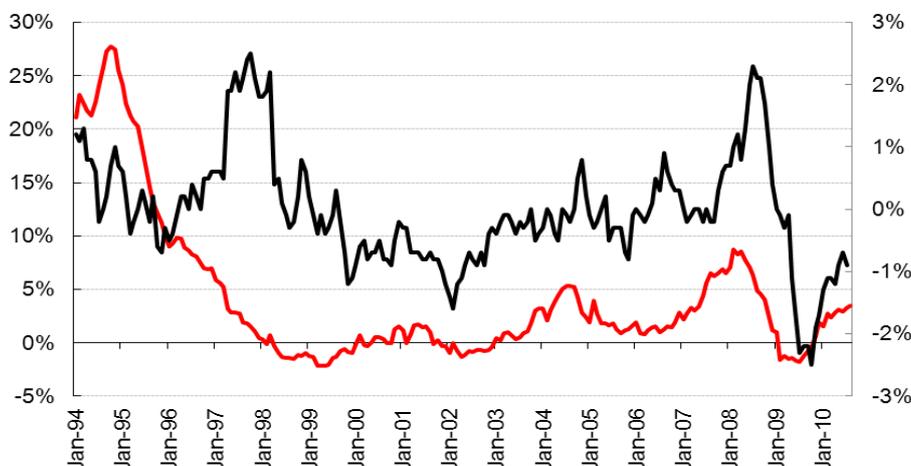
PBOC June 2010

This was the announcement ahead of the G20 meeting. Was this a meaningless gesture or a signal of intent regardless of external pressure? The Chinese have been accused of currency manipulation to foster export led growth for years, but with times hard, the anti-Sino rhetoric has escalated. US Senator Schumer has proposed a 25% tariff on all Chinese goods imported into the US. He is determined to keep "jobs and wealth from flowing out of America." US Senator Richard Shelby, the committee's most senior Republican, said: "There is no question that China manipulates its currency in order to subsidize its exports. The only question is: Why is the administration protecting China by refusing to designate it as a currency manipulator?"

It may well delight US antagonists of the peg to see such a move, but they should be careful what they wish for. A narrowing of the US current account will not be a good sign, for it is a sign foreigners are withdrawing investment.

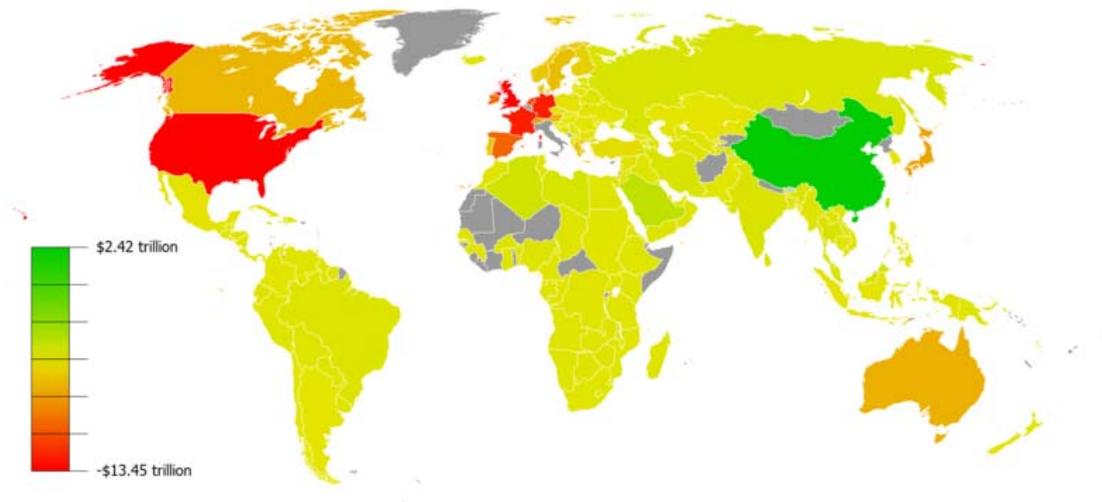
China has about 200 million unemployed or underemployed workers to bring into the modern labour force. For political stability, there is a need for 10-12 million net new jobs per year in the urban centres. A growth rate of around +8% has served to employ about 10 million new workers each year. About 3 million have been in the export sector, with exports accounting for almost 25% of GDP. The need to keep their currency competitive has been clear, but why would they move to greater flexibility of their currency now. They just have too many dollars and it is inflationary. This virtuous circle of vendor-financing which has resulted in huge asset price inflation is now fuelling goods inflation, and primarily in China.

China and Japan Inflation



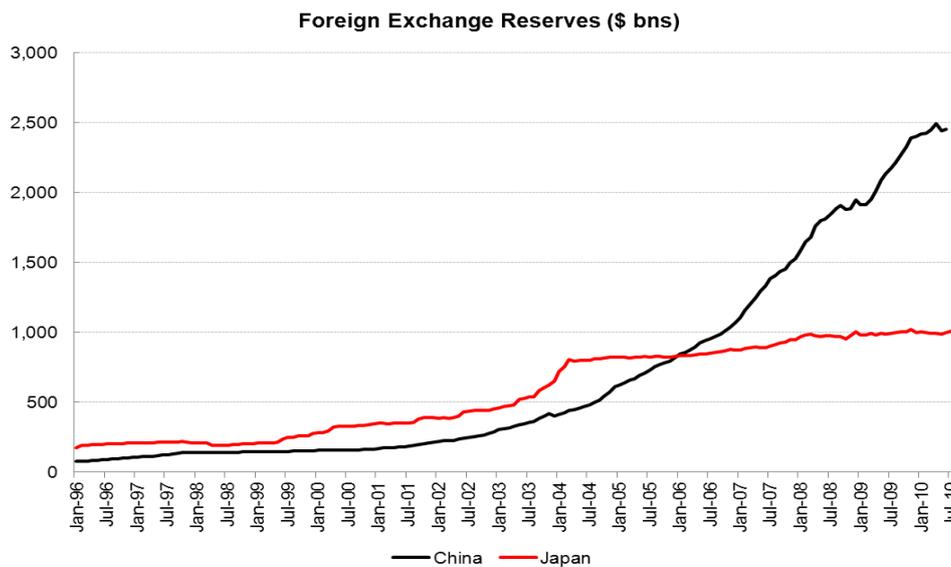
China CPI YOY (LHS) Japan CPI YOY (LHS) Source: Hinde Capital

Instead of competitive devaluation, China is seeking *competitive diversification*. In March 2009 PBOC Governor Zhou called for a new reserve currency for the World (non-US) - "that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies." This was a clear reference to the US and the *Triffin* dilemma a country faces when acting as holder of the world reserve currency. Such a country will have to run a current account deficit to meet demand for its currency. A prolonged and growing deficit undermines confidence in that currency, which undermine its integrity as the reserve currency. A country cannot simultaneously run a balance of payments current account deficit and surplus at the same time.



Source: CIA Factbook 2010

At end of 2009 65% of world currency reserves were held in US dollars, with China holding close to \$2 trillion out of \$7 plus trillion in reserves. Now as a percentage of China's GDP (PPP) of \$8.748 trillion that's a large concentration of reserve risk.

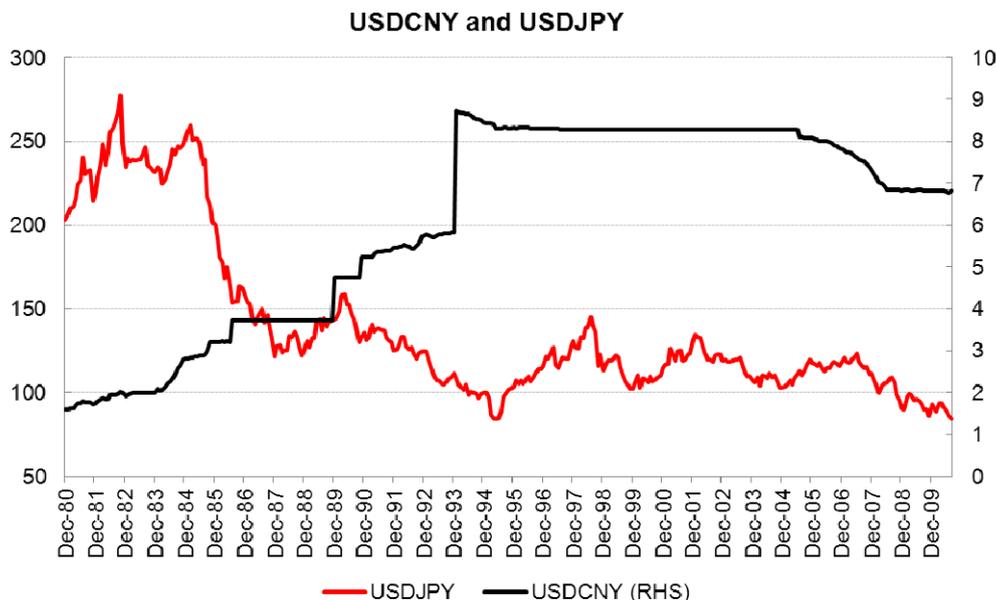


Source: Hinde Capital

The RMB revaluation process is a *rumpunch*, (a rum deal with just a bit more punch). China is playing a serious piece of brinkmanship with the world and particularly Japan. But before we develop this point, some context is needed on the evolution of the RMB.

The exchange rate regime of the Chinese currency has experienced three historical development phases, i.e. a single official rate regime, dual track rate regime and a market based managed floating regime. The most important progress in the exchange rate regime reform was made after the PRC launched its economic reform and opening up policy. In 1980, the renminbi was placed on a dual track system, i.e., the coexistence of the official rate and trade-related settlement rate, and coexistence of the official rate and swap market rate, respectively, during 1981–1985 and 1985–1993. Following that, the Chinese currency was pegged to the USD and allowed to float with a narrow band between 8.27 RMB and 8.62 RMB per USD for more than one decade.

The evolution of the renminbi exchange rate regime and determination of the exchange rate are closely related to the economic regime of the PRC as a whole. Before 1978, the PRC had a Soviet Union style socialist system. Under this system, the relationship between the PRC and major capitalist countries was not so close. This is one of the reasons why its economy lagged behind western countries and why trade and capital flows with overseas were so scarce. To improve this situation, the PRC government had to advocate a spirit of self-independence and hard work. (Forced labour?). Since there were in practice no foreign exchange markets at the time, the exchange rate existed only as a calculation unit and seems unlikely to have reflected supply and demand relations.



Source: Hinde Capital

On 1 January 1994, the PBOC announced a reference rate for the renminbi against the USD, the Hong Kong dollar, and the Japanese yen based on the weighted average price of foreign exchange transactions of the previous day's trading, marking a new stage for the exchange rate regime. In accordance with the announcement, daily movements of the exchange rate of the renminbi against the USD were limited to 0.3 per cent on either side of the reference rate announced by the PBOC. The buying and selling rates of the renminbi against the Hong Kong dollar and the Japanese yen were not permitted to deviate from more than 1 per cent on either side of the reference rate; in the case of other currencies, the deviations should not exceed 0.5 per cent on either side of their respective reference rates.

When the renminbi exchange rate and foreign exchange swap market rate were integrated, the official rate was 5.8 and swap market rate 8.6. The integration of exchange rate made the official exchange rate depreciated by 33.3 per cent.

The unified exchange rate terminated the long-standing situation of the renminbi overvaluation and, thereby, reversed a persistent trend of decline. From 1994 to the end of 1997, the renminbi's nominal exchange rate against the USD appreciated by 4.8 per cent, up to 8.2. Taking into account the rapid increase in domestic prices in the period from 1994 to 1995, the real appreciation of the renminbi against the USD was 39 per cent. Meanwhile, the renminbi's nominal and real effective exchange rates rose by 10.9 per cent and 30.2 per cent, respectively (IMF, IFS database 2004).

The appreciation of the renminbi during the period from 1994 to 1997 once again led to the expectation of a devaluation. This expectation was further intensified by the Southeast Asia financial crisis of 1998, which incurred a wave of capital flight. To prevent the crisis from spreading further, the PRC government made a commitment to not devalue the renminbi, keeping it at 8.28 RMB per USD and taking other measures to offset the external shocks to exports, including, for example, export tax refunds. This was recognized as a significant contribution by the PRC to the economic and financial stability of Asia and the world. Even US Secretary Rubin referred to China's exchange rate policy as an "island of stability".

(<http://www.ustreas.gov/press/releases/rr2476.html>.) My how quickly thoughts change. It really is all a question of perception.

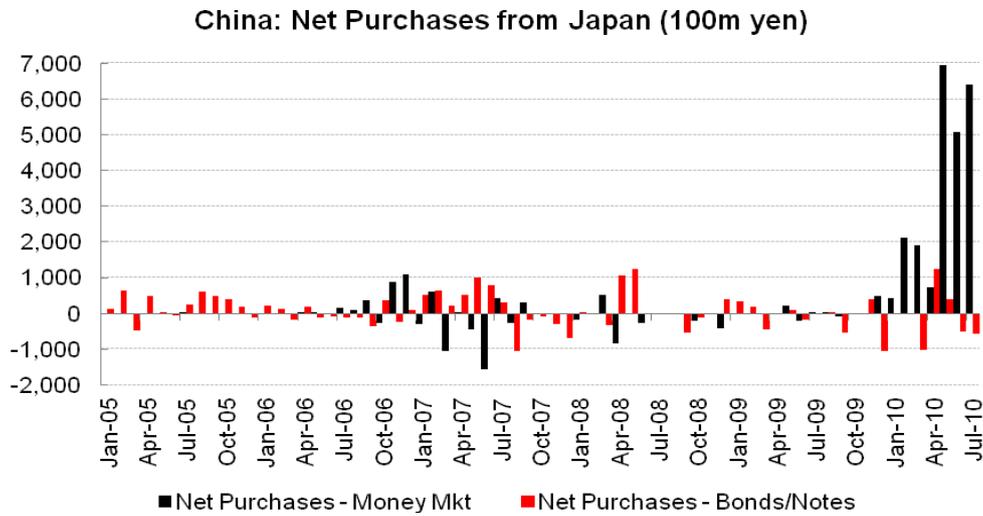
The revaluation of the renminbi in July 2005 was described by the Chinese central bank as a change in the currency regime, rather than merely a changed level of the exchange rate. The reform was said to involve a shift away from the fixed exchange rate, a gradual movement towards greater flexibility, and a peg to a basket of currencies.

This managed float was then repealed in 2008 as market volatility and recessionary dangers prompted Chinese officials to revert to a US dollar peg. The reversion ensured a stable and lower exchange rate. Chinese exports would still remain competitive even if a worse recession emerged in both the United States and Europe – major trade partners of China.

Fast forward back to June 2010 where we started and we see China has re-embarked on this managed float. In reality really a *basket* of currencies with *bands* has been created, with a trend *crawl* to a stronger RMB. China in the face of growing balance of payments surpluses, primarily with US dollar has been in a classic conflict between internal and external balance under its peg. Currency liberalisation is essential in a world where China is reliant on rest of world for many resources. It cannot be sustainably autarkic.

To reiterate - China is engaged in a serious game of brinkmanship with the World and particularly Japan. By liberalising the RMB, China far from dampening currency friction, asset protectionism and trade tensions, will actually fuel them further. The global monetary system under BWII has been imbalanced for so long that the unwinding of this febrile system will exacerbate these risks.

The development of a more diverse currency basket has already kicked off heightened currency tensions. China has acknowledged purchases of Korean won (KRW), yen (JPY) and JGB bills. \$3.5 billion of KRW and \$25bn of JGBs have been bought up to August 2010. Note - the US reported net sales of dollar assets. China has purchased these currencies primarily as the two countries have deep liquid FX and bond markets. Important ingredients when you are developing a basket of currencies against your own.



Source: MoF, Hinde Capital

The positives for China seem evident:

1. This *competitive diversification* is a means of dumping unwanted dollars on other nations in the region - primarily Japan.
2. China hasn't had some irrational proclivity for US dollars, it's just the US had a far more open trade system than Europe and rest of world. Until now that is. But with the development of ASEAN and LATAM countries plus mutual beneficial Russian relations, China has found new trade partners. It can keep up exports, whilst also grabbing essential commodity resources and widen its currency reserve holdings to boot.
3. The development of such bilateral trade agreements could ironically help keep China's real effective exchange rate down and allow them to accelerate the RMBUSD revalue.

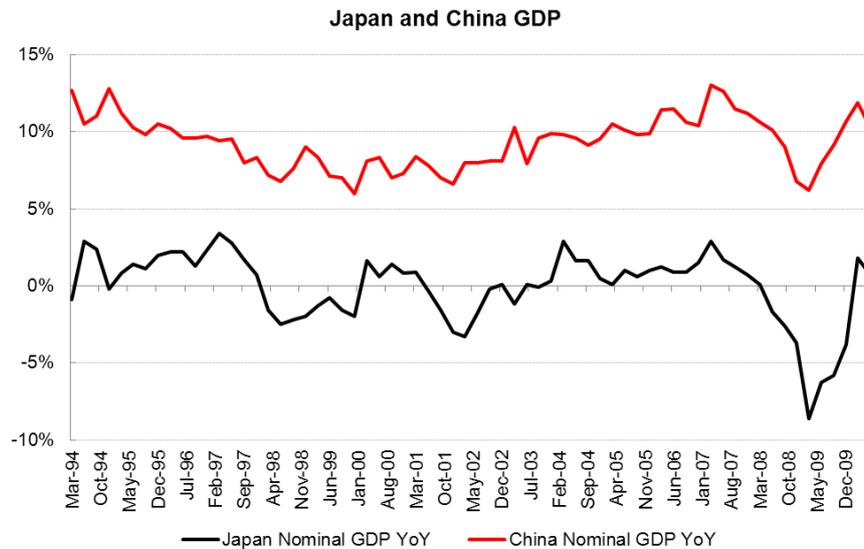


Source: Hinde Capital

Rather conveniently their stronger currencies would help reduce China's trade deficits with them, via lower import costs. Machiavellis take note. The Chinese have cleverly pushed the horns of the 'Impossible Trinity' right up the proverbial backside of the Japanese. The Japanese are anything but pleased; their response could spur a wave of global currency devaluations.

YearNing For More

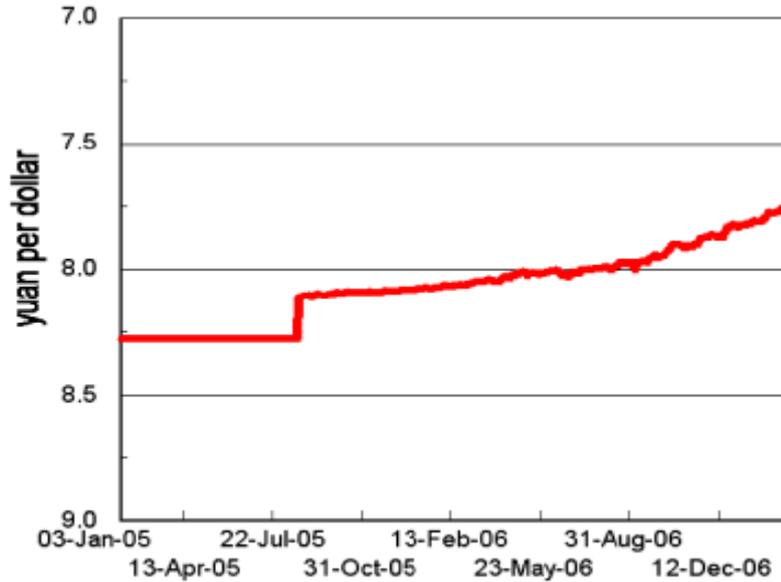
Japan is the poster child for anaemic growth. Its GDP is heavily reliant on export led growth hence why its output collapsed in 2008 in the wake of the financial crisis. A stronger yen induced by the actions of the Chinese merely revives their age old enmity.



Source: Hinde Capital

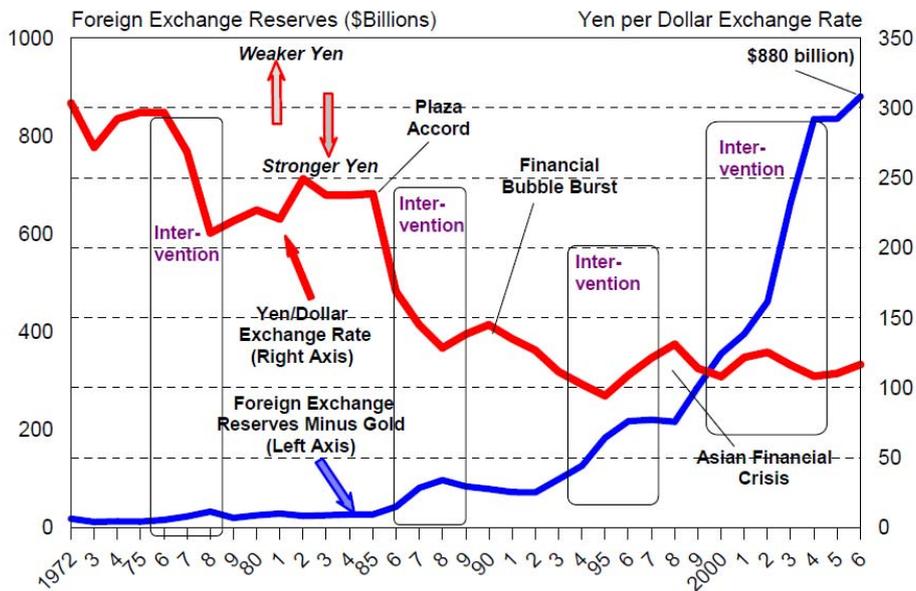
These past few decades the spectre of the Chinese currency peg has hovered over Japan's export ambitions with equal menace to Japan's 'three-earthquake-at-once' scenario. Whenever Japan has intervened to slow the upward appreciation of the yen it has raised concerns from the United States and brought charges that Tokyo was manipulating its exchange rate in order to gain unfair advantage in world trade. This intervention has to our mind largely been a response to Chinese revaluation efforts, the usual recipient of such invective.

RMB (RMB) /dollar rate post July 2005 PBOC announcement



Source: Federal Reserve Bank

Japan's Exchange Rate and Foreign Exchange Reserves 1972-2006



Source: World Bank

If you had any doubts about how Chinese intervention passes on the horn of excess dollars, see how Japan FX reserves (mostly US dollars) rose post the 1994-7 and 2004/05 yen interventions.

Japan's Real Effective Exchange Rate (Mar 1973=100)



Source: BOJ

The collective belief is that recent Japan MOF interventions, like recent Swiss FX efforts will fail. We do not subscribe to this reasoning. The recent language out of Tokyo allows us to reminisce. Remember 'Mr Yen' - Eisuke Sakakibara. He stomped all over yen strength at the 80 level, in response to the revaluation of the RMB dollar peg and the US dollar weakness. This was very successful judging by the yen REER¹ as depicted in the chart above. Likewise 2004/05 spawned the period of the yen carry trade, when interest rate differentials were particularly conducive to yen borrowers. The yen fell from 101 zone to the low 120s, but again the impact on the REER was greater.

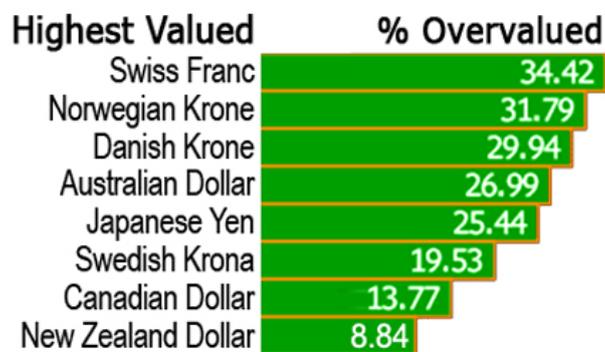
The Japanese even have a phrase for a yen induced recession - *Endaka Fukyo* - translated from Japanese means a high yen recession. Fukyo - (say it quickly) seems a pretty apt response to China. We only have to look at the impact of a 1 yen move to comprehend how much exporters are hurt by currency strength. Canon, one the world's largest electronic firms makes losses of about 6.8 billion yen for every 1 yen gain against the dollar. We would argue today it's not only the strength in yen it's the rate of change that hurts exporters. Indeed the volatility of currency movements must haunt all entrepreneurs, globally. Companies are just becoming spectators or leveraged speculators of currency markets. (As an aside - this illustrates yet another consequence of government meddling in free markets.)

¹ Real Effective Exchange Rate (REER) - the weighted average of a country's currency relative to an index or a basket of other major currencies adjusted for the effects of inflation. The weights are determined by comparing the relative trade balance, in terms of one's currency, with each other country within the index

Prime Minister Naoto Kan survived a party leadership challenge from MP Ichiro Ozawa, also from within the DPJ and celebrated with a 2 trillion yen spending spree (est. 23 billion USD.) The largest solo intervention in Japan's history. Technically speaking such actions are sterilised but usually with a lag. Now imagine we see intervention for a few years and Finance Bills are not issued to absorb this excess yen then the currency will be left to circulate around the global monetary system.

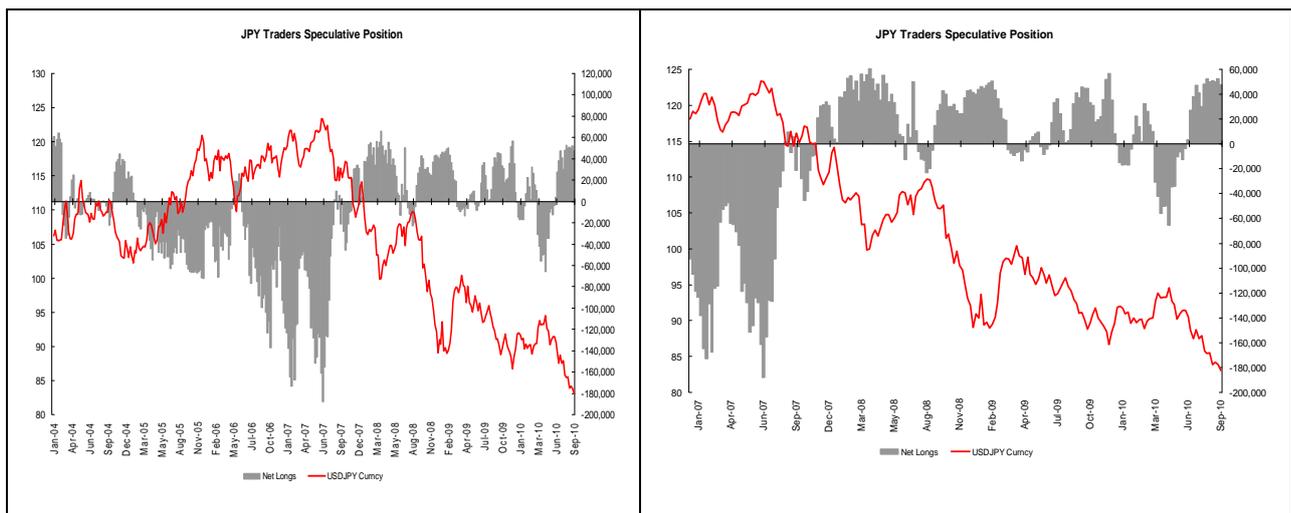
BOJ Governor released a statement (unusual) that the BOJ intends to provide ample liquidity to financial markets. You can take this to mean this intervention will be unsterilised and that even QE / rinban operations will in time resume. There is no impediment to how much they could do, even allowing for statutory ceiling limits on outstanding borrowings at the FX Fund Special Account. This perhaps explains the JGB 10 yr rally. But we do note that 40yr JGBs have not rallied, perhaps baulking at the spectre of monetised intervention. We will develop this later.

There is plenty of room for currency devaluation on an OECD PPP basis, as the chart depicts here. We believe this yen creation will assist global equity returns in nominal terms and will be real asset positive.



Source: Bloomberg

Yen positioning looks excessive both longer term and short term.



Source: Hinde Capital

<http://www.ecb.int/events/pdf/conferences/mpimp/maeda.pdf>

The impact of the FX intervention mechanism is illustrated on pp 37 of this BOJ working paper from 2005 for those who want more complexity. The intervention leaves a surfeit of dollars on the asset side of the balance sheet which usually results in US treasury purchases. We are sure a highly indebted US government will be thankful for these purchases. Alternatively we see the possibility of a fund vehicle set up to make purchases of dollar real assets. Dare we suggest commodity resources?

We really do think that this intervention is significant. Japan wants to rebuff both RMB (and US dollar weakness), which to be fair it could do through capital controls. They feel rightly aggrieved at the lack of symmetry of the capital account. Japan cannot buy Chinese FX and bonds but China can buy Japan's. We feel it more likely that in light of deteriorating economic output and unemployment Japan may succumb fully to full deficit financing. The likelihood of this rises when placed in the context of a US administration fully committed to a US dollar devaluation to undo its growth and debt ailments. Japan has to a much larger degree got more potentially pressing issues.

Japan is faced with a burgeoning fiscal deficit of epic proportions - the Japanese, Keidanren (Japanese Employer's Federation) aside, may well just want a little inflation to erode the value of their debt, in light of the dwindling options they have to continue to not only to borrow but to even service their debt. So we think 'more yen' will mean 'less for your yen' and this will set the stage for hyperinflation. Yes debt held domestically can default implicitly, it's not just countries which are reliant on external funding that experience hyperinflation. In order to pursue this thought we need to indulge in some history.

Shoup Tax Dodge and Golden Yen

The enmity of the US, China and Japan has been instrumental in Japan's modern history. Post World War II, Japan had suffered the complete destruction of its physical capital. Quite literally. Enemy bombers had levelled the cities, and let us not forget the nuclear destruction of Hiroshima and Nagasaki. Their resolve had been broken and brutally so. To our mind the only reason Japan recovered was the threat of Communist China.

In 1948 Chiang Kai-shek's Kuomintang army would be defeated by Mao Tse-tung. Washington's response was to send a certain Joseph Dodge, a Chicago banker to resurrect Japan, to act as a buffer to this growing Communist threat. Dodge re-pegged the hyperinflated yen at 360 yen or 12,600 yen per gold ounce, (arbitrarily it so happened – (the 360 representing the 360 degrees of the Sun on the national flag.), and removed all price and wage controls, liberated industry from government control, demolished subsidies, removed US economic aid, and rebalanced the budget. He banned monetisation of debt, and insisted on a balanced budget each year. All Keynesian deficit spending was outlawed. Ironically those very same outlawed measures that have seen Japan mired in depression today.

Dodge employed the economist Professor Carl S. Shoup who reshaped the Japanese tax code, making dramatic cuts and brought about an equality of tax for all. Emperor Hirohito twice decorated the Professor with the Order of the Sacred Treasure. In the period 1951 to 1974 the Japanese government under Dodge's budget guidance cut taxes every single year. They employed over 50 taxes to promote economic growth. There was no capital gains tax, a low interest income tax of 10 per cent which eventually went to zero. Tax revenue exploded as the private sector boomed with GDP growing almost 10 fold in 20 years. This was golden era for the yen. And remember all this growth took place under the non-inflationary gold-linked yen of Bretton Woods.

Another golden era but this time born of an inflationary credit boom was the mid 1980s when at the Plaza Accord of 1985 dollar intervention caused the yen to strengthen dramatically. Such strength created 'deflation'. Worse still the Japanese faced with currency loss in their dollar-denominated assets such as US government bonds saw repatriation of yen leading to yet more yen strength. The response was a dramatic lowering of interest rates. The BOJ cut rates 5 times and by February 1987, the discount rate reached a low of 2.5%. This helped to fuel a stock market and real estate boom; the unintended consequence of trying to bolster export growth. At its peak the Imperial Palace Gardens in Tokyo, comparable in size to Hyde Park, London, was purported to be worth the total value of all the real estate in California. In fact Japan owned most of that as well (well, the prime real estate anyway, like Hotel Bel Air in LA.

Yen Less

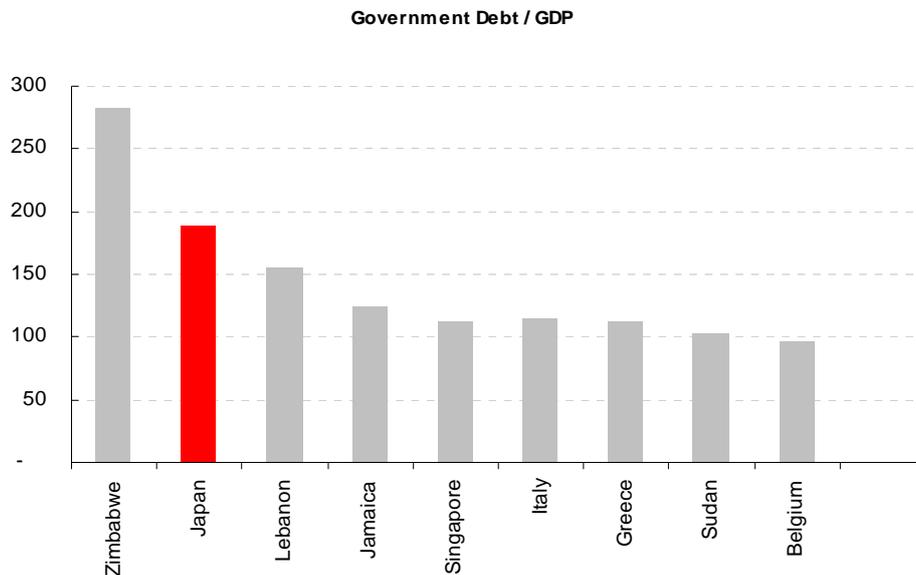
Variant Perception and Hinde have worked together to explore the ramifications of the 1990s collapse of the "Bubble Economy" (baburu keizai) and the implications for here and now:

There was a pervasive culture of 'pretend and extend', much as we have seen today in this crisis. Japan did not confront its non-performing loans as a system of keiretsu (cross-share holding agreements) terrified the Japanese of an all out collapse of the private sector.

In order to cushion the blow, the central Japanese government spent insane amounts of money in some Keynesian frenzy. They built 'white elephants' everywhere. Bridges and roads to nowhere. The result: Japan has a public debt of 200% (having risen sharply higher last year) on its way to 400% by 2040 (according to the BIS). We think they are underestimating the reality. Japan can no longer use captive domestic savings to maintain or increase this level of debt. Likewise with uncompetitive interest rates, and with sovereign entities in a growingly similar predicament - sovereign crowding out means they cannot rely on any external funding to replenish the coffers.

Japan's debt levels are now at levels only seen historically in hyperinflationary countries. Either Japan will right itself through political reform - ie debt restructuring - and tax increases and that would most likely not be enough, or it will be a prime candidate for hyperinflation.

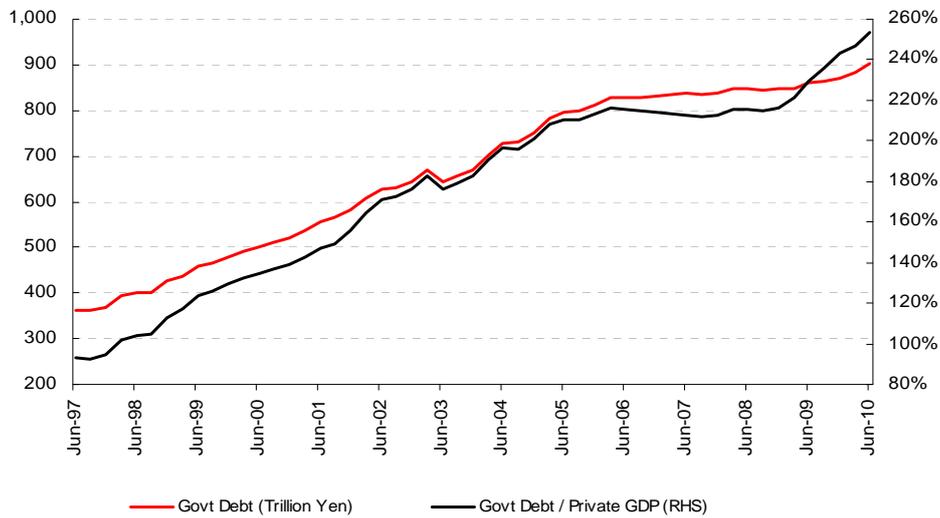
Japan is now in the company of Zimbabwe, Lebanon, Jamaica, Sudan and Egypt in the high government debt- to -GDP stakes.



Source: Variant Perception

Japan's government debt to *private* GDP is now 253%, having moved sharply higher in the last year.

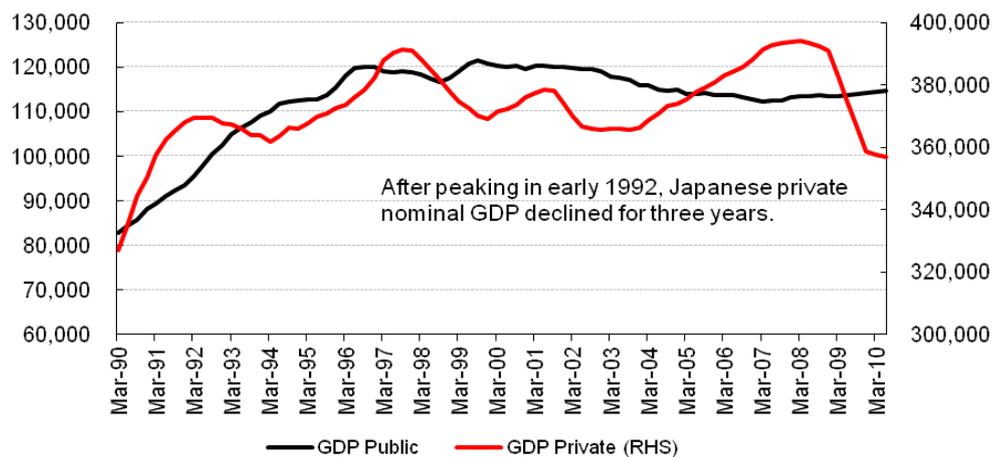
Japan: Government Debt and Private GDP (Nominal)



Source: Japan MOF, Variant Perception

Remember it is the private sector that will need to generate revenue for taxes to pay down the public debt. It's not looking good.

Japan: Public vs Private Nominal GDP (in billions of JPY)



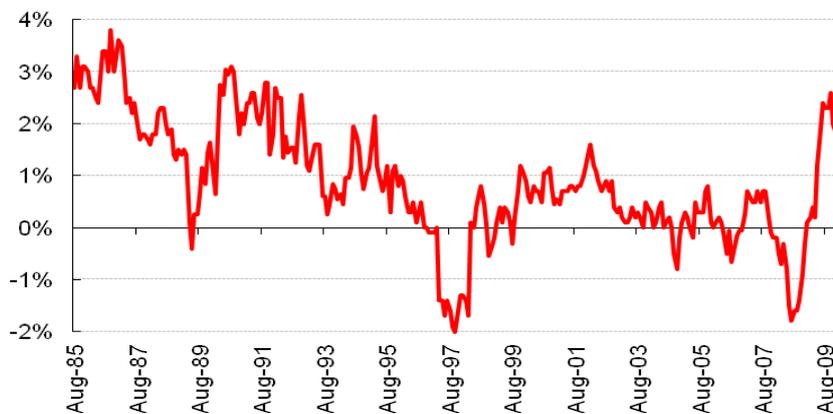
Source: Variant Perception

Undoubtedly none of this is new news, but we think analysts and markets are being complacent. They see it as impossible to see such a scenario as many believe it would spell a breakdown in social order. Well they would be right-that is exactly what will happen. (The Japanese are no longer as subservient as one would historically assume.) It seems to us that no one dared to believe housing could go down globally or that equities could not be a pension. In the same vein no one in Japan dares to believe JGBs could go down.

JGBs have not gone down in value in spite of vast issuance due to a) domestic savings, b) strong home bias amongst Japanese investors (patriots) and c) contained inflation expectations. These could be changing very quickly.

Inflation expectations remained low because the yen was the only currency experiencing the zero bound. Now the world is close to this or at the ZIRP. So at this time Japan is no longer exporting capital to the rest of world, which to our mind was the a major reason Japan experienced zero inflation this last decade.

Japanese Real Rates

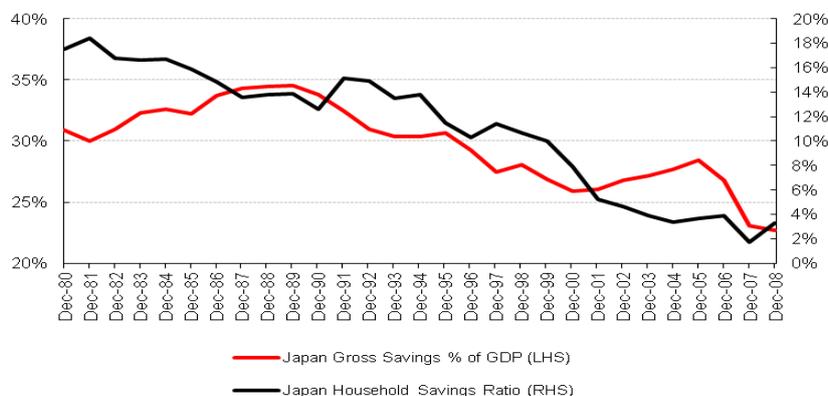


Source: Variant Perception

So inflation expectations could well rise.

If one observes the demographics of Japan, the savings rate is collapsing because the nation is getting older. They do not need to save anymore. In fact they need to cash in their pensions to receive their annuities. Savings are being used up.

Japan Savings Ratios

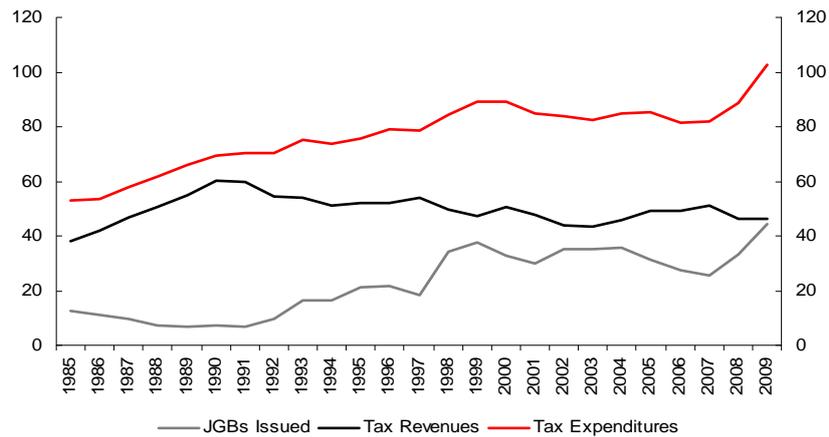


Source: Variant Perception

An awareness of the fragility of the debt situation could actually unnerve funds, even allowing for government pressure on the pension funds to keep buying government debt.

Japan's debt is over 12 years General Account Tax Revenues and within a year it will be closer to 15. It would take half a generation of Japanese taxes to pay down the debt. The current ratio is twice as high as the next highest in history, Britain, following WWII. With the current recession, Japan's FY2010 budget will be the first in the post-war period where revenues from debt (JGB issuance) will exceed tax revenues. This situation is unprecedented.

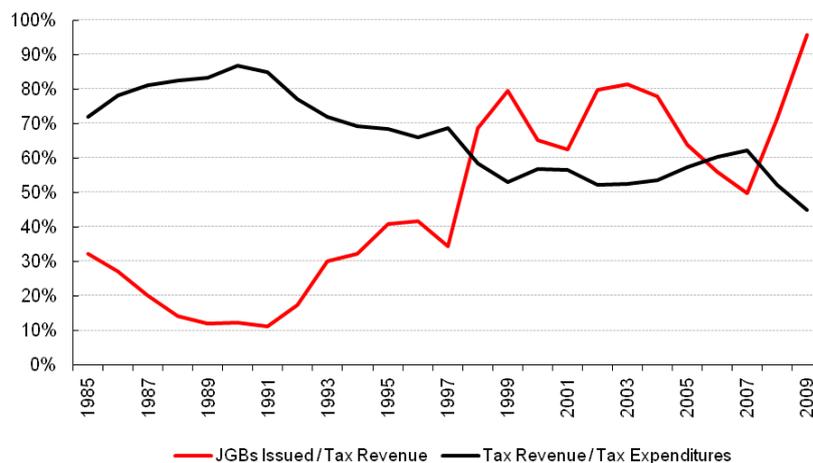
Tax Revenue, Expenditures and JGBs Issued



Source: MOF, Variant Perception

Debt redemption and interest payments make up a large part of the Japanese Government's expenses. Debt expenses in total made up 40% of tax revenues in 2009. A 1% (100bps) rise in the weighted average yield on Japanese government debt would almost double interest payment expenses, taking the total debt expense to almost 55% of tax revenues (based on 2009 figures). If Japanese yields returned to levels similar to that of the early 1990s (ie 5yrs ~ 6%), the entire tax income of the Japanese Government would be spent on debt servicing.

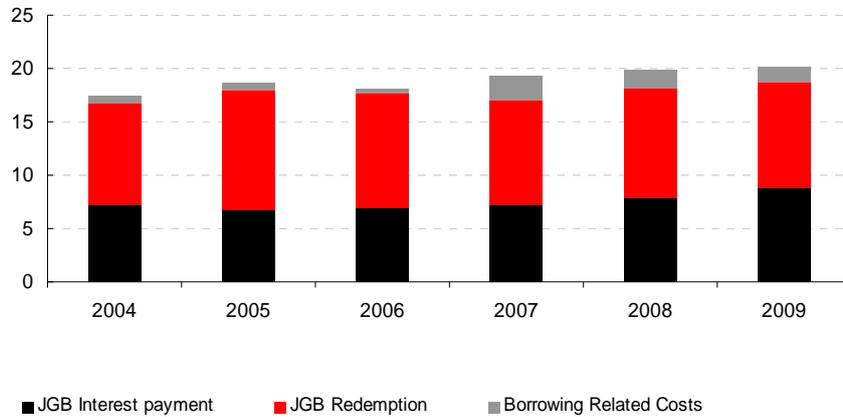
JGB Taxes, Expenditures and JGBs Issued



Source: Variant Perception

This situation is not sustainable. As the great economist Herbert Stein once said, 'If something cannot go on forever, it will stop.'

Changes in Government Debt Related Expenses (in trn JPY)



Source: MOF, Variant Perception

Almost all of the debt is funded with short term maturities, so rollover risk and higher interest rates are a very acute danger, as they are potentially more sensitive to changes in bank base rates than long end rates. Of the G5 countries only the United States has fewer long term bonds as a total proportion of debt issued.

Long Term Bonds as % of Total Outstanding Debts



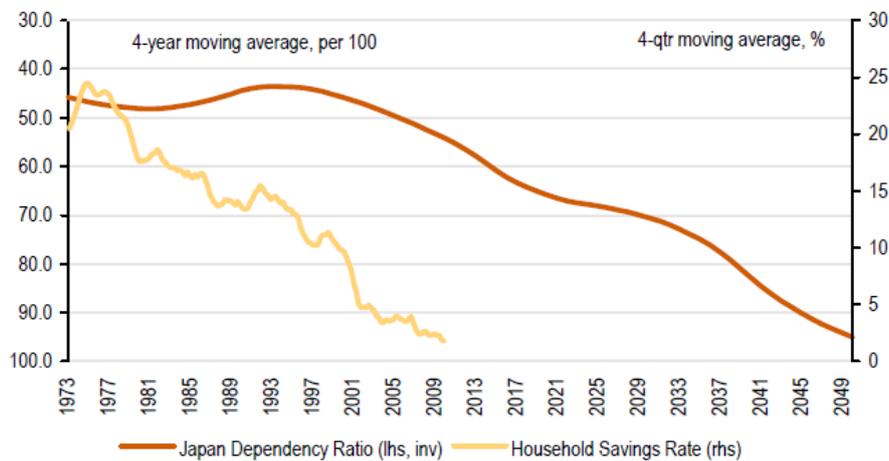
Source: Variant Perception

Japan has survived this long because foreigners don't buy Japanese bonds. Through savings and insurance companies that are directly or indirectly controlled by the state, 94% of all JGBs have been bought by the Japanese.

The three largest holders of JGBs are the Japan Post Bank, Japan Post Insurance and the Government Pension Investment Fund (GPIF). Prior to the 2001 Fiscal Investment and Loan (FILP) reform, postal savings and pension reserves were required to be deposited at the Fiscal Loan Fund. As part of the reform, the compulsory deposits were discontinued and existing deposits and interest on deposits were to be sequentially returned.

From 2001-2009, Japan Post Bank and GPIF used those returned deposits to buy JGBs, and those deposits are now almost completely liquidated. Japan Post Insurance will soon not be a likely buyer because insurance reserves have been in steady decline given Japan's demographics, and their year over year holdings growth is almost 0%. Banks have been filling the void, but don't have a ton of additional capacity given Basel II guidelines. Given the lack of internal demand, Japan will be forced to finance their issuance in international markets. We have already stated that this is highly unlikely due to sovereign debt levels around globe.

Due to aging demographics, the Japanese savings rate will not rise. The Japanese fertility rate is 1.2 children born per woman (2010est) ranking them 218 out of 223. Interestingly the only countries with lower rates are some other Asian countries S.Korea, Taiwan, Singapore, Hong Kong and Macau. The US by comparison has a rate of 2.06 which ranks them 126 in the world. The replacement rate is 2.1 - the golden rate. The demographics dictates the savings rate will go down not rise. The lifecycle savings hypothesis points out you spend when you're young and you save when you get older and then when you get much older, you will spend the money you've saved in your lifetime. Now the Japanese are getting really old, and they're about to start drawing down their savings. The savings rate will go negative.



Source: UBS research, Economic Insights – George Magnus
Demographics are destiny, deflation isn't (or needn't be) 14 July 2010

In fact, as the following chart shows, Japan's dependency ratio is now approaching 100. The dependency ratio is percentage of retired people supported by working people. Very soon Japan will have more retired people than working people and the savings rate will fall still further.

At the beginning of the letter we mentioned Disaster Prevention Day. The Japanese love their memorial days. Another revered day is 'Respect for-the-Aged' Day (敬老の日 *Keirō no hi*?), a day to honour centenarians in Japan, which fell a few weeks later on the 20th September. We are sure the aged will always be honoured but quite possibly the Disaster Prevention day may well be renamed as the Debt Prevention Day.

Japan's oldest person: Chiyono Hasegawa, 113 yrs of age



Photo: AP

The government said in January that the probability of the Tonankai earthquake, which is said likely to trigger the other two quakes, is 20 percent within 10 years and 60 to 70 percent within 30 years.

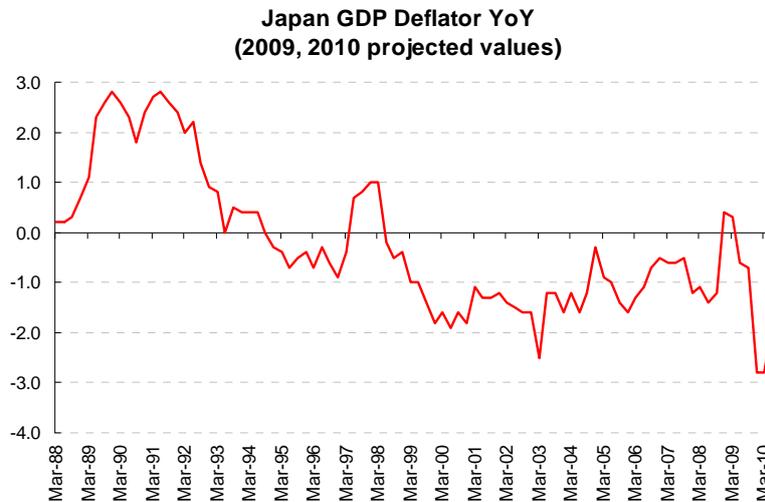
Shimbun Daily

Seem more like the odds for a default on Japanese debt and we are being generous!

We believe that the recent strength in the JGB market should be used to set up bearish bond trades. We can't remember who said it, but the old line is true. "You can't call yourself a real macro trader until you have lost money shorting Japanese bonds." But when the crisis of confidence in Japanese bonds happens, it will likely be swift, and the lucky traders who are short will become revered. JGBs were driven higher, in part by global deflation fears and international bond markets but also by the need to maintain sensible yield spreads to distorted US bond market yields. (A wave of mortgage nationalisation fears and reinvestment of pre-paid mortgages from the Fed balance sheet drove US yields lower.)

The recent increase in yen currency signifies an act that could ramp up further if US QE kicks in again in force. This will unleash a flood of yen potentially into the Japanese and global equity market which have languished at arguably now undervalued levels, particularly in the mid cap sector. The dollar purchases we believe will be recycled not into US bonds necessarily, as once would be the case, but into commodity dollar based assets. Maybe this is supposition, but Japan is not autarkic, it has large energy needs outside its nuclear capabilities.

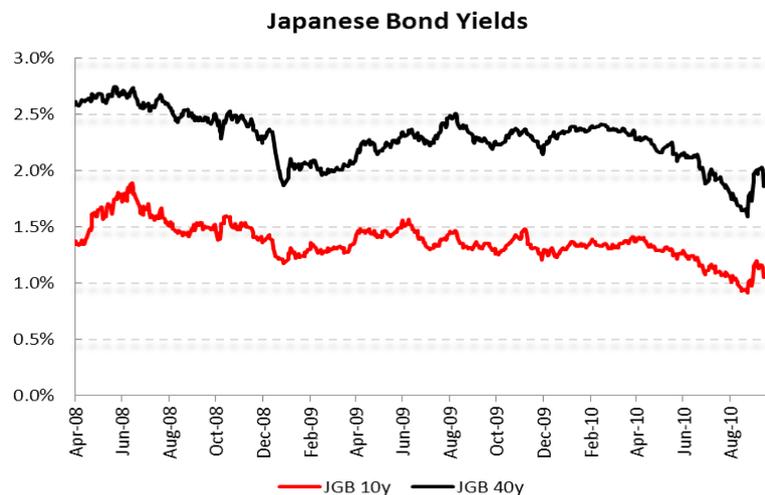
Real rates have been positive for most of the last 2 'lost' decades. Inflation would drive real rates negative. Negative real rates are an extremely good backdrop for gold. Right now, deflator projected values warn of more deflation. Authorities know this and are now acting.



Source: Hinde Capital

All bubbles burst when financing becomes an issue. The Japanese bond market will, in the not too distant future, face a fiscal crisis that will require either draconian tax increases and spending cuts, but that would be extremely socially divisive or debt monetization. This recent intervention leads us to conclude Japan will choose to print money and create an initial illusion of health. As Variant wrote – “most countries have bad choices and worse choices.” Japan has only worse choices.

If sentiment senses an issue for JGB funding, coupled with a change in inflation expectations, at these yield levels long end JGBs are susceptible to a major reversal. We would note the 40 yr JGBs have not managed to rally of late compared to the 10 yr JGBs.



Source: Hinde Capital

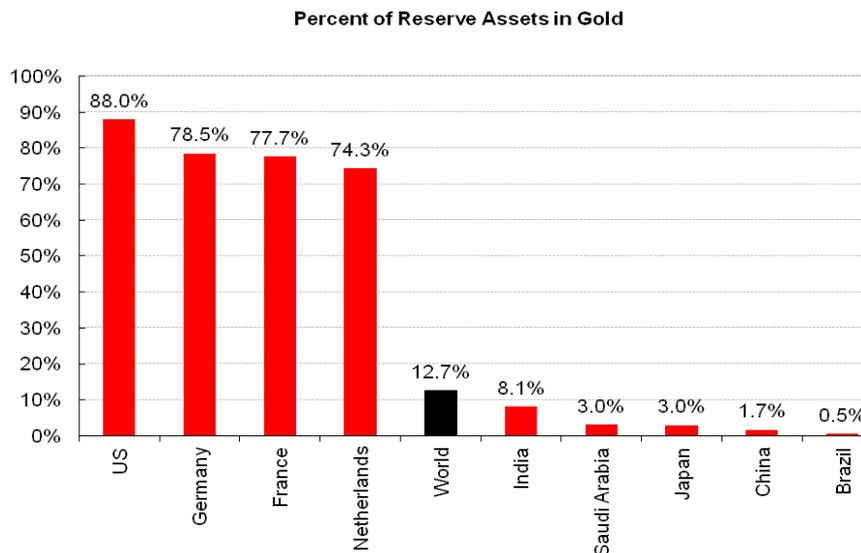
Ultimately we believe there will be a wholesale exit by Japanese out of yen (360 yen full circle here we come) and out of JGBs and in a hyperinflationary environment into gold. This is another country that has a well developed gold market (TOCOM) and affinity for gold, just like China.

A Tael of Two Countries

The ‘Cash’ was a currency denomination used in China from 621 to 1948, and the English derivation quite simply means “tangible currency”. A tael is a Chinese unit of weight. One tael is equivalent to 1.2 oz or 37.4 g. and are widely traded in Chinese-speaking countries, mainly Hong Kong and Taiwan. The **ryō** (両²) was a gold piece in pre-Meiji Japan and was originally a unit of weight from China, the tael.

But it’s been 40 or more years since the world adhered to legal tender backed by a hard, tangible asset. We believe the recent internationalisation* and liberalisation of the RMB has paved the way for a return of some type of gold standard.

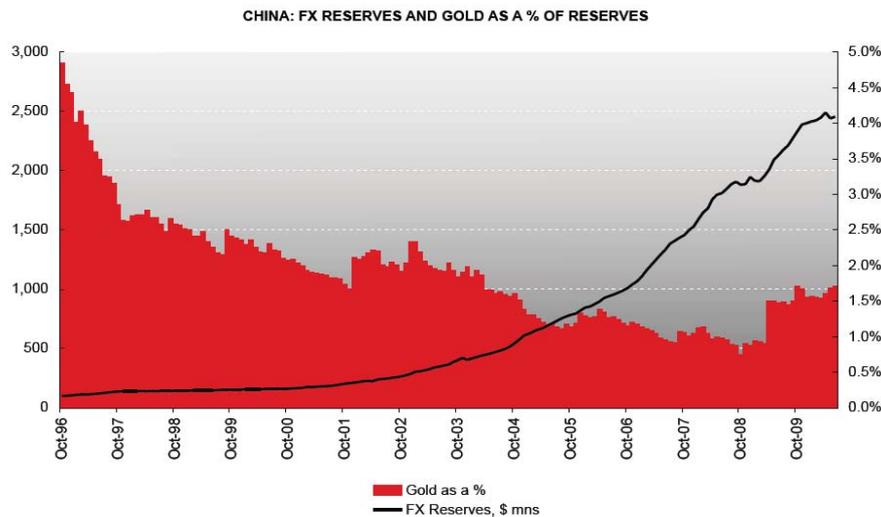
China has also experienced a second wave of liberalisation of the precious metals markets. This took place out of the blue this August. It is a defining moment for the gold and silver market, one that seemed to pass by without much fanfare. China has allowed for import and exporting, foreign participation in the Shanghai gold exchange and a general increase in mining investment. If you couple this with the state encouragement of gold and silver ownership and the desire of PBOC Zhou to move towards a ‘SDR’ like reserve currency (arguably including gold) then China has vocally declared its intention to return to “tangible” cash.



Source: Hinde Capital

Japan like China has low centralbank holdings. A move just to 10% would see almost 7 years of gold mine supply consumed at current annual mining rates. To achieve levels commensurate with that of the US’s 88% of reserve assets in gold, Japan would need to purchase 23,114 tonnes and China 56,249 tonnes.

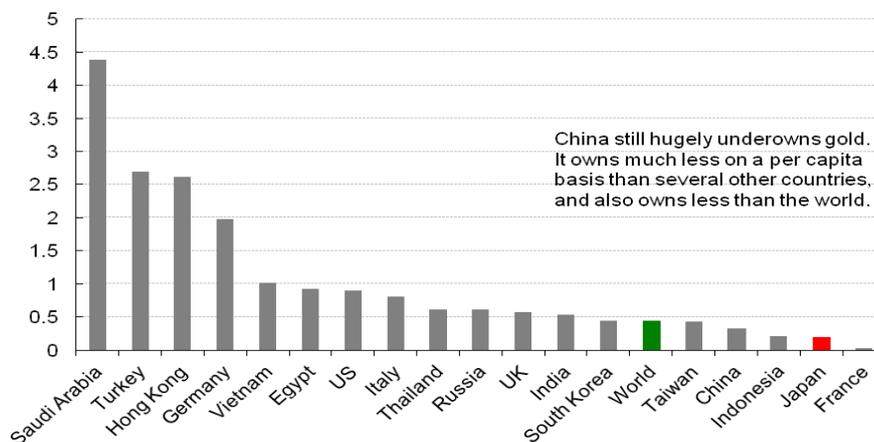
*The Chinese have set up pilot programs to allow trade in RMB in Hong Kong, and all ASEAN countries, with recent news suggesting Russian roubles and Brazilian reals will also be exchangeable.



Source: Hinde Capital

The total combined purchases would be 79,363 tonnes, which is almost 2.5x the available pool of central bank gold. No, we will not see a shift of more Western gold to the East. Certainly not at these prices. The USGS believes there is 60 to 90,000 tonnes left of gold to be excavated in the world based on current geological mapping, which is pretty all encompassing. When we put these purchases for just these two countries it would appear supply is not readily available. There is just not enough around, contrary to what one might think.

Gold Demand (grams per capita)



Source: WGC, World Bank

Now let's observe personal ownership: Japan has a lower per capita ownership of even China. The room for both to accumulate gold is good. Ironically these guys love gold, and their holdings are still very low. The Japanese have been duped into the largest Ponzi scheme ever. They just don't realise it yet.

Remember this gold per capita doesn't include investment gold. Imagine that there was a full-scale exit out of JGBs. There is 900 trillion yen worth of JGBs outstanding that is 10.588 trillion US dollars at 85 yen, today's rate. At \$1,300 per troy ounce gold this is equivalent to 8.14 billion ounces or 253,000 tonnes (8.14bn / 31250) of gold. Now we are not for one moment saying that this is realistic, as if there was a rush from JGBs they will

not be valued at par and not all JGBS will be exited. However it just goes to show how much gold could rise to reduce the amount needed to convert savings. Let's say gold went to \$13,000 then only 25,000 tonnes would need to be found for Japan. Now if you add inflation of the currency and a few noughts you can see how gold can be valued at almost unlimited numbers. Anyone still think \$1,300 is too rich?



Source: The Modern Century
Henri Cartier-Bresson's picture of the rush to retrieve gold from a Shanghai bank on the eve of the communist takeover in 1948

How times have changed, in the photo above the advent of the Communist control in the late 1940s saw Chinese citizens flock to grab gold. These very same people were summarily executed in the days that followed. Now China wants its people to purchase gold and silver. It makes it easier to move to a gold standard if everyone owns the gold!

First, at least one preoccupation of the 1944 delegates remains: how to manage exchange rates and deal with persistent trade deficits and surpluses. The problem blamed for the great depression of the 1930s – 'beggar-thy-neighbour' policies and competitive currency devaluations – may be rearing its head again today. The par value exchange rate system created in 1944 served the world fairly well until 1971, when it was abandoned unilaterally by the US. We believe that the persistent trade surpluses in Asia and corresponding deficits in the West laid the groundwork for the current crisis. The creation of an international currency, international clearing union, or system of globally managed exchange rates should be on the agenda. As the hegemony of the US wanes, there is a practical limit to how long the anachronistic system of a single country's currency serving as the vehicle for all global reserve holdings can be maintained.

Experience shows that neither a state nor a bank ever has had the unrestricted power of issuing paper money without abusing that power; in all states, therefore, the issue of paper money ought to be under some check and control; and none seems so proper for that purpose as subjecting the issuers of paper money to the obligation of paying their notes either in gold coin or bullion.

Henry Hazlitt (1984)

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