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**Speaking Notes//March2012**

**The economics of the long period: towards Strong RMB and Weak US$**

**Patrick McNutt FRSA**

[**www.patrickmcnutt.com**](http://www.patrickmcnutt.com)

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The presentation, available on the webpage noted, builds on four strands of competing issues. The objective is to introduce the audience to signaling theory, used to observe patterns in the communication of government policy. The issue is the EU debt crisis and the increasing role of China in the world economy. The purpose of the presentation is to suggest a coordinated equilibrium template of managed exchange rates for an interregnum period as the world economy recovers from GFC that discounts the likelihood of RMB internationalization. The latter process, part of a long game, has started; more trading nations continue to settle with China in RMB, HK has had RMB-deposit base and RMB bond issues embedded in its financial system since 2010 and in January 2012 UAE signed a three year currency swap agreement with China.

**Signaling cycles:**

Signaling cycles are more prevalent in the translation of government policy into action. Once we identify an empirical link between two economic variables or two players as actors in a game, the observed signals fall into a pattern. The pattern is fixed until an event occurs. During QE, for example, the US dollar weakened and when Bernanke ‘goes silent’ at recent Congressional meetings on any commitment to further QE, the dollar strengthens. The signaling adds an additional layer to US$ rates coupled with a risk-on risk-off trade and carry trade impacts. When a risk-off period begins the dollar strengthens and commentators and analysts engage in talking about the timing and likely duration of the risk-off period. Within the signaling cycle presented in the power point slides there is a solution - it is a coordinated solution that includes a coordination of monetary policy, bank regulation and exchange rates.

**Managed exchange rates**

The second theme concerns the option at G20 level of promoting a managed exchange rate regime as an intermittent stabilizer of currency misalignments during a signaling cycle. Support should come from less developed nations whose currencies continue to fall into a yoyo exchange. Elsewhere we had referred to the economies by the acronym ASLEEP. Many of the ASLEEP economies are subject to currency capture as speculators move into their currency, strengthening it and impacting on exports and challenging their export-led growth. Brazil in particular has called for a managed regime in expressing its concerns on the likelihood of currency wars.

Table 1 presents the options and provides a solution. The combination Weak$ Weak RMB would create a protectionist world; the combination Strong$ Weak RMB would be unacceptable in the US; the combination Strong$ Strong RMB is unstable as long as US$ is a risk-on risk-off currency. The solution is a Strong RMB Weak$, allowing US to adopt export-led growth as China eases into a period of strengthening RMB, by widening the US$ peg bands and facilitating off-shore hubs for RMB.

**Table 1: Solution Strong RMB Weak US$**

|  |  |  |
| --- | --- | --- |
|  | **Weak $** | **Strong $** |
| **Weak RMB** | **NO**  For ASLEEP: unable to export. | **No**  US Congress: costing US jobs |
| **Strong RMB** | **YES**  Signals from PBC: when the period is right. | **NO**  No QE: risk-off would impact. |

**China equation:**

So our third theme identifies a China equation where contrary to orthodox macroeconomics the consumer expenditure variable, C, contributes less to GDP than in any of its trading partners. With a GDP per capita of $2500 one could infer a repressed demand within the Chinese economy. With PBC inflation targets set at 5%, continued use of the RR instrument at the bank level, may dampen inflation expectations in the short period, requiring a switch to more aggressive interest rate policies in the long period. The latter runs the risk of an appreciating RMB. But more interestingly, in redefining a China equation, it is intra-ASEAN trade that is a key determinant of trade and economic activity - ASEAN nations export less than 25% to non-ASEAN trading nations. Many of these nations could opt to settle trade in RMB.

**EU debt-deflation cycle**

Finally, the EU crisis is framed in terms of an absence of a Euro currency crisis and in terms of an evolving debt-deflation cycle. As EU banks, insolvent and bankrupt, continue to deleverage and with the signing of the Fiscal Compact Treaty on March 1 2012, the EU is astride a long term deflation cycle. Reflation is not an option in 2012 as EU and EC policy makers skew away from embedded inflation. The Euro has now emerged as a carry trade, as investors buy in to carry the Australian dollar. As European banks continue to deleverage under the shadow of new Basel III capital adequacy requirements, the debt-deflation cycle will embed itself in the EU economy shackled to an ever increasingly regulated financial system and persistent austerity.

**A Thief of Nature Strategy: China and EU as ‘off-shore hub for RMB**

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**Background:**

The premise in the presentations is based on the economic importance of China and the significant ‘crowding-in’ of RMB in both Sino-international trade and in Sino-financial transactions. Both represent key drivers in a first stage in a process of internationalization. Furthermore China has signaled intent - since 2004 HK has had an RMB deposit base embedded within HK banking system, has had inaugural RMB bond issues. Malaysia and other trading nations began to settled trade in RMB in 2010.

Within a game dimension we identify the players; China as a player will play the long game in a process of internationalization, mindful of the economic and financial impact of a more open capital account. The US as a player, for example, will have more immediate concerns about the future role of the US dollar and dollar-denominated resources. ECB as a player is faced with a debt-deflation cycle across EU economies wherein net exports really have to increase enough to ‘crowd-in’ for fiscal austerity. This can only happen within an orthodox model with a devalued Euro and a low interest rate.

**Signaling cycle: economics of the long period**

Each player alternatively has different yet inter-dependent economic objectives communicated to market analysts by financial signals. Signals are becoming more frequent; they are ‘priced in’ by analysts. In the presentation we reflect on a step-like adjustment from the status quo:

Step 1: internationalization of RMB. Step 2: fully convertible currency.

The focus of the presentation is Step 1. China’s external trade is growing and intra-regional ASEAN trade is a key component part of that trade. China imports 20% of its total imports from these economies. The ASEAN and EM economies, preferring a devaluation to encourage export-led domestic growth, may opt for trade settlement and financial transactions in (revalued) RMB. In terms of trade settlement, it has been estimated by HSBC that 50% of China’s trade settlement could be settled in RMB within next three to five years.

**China equation:**

Investment is a critical part of the China equation outlined in the presentation; while consumption is estimated to explain less than 30% of GDP, investment could explain 50% of China’s GDP in 2012. It is conceivable that funding may switch from reinvested profits to external investment funds; that is, investment funds ‘crowd-in’ as China companies reorganize towards a more Anglo-Saxon governance structure with a greater demand for pay dividends and higher wages. FDI is growing in China, and the overseas companies who invest in China infrastructure may prefer to minimize currency risk and fund in RMBs. China mainland companies issue RMB-denominated corporate bonds and/or IPOs and RSUs. China companies begin to invest abroad before the internationalization of RMB.

**EU ‘Off-shore’ hub process:**

The proposed stages follow the sequence adopted in HK. The objective here is to engage a debate while recognizing the complexities that are likely to be involved.

Stage 1: EU as an off-shore hub could evolve as a process, a process that facilitates the internationalization of RMB:

Stage 2: RMB bank deposits for EU citizens and Chinese living in EU.

Stage 3: China Development Bank permit to issue RMB bonds

Stage 4: China companies begin to invest in EU..SWFs and M&As.

Stage 5: RMB settlement scheme [modeled on HK and Mainland cities model] and Bank clearing agreement

Stage 6: Listing of RMB denominated stocks

**Thief of Nature:**

A *Thief of Nature* strategy is played in the market-as-a-game when *at least* one player recognizes the vision embedded in the present set of circumstance and moves to capture that vision[[1]](#footnote-1). One can think of the *vision* as the forward-looking game environment or scenario dictated by the forces of nature but shaped in the present by the actions of a player today. What if that player was the ECB as a bond broker of a *EUCHINA* bond?

EU is in a period of economic slump. The EU economy faces a debt-deflation cycle and China is constrained by the China equation; a new macro-economic template and innovative financial solution is required. So the ECB acts as a bond broker in a pre-agreed purchase with China as favored purchased (FP). The *EUCHINA* bond would be a traditional bond with put options ensuring that EU policy-makers reach pre-agreed economic targets[[2]](#footnote-2). It could be part of a global G20 solution that includes managed exchange rates; objective - to secure economic stability. But why would China commit to this? In one respect it is what China’s economy will require in the long period – a global process to accommodate a more consumer-led growth and facilitate the regulation of domestic banks within China. The PBC’s February 2012 Report did signal a cautious note on the opening up of the Chinese financial system. But as European banks continue to deleverage and Chinese companies wish to expand abroad there may be a strategic opportunity for more Chinese investment abroad. This coupled with the continued misalignment in currencies and the threat of a protectionist currency war, does provide the ideal conditions for the long game of RMB internationalization and full convertibility to begin - Dubai has signaled an off-shore hub, why not Europe?

Ends

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1. New edition of PMcNutt (2010) *Game Embedded Strategy* McGrawHill scheduled for 2013.. [↑](#footnote-ref-1)
2. For example, interest rates could be one of the pre-agreed economic variables, and if rates were to increase then China could force ECB to repurchase the bond. ECB has an incentive to keep interest rates low until bond maturity. [↑](#footnote-ref-2)