TD Bank Financial Group

TD Economics
Observation
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WHY CHINA WANTS TO DUMP THE DOLLAR

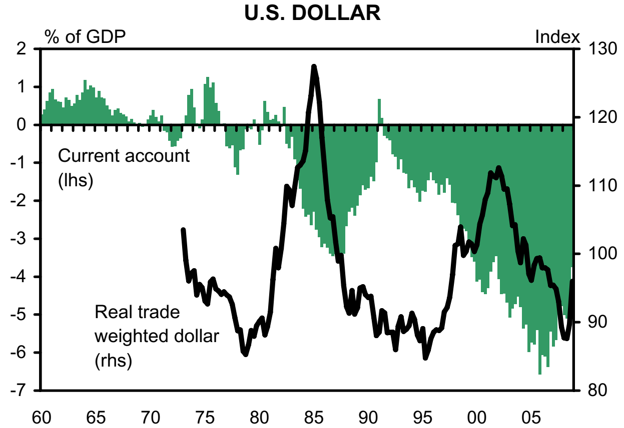
Comments from the Governor of China's central bank, Zhou Xiaochuan, that the U.S. dollar should be replaced by the SDR – Special Drawing Right – as a global reserve currency have raised some eyebrows and more than a few questions. First off, what the heck is an SDR? Second, what would this change do for the U.S.? And third, why is China suggesting this?

We address each item in turn, but the crux of the matter is that using the SDR as a global reserve currency would not change the fact that China runs a trade surplus nor the fact that a large part of that surplus is with the U.S. nor the fact that someone must hold a corresponding amount of dollar-denominated assets to resolve the balance of payments. What it could potentially do is two things. It would mean that a country which did not want to hold as many U.S. dollars, or any other currencies held in reserve for that matter, could instead exchange those dollars with the International Monetary Fund (IMF) for SDR-denominated assets. And second, it is hoped it could potentially reduce the pressure on the U.S. dollar to depreciate over time as a means of correcting its own trade deficit. In so doing, this would moderate episodes such as the capital losses China has seen on their reserves as the dollar depreciated.

HIGHLIGHTS

- **China's central bank governor has suggested the U.S. dollar should be replaced as the global reserve currency.**
- **His suggested replacement is the SDR, an IMF-managed currency which is a weighted average of the U.S. dollar, euro, yen, and sterling.**
- **This could reduce dollar volatility and perhaps mute appreciation and depreciation swings.**
- **However, the benefits are far from certain and this is certainly not a "shovel-ready" project.**
- **Politically, this could help deflect domestic criticism of the Chinese central bank that they should ease monetary conditions more.**
- **The sentiment is prevalent around the world, however, and will keep pressure on the U.S. dollar to depreciate, even as the U.S. slowly recovers.**

U.S. CURRENT ACCOUNT ADJUSTMENT AND THE U.S. DOLLAR



Source: BEA, Federal Reserve, and Haver Analytics

What is an SDR?

The SDR, or Special Drawing Right, is effectively just another currency. It was created in the 1960s by the IMF and fixed to gold prices, and when the global gold standard collapsed in the early 1970s, it became a weighted average of major reserve currencies. This currently includes the U.S. dollar, euro, sterling, and yen, with each weighted by their respective importance in global trade and capital flows.

It was the rapid growth of global trade and capital flows that prompted the creation of the SDR. There just wasn't enough gold to back all these growing flows, and it was prohibitively expensive to ship this gold all over the world as payment. However, over time, the world shifted to one global currency, the U.S. dollar, as the reserve currency of choice. Meanwhile, the SDR was generally relegated to the unit of measure for the IMF's assets and lending programs.

Is the U.S. dollar the problem?

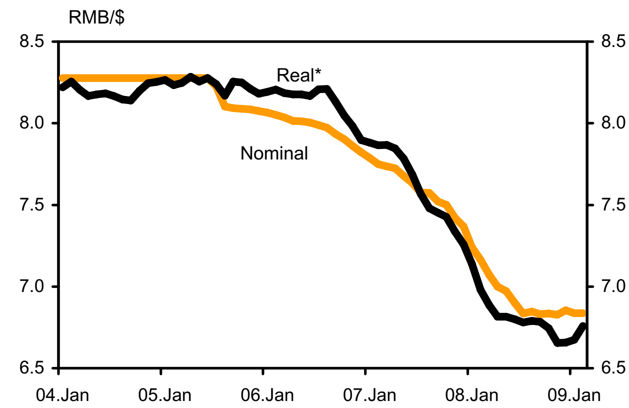
The U.S. current account was in surplus throughout the 1960s, but as the gold standard collapsed in the early 1970s, the U.S. current account trended deeper and deeper into deficit Not only that, we have seen some sizeable shifts of the U.S. dollar from time to time as a means of balancing this deficit. An argument can be made that being the global reserve currency automatically necessitates a tendency towards current account deficits. There needs to be enough of your currency to go around and a large U.S. current account deficit is simply another way of saying there are a lot of people in the world holding dollar assets.

The problem is you can point to all sorts of other reasons for this shift in the mid-1970s. Two examples within the U.S. would be innovations in credit and expectations of strong economic growth. With credit generally easier and cheaper to get in the U.S. than elsewhere, this fuels stronger consumer spending in the U.S. and therefore more imports. Alternatively, a higher expectation of future economic and income growth by U.S. workers means there is less need to save today, and therefore more of the capital investments need to be financed with foreign savings.

Even before the current crisis, there was some merit to the argument that the world has a problem handling liquidity. We can string together the global shifts since 1973 as a constant attempt at evolution of the global system. The collapse of the gold standard and introduction of floating exchange rates in the 1970s was followed shortly thereafter by skyrocketing commodity prices. This drove massive amounts of bank loans to emerging markets, which led to emerging market government debt crises. In turn, emerging markets turned to borrowing in private capital markets rather than bank loans, which led to the financial crises in the 1990s when depreciating EM currencies made those debts skyrocket in cost. To address these vulnerabilities, emerging markets accumulated vast international reserves as a byproduct of dampening currency volatility and appreciation, but this depressed the level of interest rates around the world. Cheaper borrowing costs and greater incentives to innovate in credit markets around the world eventually led to the current crisis.

Critics would seize on this as a reason the world should return to the gold standard, and the SDR in many ways is simply a softer form of a global gold standard. There is a classic problem, though, of distinguishing causation from correlation. Did the gold standard prevent global liquidity spurts? Or did the same changes in the world that took down the gold standard – growing trade and capital flows, growing wealth and demand for credit among consumers and growing economies, etc –also drive liquidity through these cycles of feast and famine? And concerns remain. Would an SDR-based system just turn the IMF into a warehouse of unwanted currencies? Would this option really limit undue pressure on unwanted currencies or spread that

RENMINBI EXCHANGE RATE



*Adjusted for US/Chinese inflation differentials; Source: Federal Reserve, BEA, China National Bureau of Statistics, Haver.

FOREIGN EXCHANGE OUTLOOK

Currency	Spot Price 3/18/2009	2009 Q2F	2009 Q3F	2009 Q4F	2010 Q1F
CAD per USD	1.265	1.220	1.205	1.149	1.149
JPY per USD	98.3	100	102	102	104
USD per EUR	1.313	1.400	1.450	1.500	1.500
USD per GBP	1.398	1.556	1.629	1.685	1.705
CHF per USD	1.168	1.107	1.097	1.080	1.080
USD per AUD	0.662	0.570	0.580	0.600	0.620
USD per NZD	0.530	0.450	0.450	0.460	0.480
CNY per USD	6.83	6.90	6.90	6.90	6.90

f: End-period forecasts by TD Economics as at March 4, 2009; Source: Federal Reserve of New York, TD Economics pressure to otherwise desirable currencies? We must be cognizant of the possible systemic risks and examine them fully. The current global system is certainly far from perfect and exploring the option of an SDR-based global system is well worth examining, but we simply have little way of knowing all of the possible drawbacks and this plan is certainly far from "shovel-ready."

Why China? Why Now?

So outside of the possible global merits, why is China's central bank Governor espousing this idea now? The central bank is under a great deal of pressure to provide even more stimulus to the economy than they already have through even lower interest rates and reserve requirements as well as allowing the renminbi to depreciate rather than hold it steady as they have during the current crisis. By making this suggestion, it helps to displace some of that criticism. It also feeds into the ongoing anger in official Chinese circles over the capital losses that have been taken on China's holdings of U.S. dollar assets, which reportedly continue to make up almost two-thirds of China's foreign exchange reserve in spite of moves over the years to diversify.

These comments come just a couple weeks after Premier Wen Jiabao expressed concern over the safety of China's holdings of U.S. Treasuries. No doubt, China is vulnerable to losses because of the large share of their holdings that are in U.S. government debt. Similarly, the U.S. government is vulnerable to a sharp selloff in Treasuries because of the large share of assets which are held by just one party, China. However, it would be mutually assured destruction for both economies if China were to suddenly sell off these Treasuries. In fact, given China's economic growth depends in large part on exports to consumers in the U.S., it is not a stretch to say that China needs the U.S. economy more than the U.S. needs the Chinese economy.

Dollar Daze

All this said, a general distaste for the U.S. dollar is nothing new. In fact, it has been at the root of our belief for many months that while the U.S. dollar was appreciating, eventually we would see a sustained move lower in the U.S. dollar. During the height of the crisis, the desire to diversify was mitigated by a search for safety. But as the dust clears, the slow economic recovery we expect in the U.S. economy, as well as a government debt burden approaching 100% of GDP before even addressing long-term issues such as Medicare, Medicaid, and Social Security, means the fundamentals simply aren't there to support the U.S. dollar at current levels.

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