

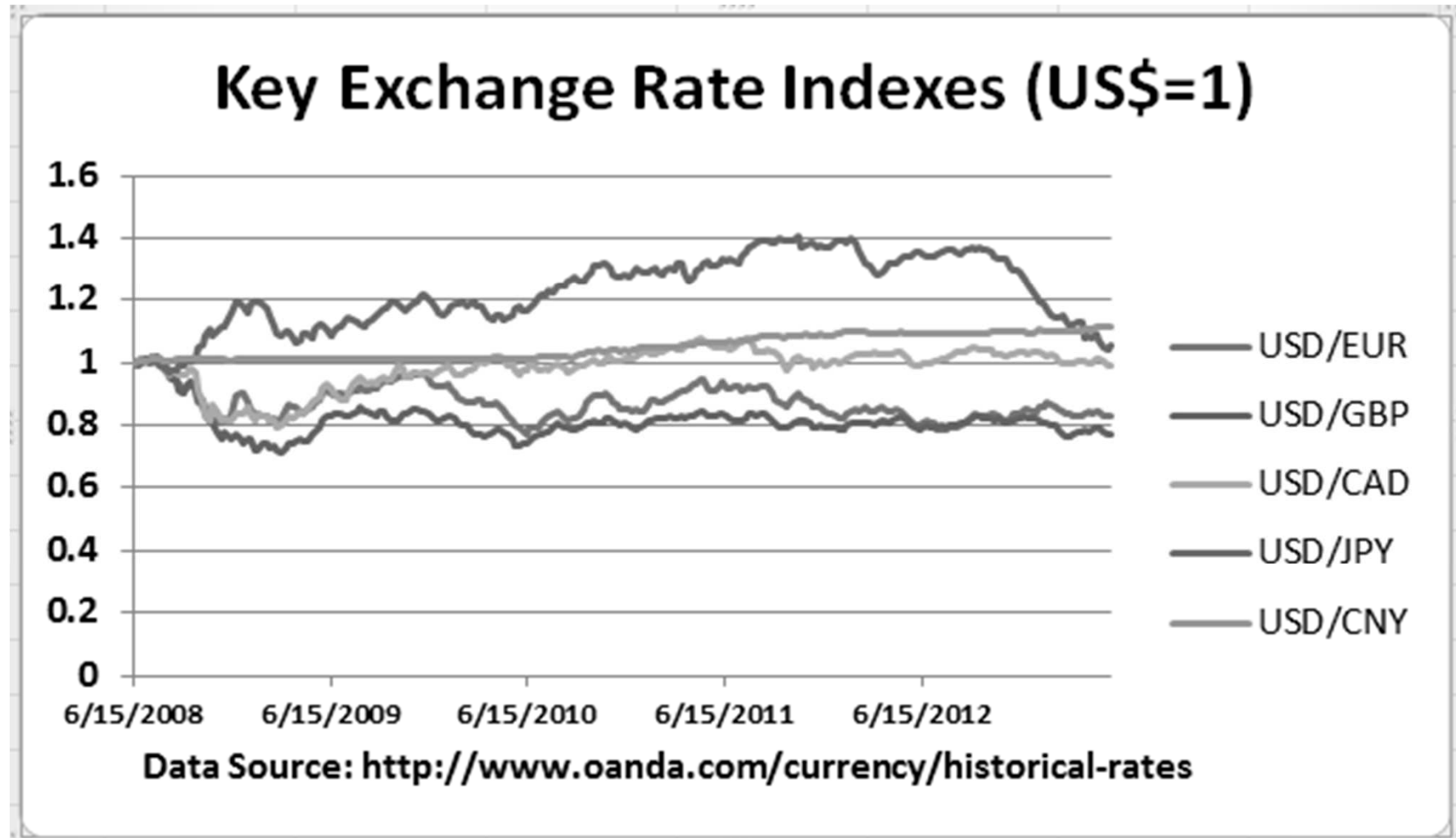
Whazup with Sovereign Currencies?

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Some Patterns Have Emerged in the Exchange Market Since the Financial Crisis



Observations on Movements in Exchange Rates

- Most currencies (except the yen and renminbi) weakened relative to the USD during the crisis because of the flight to quality.
- The yen strengthened until fairly recently when the Japanese government embarked on more expansionary monetary and fiscal policy to combat more than a decade of stagnation.
- The renminbi has been maintained in a stable relationship with the USD by the Chinese government only permitting a small appreciation.
- The euro and the UK pound fluctuated around a lower level relative to the USD with the euro strengthening until the onset of the eurozone crisis.
- Following an initial decline the Canadian dollar recovered and remains close to parity with the USD.

Sovereign Currencies Were Built on Gold

- From ancient times to the 20th century, gold was used, either directly coined or in exchange, as money as was silver.
- This was because of their intrinsic value and their convertibility.
- Historically, the strongest currencies have been associated with the most powerful nations and have been backed by gold or silver – the Spanish real, the British pound, and the U.S. Dollar.
- And private banks in these countries could redeem their deposits in these currencies, which were in turn redeemable in gold.
- The gold exchange standard reached its zenith in 1913 before it was blown up by WWI financial pressures.
- While partially restored after the war, and incorporated in the Bretton Woods system, which itself collapsed in 1971, the managed currencies of sovereign nations have replaced those formerly based on the gold standard.

Currencies as the Creation of Sovereign Entities

- Since the demise of the gold exchange standard, currencies are fiat money, with the main underlying assets being public and private debt.
- Like all things economic, their values depend on supply and demand.
- Supply is obviously how much is created.
- On the demand side, fiat money depends critically on confidence in the stability of the internal and external value of the currency and on its convertibility.
- And this depends on the quality of the underlying assets and the financial strength of the governments and the banks managing the currency and credit.
- Inflation targeting also bolsters confidence in the currency.
- The most widely-accepted currencies continued to be those of the most powerful countries – the dollar, pound, mark and yen.
- The euro is the first global currency produced by a group of countries, which, while not exactly a state, is moving in that direction.

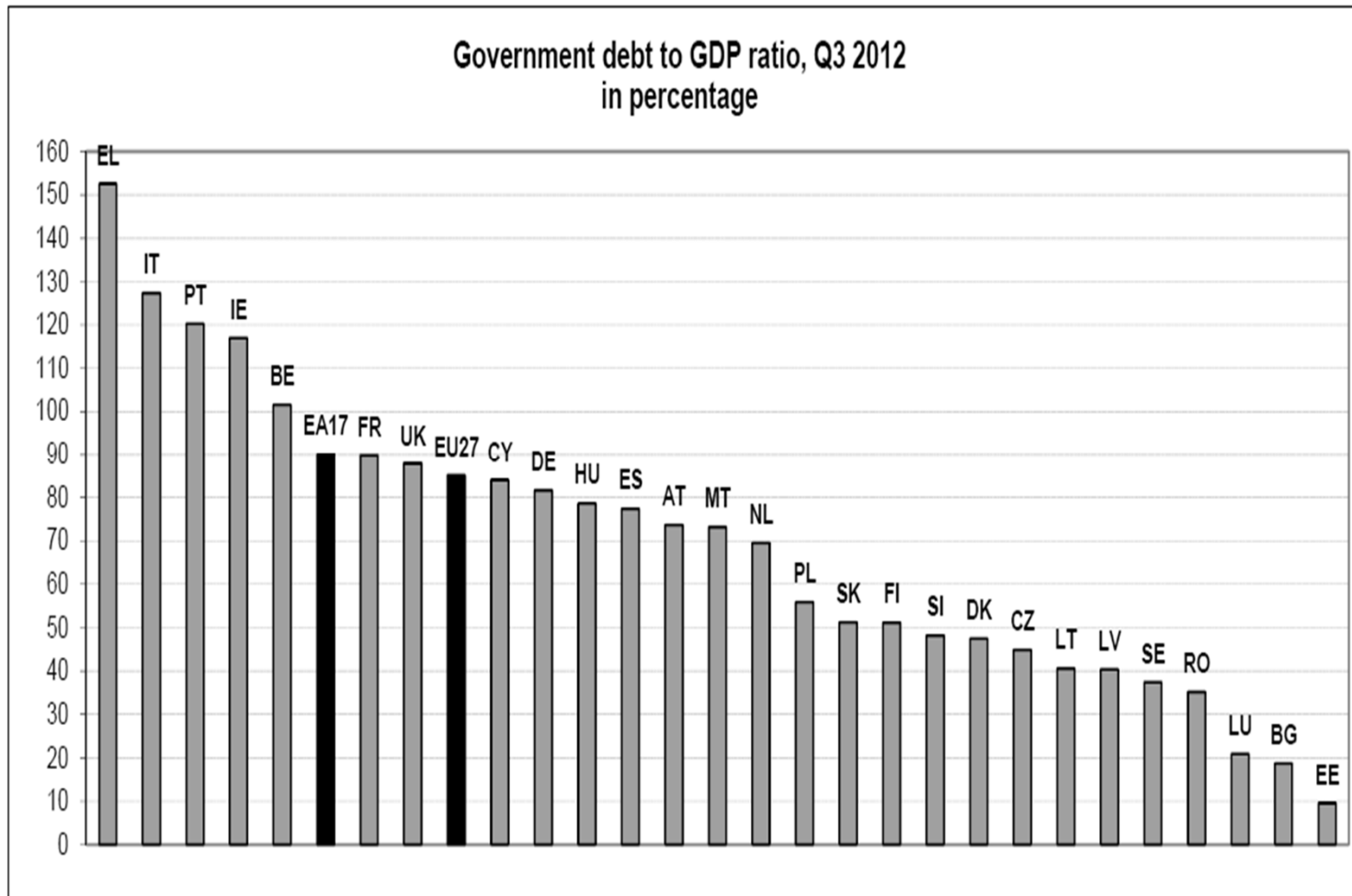
The Strength of Currencies

- Following its introduction in 1999, the euro was expected to challenge the dollar as the premier global currency being held in reserves and used for pricing important contracts.
- But the recent financial crisis (Greece and Cyprus) has underlined its limitations as a currency not tied to an integrated sovereign economic entity.
- In particular, the lack of a common fiscal policy and banking union has been identified as problematic, which is why steps are being taken to strengthen the union.
- However, it is not clear that they will be sufficient to preserve the euro zone in its entirety.
- And there is resistance from the United Kingdom which does not want to see the EU become more state-like and threaten its sovereignty and the international competitiveness of its critical financial sector.
- Nevertheless, the euro has been remarkably stable following its initial drop during the global financial crisis.

Lessons of the Euro Crisis

- The eurozone needs a lender of last resort and the ECB has had to struggle to fit the bill.
- It needs common banking regulations.
- It also requires fiscal discipline.
 - Countries like Greece can use their ability to incur high debt and get in lots of trouble with disastrous zone-wide consequences.

Debt Burdens in Europe



Eurostat, NewsRelease Euroindicators, January 23, 2013.

Future Threats to the Eurozone

- Refusal to deliver on promised austerity programs.
- Frustration of Northern European voters with profligacy in the south.
- An overleveraged and still vulnerable banking system.
- Renewed speculation against Southern European currencies.
- Sovereignty movements in Catalonia, Basque, Belgium, and Scotland.

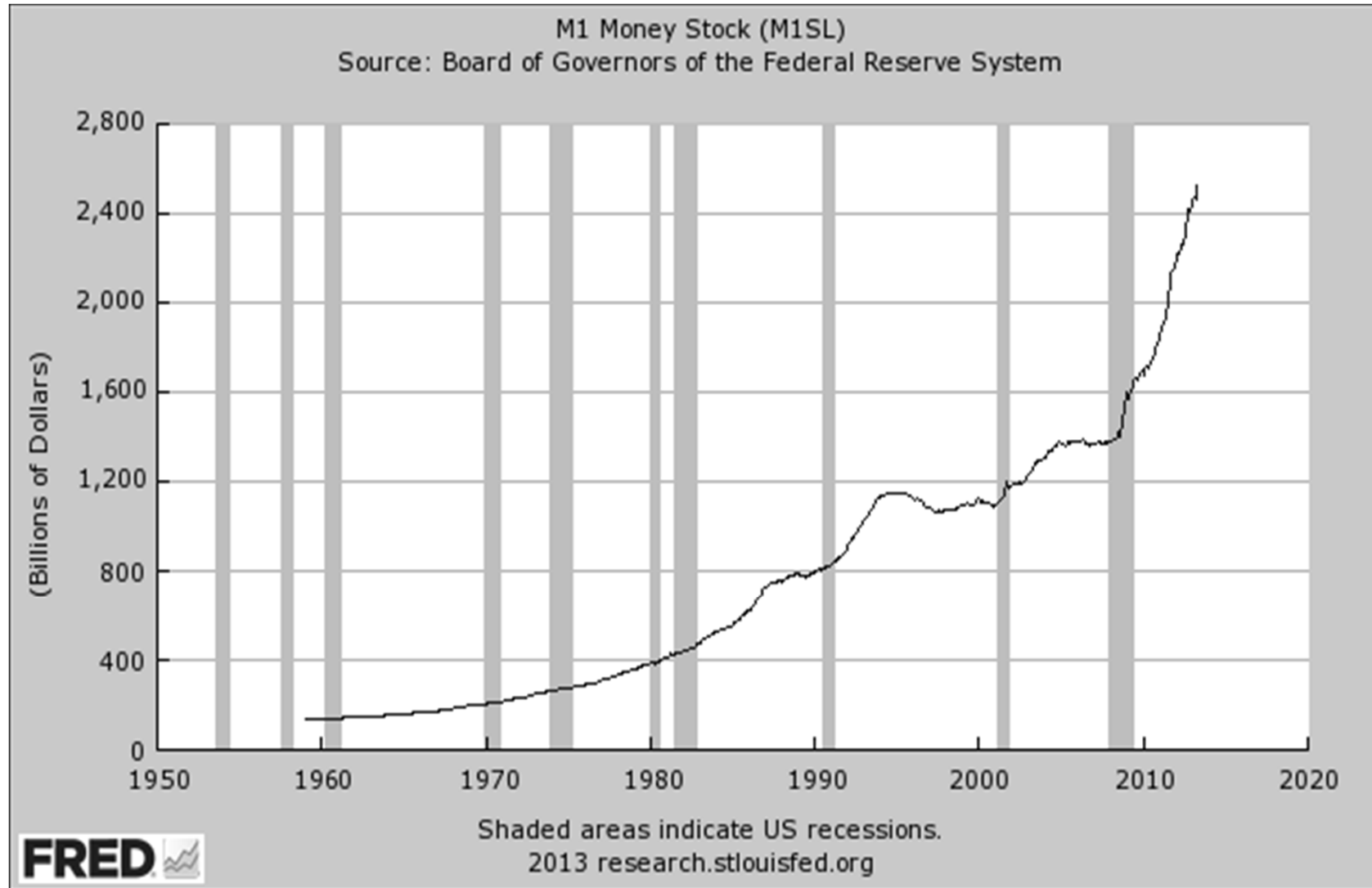
The US Dollar?

- The underlying US financial system has been strengthened since the crisis.
 - Mergers have created stronger banks.
 - Low interest rates have helped banks to rebuild their balance sheets.
 - The Wall Street Reform and Financial Protection Act.
- But the growth of debt and monetary expansion create risks that may undermine its future value.

Monetary Policy has been Very Expansionary

- The Federal Reserve has quadrupled its balance sheet to over \$3 trillion, raising the monetary base.
- QE is continuing at \$85 billion a month.
- And money supply (both M1 and M2) has been growing very rapidly.
- Granted, this is necessary to keep interest rates low in the face of ballooning government debt and to promote growth.

M1 Growing Rapidly



Hard Questions

- When will inflation pick up?
- Or is this time different?
- When will the Fed start tapering off QE?
- How will the excess reserves be sterilized to prevent an excessive increase in the money supply?
- What will be the implications of this for real growth and unemployment and the external value of the dollar?

The Yen and the Renminbi

- The yen has been dropping as Japan pursues Abenomics to counter decades of stagnation.
 - A weaker yen will challenge other emerging market countries.
 - Could make the yen a less attractive asset.
- The Renminbi has appreciated modestly.
 - But it's still considered undervalued, most notably by the US.
 - That it's not fully convertible makes investors leary.
 - However, some comfort should be provided China's \$3.5 trillion in foreign exchange reserves.
- The US dollar will not face immediate challenges from Asia to its status as the world's premier convertible currency although it will probably welcome further appreciation of the renminbi.

The Canadian Dollar

- The Canadian dollar is to a certain extent a commodity currency tied to oil and other volatile resources prices, but it also doesn't tend to wander too far away from the US dollar.
- Housing price correction could also impact the Canadian dollar. But which direction?
- Fears that Canadian dollar may weaken substantially, to, as some say, as low as 90 cents by late 2013 or early 2014 (TD Economics, May 9, 2013).
- Attractiveness of the US Dollar in times of crisis.
- But this could be offset by pickup in US inflation.
- Regardless of the forces that buffet it, the Canadian dollar will remain fundamentally sound because of the underlying strength of the Canadian economy and policy.

Convertibility of Sovereign Currencies

- Many nations that are currently part of larger countries are discussing autonomy.
- This raises many questions for their monetary policies and their impact on their economies.
 - What could guarantee the value of the new currencies if they are established?
 - Will a central bank have to be created to manage the monetary system and steer the economy?
 - Would the debt of the new country have to be cleared or rescheduled?
 - Would debt issues undermine the values of the new currencies?
 - How would international trade be affected?
 - What would be the implications for local prices if new currencies are weak?

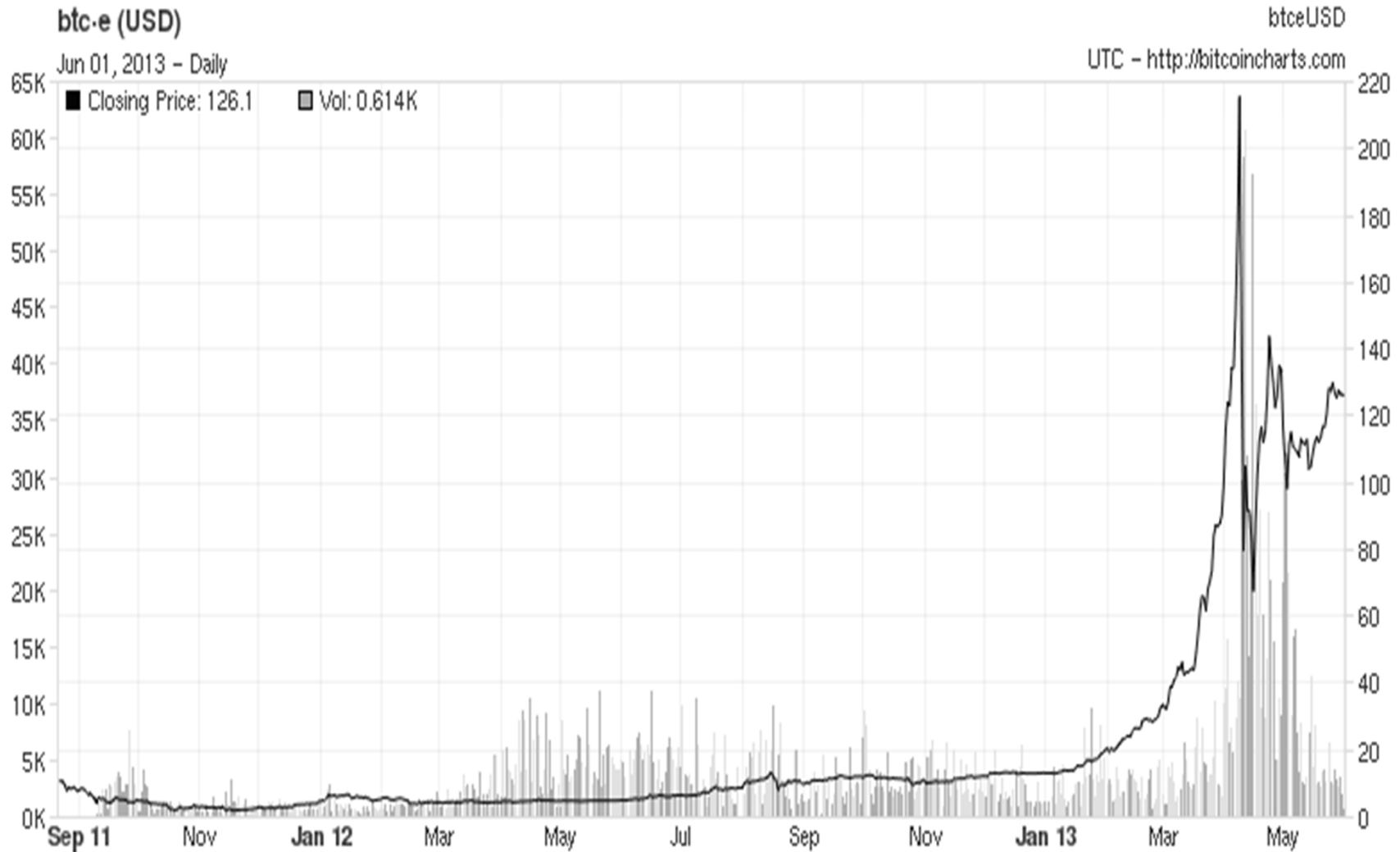
What is Bitcoin?

- Bitcoin is something new in the world of currencies, a virtual currency created by “miners” using some sort of cryptographic mathematical algorithm.
- It has been around since June 2009 when it was introduced by a shadowy figure named Satoshi Nakamoto who has since disappeared.
- Unlike conventional currencies like the dollar and euro centrally managed by sovereign governments and their central banks, the bitcoin is decentralized, meaning that it is controlled by its users although its algorithm is supposed to limit production to 21 million units.
- Like other currencies, it can be used to make purchases, mostly on the internet i.e. alpaca sweaters and the recently-publicized Porche.

Bitcoin Gets above the Radar

- While the bitcoin took a while to get started, it has recently ballooned in value before dropping back attracting a lot of media attention.
- There are currently 11.2 million bitcoins virtually existing, worth \$1.45 billion.

The Price of a Bitcoin



<http://bitcoincharts.com/charts/btceUSD#tgCzm1g10zm2g25zv>

Money Laundering through Bitcoin?

- An important characteristic of the bitcoin is that its use can not be (easily?) regulated by governments.
- This has led to concerns that it could be used for money laundering or other criminal purposes.
- Last week the U.S. Treasury shut down Liberty Reserve the supplier of similar anonymous virtual money transfer services.

The Future of Bitcoin?

- Bitcoin does not currently satisfy the key requirements for an acceptable currency.
 - Unit of account.
 - Store of value
 - Medium of exchange.
- It lacks credibility and transparency.
- Its price fluctuates more like a volatile commodity than a real currency.
- Its recent price movements have been bubblely, underlining its riskiness as a store of value.
- Its small billion dollar capitalization is dwarfed by sovereign currencies (US M2 is \$10.5 trillion now).
- There's a risk that Governments could try to shut it down if it gets too large and causes problems.
- It is still too early to say if it, or something similar, has legs.
- But it certainly won't be taking any significant market share from sovereign convertible currencies in the next few years.

Conclusions

- The US dollar will still remain the world's most important sovereign currency even if inflation picks up.
- The euro, the yen and the renminbi are not in a position to challenge its dominant status.
- The Canadian dollar may weaken relative to the US dollar, but it will continue to trade in a relatively narrow band around the USD and remain one of the world's most solid second-rank sovereign currencies.