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Towards a stable multi-reserve currency system?

Gold to benefit from long-term FX changes

Gold has had a good run over the past ten years. I have tended to underestimate it, mainly because I get exasperated by the gold bugs who insist that the world (or any one country) could and should return to a gold standard. Not only is that a bad idea, it is above all not possible – there just isn't enough gold! But, intriguingly, gold may yet return to play a more important role in the international monetary system.

Last Friday in Beijing, OMFIF published *Gold, the renminbi and the multi-currency reserve system*, a report written on behalf of the World Gold Council.[1] The report reaches two interesting conclusions: First, when it comes to reserve currencies, we may be headed into the unchartered waters of a multi-reserve currency system. Second, the role of gold in the world monetary system could and should, as a result, increase, and there are long-term consequences for other currencies as well.

These two developments go together.

A reserve currency in the modern sense of the word signifies a currency held as part of the foreign exchange reserves of central banks and other monetary authorities; a currency that is used in trade, not only with the issuing country but also among countries that do not include the issuer; and a currency that is used in official investment and financial transactions.[2] The existence of a reserve currency presupposes international trade between countries with different currencies. From this perspective, there have only been two dominant reserve currencies, sterling from the late 18th Century until (somewhat

[1] The full report is available from OMFIF (www.omfif.org).
[2] In practice, these three aspects are mixed. An oil-exporting country may, for example, choose to denominate part of its sales of energy to China in renminbi, and will both hold stocks of renminbi in its reserves and also wish to carry out renminbi bond issues in either Hong Kong or Shanghai

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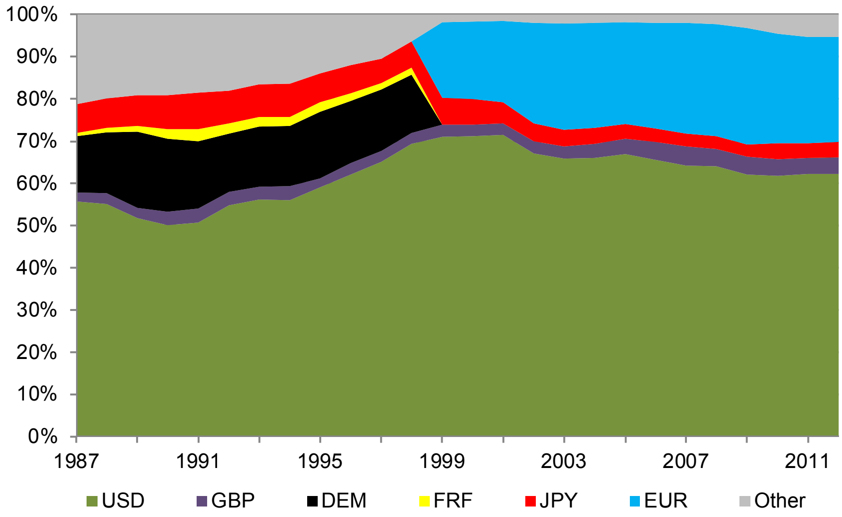
arbitrarily) 1976; and the dollar since (again somewhat arbitrarily) the First World War. While the two coexisted from about 1916 to 1976, the period was mainly one of sterling decline and dollar ascent in terms of importance.

While there have from time to time been attempts to challenge what Valery Giscard d'Estaing once called the "exorbitant privilege" that the US enjoys by having its currency used globally, these challenges – mainly from the D-Mark and the yen – were half-hearted. For one thing, being a reserve currency issuer not only brings benefits, but there are also some significant costs. Notable among these are the need to generally run a current account deficit to supply the world with liquidity, the loss of control of the exchange rate (more relevant for Japan than for Germany) and an increased responsibility for the health of the world financial system (something the USA did not realise at the time of the Great Depression).

However, one aim behind the creation of the euro was to establish a rival reserve currency. Moreover, the Chinese authorities have made it clear that they wish the renminbi (RMB) to play a more important international role and eventually become a reserve currency as well.

These developments raise a number of question marks. First, one has to assume that the US is unwilling to give up the dollar's role as a reserve currency and is likely to resist any trend in that direction. So too did Britain in the aftermath of the Second World War; but the US economy is vastly more important and vibrant today than the British was then. The US remains the world's largest, most dynamic and flexible economy. Nevertheless, the IMF's COFER data show that the euro's share of declared FX reserves is already greater than those of the legacy currencies combined. In addition, already some central banks (eg, in Europe the National Bank of Austria) are already beginning to build up RMB reserves.

Declared currency reserves, %



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The euro possesses the necessary liquidity and deep capital markets to be a reserve currency, but, of course, has its own problems right now. By contrast, the RMB is far from becoming a ‘real’ reserve currency. For one thing, in order for that to happen, China would have to abandon the RMB/dollar peg. If the RMB is pegged to the dollar, why would anyone wish to hold RMB instead of the more liquid, tradable and useful dollar? Possibly in order to curry favour with China, possibly if you have currency controls and difficulty getting hard currency and find it easier to arrange bilaterally to get RMB than dollars. But this is all for minimal amounts. To play a greater independent role, the RMB would have to float. In addition, China would have to fully liberalise its current and capital accounts and make the RMB convertible. It would also have to develop both deep and wide financial markets; and give up any attempt at controlling entry to and exit from the RMB. While at least some of this supposedly is on the cards sometime in the future, much would then depend on whether markets would be prepared to move towards a greater role for the RMB.

However, assuming they do – and assuming that the euro successfully overcomes its problems in some way – the world would be sailing into the unknown waters of a multi-reserve currency system. This has never really existed before. It isn’t even clear if it *can* exist, at least on a stable basis. But, if it does, there are some interesting consequences for gold.

The previous shift from one reserve currency to another – ie, sterling to dollar – saw the demand for gold rise whenever there was turbulence. If this occurs with two currencies, it is the more likely to occur with three (more if we assume that there will still be regional or lesser roles played by the likes of sterling, the yen and possibly others as well), where the possible permutations multiply.

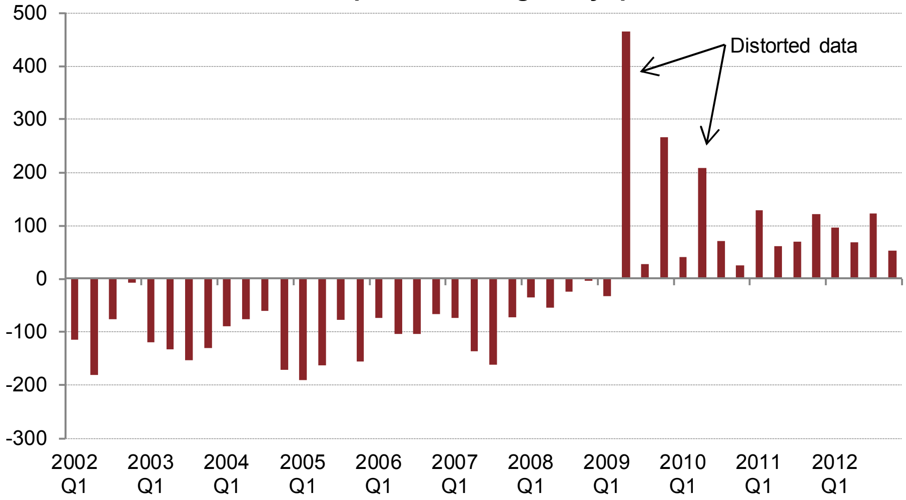
One important driver here is likely to be the shift in composition of Chinese FX reserves. They are likely to diminish – their size is already long since ridiculous for a country like China. But, in addition, their composition will change as well. An issuer of a reserve currency does not need to hold the liabilities of others as reserves. Gold constitutes more than 70% of US FX reserves; as it does of the reserves of Germany, France and Italy as well. If the RMB is a reserve currency, why would China wish to hold a greater share of its reserves in dollars? Possibly as an investment; but not the tune of more than 2 trillion dollars (assuming euros make up one quarter of Chinese FX reserves, as has been claimed).

Of course, this creates a dilemma for China – or, rather, exacerbates an already existing one. If you have too many dollars, how can you rebalance your holdings in any way *without* triggering a sharp fall in the value of your current assets? A major shift in Chinese FX holdings towards gold, particularly if coinciding with an attempt to slim the size of those reserves, will put substantial downward pressure on the dollar. We have already seen this whenever there have been trial balloons from countries (eg, Korea or Russia) talking about reducing their dollar holdings. This may be temporary or it may last – that will depend on many other factors. It will, however, mean turbulence.

In addition, the emergence of a stable (if possible) multi-reserve currency system will probably also mean a greater role for gold. But that presupposes a change in how gold is seen. Gold is today mainly a hedge against deflation (*not* against inflation!) and a geopolitical, ie, dollar hedge. In a multi-reserve currency system, gold would presumably become a hedge against *all* currencies; but this also means gold would have to be traded more actively by central banks, instead of being bought and stored (or, occasionally, sold). In other words, gold would become more of a currency like others, still without being anyone's liability. What gold would not do, however, is to replace any existing fiat currency.

Are there any signs of any of this actually happening. Well, central banks, for long net sellers of gold, turned into net buyers in late 2009, and have remained so since then. In fact, the numbers in the chart below are probably understated, since some countries, eg, China, tend to buy gold and only report in a lump sum a long period of purchases. (This distorted the data for Q2 2009.)

Official sector net purchases of gold by quarter, tonnes



Source: World Gold Council

None of this is happening overnight. In fact, it is probably a process that will take 5-10 years before being completed. But the impact of the changes will be felt much sooner, on gold and on exchange rates.

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