The Upcoming Monetary War, With Gold As An Arbiter

Charles Gave
cgave@gavekal.com

When President Trump was recently asked if he was starting a war in traded goods with China, he countered that the US had lost that struggle 20 years ago. As the US retains a comparative advantage in technology, such arguments have led some to conclude that the world's two biggest economies will fight their next economic battle in this new theater. That may be true, but for me the real fight will be less about trade than a struggle for dominance between the US dollar and the renminbi.

The reserve currency can only be operated by a nation which has dominance in a range of areas

To begin, remember that any currency has three basic functions: it should be a medium of exchange, a unit of account and a store of value. To be elevated to reserve currency status it must also be fully convertible and accessible at any time without constraint. The nation controlling such a currency should control the sea lanes and have the largest financial market, such that in times of stress it can lend money to others. It should be technologically dominant, so that it has the best weapons and runs the highest margin businesses. It should also be a cultural power, such that it educates the children of the global elites. It also helps to be dominant in agriculture.

On this score card, the US dollar is starting to face certain problems:

The US looks to have overreached in terms of the control it exerts over dollar transactions

- After the 9/11 attacks, the US chose to extend the reach of US courts, so control was exerted over any parties using US dollars regardless of their nationality or where transactions took place. The US basically decided to abandon unconstrained access to the dollar. This "weaponization" of its currency means that any country, company or individual is vulnerable to their assets being frozen (in recent years, Iran, Russia and Sudan have found this out). This policy amounts to an attack on the sovereignty of other nations, who in the short term may have no option but to bite the bullet. Yet in the longer term you can be sure they are seeking ways to put their money beyond the reach of US officials and lawyers.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US MBA mortgage application fell -0.2% for the week ended Apr 20, from 4.9%	N/A	Purchase application growth remains stable; expect weaker housing market as rates rise
French consumer confidence rose to 101 in Apr, from 100 in Mar	Above 100 expected	Taxes on tobacco & higher social security payments hurt since Jun; expect pickup
South Korea GDP rose 2.8% YoY in 1Q18, unchanged from 4Q17	Below 2.9% expected; driven primarily by uptick in govt spending	Positive growth momentum and mild inflationary pressure to allow BoK to remain on hold
Turkey raised late-liquidity window lending rate by 75bp to 13.5%	Above 50bp expected; other key interest rates left unchanged	Further rate hikes are the only way for CBRT to stem inflation and currency slide

- Anyone looking at the trajectory of US budget deficits in the coming decades must be alarmed. The only solution seems to be an eventual monetization of the US debt pile as deficits become too big for the market to absorb. At such a point, the US dollar may not retain the three basic virtues of money outlined above.

The conclusion must be that only "good guys" have guaranteed access to their US dollar reserves, while the US's inability to tackle its fiscal problems leaves everyone vulnerable to their savings vanishing like snow under the sun.

China is not ready to run a reserve currency but it is putting in place the institutional infrastructure

And this of course brings me to China, which may not yet be ready to preside over a reserve currency, but is building infrastructure capable of running an "international monetary order". Witness the Asian Infrastructure Investment Bank, which is a facsimile of the World Bank, and the People's Bank of China offering renminbi swap lines to multiple central banks, so it can provide emergency lending in times of stress.

For now, China seems to be testing the question of whether it is necessary to have a reserve currency to conduct trade relations (we know from Milton Friedman that one is not needed). After all, Russia has already moved to a renminbi-based price for its oil, while Iran seems to be using the euro.

Beijing seems set on "de-dollarizing" the world economy

Simply put, China seems set on "de-dollarizing" the world, thereby challenging what French economist, Jacques Rueff dubbed the US's "imperial privilege". Rueff meant the US could live beyond its means without consequences, as it could settle current account deficits by printing its own currency. This reality meant that the world's financial system had to be centered in New-York, just as core political transactions were done in Washington. In the new world envisaged by China, this "privilege" vanishes and countries instead trade on the basis of their products and their savings.

After all, Europe and the US are moving towards a situation where they lack savings and so risk losing their primacy in financial markets in favor of those jurisdictions with the biggest savings pools. Simply put, by the time Hong Kong reverts fully to mainland control in 2047, China wants it to be the world's biggest financial market, with Singapore playing a complimentary role, just as London has in recent decades to New York.

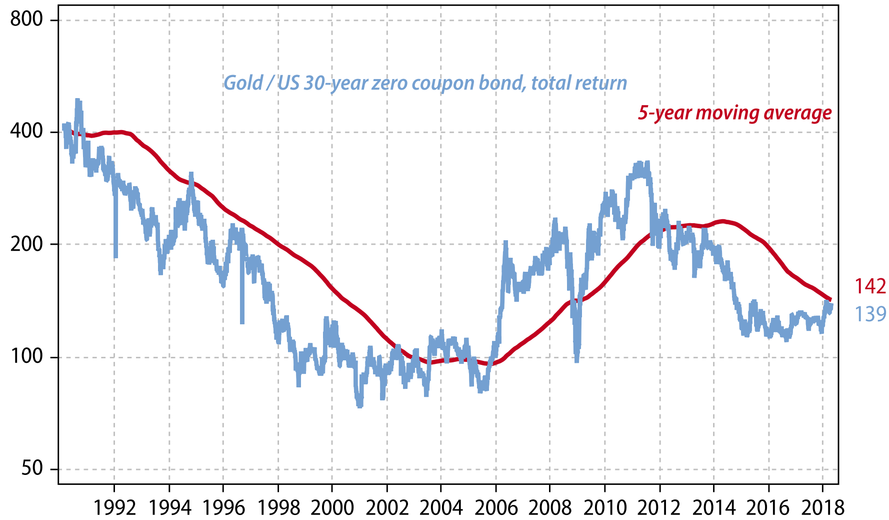
China can get around its full convertibility problem using gold

Now, most people tell me that the renminbi cannot become a global currency as it has a closed capital account. The answer to that objection is simple: China has just to offer a conversion in gold to anybody who has too many renminbi. And indeed it is headed in that direction (see **The Most Important Change And Its Natural Hedge**). In recent years the Chinese have bought all the gold they can lay their hands on, as have the Russians.

So, the real economic struggle between the US and China may not be fought out over trade or technology, but end up as a monetary war. In this regard, watch gold as any significant rise in its price versus the US bond market will be a defeat for Washington; any fall in this ratio should be seen as a victory. In recent years we have been in a stalemate (see chart overleaf). I doubt that this situation will last.

Ratio: gold to US 30-year zero coupon bond index

Ratio > its 5y ma: China winning, loss of confidence in the US dollar; ratio < 5y ma: China losing



Gavekal Data/Macrobond