

Observations Early in the Pacific Century

The economic historian Arnold Toynbee argued that civilization began in the East, expanded around the world, and will return to the East. Even if expressed somewhat differently, many people seem to believe that the 21st century will be a Pacific century. The center of the world economy for the last couple of centuries has been the Northern Atlantic. This has shifted to the Northern Pacific. Since the early 1980s, trade volumes going across the Pacific have been greater than that crossing the Atlantic.

The United States is of course a Pacific power as well as an Atlantic power. And if this century is a Pacific Century, it may also still be an American century. However, like a political corollary to the Heisenberg uncertainty principle in sub-atomic physics, or George Soros' "reflexivity" principle, the actions of the U.S. and Asia will determine their fates.

Indeed the relationship between Asia and the U.S. was an important driver in the foreign exchange market in recent days and investors will have to continue to wrestle with the implications.

Unilateralism...

Japan intervened in the foreign exchange market for the first time in six years. The amount of the intervention, judging from money market conditions rather than market talk, appears to be a single day record of around \$20 billion. Officials do not appear to be sterilizing or neutralizing the intervention's impact, which it usually does by issuing financing bills.

The intervention was unilateral on the Bank of Japan's part. It was widely recognized that Europe and especially the U.S. were not very sympathetic to its plight. At most, Japanese officials could have only realistically hoped (asked?) for no public criticism.

Yet even this minimal cooperation could not be secured. The ECB at first expressed some support for the Japanese position, but within 12 hours Sam Levin, the chair of the powerful U.S. House of Representative Ways and Means Committee said he was "deeply disturbed" by the unilateral nature of the intervention.

...or Nothing

A little more than 24-hours after the intervention had been confirmed, Luxembourg Prime Minister (and head of the Eurogroup) Junker was quoted on the news wires that he was "not happy" about the unilateral nature of the intervention. Indeed he went further: The Eurogroup was "insisting" that Japan "step back" from unilateral intervention.

These demands are unreasonable. There is no precedent for the U.S. and/or Europe to have a veto over Japanese exchange rate policy. If the Japanese yen was clearly under-valued, as it had been during and in the subsequent 15 years after the collapse of Bretton Woods, the rhetoric might be more understandable. However, by the OECD's own measures, the yen is among the most over-valued of the major currencies, by more than 25%. It is not as if Japan is seeking a weak yen, simply one less over-valued.

And it is more than just over-valuation. Japan's macro-economic conditions, including deflation and an economy that contracted in nominal terms in Q2, are simply aggravated by the currency appreciation (40% on a trade weighted basis in the two years since Lehman's demise).

No Chindia or Chimerica, Please

Most observers miss that this is really an eddy in a much larger river. Just like many in Taiwan will judge China, in part, by how it treats Hong Kong, so too, how the U.S. and Europe treats Japan will influence China's perceptions and therefore negotiations with the U.S.

Many Chinese officials believe that the unrelenting pressure for yen appreciation is a major factor in Japan's last two lost decades and the national malaise. No matter how much the yen appreciated, it did not satisfy some parts of U.S. industry and their political representatives.

Many have asked whether Japan's plight foretells the future of the U.S., but from Beijing's point of view, the question is whether the yen is the future of the Chinese yuan. From June 21st, when China announced it was adopting a more flexible currency regime, through the end of August, the yuan actually depreciated by 0.16% against the dollar (and a little more than 3.0% against the euro). Some officials in Europe and the U.S. feel that they have been betrayed.

A Macabre Dance

In some respects, the U.S., Europe, and China have only recently renewed their historical engagement. How the post-Mao China acts on the world stage is still evolving. A tendency appears to be emerging. Simply put, when a significant event occurs in which Chinese officials cannot control the outcome and in which they may come under criticism, they "do something".

It was on the eve of a G20 meeting that the PBOC Governor was allowed to muse publicly on the need for international monetary reform. It was on the eve of the last G20 meeting that China announced it would adopt a more flexible currency.

Indeed, as the next G20 meeting approaches China is in the cross-hairs of the U.S. Congress. They will be going before their constituents having to offer some narrative to explain the stubbornly high levels of real unemployment with little prospect of near-term improvement, and lo-and-behold the yuan is appreciating.

The yuan has appreciated about 1.25% in the first half of September. This is the fastest pace of change since the one-off devaluation in July 2005 that signaled the beginning of a three-year 20%+ appreciation of the yuan. This is setting up then for the biggest quarterly advance of the yuan in two years.

Another Current

Official data are likely to mark 2010 as the year that China surpassed Japan to move into second place in terms of current dollar GDP. China has become Japan's largest export market and the yen has appreciated by more than 25% against the yuan over the past two years and this is understood as a competitive disadvantage for Japan.

As China projects its power regionally, it first comes against Japan, thus the rise of China has come at Japan's expense (thus far) more than that of the U.S. Unsurprisingly there is a significant flare up in tensions now, to cite but one example, over contested waters in the East China Sea. The rivalry takes place on various levels over numerous channels.

The capital markets are obviously one of the arenas of competition between countries. Chinese officials recognize they have accumulated too many dollars in reserves. How can they reduce their holdings in an orderly way? What if they could transfer some of the Treasury/Agency holdings to another central bank; but who and how?

Consider that during the first seven months of the year, China purchased ¥2.3 trillion (~\$27.5 billion) of Japanese debt instruments (primarily bills). This, in fact, helped drive the yen higher and ultimately forced Japanese officials to intervene, so the scenario goes. In other words, China managed to diversify its reserves while "forcing" Japan to hold more Treasuries.

Simply Can't Absorb It

The scenario has several, potentially fatal, problems. First, China was a net seller of Japanese securities in 2009, so some of which may be a re-balancing. Second, it is not clear how much that \$27.5 billion of Chinese purchases over seven months really moved the dollar-yen exchange rate, which is among the most actively traded dollar-pairs in the \$4 trillion a day market. Third, scale is also a problem in terms of diversifying Chinese reserves, which are in excess of \$2.5 trillion. Fourth, the U.S. Treasury's International Capital report shows that China continues to purchase U.S. securities.

Yet, while Chinese purchases pale in comparison to the Japanese bill and bond market and the size of the foreign exchange market, it does account for 50% of the China's reserve accumulation during the first half of this year. And this is the point—China is steadfastly pursuing its own national interest (as it sees it) by diversifying the new inflow of reserves. The past accumulation (stock) is so large that the quarterly change (flows) is not very significant.

China is also believed to be purchasing other bonds from Asian countries, especially South Korea. Going forward this may cause additional tensions in the region. The size of the flows may be relatively more important, impacting interest rates and other financial variables in undesirable directions or magnitudes. China may find its ability to export its excess savings into the region limited, as many of those countries are also facing challenges emanating from current account and capital account surpluses.

Consistency: The Hobgoblin of Small Minds?

U.S. and European officials will view their positions toward Japan and China in terms of their foreign exchange policy as perfectly consistent: let the markets determine the price of the currencies. To Japan, the inconsistency lies in different values - i.e., the yen is over-valued and the yuan is under-valued.

To China there is a different inconsistency. It is the inconsistency between problem and solution. The most profound and acute problems faced by the U.S. and Europe are not caused. Nor can be cured by the yuan's exchange rate. A stronger yuan will not replace the real estate, insurance, and finance jobs lost. It will not encourage U.S. and European banks to take their trillions of dollars in excess reserves and lend to businesses, households and governments. It will not stabilize the debt/GDP ratios of the peripheral countries in Europe, let alone those of the U.S. and U.K. And it will certainly not resolve trade imbalances, which are a function of savings, investment, consumption and demographic considerations.

Welcome to the Pacific Century.

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