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First Trust

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Monday Morning Outlook

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China and the Dollar

Chinese leader Hu Jintao visits the US this week. Getting past the public pleasantries, our leaders will have much to say behind closed doors. On economic issues, the focus will be on monetary policy, particularly the role of the US dollar, the RMB/$ exchange rate, and the recent jump in China's inflation.

On the issue of the US dollar's role as the world's reserve currency, we think the critical comments out of China – as well as other comments from France, Russia, and the Middle East – are just bluster.

Countries that do not have a gold standard – which, at this point in history, includes *all* of them – must still back their currencies with something. These "reserves" create confidence. The Federal Reserve typically uses US Treasury securities as reserves, although it also holds many mortgage-backed securities these days. The Fed makes a profit on these holdings and turns them over to the government. The European Central Bank also holds the sovereign debt of its member countries and turns their earnings over to member governments.

Emerging market central banks have a choice of what to hold as reserves, and they will always make the one that maximizes earnings and creates the most confidence in their currencies. That's why China links its currency to the dollar and holds mostly US Treasury debt as reserves.

No one forces a foreign central bank to buy US Treasury debt. Each country would prefer to have their central bank buy their own local government debt as reserves. But who would trust these currencies if they were backed up by local government debt? Imagine Thailand trying to encourage the use of its currency if it was backed only by Thai government debt. And if fewer people held the currency, the central bank would generate lower profits to hand over to the government.

In other words, the international role of the dollar is a by-product of profit-seeking central banks pursuing their own self-interest. And that's not going to change anytime soon. There is simply no other instrument issued by anyone that has the liquidity and certainty of payment of US Treasury debt.

Moreover, as emerging markets keep growing, their central banks will issue more local currency, which will continue to elevate the demand for Treasury debt. So while other countries must learn to accept the US dollar's role, Americans must learn to accept that, over time, the share of our debt owned by foreigners is likely to keep rising. And, that the demand for US debt helps generate large US trade deficits.

Many assume large foreign ownership of US debt makes the US vulnerable to foreign governments. We think the vulnerability is the other way around. For example, the US could protect Taiwan with its Navy. Or, instead, the US could send a message that any attack would mean no payments on our debt to the attacking country until it withdraws and makes reparations. The US did something similar when World War II began. No wonder Hu Jintao told the Washington Post "the current international currency system is a product of the past." China realizes it's vulnerable. But, any major changes are decades in the future. The dollar will remain the world's reserve currency for a long time to come.

This does not mean the dollar cannot lose value. The yuan can strengthen as China continues to emerge from Mao's Communist tyranny. Since mid-2010, the yuan has gained 3.5% versus the dollar, which adds to the 17.4% appreciation that occurred between mid-2005 and mid-2008.

We think this trend will continue. It has to. The US is running a very loose monetary policy, and because China links to the dollar it is experiencing rising inflation. Commodity prices, like oil, are rising rapidly and China, which imports lots of commodities for processing into consumer goods, is feeling that inflationary pain before it hits home in the US. Letting the yuan gain versus the dollar is one way for China to ease the pain from the Fed's overly loose monetary policy. It's also a way for China to enhance the purchasing power of its workers and companies.

The US should not take this week's visit as an opportunity to lecture the Chinese about the yuan. If we do, Fed Chairman Ben Bernanke may find himself on the receiving end of a lecture about the importance of price stability and how to run a central bank. And he would deserve it.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-18 / 7:30 am	Empire State Mfg Index - Jan	12.5	**20.0**	11.9	10.6
1-19 / 7:30 am	Housing Starts - Dec	0.550 Mil	**0.536 Mil**		0.555 Mil
1-20 / 7:30 am	Initial Claims - Jan 15	422K	**424K**		445K
9:00 am	Philly Fed Survey - Jan	+20.4	**+22.4**		+20.8
9:00 am	Leading Indicators - Dec	+0.6%	**+0.6%**		+1.1%
9:00 am	Existing Home Sales - Dec	4.87 Mil	**4.97 Mil**		4.68 Mil