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Angst in the global FX village

Confidence must be earned
Amundi
ASSET MANAGEMENT

Contents

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Executive summary

The FX regime of the last 20-25 years was characterised by a massive accumulation of USD reserves by export-oriented Asian countries, overall low FX volatility, and a still dominant role for the USD as a 'public good' facilitating global trade. This has been a key infrastructure of the broader 'Globalisation 1.0' economic and financial regime, marked by the rapid expansion of trade and offshoring, low inflation and low interest rates. This regime is now coming to an end due to global economic and monetary policy fragmentation and desynchronisation, together with the resurgence of inflation and new threats of 'weaponisation' of FX reserves.

The current energy crisis is showing how the old system's foundations are beginning to shake. It may pave the way to changes in countries' attitudes, be they cooperative or competitive, against a backdrop of rising FX volatility and misalignments.

Longer term, the structure and dynamics of capital flows will probably change for good, mirroring structural changes in trade and current account imbalances. More specifically, China and Japan will no longer act as the 'liquidity pumps' they once were. As they have no obvious successors, global current account imbalances will probably shrink, implying a number of (sometimes painful) adjustments.

The attitude of global reserve managers is also likely to change as, given economic desynchronisation and higher inflation, they turn their focus away from their liquidity mandate and devote more attention to real returns, diversification and more active FX strategies.

What shape a new (more or less stable) FX regime will take is still unclear. While it will take several years or more to emerge, a two-bloc system centred on the USD and the renminbi (together with a number of other more or less peripheral sets of related countries) may be the most probable scenario. However, there would still be many differences in the roles played by the USD and renminbi within their respective blocs. Conversely, there are also reasons why the USD could be able to maintain its role as the only global anchor.

For investors, the current changes have several implications.

Short term, they should be mindful of the increasing risks in further riding out the wave of current misalignments. Longer term, they should consider – carefully and minding the differences between time horizons – playing the rise of the renminbi as the only credible alternative to the dollar.

To take advantage of the rising diversifying power of geographic allocation, which includes a major FX component, they should understand the changing drivers of higher FX volatility. These can include monetary policy desynchronisation, but also shifts in balance of payment equilibria, and the priorities of reserve managers. Finally, they should seek exposure to domestic sectors that will, through shifts in capital flows, benefit from the reinternalisation of previously externalised global savings.

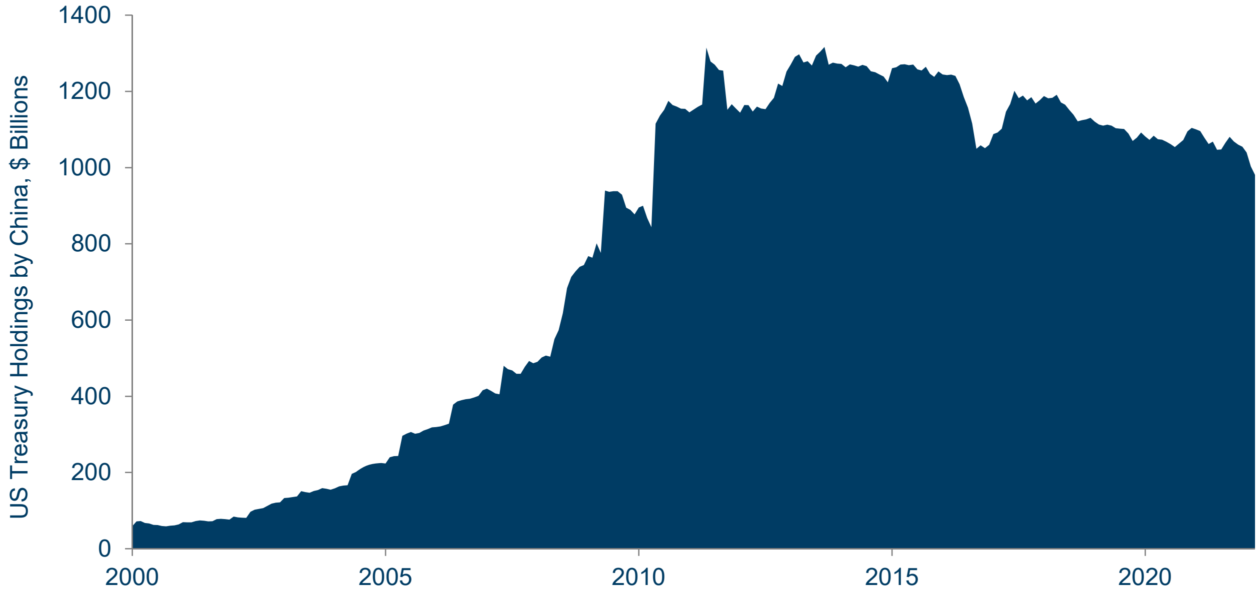
The previous FX regime

A chicken and egg circuit of current account imbalances and FX reserves accumulation

What we call here the 'previous FX regime' is a situation that dates back to the mid-1990s. At its core was the so-called Asian-Chinese platform's recycling of current account surpluses into USD-denominated FX reserves. This distinct pattern formed after two decades of high FX volatility (sometimes called 'The Great De-anchoring'[1] or 'Non-Bretton Woods') that ensued after 1971 when the USD's convertibility into gold was suspended. The final years of this period were also marked by a series of international agreements to coordinate currency intervention. Notably these included the 1985 Plaza agreement to appreciate, among others, the JPY and DEM versus the USD, and the 1987 Louvre agreement to halt these movements.

Since the 1990s, accumulation of FX reserves has been a deliberate policy by Asian countries in order to maintain an undervaluation of their currencies and so preserve their export-led models. First among these was China, which recycled its current account surplus through US Treasuries purchases, thereby financing the large US current account deficit. In exchange for foreign goods and services, the US was therefore exporting USD and USD-denominated assets that US domestic savings were insufficient to finance. While their rivalry was growing, the two countries were nevertheless entwined by a system of mutual trade and financial interdependence (sometimes named 'Chinamerica'[2]). More generally, through its basic balance deficit (i.e. the part of its current account financed by foreign flows into USD cash, Treasuries and other portfolio securities rather than into Foreign Direct Investments), the US was providing an essential global public good: the dollars that the rest of the world needed for global trade. This relationship became a key pillar of what we call the 'Globalisation 1.0' world economic and financial systems of the last decades.

Figure 1: China's accumulation of reserves in US dollars



Source: Amundi Institute, Bloomberg. Data as of 31 July 2022.

[1] *See Ilzetzki, E., Reinhart, C.M., Rogoff, K.S. (2021), 'Rethinking exchange rate regimes', NBER Working Paper, No.29347, October 2021.*

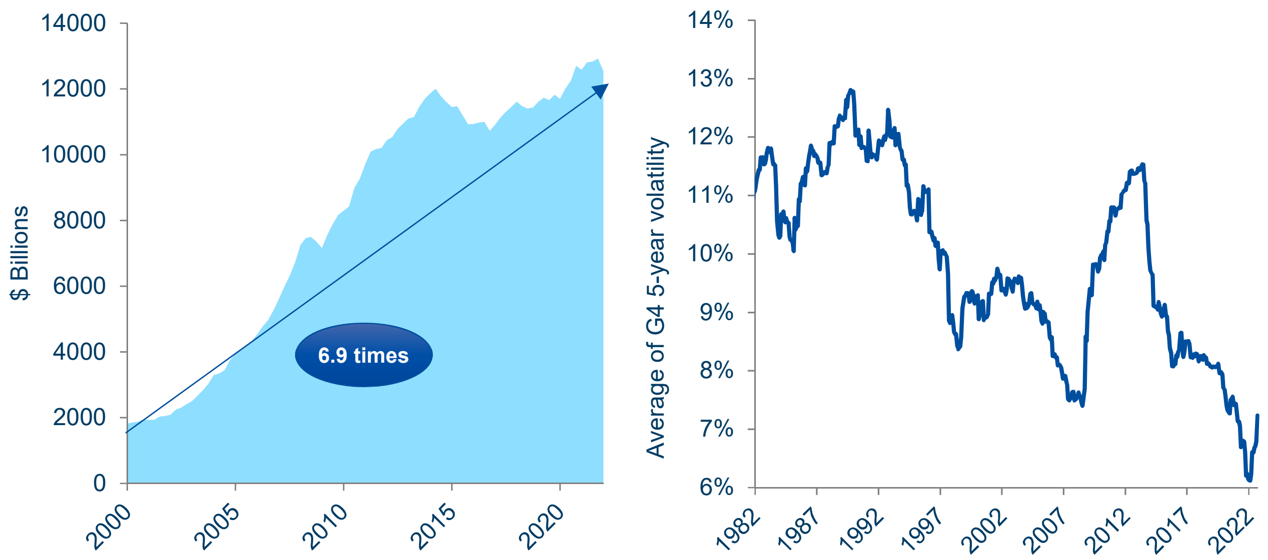
[2] *See Ferguson, N. Schularick, M. (2009), 'The end of Chinamerica', Harvard Business School Working Paper, No.37, October 2009.*

This currency regime had important domestic implications for most countries. Major consequences of the 'chicken and egg' circuit of current account imbalances and FX accumulation were the **downward pressure on risk-free interest rates and increases in money supplies** in both Western economies (where long-term rates were therefore artificially low even before the advent of QE) and Asian ones. This caused asset price inflation (although, prior to COVID, not goods and services price inflation in part thanks to the deflationary influence of low Asian wages) and various forms of asset and credit bubbles. Arguably, it also inflicted long-term damage to Western productive capacities, and accelerated the rise of China as a manufacturing powerhouse and an all-round superpower.

> *"The regime of the last 20 years was also characterised by very low exchange rate volatility, in sharp contrast with the preceding period"*

Willing accumulation of reserves by export-oriented countries to tame appreciating pressure on their domestic currencies kept volatility low. Moreover, after the 1997 Asian crisis, many countries (not just the 'Asian platform' ones), rather than choosing between a fixed or fully flexible exchange rate regime, opted for managed flexibility through use of reserves rather than capital controls. This also contributed to decreased EM FX volatility, including by limiting speculative attacks. However, as most interventions were aimed at preventing the appreciation of domestic currencies, it further increased global reserve accumulation. Total global reserves increased almost seven-fold between 2000 and 2022, with China holding slightly more than a quarter.

Figure 2: Booming total foreign exchange reserves at a time of collapsing volatility for G4 currencies



Source: Amundi Institute on IMF Currency Composition of Official Foreign Exchange Reserves (COFER). Data as of 3 August 2022. The G4 Average volatility is calculated taking the average of the 5-year rolling volatilities on the USD, EUR, GBP and JPY spot rates calculated on weekly data. Data as of 28 September 2022.

Another critical factor that limited large FX moves (particularly across Western currencies, although not exclusively) was the combination of low inflation, low interest rates, and synchronised monetary policies that pushed volatility to levels that were even lower than those during the Bretton Woods[3] period (and which led some observers to call the 2000-2020 period 'Extended Bretton Woods II"). The COVID crisis, at least until mid-2021, was remarkable in terms of how FX volatility remained muted compared to a backdrop of extreme macroeconomic and financial asset price volatility. Finally, the last 20 years also saw the development of swap line arrangements between central banks, which contributed to limit episodes of FX liquidity shortages.

[3] *See previous reference to Ilzetzki, Reinhart and Rogoff.*

USD: a fiat currency at the centre

The previous FX regime maintained the USD as its core, 'central' or 'anchor' currency. While a purely fiat currency, no longer convertible into gold, the USD did retain the necessary characteristics to fulfil this role. First, it is the currency of a country with a large domestic market and current account deficit (such that it provides its currency to the rest of the world in exchange for goods and services) and free capital flows. A central (or anchor) currency must also inspire trust, from the perspective of external investors, defined in several ways (rule of law, general stability and economic growth prospects, moderate inflation and credible central bank, overall geopolitical might)[4]. These are all boxes that the US ticks. Another advantage is for the central currency to rely on deep and liquid financial markets, preferably disintermediated and securities-based. Based on these standards, US financial markets are unmatched.

The gradual weakening in price and status of the US dollar (which, according to the Triffin dilemma, is supposed to happen with the central currency) has been very limited. Pessimistic literature announcing its demise was not validated.

- A number of Asian currencies did appreciate, although only very gradually. However, the **USD did not depreciate against most other major DM currencies.** It did lose some ground in terms of weight in international reserves, but less so as a trade currency, and its weight even increased in other aspects (for example, in terms of denomination of international bonds).

- **The USD maintained and even increased its status, despite the falling share of US GDP in the global economy, for several reasons.** Globalisation of trade made it very convenient to price all steps of integrated supply chains in the same currency, thereby benefitting the incumbent anchor. Low inflation also made the real return on USD-denominated fixed income assets very predictable. Last but not least, the USD was supported by a global consensus – that is, a system of shared, self-fulfilling narratives and beliefs in the dollar as a stable reference.

- **It is also true that no alternative currency proved sufficiently credible.** The fact that the euro did not enhance its global role was surprising to many. As a matter of fact, the euro's weight in global FX today is more or less comparable to that of the euro area within the global economy (depending on the metrics used, be it trading volume, reserves, trade invoicing currency, international bonds, etc) and not much greater than the combined weight previously held by the currencies it replaced[5]. Frequently mentioned reasons for this limited expansion include the fragmented nature of the euro sovereign bond markets and, more generally, the euro area's insufficiently integrated capital markets. Compared to the US, the region also has a lower share of securities-based financing. However, a more profound reason could be the outsized euro current account surplus, which, although recycled very differently compared to China's (i.e. through FDI and portfolio investments rather than reserves), means that the region is exporting its currency in much smaller amounts than the US.

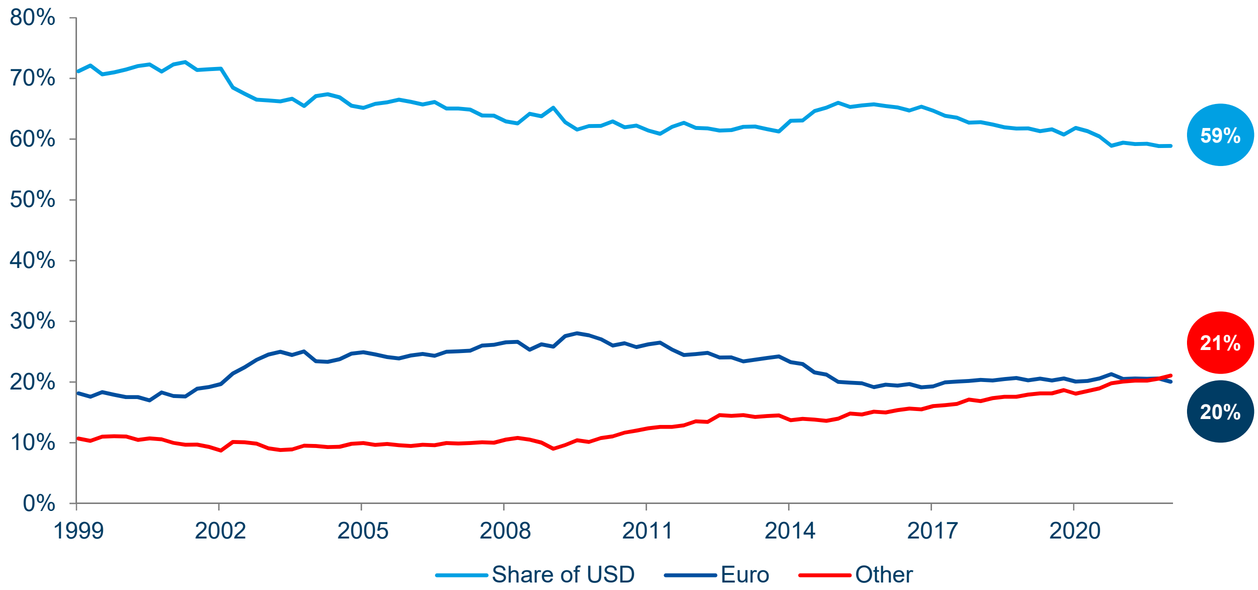
- While the renminbi, starting from very low levels, gained some ground in most regards, its weight according to all global FX metrics is still much lower than China's weight in the world economy. It is generally believed that restrictions (capital controls and others), and to some extent doubts concerning the rule of law, have been major impediments to its rise as a global currency[6]. Additionally, the declining FX volatility may have played a role by reducing the attractiveness of holding non-USD reserves for diversification.

[4] *There is a debate concerning whether democracy is also an advantage per se, or whether investors value political continuity (of a government determined to honour its commitments vis-à-vis investors) above all. See Eichengreen, B. (2013), 'Number One Country, Number One Currency?', The World Economy, 36(4), pp.363-374.*

[5] *See European Central Bank. (2022), 'The international role of the euro', report, June 2022.*

[6] *Some studies point to a repeating pattern here, stressing that the USD's rise may itself have been slowed in the years between the two world wars (where it gradually replaced the British Pound), by a number of financial restrictions. For a time, the international role of the USD remained well below the USA's weight in the global economy. See the previous reference to Ilzetzki, Reinhart and Rogoff.*

Figure 3: Currency composition of global foreign exchange reserves



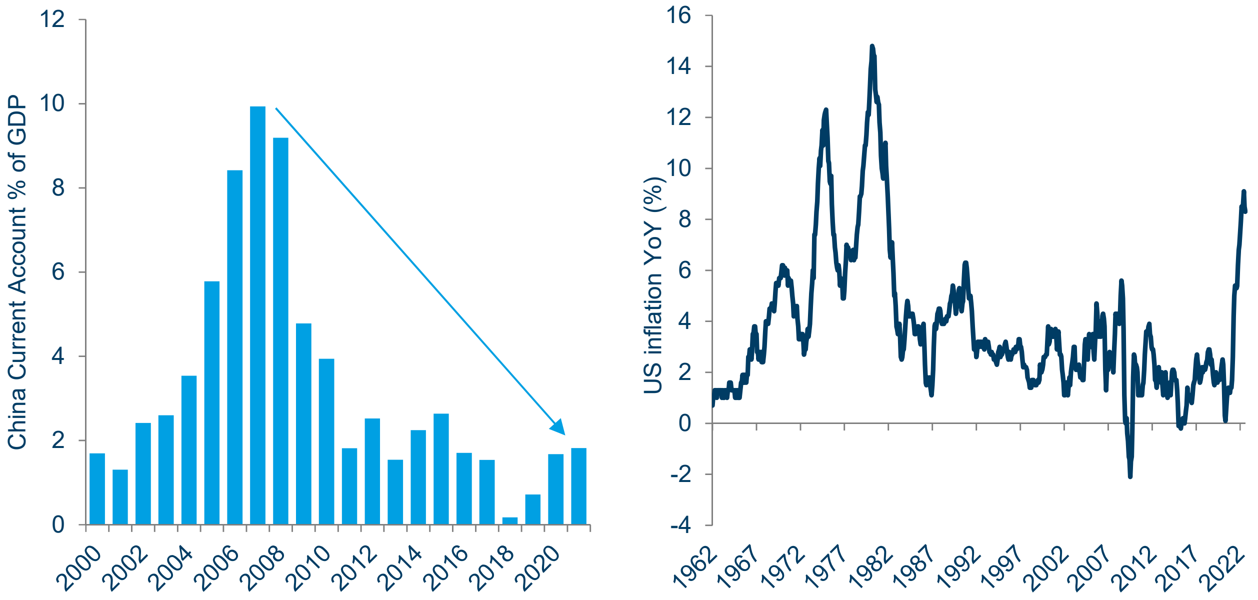
Source: Amundi Institute on IMF Currency Composition of Official Foreign Exchange Reserves (COFER). Data as of 3 August 2022. The Other category includes all the other reporting currencies (not euro or USD).

A regime now reaching its limits

Many of the beliefs and narratives that underpinned the USD's central role (starting with the attractiveness of holding USD reserves) are currently being questioned. Some of these doubts may even start to address the USD's ability to fulfil the fundamental functions of money as a safe store of value and as an easily available means of exchange:

- First, **the new inflationary regime may challenge the belief in the USD's status as a safe asset simply by raising the question of the real yield,** or at least of investors' capacity to preserve value by holding the central currency, even in the form of bonds. Reserve managers themselves, who so far have primarily been holding USD to fulfil a liquidity mandate, may open their eyes on this 'Keynesian' price to pay in terms of value erosion and turn their focus more towards real returns.
- Additionally, **against a backdrop of deglobalisation,** regionalisation of trade, receding global value chains and reshoring of manufacturing activities, **holding USD liquidity may gradually become a less pressing need** (be it for the purpose of trade or to preserve competitiveness through FX management).
- Similarly, but in terms of narratives, the extent to which public goods provided by the USD-centric system (essentially the supply of a key anchor to globalised trade) will continue to be highly valued is also becoming less certain. **New priorities are emerging** following a period during which the globalisation story, although controversial in Western countries, has been a positive one for most economic participants of many countries. Rising concerns about inequality and sovereignty, as well as, to some extent, the climate topic, are widely regarded as better addressed at domestic and regional levels.
- Moreover, **the recent 'weaponisation' of Western currency-denominated FX reserves against the backdrop of the Russia-Ukraine conflict has largely been seen as a wake-up call for non-Western central banks.** It showed that access to these reserves cannot be taken for granted, but, rather, may become conditional upon maintaining good relations with Western governments.
- Finally, even before the advent of COVID, whether China would retain a large, positive current account surplus enabling a structural accumulation of reserves did not seem such a clear-cut prospect. Due to rapidly growing imports, the **Chinese current account reached an almost balanced position in 2018** and was below 1% of GDP in 2019 before the COVID disruptions. Moreover, since 2015, there had been episodes of Chinese FX interventions to fend off market-led depreciating (rather than appreciating) pressures on the renminbi.

Figure 4: China's current account balance and US inflation will challenge the USD



Source: Amundi Institute on IMF data as of April 2022 (left), and Bloomberg as of 31 August 2022 (right).

> *"In the post-COVID world, cracks in the old regime have suddenly become more visible"*

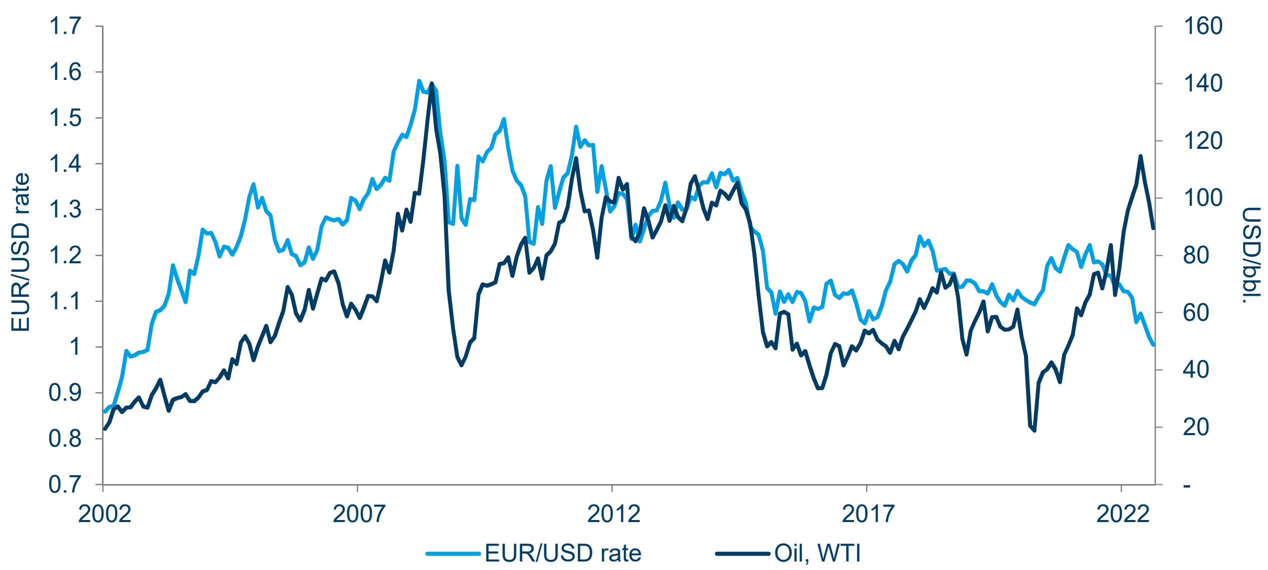
The immediate new challenges: energy and inflation

From inflation dislocation to currency misalignment

The current spike in inflation, which incorporates a large energy component, is altering some traditional patterns of current account imbalances, generating major stress and misalignments in the global currency order. These movements are already creating winners and losers: the USD has been more resilient while the EUR and JPY have been more exposed. Rising deviations from PPP and diverging changes in CPI/PPI ratios have been observed. While these could be short-term disruptions, it is also possible, prospectively, that the energy shock could lead to a loss of productivity in some countries (a potential cause of further deviation from PPP). The energy transition could possibly then lead to even greater shifts (extending the combination of low growth and high inflation).

In the case of the EUR/USD parity (even though its drop can be explained first and foremost by the gap in the rate differential and to a lesser extent by geopolitical factors), it is noteworthy that the energy shock caused Germany to post (in May 2022) a monthly current account deficit for the first time since 1991. Also pointing to specific worries for Europe is the fact that the traditional EUR/USD correlation with oil was not seen at all at the end of 2021 and beginning of 2022.

Figure 5: EUR/USD rate and oil price (WTI)



Source: Amundi Institute on Bloomberg. Data as of 31 August 2022.

The energy shock, combined with large differences in inflation, also had a very visible impact on the JPY in a major, tangible sign of misalignment in the FX system. Rising energy costs (Japan being a huge importer of energy) are driving down the country's trade balance and current account (and therefore net capital exports). At the same time, monetary policy divergence is increasing as the Bank of Japan (BoJ) is sticking to its yield curve control policy. **These combined effects have taken the country's real effective exchange rate to its lowest level in the last 50 years**. Japan, which has long been a major buyer of foreign assets, is therefore left with little room to maintain this role, a potentially disruptive force that could affect the equilibrium of global bond and equity markets (i.e. upward effect on rates, downward effect on risky assets). Since there is no obvious route for classic monetary policy (rate hikes) to take without hammering other sectors of the Japanese economy, FX interventions remain, so far, the only viable option.

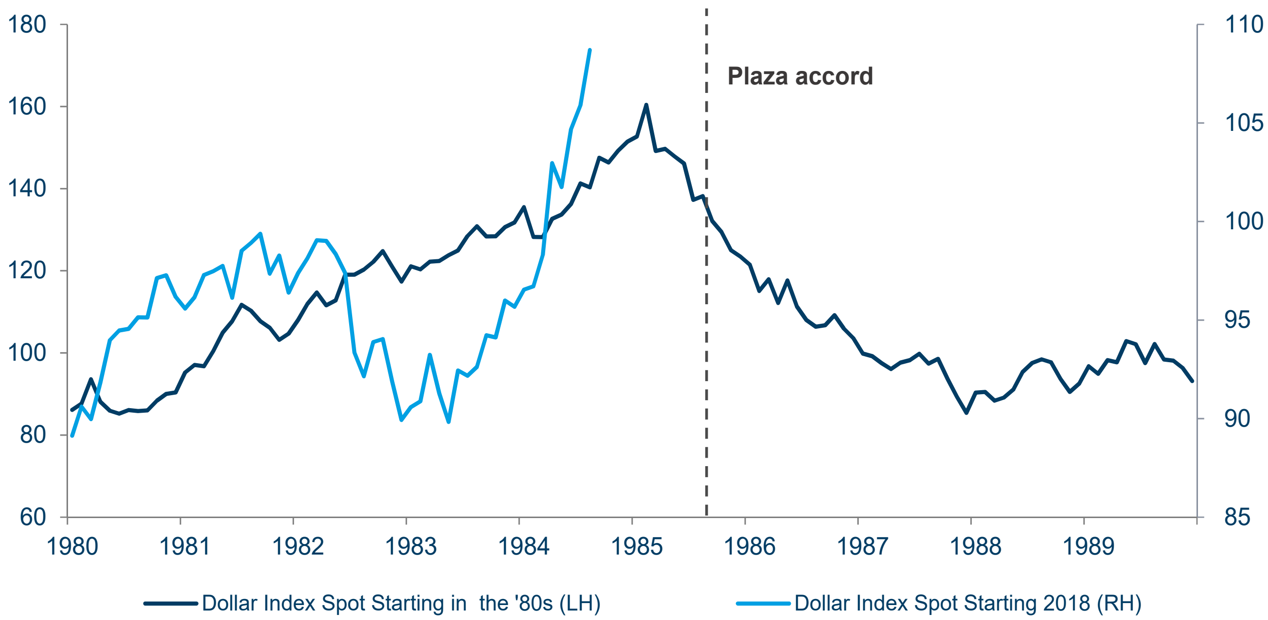
The JPY's depreciation also poses a major dilemma for China, although it is likely to respond in a more orthodox/Wicksellian (rather than Keynesian) way. From the Chinese perspective, the CNY/JPY parity is now around 20, its highest level since the great devaluation of the renminbi in 1994. A weak JPY has contributed to raising China's real, effective exchange rate to its highest level since then. This is equivalent to a quantitative tightening in China, reducing the country's current account surplus and generating deflationary pressure. For the record, when the renminbi's value appreciated sharply in 2015-2016, reaching levels similar to those seen today, a depreciation ensued. It is not certain, however, that China will pursue this road given its weakness against the dollar. In fact, this could send a problematic signal for capital flows while the country is pursuing long-term strategic objectives, including bolstering the renminbi's international status (as a competitor to the USD, although the latter's rapid appreciation has made this goal more demanding) and reshaping its economy towards a more domestic-oriented GDP structure. Most likely, within the trade-off between its different objectives, China will adopt a more 'Wicksellian' attitude, **accepting some of the pain inherent in the appreciation of its currency** (similar to Germany in pre-euro episodes of Deutsche mark appreciation) **or limiting itself to targeted CNY/JPY interventions.**

What remains to be seen is whether countries will respond to this new episode of 'Great De-anchoring' through a cooperative or a competitive approach.

The road back to Plaza or to a reverse currency war?

A cooperative approach would mean large countries taking the road back to Plaza. The low EUR and JPY are proving to be damaging for their respective economies and, at least over the medium term, many sectors in the US may be penalised by a strong USD. The most likely outcome of such an agreement would therefore be coordinated interventions in the same direction as in 1985 (JPY and EUR appreciation, USD depreciation). This appears all the more in the interest of all parties since an important difference with the 1985 situation is that Japan and Germany are experiencing much weaker growth now. At that time, growth was driven by rising trade balances and current account surpluses (coinciding with buoyant equities markets), which had to be sacrificed for fear of a protectionist wave in the US. While China was obviously absent from the Plaza accord, today, it may welcome a slightly less strong USD, making it easier for the renminbi to maintain the necessary momentum to bolster its international status over the long run. Moreover, although China's participation in such an agreement is highly uncertain, it would send a powerful message in terms of the kind of relationship it wants to have with the US and the rest of the world. However, the risks involved in a Plaza-type deal must also be considered. At some point, continued EUR and JPY appreciation may negatively affect European and Japanese growth. Several observers attribute the extreme Japanese financial bubble of the 1990s to the interest rate cuts and rapid expansion of money supply that followed the Plaza agreement, which were intended to offset the damage caused by a rising JPY.

Figure 6: The USD during the 1980s at the time of the Plaza accord vs the USD today



Source: Amundi Institute on Bloomberg. Data as of 31 August 2022.

Whether the current incentives are strong enough to support such an agreement is uncertain. Once again, it may be a question of narratives. At the time of the Plaza accord, economic growth was led by the rapid globalisation of trade in goods and financial globalisation was expanding rapidly. In contrast, today, we are witnessing the retreat of global value chains, on-shoring and regionalisation of trade, and countries may prioritise domestic economic policies over and above international policy coordination.

On the other hand, a competitive approach would imply that countries are headed towards a 'reverse currency war'. A 'currency war' usually involves countries competing to depreciate their currencies in order to gain relative price competitiveness on export markets. The incentive, this time, could be reversed. In a context of high imported, energy-led inflation, a weaker currency exacerbates the downside. Therefore, **countries may compete to appreciate their currencies in a potentially zero- or negative-sum game,** according to a 'they cannot all have it strong' (instead of 'weak') principle.

Beyond considerations concerning short-term policy responses to current disruptions, a broader question remains: what sort of 'stable regime', if any, could replace the currency order of the last 20 years?

Shifting financial deglobalisation

Liquidity pumps and the structure of global capital flows: shifting

Longer term, the structure and dynamics of capital flows could be changing for good, mirroring structural changes in current account imbalances. A new exchange rate regime should logically emerge as part of a new trade and capital flow equilibrium if and when it reaches a distinct, more or less stable, pattern.

China and Japan, so far the two largest 'liquidity pumps' (at least in terms of US Treasuries purchases), could be the main 'pieces' to change. As previously mentioned, due to the rapid growth of its internal market and new economic strategy, China may not be a current account surplus country for much longer and will therefore be increasingly less in a position to amass reserves. Similarly**, Japan is likely to gradually re-internalise its savings to meet domestic requirements, including public debt financing.** It's not at all obvious which countries can step up to fill the 'liquidity pump' role. Global current accounts are necessarily a zero-sum game, since not all blocs/ regions can simultaneously run current account deficits: reduced surpluses in one area must be offset by a smaller deficit (or larger surplus) in another.

The euro area is likely to retain a large current account surplus beyond the current short-term disruptions. Unless the current energy crisis does not abate at all, or unless European nations suddenly initiate massive internal investments, the region benefits from the strength of its manufacturing members. However, that surplus may remain invested in other ways than the accumulation of financial assets. **On the other hand, energy-exporting nations could be the ones in a position to accumulate more financial assets**, especially if energy prices remain structurally higher. The same is true for other export-oriented EM nations that are smaller than China but growing.

Nonetheless, it is unlikely that the role played by China (or the broader 'Asian platform') during much of the last 20 years can fully be replaced. Global current account imbalances are likely to be less than they were, meaning that cross-country recycling of savings is likely to be down in general. In countries with large and negative basic balances, and which currency and bond markets have until now received massive foreign inflows (starting with the US), this may mean some (sometimes painful) adjustments. Pressure on real rates will be to the upside whereas pressure on currency and asset prices will be the downside; these adjustments may inflict some pain.

> *“It is doubtful that China's role over the last 20 years can fully be replaced”*

FX reserves accumulation and structure: shifting

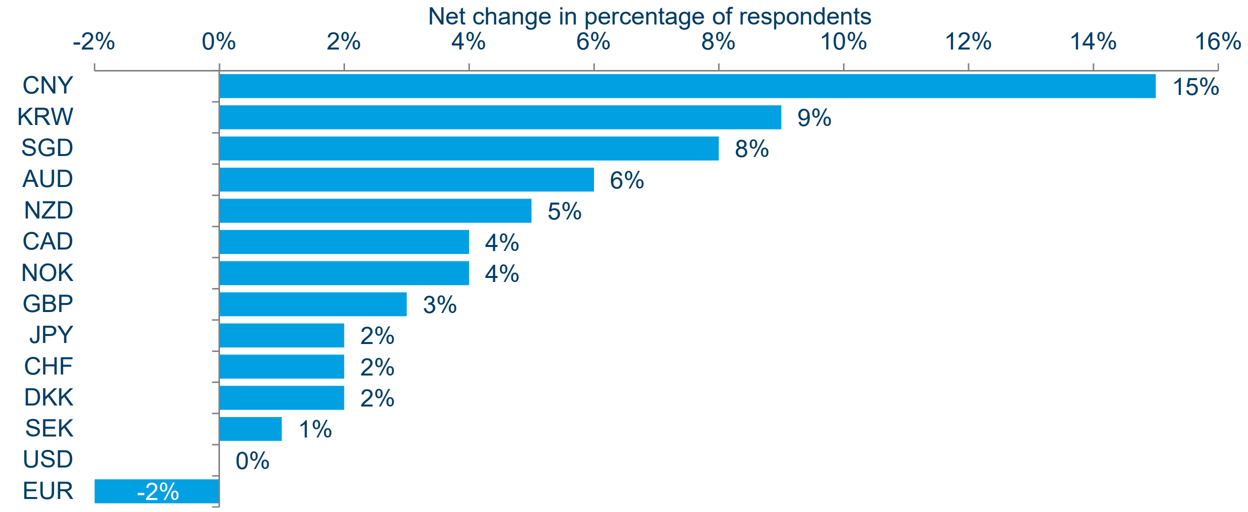
The advantages of accumulating and holding reserves will gradually become less clear. It is true that many countries are likely to retain managed floating exchange rate systems (whether China will transition to a fully floating system, and when, is open for debate). For them, reserves will remain a precious tool at least to depreciate their currencies when deemed necessary. In the opposite case, however – that is, to appreciate currency or rather fend off depreciating market pressure – reserves may be seen as increasingly less useful in a higher FX volatility regime: mostly used dissuasively, and fulfilling their role only if not actually employed.

However, as more countries transition away from export-led economic models, even structural interventions to depreciate currencies may become less frequent. Moreover, the aforementioned risk of 'weaponisation' – mostly by Western countries today, although tomorrow it could be China – is likely to grow if the world heads towards a lasting period of geopolitical instability. The accumulation of reserves could increasingly be seen as fuelling monetary disorders, sunspot equilibria wherein investors' expectations prevail over fundamentals, and asset price bubbles. Finally, despite the USD's current strength, narratives concerning its long-term depreciation may soon re-emerge as the mismatch between the USD's role and the weight of the US economy increases. This would renew the Triffin dilemma and raise concerns that it would trigger losses for its foreign official holders.

Over and above the lower amount of FX reserves, the very structure of reserves will be revisited to meet new objectives: value will increasingly take precedence over liquidity. Reserve managers are likely to seek assets that are less 'externally' useful in terms of trade competitiveness but more highly remunerated in real terms. They will look for greater diversification both in terms of geopolitical exposure and relative to different countries' trade structures and inflationary risks.

There will be a shift away from US government bonds towards other assets, including other currencies, gold, private financial assets, real assets, and potentially even 'exotic' newcomers like cryptocurrencies. Moreover, against a backdrop of 'Keynesian' inflationary dynamics in the prices of goods and services rather than assets, and less synchronised monetary policies, reserve managers may look beyond safe, liquid, value-preserving assets. They could be driven towards more active FX strategies as, in an inflationary world characterised by diminished real returns, FX could become a key component of portfolio performance.

Figure 7: Central banks' changes in currency eligibility for reserves 2021 vs 2019, World Bank Survey



Source: Amundi Institute on World Bank Third RAMP survey on the Reserve Management Practices of Central Banks, Second RAMP survey on the Reserve Management Practices of Central Banks.

Fragmentation and autonomy

Continued de-globalisation and fragmentation trends should make the future FX system less USD-centric. On the one hand, incumbency is a major advantage. History shows that replacing anchor currencies requires either a major geopolitical shock or a long transition period, and therefore occurs very infrequently[7]. On the other, countries are likely to reconsider globalisation's cost/opportunity trade-offs. Trade will gradually become less of a priority while reshoring accelerates due to political and technical factors (such as progress in automation). **The growing focus on domestic demand will come with a search for autonomy, more political 'insulation' and focus on regional geopolitical priorities. In this context, the USD-centric monetary monopoly – a key pillar of globalisation – will be less stable.** Its gradual erosion will correspond to the end of the 'Globalisation 1.0' (1990-2020) way of financing global growth (wherein the USD was a public good), and of the corresponding structure of global capital flows.

> *"Fragmentation can lead to a multipolar order rather than disorder. The emergence of several regional blocs is a plausible scenario having major implications for FX"*

[7] *See previous reference to Eichengreen.*

Towards a two-bloc/multipolar FX system

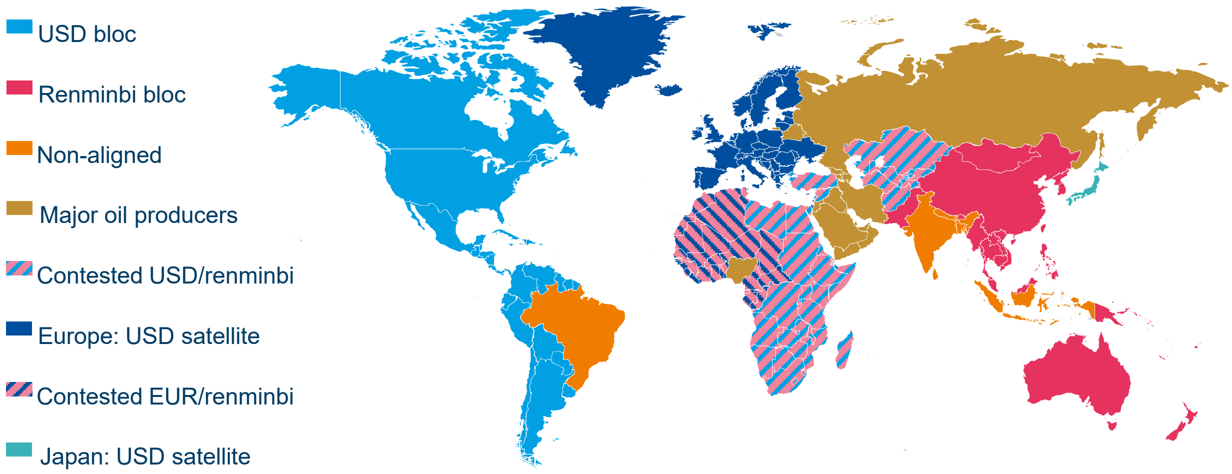
Towards a two-bloc system centred on the US and China?

The emergence of a two-bloc trade system centred on the US and China as a key architectural infrastructure of a new 'Globalisation 2.0' regime seems logical. Over the very long run, each bloc would use the currency of its dominant country as its central currency and recycle current account imbalances internally. This implies a major erosion in the role of the USD and a simultaneous expansion of the renminbi. Trade across each bloc would remain significant, but it would not lead to massive capital flows or reserves accumulation, absent a large current account imbalance between the two. That trade could even be settled partly in gold, the only reserve that is not someone else's liability.

Due to its geopolitical importance, energy may be a key factor extending to FX this new two-bloc division that may start with trade. Indeed, each bloc may seek to price energy in the currency of its own camp as the global trade structure loses ground to more localised flows. However, the US is likely to put up a fight to maintain global oil pricing in USD, as it probably sees this as a major strategic advantage.

Within this new global system, Europe (and presumably Japan) would remain peripheral, but related to the US bloc. A number of large EM countries, such as Brazil, India and Indonesia, may once again establish a non-aligned group. Some countries may even attempt to trade under a gold-based system, which would be highly deflationary, as opposed to the inflationary fiat currency system. Other oil-exporting countries sitting in either camp, notably Middle Eastern producers and Russia, will probably keep buying large amounts of reserves in USD or renminbi since energy would be priced in both global currencies.

Figure 8: Towards a multi-bloc FX system



Source: Amundi Institute.

The renminbi's journey to anchor currency status: long and with many pitfalls

A major question concerns the lengths China would have to go in order for the renminbi to become the anchor currency for a China-centric bloc. It would require major steps in terms of freeing capital flows and possibly losing part of its internal political control, although there exists a possibility that foreign investors will seek political continuity, predictability and enforceability of the commitments made to them, rather than democracy per se.

Simultaneously, it would require other countries to accept some degree of subordination to China's monetary policy, with significant geopolitical implications. Moreover, as already mentioned, China would be required to pursue relatively tight 'Wicksellian' or monetarist policies to strengthen its currency in order to inspire trust, favour capital inflows, and bolster the development of its internal financial markets.

In any case, achieving the structuring of a two-bloc FX system is likely to take years, if not decades, given the underdeveloped role of the renminbi today. That being said, there are signs of East Asian central banks actively limiting the fluctuations of their currencies against the renminbi rather than the dollar: a pattern that is reminiscent to the European 'Snake in the Tunnel' system of the 1970s.

Moreover, it is unlikely the two blocs would be perfectly symmetrical in their functioning. Important differences in intra-bloc current account imbalances, capital flows and reserve accumulation patterns, intra-bloc exchange rate systems, and the shape and extent of the anchor currency's domination within each bloc are likely to persist. Additionally, the vision of an East Asian bloc dominated by China and the renminbi does not currently match the existing geopolitical alliances in the region. This could be another, perhaps debatable, obstacle for the renminbi to rival the USD as a global anchor currency[8].

The possibility that the world remains USD-centric?

It is difficult to believe that the role of the renminbi will not increase over time as long as China's weight in the global economy continues to grow. The debate mostly concerns the pace and the extent of its rise, and whether it can become a credible competitor to the USD. The aforementioned two-bloc system is a probable scenario, but an alternative exists wherein the USD's domination persists, or extends further.

- One reason why the USD could retain its global role is that, contrary to today's mainstream belief, globalisation could persist in the coming years. This would happen if the much-publicised deglobalisation of trade in goods were more than offset by the less visible but growing globalisation of services, a potentially important feature of 'Globalisation 2.0'. In fact, new technologies offer increasingly easier ways to fractionalise services works and processes across countries and continents, paving the way for a new wave of offshoring, this time of nonmanufacturing activities. The incumbent USD-anchor could take advantage of the need to find a common numeraire to organise integrated services value chains.

- A related reason could be technological developments in the financial and monetary sphere where the USD had a significant head start. For instance, USD-based private digital stablecoins represent, by far, the majority of all digital stablecoins and are largely used outside of US territory. They are widely seen as potential vectors of further dollarisation in certain non-US sectors, particularly in fintech and potentially in e-commerce, as acknowledged by US authorities themselves[9]. For the same reason, they have also raised concerns among non-US authorities. Digital stablecoins offer very practical features, such as instant settlement, that make them suitable to many interactions with innovative applications, opening many possibilities of 'programmable money'. Additionally, more users, including foreign ones, could soon be reassured into using USD-based stablecoins, as full regulation of at least some stablecoins by the US government could soon occur. To what extent China and the euro area will be able to compete with their own digital currencies, whether public or private, is today very uncertain[10].

- Finally, China hitting a major bump on its path to growth, or running into political stability problems, would leave the world with few alternatives to the USD. This is especially true considering the euro's shortcomings, including its structural current account surplus, lack of a unified safe asset and fragmented financial markets.

[8] *See previous reference to Eichengreen.*

[9] *For example, in Liao, G. Caramichael, J. (2022), 'Stablecoins: Growth Potential and Impact on Banking', International Finance Discussion Papers, No.1334. Washington: Board of Governors of the Federal Reserve System.*

[10] *The US authorities find it less urgent than their Chinese or European counterparts to get a head start on the development of a public digital dollar. First, because of the USD's current dominant status, second (probably) because they may consider that well-regulated private USD-based stablecoins can fulfill a similar role, also giving the public sector the option to internalise private stablecoin technology later on if needed.*

Investor roadmap

This changing FX environment will bring risks but also many opportunities for investors.

1

In the short term, investors should be wary of trying to further ride the wave of misalignments generated by the energy crisis and by fragmentation of monetary policies. There is a growing risk in pursuing those trades from current levels. As we have tried to show, while many of the underlying dislocation factors may persist, countries may attempt to resolve some misalignments. Whether these attempts take a cooperative or a competitive shape, they are likely to cause sharp market reversals.

2

A longer-term question relates to the opportunity of holding renminbi, as the only credible alternative to the dollar as an anchor currency. Time horizons matter a lot here. To support the status of its currency, China will need to provide a growing amount of renminbis and renminbi-dominated assets for the world to hold in non-resident portfolios, including central bank reserves. There is clearly a risk that this initial liquidity effect will cause downward pressure on the currency, similar to what happened with the euro when it was introduced, and all the more so if it happens against a backdrop of a shrinking Chinese current account surplus possibly soon becoming a deficit. However, **assuming the renminbi does eventually become the anchor currency of a regional trade bloc or a rising vessel for diversification, it should benefit from this new store of value effect at a time when the erosion of the USD's status could well accelerate.**

3

More generally, for bondholders, the benefits of currency diversification should increase. This is a consequence of the inflationary environment and the desynchronisation of monetary policies and economic cycles that diminish the co-movement of global risk. Similar to reserve managers, private investors will need to be mindful of the fact that **active FX strategies may increasingly become important drivers of portfolio performance.** In a world of low real returns, 'safe' assets will no longer be 'safe'. Additionally, the FX system will undoubtedly become more fragmented before it possibly stabilises into regional blocs or another stable order. **Volatility will probably increase compared to the past 20 years, making it essential for successful FX strategies to understand its drivers.**

4

In addition to the desynchronisation of monetary policies, the changing attitudes of FX reserves managers and shifts in balance of payments equilibria may become important drivers of large FX movements. This means that the usual, fundamentals-based PPP approaches will tend to become less useful. As the previous reasons for holding reserves (for trade or currency management) are receding, reserve managers will take currencies more into consideration because of their remuneration or appreciation prospects (or both). Some may no longer wish to hold large quantities of certain currencies, should rates fall or the prospect of depreciation increase. Together with focusing on the flows that need to be absorbed, investors should therefore also focus on the stocks of reserves. Accelerating trade shifts may also cause some non-USD currencies to become more attractive for the purpose of trade or because some countries may accumulate them as FX reserves to manage their own exchange rates.

5

Finally, investors should consider that a reason for shrinking current account mismatches, and therefore shrinking cross-border capital flows, will be the development of active public policies to reinternalise savings. They will need to identify which asset classes will benefit from this reinternalisation, which typically starts with those sectors that are targeted by fiscal stimulus plans, be it through public spending or through measures ensuring preferable funding conditions.

Currency: importance of the basic balance and stock effect for investors

Investors have two basic reasons to hold a currency:

1. Remuneration:

The currency needs to be well remunerated vs others, given the risk of depreciation or appreciation.

2. Valuation:

The currency should preferably be undervalued and/or have some appreciation potential.

In terms of flows, a country's basic balance (roughly the part of its current deficit financed by inflows in its currency, government bonds and financial markets, rather than by FDI) can be interpreted as the quantity that the rest of the world needs to absorb.

However, investors must also consider the stock effect: that is, when market holders who have accumulated a stock of a currency may or may not be willing to continue to hold it at a certain price.

A currency is therefore in danger if the absorption capacity at a given price is saturated.

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