Monthly Comment

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Triffin Revisited: Why the Unwinding of the Dilemma Matters

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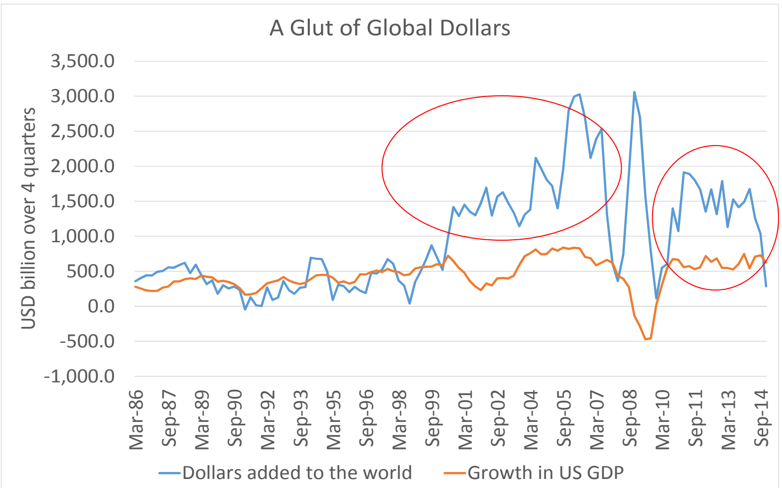
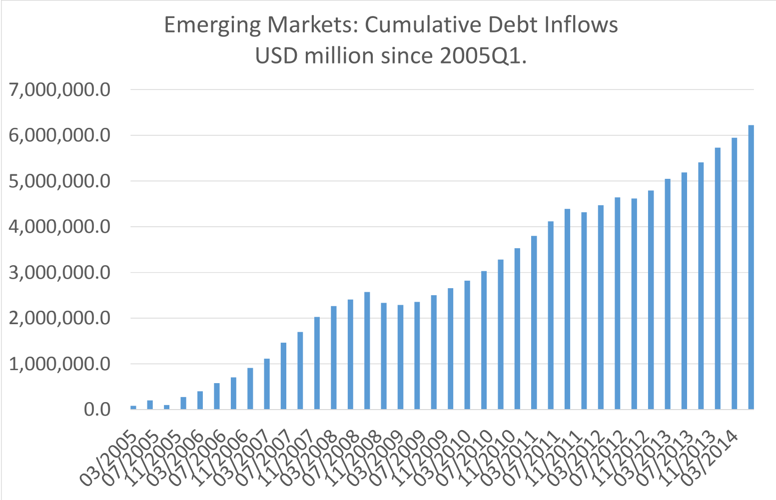
There is a well-known dilemma that exists for the country that "owns" or operates the global reserve currency. Since global trade and many capital account transactions are settled in the reserve currency, it is incumbent on the economy that provides the reserve currency to ensure that it is a net exporter of its currency so as to accommodate global growth and hence the growing need for reserves and international settlement funds. During the Bretton Woods era this requirement was identified by then US Treasury Secretary Triffin as implying that the US needed to run persistent current account deficits to supply an ever-increasing supply of dollars to the world. This situation did, though, imply that the US would also find itself amassing substantial liabilities to the foreigners that owned these claims on the Federal Reserve (that is, dollars), which he identified as representing a potential problem for the US itself. The Triffin Dilemma for the US came to be defined by "the conflict of economic interests that arises between short-term domestic and long-term international objectives for countries whose currencies serve as global reserve currencies" (not that this prevented the US from exploiting the situation during the Vietnam War).

Triffin was, though, writing in a world in which there were stringent capital controls and we would argue that when considering the "growth in the supply of the reserve currency to the global system" one should include not just the current account balance but also the reserve currency country's exports of capital. In effect, we are suggesting that the purchase of a security by a US resident in a foreign country is just as capable of providing dollars to the rest of the world as is the purchase of another country's exports by a US-based entity. Crucially, if we employ this definition, we find that between the mid-1950s and the late 1990s the supply of dollars from the US to the rest of the world essentially expanded by the same dollar amount that the US economy was itself expanding. There were terms in which the supply was a little greater (for example, the early 1970s, mid-1980s and the mid-1990s) and periods in which it was perhaps a little slower (early 1980s, early 1990s) but in general the two series were reasonably well correlated until 1999. Thereafter, though, it would seem that Greenspan's response to the Asian Crisis/LTCM debacle and the subsequent dramatic breakdown in the link between the rate at which the US was exporting dollars and the growth in the economy. By the mid-2000s, the US was exporting dollars at almost six times its usual rate relative to the growth in the country's GDP.



The late 1990s and early 2000s were Greenspan's "purple patch" and he perhaps singlehandedly took central banks into a new era of "predictability" at all costs. Gone was the Karl-Otto Pohl (German) central bank doctrine that central banks had to be unpredictable "to keep markets on their toes" and instead Greenspan signalled his intentions far in advance, moved cautiously and predictably and exercised his "put" when necessary. We quipped in the mid-2000s that our new-born son could probably have recognised the pattern in Greenspan's half-hearted monetary tightening that was supposed to – but clearly failed to – prevent the global credit boom that led to the GFC. A large part of this credit boom took the form of, and was in turn based on, the explosion in the exports of dollars from the US that Greenspan was presiding over – rather ironically to great acclaim. This was the era of not just the internationalisation of the US savings industry but more importantly the ascendency of the "carry trade" in all of its various guises and these accounted for much of the exportation of dollars. The system paused somewhat dramatically during the GFC but by 2010 it was back with a vengeance as Greenspan's understudy repeated the policies of his mentor.



As we know from our own work and that of others, the favourite destinations for these exports of dollars tended to be either the Emerging Markets or our relatively high-yielding Southern Hemisphere currencies and as we have noted elsewhere these two groups received somewhere between $8-$9 trillion of cumulative inflows into our debt markets alone (we also received equity related flows but we have not included these flow in the figures above). Particular favourites were New Zealand, of course, as well as Brazil, Australia, China, South Africa and Turkey. The recipient countries then used the inflows to fund significant expansions of domestic credit and this was particularly noticeable (but not exclusively) in the countries in which the central banks attempted to intervene in the domestic currencies to prevent them appreciating too quickly under the influence of the incoming dollar "bombardment". We would also note that Japan, Europe and the UK also added to the inflows intermittently but the primary arbiter of global liquidity was the growth in the supply of the reserve currency.

In many ways, the most interesting feature of the last two charts contained within this Comment are simply their scales. The exportation of dollars and the subsequent inflows into the EM are measured not in the billions but in the trillions and they have occurred at a time in which global nominal GDP growth has definitely been occurring in billions rather than trillions. Moreover, as a result of the advent of deflation that we have described in our reports over recent months, we suspect that global nominal GDP growth is currently not so much dwindling as in all probability turning profoundly negative in dollar terms.In dollar terms, the Eurozone's level of nominal GDP is now more than 10% smaller than it was a year ago, Japan's GDP is 11% smaller in dollar terms, Brazil's is probably 7-8% lower, China's nominal GDP is likely to be unchanged and the UK's level of GDP in dollar terms is now a little lower than it was at this point last year. As a result – and quite simply – there is no longer the same level of dollar-denominated GDP to support all of the dollar-denominated debt that Greenspan and Bernanke allowed and actively encouraged to be created during their profligate reigns and hence we may have entered into a semi-autonomous international dollar deleveraging cycle.

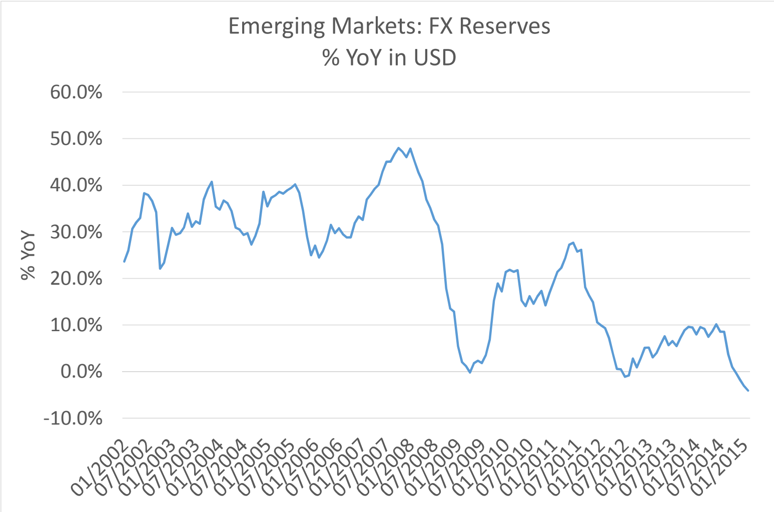
We should also note at this point that the Greenspan mantra of central bank predictability at all costs is also on the wane. In some cases, this has been deliberate (for example, the Swiss National Bank) or it may be because they are becoming increasingly "data dependent". Alternatively, it may simply be because the central banks themselves do not really understand what is going on and are flailing around as a result (the FOMC did just enact a rather spectacular U-turn).

Whatever the causation, it does seem that central banks are becoming a lot less predictable and we note ourselves that many international investors seem to be losing faith in their abilities and perceived omnipotence. This implied increase in uncertainty would also suggest that the markets would want to start unwinding some of their more extreme positions – although this might also explain why so many people are clinging onto the "hope" of a connected ECB and its apparent time-specific commitment to maintaining its own version of QE, even if we suspect that from a practical perspective the ECB will not be able to sustain its current policy stance for anything like as long as it is suggesting.

Deleveraging Is Occurring

In a sense, it perhaps does not matter exactly why there is an international dollar deleveraging cycle occurring, if only because there is ample evidence from the US's own data and that of its former recipients that the great dollar liquidity boom of the last 10-15 years is reversing. The USD-RMB carry trade is unwinding, the SGD trade is unwinding (quite violently judging by the MAS's reserve data), the

CAD trade is unwinding and we suspect that the AUD trade would unwind quite rapidly if the RBA attempted to reduce interest rates, while events in Brazil seem to be gaining an unwelcome momentum.



As ever, any deleveraging cycle will almost by definition be deflationary for growth and ultimately asset prices if it is allowed to continue. The question for investors is therefore is the current cycle being led by structural factors that are likely to persist, such as the unwind of Greenspan-nomics and its associated central bank predictability, or is it merely a cyclical reaction to the markets' (misplaced?) expectations for higher US interest rates and the recent widespread competitive currency depreciations. If it is the latter, receding expectations of a rate hike from the FRB may yet stem the tide but judging by the price action over recent days, the process may be rather more structural than many appreciate.

In the near term, it is quite probable that capital outflows from Japan and Europe may be able to sustain global liquidity a while longer (as they did in late 2006/early 2007) but this will come at the cost of savers (and financial institutions) in these countries providing the liquidity presumably towards the end of the cycle for dollar-based investors to exit (again, as they did in 2007…) and this may not be in their best interests over the longer term. Moreover, since these currencies are not reserve currencies, they are unlikely to be as "powerful" as dollar flows and therefore if the dollar deleveraging cycle is to end, it will probably require some form of new ZIRP/QE commitment from Yellen...

Ultimately, we believe that the dollar deleveraging cycle, if maintained, will result in further world trade price deflation, further profit compression around the world and further economic disappointment that will soon begin to adversely impact risk assets in a more general way – and if the deleveraging cycle gathers pace then it is quite possible that there may even be some more violent event along the lines of the LTCM unwind of 1998 (which was also at its heart a deleveraging event). Therefore, for market participants, we would argue that very close attention should be paid to the direction of the dollar over the next few months; if it continues its upward trajectory, this will likely be a sign that dollar deleveraging is gathering pace.

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