CURRENCY WARS

The US Government supports a weaker Dollar; however, there are other influencing factors as the currency war is building steam!

The currency war I refer to here is that which is now ongoing between countries who are trying to lower the value of their currencies, in order to gain a trade advantage and/or make their debts more manageable.

The current currency war is in many ways just a show, where a weaker currency is not the main goal at all. Accepting the premise that when a country conducts most of its trade in another currency, it cedes power to the "reserve currency" issuer. As it stands that position of power is held by the USA, through what is commonly known as the US Dollar trading standard system.

To emphasize this point almost everything from Gold to Oil, and most other things too, are traded in US Dollars. Hence, the world's central banks have to hold many Dollars as reserves. The result is an almost infinite global demand for US Dollars, which provides Washington with the power to borrow vast sums, indeed almost as it wants, and to govern without having to resort to hard spending and tax choices that other countries are forced to do in order to maintain and try to bolster their economic survival.

The current system significantly empowers the US to fund a military that dwarfs others and as this nation continues to throw their weight around many now feel that this is far out of proportion to its population or moral authority.

Consider for a moment other up and coming large powers like China, Russia, India or Brazil. "Dollar hegemony" becomes a major hurdle.

To those in the power struggle there is an advantage to be gained by cutting the Dollar out of bi-lateral trade in favour of their own currencies and China and Brazil are now embarking on trying to collaborate in this way;

China, Brazil sign trade, currency deal ahead of BRICS summit

BRICS members China and Brazil agreed last Tuesday to trade in their own currencies the equivalent of up to $30 billion per year, moving to take almost half of their trade exchanges out of the US Dollar zone.

This agreement, set for three years, was signed just hours before the start of the recent BRICS summit in South Africa. More importantly it marked a step by two major economies of the emerging powers group to make real changes to global trade flows, which has been long dominated by the United States and Europe.

The current US Dollar trading standard system is under pressure. The Brazilian Central Bank Governor commented that it is not to specifically establish new relations with China, but to expand relations to be used in the case of turbulence in financial markets.

However, this is no small change in the trade pattern between the two countries, which totalled around $75 billion in 2012. Brazilian officials have underlined that they plan to have the trade and currency deal fully operational sometime in the second half of 2013.

At the summit in Durban, which is the fifth held since 2009, the group - Brazil, Russia, India, China and South Africa - are widely expected to endorse plans to create a joint foreign exchange reserves pool and an infrastructure bank.

Statistics by the IMF show that US Dollars currently make up about 62% of allocated central bank currency reserves, with the other 38% in mostly Sterling and Euros with Yen amounting to around 4%. At present the Chinese Yuan is virtually zero. I would point out to members that China is now the world's biggest trading power, with Brazil and India not that far behind.

Why does the Dollar continue to dominate world trade, with all the advantages and power which that provides? Well it has been that way since World War II; however, the current system is under mounting pressure now.

I believe that as bi-lateral trade deals like the above become more common, countries trading with China and Brazil in local currencies instead of Dollars will need large Yuan and real reserves and correspondingly fewer Dollars. As central banks start selling US Dollars and start to buy other currencies, this will, things being equal, force the value of the Dollar downward.

An orderly transition to a multi-reserve-currency world would make US export industries more profitable and their large debts less onerous (according to conventional wisdom).

However, they are not likely to get what they wish for I would cite that markets do not normally carry out orderly transitions, as we are continually reminded. They start in one direction and then, when a critical mass of players decides the trend will continue, they go parabolic. The asset(s) setting the trend usually soar(s) or plunge(s) leading to other problems.

From a combination of US policy, which is purposely designed to weaken the Dollar and the fact that other countries are actively trying to negatively affect the Dollar in its role as reserve currency, we could see a gradual, but perhaps more choppy decline in its value.

Recently I reported that Sterling was undervalued in Dollar terms; it hit 1.488 and since then it has gained ground just as I predicted, this of course has profited those invested in the RIO Professional Investor's Fund - which always allocates a small percentage of its assets class to trading the three main currencies (Yen, Dollar and Sterling) which not only gives an element of protection to the Fund and its assets from the continued US Dollar decline but offers what can only be described as a very profitable strategy. As the currency wars continue this will produce further opportunities for my currency trades. More importantly it also affords the fund the opportunity to profit from the status quo highlighted in this report. Members should watch the Yen as it will fall further in Dollar terms and we should see it cross the 100 marker this month.

For those invested or considering investment the Professional Investors Fund has posted three consecutive gains this year, so far this month all trades are currently in profit, with a further two trades closing profitably this week.

William Gray
The RIO Club