

ABOUT THE ECONOMIC CRISIS

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The economic crisis that the global economy is facing nowadays has started with the financial crisis of the U.S financial system. We are talking about an unprecedented speculative bubble at global level which has overcome the previous bubbles, created by the dotcoms or the pyramidal games (such as Caritas) at national or regional level.

The financial crisis, apparently caused by deficient risk management, is a null sum game, in which the wealth gains are made private and loses are socialized. The epicenter is the U.S, where favorable conditions are created to facilitate the real estate credit (a home for each family); institutions to guarantee these credits were created by the state and the interest rate was reduced a lot. The main vector for triggering the crisis was the credit default swap created by JP Morgan.

*Keywords: economic crisis, exchange rate, metal reserves
Cod JEL: F5, G1*

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An important wheel in the market economy is the one connecting the capital price with the interest rate: the decrease of interest rate determines the capital price to increase (inclusive the real estates). The increase in real estate prices has encouraged the mortgage credit, and so the bubble started to enlarge by issuing financial instruments which proved to be harmful.

The financial derivatives are titles bounded to a financial instrument, merchandise or indicator, with the purpose of negotiating financial risks on the financial markets.

The mortgage credits (and afterwards other credits too) were over secured, and the financial titles issued this way and guaranteed by assets (ABS - asset-backed security or MBS - mortgage-backed security) have highly increased and spread widely. They promised high earnings and appeared to have a low risk degree. A lot of banks, investment societies and pension funds have made large investments in such financial products.

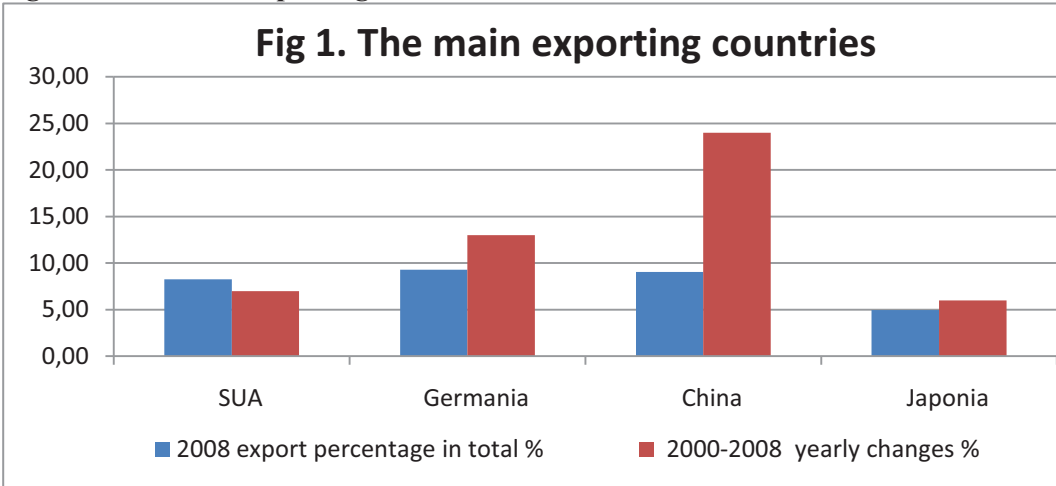
As the interest rate in the US (and other countries) has increased and the price of real estate has decreased, the speculative bubble has deflated. The weight of toxic assets in the balance of financial institutions was so high, that many of them have gone bankrupt. The lack of faith between banks has led to stagnation of crediting, inclusive of the production crediting and so the crisis has affected the real economy.

The decrease of production (by closing some unities, shortening the working hours) has led to decrease in the incomes and in the demand. The demand for imports is decreasing more than the one for local products, so that countries with a large weight of export in production are more affected by this diminishing of demand than others.

The world trade is decreasing. In crisis conditions, if the demand decreases, the prices decrease too, also the international prices and the relation between currencies change.

The most important world exporting countries are: Germany, China, USA and Japan (Figure 1)

Figure 1: The main exporting countries



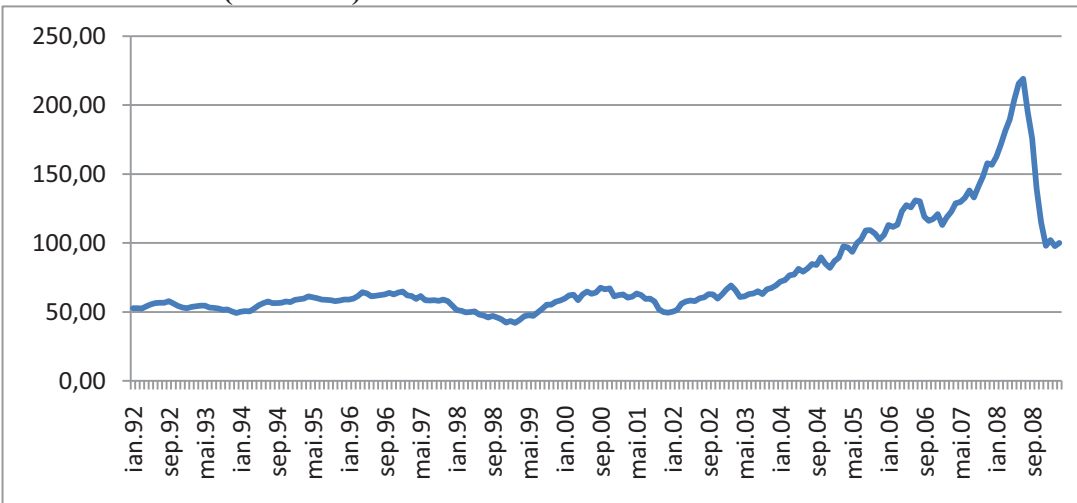
Source: WTO, World Trade 2008, Prospects for 2009, Press/554

After many decades of USA being the largest world exporter, in the last years Germany has taken the lead, and China has taken the place of Japan (3), and most recently it became the second world largest exporter, outrunning The United States.

For the large exporters, the US represents one of the most important selling markets. USA is today the world largest importer. The diminishing of the US demand for import, as a result of the crisis, has affected strongly Germany, China and Japan. All of these countries have searched a solution to compensate the decrease of extern demand (especially from USA) for their products by stimulating intern demand for consumption and investments.

As the world import has decreased, the prices for the primary commodities which are traded widely have also decreased (Figure 2).

Figure 2: The primary commodity price index in world trade – monthly average figures Jan 1992-march 2009 (2005=100)



Source: IMF Database, April 2009

The most spectacular decrease of commodity prices has occurred in the summer of 2008.

The most important commodity products are metals and oil, and their prices have followed the group trend, having a harsh evolution.

The price for oil has also decreased, more than the metal. As the commodity prices have decreased in the USA, China and other countries, the idea of investing in the so called “hard assets” has appeared.

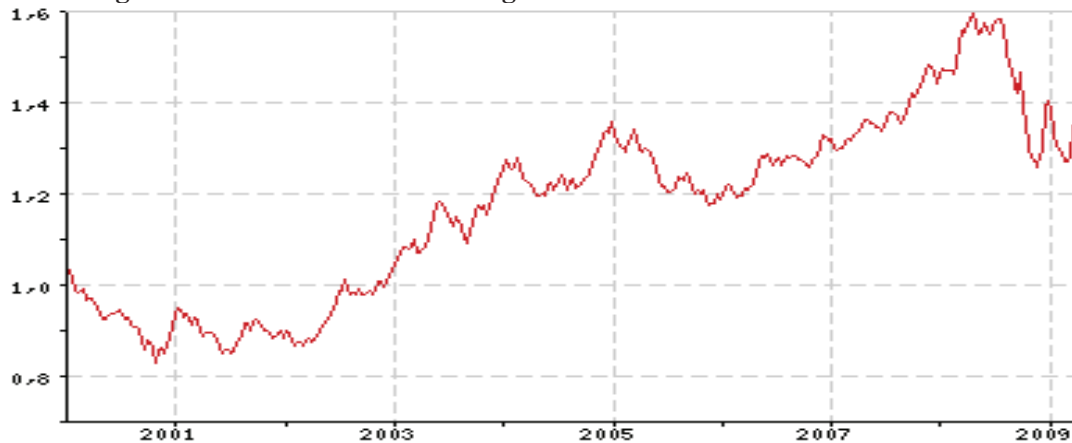
Theoretically, from shares you get dividends, from loans you get interest and from real estate you get rent. The holding of raw materials implies expenses (stocking costs, depositing costs), and doesn't offer any direct payments. So why would anyone invest in raw materials? Just like the other assets, these are subjected to price fluctuations. The fluctuations depend on the demand in the industry and the storage capacities. If we look at the evolution of these prices in the past 15-25 years, we observe that the current price is higher than a few years before, but it seems to be getting more stable. Anyway, increases in price at the level of the first semester of 2008 are unlikely, so the possession of commodity stocks doesn't appear to be the optimum investment. If the United States has great capacities for oil storing¹¹⁶, that means that China should increase the ones it has, which implies great investments. So it would make more sense for China to invest in transforming the coal (which is a plentiful resource for them) into gas.

A complicated issue in the process of adjusting the financial economy to the level of the real one is tied to dollar value, as an international currency, in connection to other currencies. In the last years the dollar exchange rate has decreased, mainly because of the chronic deficit of the US trade balance and budget.

The decrease in comparison with SDR was not spectacular, because the dollar has a big percentage in the SDR basket, but has been spectacular in comparison with the euro (figure 3) and the renminbi (figure 4). We cannot predict the future evolution of the dollar in comparison with other currencies.

From the year 1995 to 2000 the exchange rate of the dollar in SDR has increased with 25%, and then it reversed, decreasing with 30%.

Figure 3: the Euro-dollar exchange rate



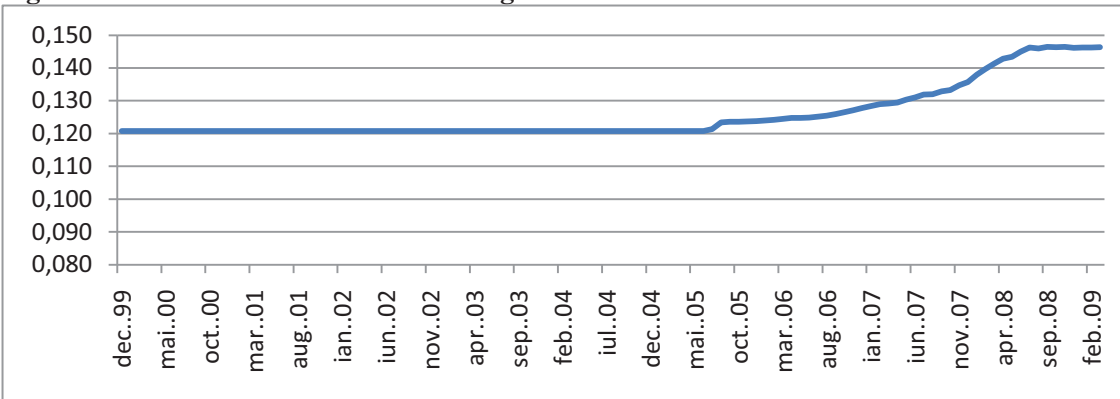
Source: IMF Database, March 2009, Der Spiegel apr.2009

We observe that the dollar exchange rate has decreased with 85% from 2001 to 2008, and increased with 20% in the second half of 2008.

116 The oil reserves in USA and China are modest. The largest reserves, in 2007, were in Saudi Arabia – 264,2 mrd. Barrels, Canada – 180 mrd. Barrels, Iran– 138,4 mrd. Barrels etc. (Handelsblatt, 21.04.2009)

The Chinese currency has been in an almost fixed exchange rate to the dollar until June 2005, then it increased its value by 30% until June 2008 and since then the exchange rate is relatively constant. After June 2005, the renminbi-dollar exchange rate is similar to the euro-dollar one.

Figure 8: The Renmibi to Dollar exchange rate



Source: People's Bank of China, Statistics, 1999 - 2009

China holds large dollar reserves because of the great US deficits in trade balance with China.¹¹⁷

China's strategy: trading reserves for resources

Considering that China had large deposits of longer-dated US Treasuries, The Central Bank had to react at the global crisis situation by elaborating a strategy to decrease exposure to the dollar, which affected the stability of its national reserves.

The first step that The Central Chinese Bank did was to divest itself of longer-dated US Treasuries in favour of shorter-dated ones.

Another idea was to buy strategic resources, which prices have decreased because of the financial crisis, with two benefits at once: helping the Central Bank to decrease exposure to the dollar, holding hard assets with chances to make greater profit (because of their decreased current prices). We can say that from a geopolitical view China appears as a strategic player on the world scene, seeking to gain a favorable position considering the present global crisis.

On a large view, we can say that China's strategy and its actions in the recent global context might have major implications over the dollar's evolution, the American economy and over the international financial system. That why it is so interesting to find out which is China's strategy, how it will be implemented and how it will affect the other economic and politic actors.

Officially, China's reserves are of \$1,95 trillion. Regarding the composition of these reserves, according to the most recent Treasury International Capital (TIC) report, China has holdings of US Treasuries of \$696 billion, but it seems like the amount is likely to be bigger than that figure, since some of the purchases of Treasuries made by the UK and Hong Kong should actually be attributed to China's Central Bank. China also holds US government-sponsored agency debt (Fannie Mae and Freddie Mac paper).

On the other hand, the assets holdings of FED have highly increased in the past months, because the purpose of the US Treasury to recover the American financial system, but the percentage of best assets (AAA) was reduced to a quarter of the total, in comparison to three quarters last year.

Taking in consideration the increased risk aversion of international investors, there are more and more buyers for the US Treasuries, which offer increased safety at lower profit margins. So, that takes significant pressure off of China to soak up the new issuance of US debt.

¹¹⁷ We can say that China, Japan and other countries are financing the American deficit. Some say that the USA consumes Chinese products with money from the Chinese, and the Chinese are maintaining their growth based on the request of Uncle Sam (Yves Thréard, Le Figaro, le 12 avril 2009).

The estimate of the total exposure of China's central bank to dollar denominated assets is about 70%. This has generated concern among Chinese officials, a desirable situation being a total exposure to the dollar of 50% or less of the total reserves. That would provide more safety in the case of an excessive decline in the value of the dollar.

In order to achieve this objective, China would have to converse existing dollar denominated assets in value of \$450 billion in new assets, and accomplish this without triggering a global dollar panic.

Fang Shangpu, deputy director of SAFE (State Administration of Foreign Exchange), has made a declaration (18 February 2009) concerning the amount of US government bonds held by China, stating that they included not only the investments from the reserves, but also from other financial institutions. The main principle in reserves management for China is ensuring safety and the value of the reserves.

Considering the evolution of the „subprime” crisis from the USA into an international financial crisis, the Chinese officials declared that changes in the global market have been closely followed and measures were taken to evaluate and remove risks. Obviously Chinese officials were aware, for several years now, of the increasing risks of too great exposure to the dollar. So it is hard to suppose that they failed to formulate strategies designed to limit that exposure to safer levels.

So the rising question is: which is China's strategy to decrease exposure of its reserves to the dollar?

According to the researches of de Rachel Ziemba of RGE Monitor, in the first two months of 2009, China has made deals for buying hard assets worth over \$50 billion.

On 23 February 2009 there was an article in China Daily, which presented that as part of the National Energy Administration's three-year plan for the oil and gas industry, the government is considering setting up a fund to support firms in their pursuit of foreign mergers and acquisitions. Fang Shangpu, deputy director of SAFE, added that more measures will be introduced to support firms seeking to expand overseas. The analyst Han Xiaoping said it is time for China to convert some of its capital reserves into resources reserves, considering the fact that global oil prices have fallen 70% last year, to about \$40 a barrel.

Jiang Jiemin, the president of PetroChina, said that the low share prices of some global resource companies provide China new opportunities. Investments in hard assets, so called „wealth deposits”, natural resources or shares from exploiting companies (with small prices because of the financial crises) seemed like a good solution for using China's financial resources, considering the high risk of financial investments.

It is interesting to analyze the effect of this converse financial reserve in resources strategy to the evolution of the dollar.

First we have to consider the currencies used for the transactions. If the resources buys are made in dollars then the impact on the dollar as main reserve currency might be minimum. If other strong currencies are involved in the transactions, then the international role of the dollar could be undermined.

China suggested at the G20 meeting that the SDR should be used as an international exchange currency in the place of dollar. The proposition was considered to be unreasonable. It would be possible to include the Chinese currency in the SDR basket, considering this country's share of the global economy.

The details of implementing the strategy of decreasing exposure of China's reserves to the dollar are still unknown; there could be swaps among the various state-controlled entities and private Chinese investors or some opaque means. It is obvious that China will continue to buy resources as long as their prices stay low, the estimation of transactions is of a total \$35 billion/month.

Anyway the financial economy of China is closer to the real one in comparison to other countries.

At global level it is time for the adjustment of the financial economy to the real economy. In this period there shall be redistribution of wealth and final results of the null sum game. The measures implemented at a large scale by the economic powers (G20) and the IMF is leading to the end of the crises.

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