Press release

informed RCM

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RCM sees flexible exchange rates as key instrument for eliminating global imbalances

- **Utermann: "The economic scales need more weight on the Asian currency side"**

"In Europe we assumed for too long that the Greek rescue package put together by the EU and the IMF would only be a theoretical notion", says Andreas Utermann, Global CIO of RCM, a company of Allianz Global Investors. However, he does not believe there is much risk of a knock-on effect: "In Portugal and Spain we have a different situation as the debt base in those countries is lower and there were no doubts about their fulfilling the Maastricht criteria on accession to the euro." Nevertheless, he cannot rule out that, if economic development flags or if the Greek savings programmes fail to achieve the desired effect, the credit-standing of these countries will also suffer.

On the consequences for the euro as a key currency in the international monetary system Wilhelm Schorn, CIO for currencies at RCM, adds, "The euro's credibility has no doubt suffered and I dare say that will continue to be the case until new legal regulations are introduced in the eurozone. This will probably make the relinquishment of fiscal autonomy in favor of a clearly defined form of solidarity or a uniform fiscal policy inevitable. Even if there is still a long road ahead."

The meaning of currencies in the global context

As a consequence of globalisation and a long period of low interest rates Utermann expects growth to shift from the industrialized world to the emerging markets. According to RCM's experts, in the long run currencies will play a leading role in resolving the global imbalances stemming from huge state deficits in the West, on the one hand, and soaring savings rates in other parts of the world, on the other hand.

Together Utermann and Schorn point to the tensions and political and economic upheaval in which the dollar, the renminbi and the euro are currently caught up.

Floating exchange rates instrumental in achieving economic balance

The global trading scenario has been characterised by extraordinarily high current-account surpluses in China mirrored by extraordinarily high current-account deficits in the USA. China's huge dollar holdings have served the USA as a credit base to import Asian goods, which only went to make matters worse.

"A revaluation of the renminbi could take the edge off China's competitiveness and thereby set a gradual reduction of the imbalance in motion. Instead, the Chinese currency's rigid exchange rate is keeping the situation intact", explains Utermann.

This exemplifies how flexible exchange rates work as a vital tool of adjustment between economies with different growth rates and levels of productivity.

Current-account deficits and surpluses need to be balanced

In Utermann's view a further important step along the path to global balance is the modification of the international currency system. At the moment this is putting more pressure on deficit countries to balance their current accounts than on surplus countries. However, in Utermann's opinion "current account deficits are no more absolutely negative than

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current account surpluses are absolutely positive". This is why he considers John Maynard Keynes's proposal to pool the foreign exchange reserves of IMF member states in special drawing rights (SDRs) and to fine both deficit and surplus countries. "That way there would be an incentive to reduce surpluses and at the same time a more simple method of balancing current account deficits."

'Greek tragedy' reveals euro's design weaknesses

Now that the financial crisis is over major divergences are also becoming evident among the individual countries of the euro zone. At the very latest since the Greek crisis this is another area where the lack of an adjustment tool for rectifying economic imbalances – namely floating exchange rates – has been making itself felt. However, Wilhelm Schorn identifies a major cause of the dramatic development in the fact that Greece's financial situation was already precarious when the country joined the EU in 2001.

Although he considers it unlikely that the euro will fail, not least because of the high opportunity cost involved, some fundamental flaws in its design nevertheless make him sceptical. "The 'Greek tragedy' has laid bare structural deficits in the Treaty of Lisbon and the Maastricht Treaty. Limiting debt and price levels does not suffice to safeguard a common currency." Schorn went on to explain that as long as there are no mechanisms, enshrined in the treaties, for sanctioning highly indebted member countries, it will be difficult to assess the degree to which necessary savings measures are politically enforceable in Southern Europe, and this constitutes a potential threat.

The US dollar's uncertain future in the global currency system

At the moment one of the most important questions – that of the future role of the US dollar in the global currency system – is being overshadowed by current developments in Europe. Nevertheless, Schorn points out that this does not mean the question has in any way diminished in significance.

As early as last year emerging markets rich in reserve currency holdings started to harbour doubts about whether they should go on accepting the dollar as the key currency without limitation. The debate reflects concerns about the value of the huge dollar holdings. On the one hand these concerns are prompted by the currency risk and on the other hand they are based on long-term inflationary dangers.

There are valid political and economic arguments that support the debate about the dollar as an international reserve currency, since, as the issuing country, the USA must pay due attention to domestic interests by maintaining an appropriate money supply and at the same time satisfy the global demand for a reserve currency. However, Triffin's dilemma, as this paradox is called, also delivers substantial macroeconomic advantages, such as the possibility of taking up loans in one's own currency abroad at favourable rates.

Yet, according to Schorn, some fundamental conditions have to be fulfilled before the greenback actually does forfeit its preeminence. "The Chinese-Russian proposal to replace the dollar with special drawing rights would have to be accompanied by a reform of the IMF and the global currency system. The currencies of the BRIC countries ought to be incorporated into the SDRs." However, to achieve this, the BRIC currencies would first also have to be allowed to float, Schorn added.

Investment risks and opportunities

RCM's experts are assuming that the US dollar will be weak in the long term – not least because combating inflation is only a weak component of the FED's monetary policy. Nevertheless, the dollar can be expected to make gains in the course of this year as the interest rate differentials against the euro and the yen are set to rise.

In the long term investors should watch Asian currencies as well, as in future these will play a more prominent role in the international currency structure.

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Awards

- RCM named winner of Active North American Equity at Pensions & Investment Provider awards 2009. RCM US Large Cap Select Growth is managed by Scott Migliori, CIO for US Equities, RCM.
- RCM named No.1 leading fund management firm for SRI Research by Thomson Reuters Extel 2009.
- Global CIO of RCM, Andreas Utermann, named CIO of the Year by Funds Europe magazine 2008.
- Winner of European Investment Trust of the Year by Investment Week magazine, 2008, for the RCM-managed Charter European Trust.
- Allianz RCM Global EcoTrends Fund named winner Best Climate Change Investment fund 2008, by Holden & Partners/ Incisive Media.

About RCM (all data source: RCM as at 31/12/09)

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