CHINA PONDERS ITS NEXT MOVE

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Over the course of the second half of 2013, one of the key stories has been the debt ceiling debate taking place in the United States. From an international perspective, probably the long-term story is really how international reserve managers, in particular the Chinese, will react to this debate. The reason for this is simply enough that over the course of the last 11 years, China has amassed around about $3.5 trillion worth of foreign exchange reserves, of which around about $1.2 trillion, according to official sources, are invested in U.S. government debt. They, therefore, have a vested interest in what happens with this debate.

There have been concerns within China, really since 2006, over what's happening, not just about the fiscal story, but about the dollar as well. However, these concerns have become rather more heightened over the course of the last two and a half years. We saw very similar concerns being expressed during the time of the 2011 crisis and at the time of the Standard & Poor's downgrade in August 2011. And those concerns have resurfaced in official commentary once again during October of this year.

What really matters, though, here, is what China does next. And, whilst clearly they would hope that the United States will deal with the fiscal story in a sensible fashion, the only way they can ultimately break the cycle of having to lend more money back to the United States, as they accumulate foreign exchange reserves, is to liberalize their currency policy.

There have been signs over the last two and a half years that they have been moving forward on this front, and there are certainly signs that before the end of this year, we actually will see a plan towards the ultimate liberalization or at least a dirty float for the currency, probably be some point between the point of 2015 and 2016.

The key for the foreign exchange markets with this is to ask what happens when that liberalization takes place and what it means for the international currency markets, as well as for the government debt markets.

From the currency perspective, it probably means that those currencies that have benefited over time probably don't get as much support from diversification. But probably more importantly, it means that the local government bond markets that have benefitted from Chinese buying, and here, quite clearly, I'm thinking of the United States, start to find themselves under real pressure.

So, from this point of view, it is fairly clear that the next two years the United States needs to deal with its fiscal issues in order to win back the confidence of the international reserve managers. If not, the problem will be that rising debt costs will start to become an issue and possibly even further pressure downward on the dollar could start to become a real concern.