

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

# ECONOMIC WINTER



## China's Renminbi: The World's Next Reserve Currency?

### China's Membership in the World Trade Organization

China has been a member of the World Trade Organization (WTO) for a little more than ten years. Over that decade, has China established a good track record of adhering to the WTO rules and agreements? Has China earned the respect of its major international trading partners within the WTO? Certainly, regional agreements established by China with Russia and Japan to settle trade transactions via their respective currencies enable them to diversify their reserves away from the U.S. dollar. However, it would appear that China has not yet fully matured as a member of the WTO. Just last week, as reported in the *Globe and Mail*, as the risk of a global shortage of rare-earth minerals increases, the United States, Japan and the 27-country European Union filed a complaint with the WTO against China's export restrictions and duties on metals, including 17 rare-earth minerals, which are used in the manufacture of electronics and high-tech products. The rare-earth minerals are valued for their indigenous properties of strength, magnetism and luminescence. China possesses about one-third of the planet's rare earths, yet controls more than 90% of global production. In a televised Washington speech, U.S. President Obama stated: "American manufacturers require access to rare earth minerals which China produces. If China would simply let the market work on its own, we'd have no objections. However, their current policies are currently preventing that from happening and they go against the very (WTO) rules which China agreed to follow." The complaint, which will receive a ruling by year end, demands that China remove its export restrictions or face trade sanctions.

China's Ministry of Commerce defended Beijing's stance on rare earth minerals, stating it is ready to respond at the WTO; noting that it has repeatedly explained to other governments already that its raw materials export policy "aims to protect resources and the environment," not distort industry. Xinhua, China's state-run news agency, warned the complaint to the WTO could "trigger a backlash from China, instead of settling the rift."

Trade experts agree that the WTO usually rules against export quotas, but whatever the outcome, the rare-earths trade dispute seems likely to escalate. Eswar Prasad, a Cornell University professor of trade policy, commented: "Beijing is probably preparing a fierce counterpunch, especially since China is in the midst of its own leadership transition and can ill afford to be seen as caving in to international pressure."

According to the *Wall Street Journal*, China currently produces 95% of rare earths, up from 40% in 1995. In recent years, it has cut export quotas to around 30,000 metric tons a year from 65,000 tons, citing environmental concerns and a desire to keep the industry sustainable. The U.S. Defense Department estimates that rare earth-prices have surged between 4 and 49 times, compared with their values in current dollars in 2001. While prices have been easing in recent months, they remain historically high. Rare-earth production in the rest of the world is expected to match China's output by 2020, as others accelerate mine production to counter China's dominance. Total (annual) global production just exceeds 120,000 tons, making it a market of only a few billion dollars; compared with 1.5 billion tons and a market of more than a trillion dollars for iron

## Wide Application

Here are uses of rare earths and other minerals the U.S. calls strategic.

Rare earth materials	Photovoltaic films COATINGS	Wind turbines MAGNETS	Vehicles MAGNETS	Vehicles BATTERIES	Lighting PHOSPHORS
Indium	Orange				
Gallium	Orange				
Tellurium	Orange				
Dysprosium		Orange	Orange		
Praesodymium		Orange	Orange	Orange	
Neodymium		Orange	Orange	Orange	
Lanthanum				Orange	Orange
Cobalt				Orange	
Manganese				Orange	
Nickel				Orange	
Lithium				Orange	
Cerium				Orange	Orange
Terbium					Orange
Europium					Orange
Yttrium					Orange

Source: U.S. Department of Energy The Wall Street Journal

ore, steel's main ingredient. However, high tech firms need the minerals at affordable prices and have ferociously lobbied governments in Brussels, Washington and Tokyo – arguments which resonate, since rare-earths also have numerous military applications.

Paul McGuinness, Chief Financial Officer at Frontier Rare Earths Ltd. in South Africa (10% owned by Korea Resources Corp.) explains: "Our company is building a separation plant for a total project cost of about \$900 million (U.S.). You need to turn the rare earths into metals; and then alloy, then a magnet, before it even ends up in a product. Until 2016 at least, China will retain its dominance of global production. That's why you're seeing big users like Samsung and Toyota looking to go downstream. Our Korean partners don't want to rely on China indefinitely, for something that is so critical to major elements of Korean industry."

### China's Corporate Espionage

According to a recent study compiled by Bloomberg Businessweek, last November, 14 U.S. intelligence agencies issued a report describing a far-reaching industrial espionage campaign by Chinese spy agencies. This campaign has been ongoing for years and targets a swath of industries: biotechnology, telecommunications and nanotechnology; as well as clean energy. One American metallurgical company lost technology to China's hackers that cost \$1 billion (U.S.) and 20 years to develop. An Apple Inc. global supply manager pleaded guilty in 2011 to funneling designs and pricing information to China and other countries; a Ford Motor Co. engineer was sentenced to six years in prison in 2010 for attempting to smuggle 4,000 documents, including design specifications, to China. Earlier this month, the National Aeronautics and Space Administration (NASA) informed the U.S. Congress that China-based hackers had gained access to sensitive files stored on computers at the Jet Propulsion Laboratory. As the trend continues, political leaders and intelligence officials in the U.S. and Europe are coming to a disturbing conclusion. As stated by General Keith Alexander, Director of the U.S. National Security Agency at a January conference at New York's Fordham University: "It's the greatest transfer of wealth in history."

## The American Superconductor / Sinovel Wind Group Relationship

In June 2011, three men squeezed inside a wind turbine in China's Gobi Desert. They were employees of American Superconductor Corp. (AMSC), a manufacturer of computer systems that serve as the electronic brains of the device. Periodically, AMSC workers are required to visit a wind farm in some desolate location to check on the equipment, perform maintenance and make repairs. On this occasion, the AMSC technicians were investigating a malfunction. They entered the cylindrical main shaft of the turbine, harnessed themselves to a ladder and climbed up 230 feet in darkness to the nacelle; an overpacked compartment which holds the machinery used to convert the rotation of the blades into electricity. Devens, Massachusetts-based AMSC had been using the turbine, manufactured by the company's largest customer, China's Sinovel Wind Group Co., to test a new version of its control system software. The software was designed to disable the turbine several weeks earlier, at the end of the testing period. However, for some reason, this turbine ignored the system's shutdown command, so the blades kept right on spinning. The AMSC technicians tapped into the turbine's computer to research the problem.



Sinovel's wind turbines in Ulanhot City, Inner Mongolia Autonomous Region, China on May 16, 2011

Source: Xu Xiaolin / Corbis / Bloomberg

The difficulty wasn't immediately clear, so the technicians made a copy of the control system's software and forwarded it to the company's research center in Klagenfurt, Austria, which produced some startling findings. The Sinovel turbine appeared to be operating on a stolen version of AMSC's software. Worse still, the software revealed Beijing-based Sinovel had complete access to AMSC's proprietary source code. Ergo, Sinovel didn't need AMSC anymore.

Three days after that expedition in the Gobi Desert, Daniel McGahn, AMSC's chief executive officer, received the news on his mobile phone while travelling in Russia. Hired in 2006, McGahn helped revamp the then-floundering company by focusing it on two things: China and wind power. Those investments paid off for a while, as Sinovel purchased more and more turbine controllers from AMSC. Then in March 2011, Sinovel abruptly and inexplicably began refusing AMSC's shipments at its enormous turbine assembly factory in Liaoning province. On April 5th, AMSC had no choice but to announce that Sinovel – then its biggest customer, accounting for more than two-thirds of the company's \$315 million (U.S.) revenues in 2010 – had ceased making purchases. Investors fled, erasing 40% of AMSC's market cap in a single day and 84% of it by September ... On June 15th., standing in a St. Petersburg office tower, McGahn listened to the report from the Austrian team for 30 minutes and felt the blood drain from his face. For months, he had been trying to save the relationship with Sinovel, but was making no progress. By the time he ended the phone call from his Austrian team, he knew why.

AMSC has presented to law enforcement officials in Austria and China, computer logs and messages which show Sinovel courting one of AMSC's employees and paying him to assist in the proprietary software code theft. Sinovel had been caught red-handed. AMSC has filed four complaints against Sinovel in Chinese courts ... seeking \$1.2 billion (U.S.) in damages. Sinovel has filed its own countersuits, claiming AMSC owes it \$207 million (U.S.) for problems including defective equipment. Democratic U.S. Senator from AMSC's home state and Chairman of the Senate Foreign Relations Committee railed: **“This is a red-hot smoking gun example. If this is the way the Chinese choose to do business, it's going to be very contentious and tough sledding for this relationship.”** U.S. politicians and corporate executives have complained about China's intellectual property abuses for years, to little effect. For example, Chinese officials have promised to crack down on the theft of Microsoft Corp.'s Windows operating system; but the company states it is still witnessing mass downloads of its software which has never been paid for.

## Leading U.S. Republican Presidential Candidates' Views on China

Former Massachusetts Governor Mitt Romney's comments regarding China have been intensifying over the past year, as he increasingly advocates a hardline approach in dealing with Beijing. “Well, China has an interest in trade. Since China has 20 million people coming off the farms and into the cities every year, the government wants them to be able to find employment. The Chinese want to have access to global markets ... but we must make them understand that they have to play by the rules. They can't hack into our computer systems and steal software from our government or our corporations. They can't take American patents and designs and duplicate or, counterfeit them; and then sell them around the world. Also, they can't manipulate their currency in such a way that enables their (export) prices to be lower than they otherwise would be. If the Chinese act fairly, then we'll have open trade with them.”

Former U.S. Senator from Pennsylvania Rick Santorum doesn't want a trade war with China, rather: “I want to beat China ... by making America the most attractive place in the world to do business. Some have suggested we need to impose trade tariffs. That just taxes you and I don't want to do that. I want to create an atmosphere where businesses and manufacturers can be profitable. We'll lower taxes and repatriate funds which will not be taxed if you invest them in plant and equipment. Certainly, we need to do that with the economic agenda that I have already outlined.”

## China Suggests Renminbi Is Close to Fair Value

According to figures released last week by the National Bureau of Statistics, China posted a trade deficit of \$31.5 billion (U.S.) in February, its biggest monthly deficit since 1998. At the annual session of the National People's Congress, deputy central bank governor Yi Gang suggested: “This trade deficit is a positive sign that the renminbi exchange rate is close to its equilibrium level.” When asked whether the



central bank had decided to halt the appreciation of the renminbi against the U.S. dollar, central bank governor Zhou Xiaochuan stated: “Generally speaking, as the renminbi exchange rate approaches the equilibrium point ... we should allow and encourage a greater role for market supply and demand. In 2011, China recorded a trade deficit over the first few months, but ended the year with a \$150 billion (U.S.) trade surplus. However, the unstable economic and financial situation in Europe and a slow global economic recovery are the biggest uncertainties for China’s economy this year. According to the Financial Times, China’s trade data, cross-border capital flows and slower accumulation of foreign exchange reserves as evidence that the renminbi is no longer grossly overvalued. Paul Mackel, Asian currency researcher at HSBC recently noted: “This structural change in China’s balance of payments has profound implications for the currency. Fundamental surpluses have continued to narrow and the renminbi is closer to the equilibrium value than ever before.”

### Cautious Optimism at the International Monetary Fund

As part of a recent speech to Chinese policymakers and global business leaders in Beijing, International Monetary Fund (IMF) Managing Director Christine Lagarde waxed: “China’s renminbi could become a reserve currency in the future, but the country needs a road map for a stronger, more flexible exchange rate, more effective liquidity and monetary management, with higher quality supervision and regulation, with a more well-developed financial market, with flexible deposit and lending rates, and finally with the opening up of the capital account. If all that happens, there is no reason why the renminbi will not reach the status of a reserve currency, occupying a position on a par with China’s economic status ... Lingering weaknesses in the global (economic) outlook reinforces the importance of China maintaining a prominent role in global policy discussions and accelerating reform in its own economy. (From my perspective), I see three priorities for China: firstly, to support (economic) growth; secondly, to shift its drivers of economic growth away from investment and exports towards domestic consumption; and thirdly, to spread wealth more widely. It is crucial that the world’s major economies are working together with the same objective. We are all interconnected and we are all affected by each other’s policy actions. We need to prepare for success together. If we stand together, the whole will be more than the sum of the parts.”

### The Inexorable Increase in Chinese Gold Imports

According to GoldMoney, just over a year ago, the balance between Chinese gold production and (domestic) demand began to change. China’s mining companies were unable to produce enough gold to satisfy the growing domestic demand, with the result that China began importing gold (bullion). The importation of gold trend began modestly and received little attention. In September 2011, the Financial Times reported: “Data from the Hong Kong government showed that China imported a record 56.9 tonnes of gold in September, a six-fold increase from 2010. Monthly gold imports for most of 2010 and 2011 averaged about 10 tonnes, but buying increased over the July – September period of 2011 ... as China imported about 140 tonnes from Hong Kong.” More recently, Reuters News reported: “China imported nearly 20% more gold from Hong Kong in November 2011 than in October, continuing a trend of sharply rising purchases that saw bullion flows to the mainland more than treble in the first eleven months of last year, as recorded by the Hong Kong and Statistics Department.” Accordingly, we cannot dismiss out of hand the suggestion that China may be accumulating gold bullion in order to return some form of a gold standard; if, as, or when the renminbi may achieve world reserve currency status. As history has well documented, global reserve currency status, eventually, always defaults to the world’s largest creditor nation.

### Economic Parallels to the 1930’s

Over the last several years, China’s economic growth has mirrored the domestic growth of the United States in the 1920’s. Inasmuch as speculation in the U.S. stock market and high loan levels during that period culminated in the market crash of October 1929 and the ensuing economic depression of the 1930’s; malinvestment in China today will result in a banking system failure and a collapse of the monetary system, as well as in global trade. As was the case with U.S. in the 1930’s, this may drive China into a period of isolationism.



Unemployed men waiting at a Chicago soup kitchen in February 1931. Source: Market Watch News

### A Return to Commodity Money

In his book, *Paper Money Collapse – The Folly of Elastic Money and the Coming Monetary Breakdown* (John Wiley & Sons Inc. 2011), author Detlev Schlichter expounds: “My hope is rather that from the ashes of the collapsed paper money system, a monetary order arises that is, once again, based on the market’s choice of a monetary medium and that is regulated entirely by market forces, by the free, voluntary, and spontaneous interaction of the trading public and not by government dictate. In this system, financial services will be offered by true entrepreneurs, by fully capitalist enterprises and the state will be completely removed from society’s financial sphere. My very strong conviction is that this system will again be based on gold, given gold’s unique qualification and its unparalleled standing as the world’s eternal money. Over the past ten years, the market has already begun to remonetize gold. I believe that this will continue. The public has accepted the state’s inferior fiat money long enough. Withdrawal of that support and a shift to gold as international money and apolitical money has already commenced. I think it will continue to be the big story in markets and in politics going forward.”

### The BRICS South-South Bank

As documented in the latest *Privateer* issue: “On March 29th. the heads of state of the BRICS (Brazil, Russia, India, China, South Africa) nations met in India. The major item on the BRICS agenda was their decision to work towards the establishment of what is termed a ‘South-South Bank’ funded entirely by themselves and ‘other developing nations.’ The bank is planned to be a replacement for the World Bank and the Organization for Economic Cooperation and Development (OECD). Unmentioned but unmistakable is the longer term goal of freezing the International Monetary Fund out of Asia. There is also a more ambitious undertaking, a plan to endorse the Chinese Yuan (renminbi) as the major trading currency for the BRICS nations and eventually as the currency of trade across the ‘emerging markets.’ The goal here is equally obvious. It is to supplant the U.S. Dollar as the Asian reserve currency.

In the aftermath of the U.S. impasse on cutting spending and reducing government deficits in July 2011, Asia (with the possible exception of Japan) has concluded that the risk of leaving the U.S. Dollar as the major reserve currency behind their financial system(s) is simply too great. China's foreign reserve holdings of U.S. Dollar denominated paper have been declining for nearly a year. China and Russia agreed to use each other's currencies in cross-border trade late last year. Early in 2012, China and Japan formally agreed to hold each other's sovereign debt paper as reserves. In both of these instances, and several more, the object of the exercise was to exclude the U.S. Dollar from cross-border Asian trade as a preparation towards reducing (at the very least) the role of the U.S. Dollar in Asian reserves."

### China to Allow More Foreign Investment

Just this week, China has almost tripled the amount of money foreign institutions can invest in its capital markets, in the latest move aimed at loosening strict capital controls and internationalizing the renminbi. The China Securities Regulatory Commission announced that international fund managers would be allowed to invest a combined total of \$80 billion (U.S.) in China's onshore capital markets – up from the previous limit of \$30 billion (U.S.) in an expansion of the so-termed qualified foreign institutional investor (QFII) quota. Beijing also increased the total amount of renminbi that foreign investors can raise in Hong Kong for investment on the mainland, from 20 renminbi (\$3.2 billion U.S.) to 70 billion renminbi. Concurrently, according to the Financial Times, China's Premier Wen Jiabao endorsed bolder financial reforms when he declared that the government intended to "smash the monopoly" of the country's big state-owned banks, for whom "profits come too easily." Premier Jiabao's comments appeared aimed at advancing reforms that would remove the current cap on deposit rates and a floor on lending rates that guarantee banks a healthy profit margin. The reform is also a necessary step towards full convertibility. Separately, at a conference in southern China, Dai Xianglong, China's former central bank governor, and the person now responsible for managing the country's largest pension fund, commented: "China should accelerate renminbi convertibility on the capital account to make it become a currency that can be used for the purpose of investment."

### The China Syndrome

China's economy is currently growing more than three times faster than America's, to the point where some analysts believe that China is now so rich that it can begin to dictate economic policy to the United States and to the world. The International Monetary Fund has stated that by 2016, the Chinese economy will become the world's largest economy, surpassing the United States. Indeed, the Peterson Institute and data compiled by the University of Pennsylvania suggests that on a purchasing power basis, China's economy is already larger than America's. Salient facts are that Beijing only has \$1.9 trillion (U.S.) of debt compared to Washington's long-term obligations and promises of \$145 trillion (U.S.) of debt. At present, Washington must borrow nearly half of every dollar that it spends. China's economy is powered by 810 million workers compared to 160 million in the United States, to the point where China has become the world's number one mine operator, manufacturer, automobile manufacturer and exporter.

### The Obama Administration Currency Firewall

Recognizing that many countries are losing confidence in the U.S. dollar as the world's reserve currency, as mentioned above in the China/Russia and China/Japan cross-border currency agreements, the Obama Administration would appear to be waging a crude oil military campaign designed to preserve the dollar's favoured status. Over the last few years, any oil producing country, particularly in the Middle East, contemplating a pricing change in crude oil away from U.S. dollars, such as in Libya and Iraq, has been invaded by the U.S. Despite economic and financial sanctions, Iran is already marketing its oil in other currencies to several countries. Whether or not it is prompted by Israel, will the U.S. eventually be crossing the Rubicon (read Persian Gulf) next?

## Summary

In his televised address of March 14th, U.S. President Barack Obama stated: "During my administration, America has doubled the number of World Trade Organization cases against China. Be it resolved, the United States will not allow other countries to get away with skirting WTO rules." Currently, from the manufacture of solar panel cells to the cornering of the rare-earth minerals market, we can only adjudge China's trade policy mindset to be grounded in domestic self-interest and if WTO rules are broken, so be it. Likewise, in the realm of intellectual corporate property abuse, Chinese companies blatantly bribing employees of western companies in order to steal their software technology and possibly drive them out of business, seems to be standard fare and common practice. Despite the guarded optimism of the IMF's Christine Lagarde and the slow pace of China's economic reform implementation to date, we perceive a steadily evolving strategy being deliberately embraced by the Chinese leadership towards attaining reserve currency status for the renminbi.

## Addendum

"The evils of this deluge of paper money are not to be removed until our citizens are generally and radically instructed in their cause and consequences, and silence by their authority the interested clamors and sophistry of speculating, shaving and banking institutions. Till then, we must be content to return quo ad hoc to the savage state, to recur to barter in the exchange of our property for want of a stable common means of value, that now in use being less fixed than the beads and wampum of the Indian, and to deliver up our citizens, their property and their labor, passive victims to the swindling tricks of bankers and mountebankers." – Thomas Jefferson, third President of the U.S. to John Adams, second President of the U.S. in March 1819.

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**"Those who cannot remember the past are condemned to repeat it". Santayana**