China takes steps towards full convertibility of the yuan

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China recently announced a series of measures to protect its economy against a possible devaluation of the US dollar by decoupling the Asian currencies from the American currency and using the Chinese yuan to gain access to raw materials from South America, the Caribbean and, most importantly, Russia.

The Chinese government has serious reasons to be alarmed. As the financial crisis deepens and the US debt multiplies to unprecedented levels, the possibilities of the US dollar failing to maintain its privileged position as the world reserve currency are very real.

Under such a scenario, China has much to lose. Its economy has been built around exports to the US, and the Chinese government holds $744 billion in US Treasury bonds, whose value would fall should the dollar be devaluated.

So far, the 21 percent gain of the yuan against the dollar since the yuan's fixed exchanged rate was scrapped in 2005 has eroded China's reserves as well as exporters' profits. This was a factor in February's 25.7 percent fall in exports in February.

The leaders of the Chinese Communist Party are aware that China lacks a domestic market capable of supporting the growth levels it needs to avoid mass unemployment. The jobless rate among China's 225 million rural migrant workers has already reached 10 percent.

With a million college graduates from 2008 yet to find a job, another 6 million will join the labor market this year. The Chinese leaders fear that unemployment could lead to social unrest, threatening the wealth and privileges they have carved out for themselves since China opened itself to the world market.

Towards full convertibility of the yuan

Concerns over the stability of the US dollar led China last March to lobby the Group of 20 for the adoption of a "super-sovereign reserve currency." This move, China feels, is necessary, all the more so since the yuan cannot be a reserve currency today because it is not fully convertible.

To redress this problem, China has embarked on a program to ensure that the yuan gains full convertibility in the not-too-distant future and is thereby in a position to compete with the dollar at some point for the role of world reserve currency.

The measures announced so far represent "baby steps toward liberalization of China's capital account and internationalization of the renminbi," said Tim Condon, head of Asia research at ING Group NV in Singapore. (Renminbi is another name for the yuan.)

Condon added, "Access to renminbi is not going to be an issue. China is using its financial might to hedge any risk it might face in terms of supplies of central raw materials for its growth and demand in other markets for its products."

In a series of statements, the Chinese government has expressed its commitment to make the yuan a fully convertible currency. "China's State Council said last week it allowed yuan settlement for international trade in Shanghai and four cities in Guangdong province—Guangzhou, Shenzhen, Zhuhai and Dongguan—to promote global use of the currency and protect companies from swings in the dollar," reported *Bloomberg News* on April 9.

Other steps include the decision by the People's Bank of China, approved in November 2008, to provide currency swaps for 650 billion yuan ($95 billion) to Belarus, Hong Kong, Indonesia, Malaysia, South Korea and Argentina. Last month, a similar arrangement with Jamaica was announced.

Bank Indonesia Deputy Governor Hartadi Sarwono told *Bloomberg News* last month that a 100 billion currency swap will enable Indonesia to buy Chinese goods using yuans for the first time.

China is also moving closer to eliminating the remnants of Hong Kong's previous status as a British protectorate. Hong Kong will become the first city outside mainland China to start settling trades in yuans. In addition, China plans to allow Hong Kong companies to issue debt in yuans. Hong Kong had been accepting payments in yuan since 2004 to attract tourists from the mainland.

"It will reduce foreign exchange risks for companies, create more business for Hong Kong banks and diversify use of yuan funds," Donald Tsang, chief executive of Hong Kong said at a press briefing last month, according to *Bloomberg News.* "The policy has already been approved. It's almost here."

With these actions, China plans to protect its exports to Hong Kong, Macao and the ASEAN nations, which reached $402.7 billion in 2008, a substantial 20 percent of China's total trading volume. This is a sufficiently large volume to make a statement to the world on the benefits of trading with China in yuans, rather than US dollars.

Latin America is another case in point. China is stepping in to fill a vacuum left in the region by a US in financial turmoil. A $10 billion currency swap will allow Argentina to purchase Chinese goods without using its depleted US dollar reserves.

The Argentina deal came as a direct challenge to US dictates in the region. The Argentina-China currency swap was announced a few weeks after the US approved $30 billion in swaps each to Mexico and Brazil, but was unwilling to extend a line to Argentina, which has yet to clear its defaulted Paris Club debt.

As the Argentine daily, *La Nación,* put it, the yuan swap was a "historical agreement with China to eliminate the US dollar on commercial exchanges." For China, it represents the prospect of increasing its exports to a region where it already occupies the position of second trading partner after the US. Surely, other Latin American countries will follow closely the progress of this deal.

As China consolidates its influence among the ASEAN nations, moves to eliminate any vestiges of the British occupation of Hong Kong, and opens long-term relations with Latin America countries, it is significant that the steady steps taken by China to decouple its currency—and exports—from the US dollar have not received the attention they deserve in the American media. So far, economic analysts, speaking through American newspapers and cable news programs, have focused their commentary on what is happening to the US public debt, the ups and downs of the New York Stock Exchange and President Obama's attempts to rescue Wall Street.

These are important aspects of the world crisis. But it is an illusion to think that these developments can be understood while leaving China out of the analysis. In reality, the measures to establish full convertibility of the Chinese yuan are highly correlated with developments in the US.

The far-reaching consequences, including the challenge to the US dollar, implicit in making the yuan fully convertible were dealt with on the *Asia News* web site (January 1, 2009). It noted: "If, after a trial period, China makes its currency convertible, the consequence is that importing countries must have reserves of yuan. To get them, central banks around the world will have to divest themselves of US assets and Treasury bonds. The euro has a rather limited role in Asian exchange."

Maurizio d'Orlando, the chief economic analyst for *Asia News*, explained the relationship between yuan convertibility and the US dollar in a series of articles published on the Internet over the past six months. He wrote: "The massive levels reached by the foreign debt of the United States and the excessive and unjustified devaluation of China's yuan are two high-risk factors for the world economy and stability."

The huge US debt is threatening the US dollar's position in the world. The unthinkable has become a possibility: that the US government may become insolvent, unable to borrow to cover its debt.

The American media has thus far not dared to analyze the future of the dollar. Because it strictly adheres to looking at the world from the point of view of the profit interests of the American ruling class, it finds it all but impossible to consider such a possibility. Having grown accustomed to seeing the US make others behave the way the US wants, the media lives in a state of denial. Nevertheless, there is mounting statistical data pointing in the direction of the possibility of insolvency.

US debt

In an article written in December 2008, Maurizio d'Orlando examined the explosion of US debt. He wrote that it "grew from $6.9 trillion as of 31 December 2003 to $13.4 trillion as of 31 December 2007. This is internationally circulated currency."

The rate of growth of the debt has increased since the financial crisis began in the summer of 2007. The US public debt stood at $10.6 trillion, or 76.6 percent of gross domestic product (GDP), at the end of 2008. "Adding the Paulson plan and the rescue package for Fannie Mae and Freddie Mac (but not counting that for AIG), the ratio jumped to 118 percent," wrote d'Orlando.

He continued: "If the figures published by *Bloomberg* are correct—$7.74 trillion in rescue packages—we arrive at about $23.3 trillion of public debt, for a ratio of 169 percent of GDP. In just a short period of time, the public debt of the United States has almost doubled or tripled. Whatever the case may be, it is far too high."

"We can nonetheless roughly assume," d'Orlando noted, "that a breaking point is quickly coming up, because if we add up US public debt and spending commitments in health care (Medicaid and Medicare) and pensions (Social Security), we get to 429.27 percent of GDP."

An International Monetary Fund (IMF) study found that when the foreign-owned public debt of a country reaches 60 percent of GDP, that country faces the risks of a major monetary crisis. By the end of 2007, the ratio of US foreign-owned debt stood at 61.8 percent, up from 54.4 percent the previous year.

Even if one sets aside US commitments to Medicare, Medicaid and Social Security, its current public debt, at least 118 percent of GDP, implies that its foreign-owned debt stands at 73 percent of GDP, far above the 60 percent limit calculated by the IMF.

The only reason the IMF's 60 percent limit does not apply to the US is that the US dollar remains the world reserve currency. Were the US dollar to lose its uniquely privileged position in world trade, the result would be nothing less than catastrophic.

It must also be borne in mind that Asian investors, especially the Japanese and Chinese, are the main foreign investors in US financial assets.

What are the alternatives for the US? Monetary policy reached a dead-end the day Federal Reserve Chairman Ben Bernanke set the federal funds interest rate at zero. The fiscal plans launched by the Obama administration—including the many rescue schemes offered to banks, insurers and auto makers—still do not satisfy Wall Street, and more may be allotted to bail out the banks. Most market practitioners consider the bottom of the financial crisis hasn't been reached yet.

There is a real risk that fiscal policies alone won't work either. As Washington runs out of options, the next measure available to the government is a massive devaluation of the US dollar. That would have the effect of exporting the crisis to other countries, and would unquestionably raise calls by major US competitors to replace the dollar with another currency or basket of currencies as the world reserve currency.

Undervaluation of the yuan

For trade between China and the US, a devaluation of the US dollar is equivalent to an appreciation of the yuan. *Asia News* estimates that the yuan is undervalued by 55.5 percent.

"Currently," writes *Asia News*, "because the exchange rate is controlled by the People's Bank of China, the US dollar is worth about 6.8798 yuan.... If we applied the same relationship between China's GDP in current dollars (6.04 percent of world GDP) and China's GDP at purchasing power parity (which is 10.78 percent of World GDP), a US dollar should be exchanged at 3.821 yuan (hence the latter is undervalued by 55.54 per cent)."

A yuan appreciation of such magnitude—or a similar massive devaluation of the US dollar—would bring about a collapse of Chinese exports. Factories would have to shut down and lay off workers. This would cause social upheavals and threaten the power of the Chinese Communist Party and the cast of corrupt individuals who have enriched themselves by seeding capitalism in China. Equally affected would be foreigners who have at stake billions in direct investments in China.

Asia News writes, "Seen as the world's workshop, China is a great success, but if we consider the amount of human resources, capital and raw materials used with regards to GDP growth per unit, then its system of production appears very inefficient. What is more, China's yuan devaluation in 1994 led right to the 1998 Asian crisis. For Asia, that crisis was the price to pay for China's transition from Communism to a market economy, the equivalent in some ways to the 1989 collapse of the Berlin Wall."

Asia News summarized the relationship between China and the US in the following way: "Globalization is based on an unbalanced economic model. So far, public and private consumption in the United States have driven world demand. US consumers made export-driven growth in many countries possible.

"The absurdity of this method lies in the fact that producers get underpaid and are forced into saving in order to provide credit for those who do not produce and could hardly afford to buy. Workers in China, Brazil and India get starvation wages to produce goods tailor-made for the US (and Western) market, whilst US consumers are unable to generate corresponding resources and value.

"In fact, the trend for the US GDP is negative since the third quarter of 2000 when calculated on the basis of inflation as calculated prior to the Clinton era. Yet US consumers have been pushed, flattered and funded to live above their means, almost forced to buy every kind of goods. This is why there is a solvency problem."

In fact, consumers in the US have been forced to assume an ever bigger and more unsustainable burden of debt while their wages steadily eroded as a result of corporate and government policy.

The steps taken by China to decouple its exports from the US dollar and increase its influence in emerging markets are strong indications that the financial crisis is evolving toward a new stage in which the major countries will use their currencies, economic and political muscle, and military might to carve out a larger share in a new division of the world economy.