WORLD: FRENCH LEADER TALKS CHINA P.14 | BUSINESS: DISCUSSING DAVOS 2014 P.24

## BEUNGREVIEW

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#### Stronger Yuan Arouses Concern

RMB appreciation comes with strings attached



The Chinese Dream: A Continuation of the Peaceful Rise

A French view of China's future

#### THE DESK

» Making the Yuan More Flexible 0

## THIS WEEK COVER STORY

» The Renminbi As Game Changer
As the yuan rises, U.S. dollar declines

#### **WORLD**

**»** A Tripartite Tilt 16
Right-wing hardliners cause more trouble

» India's Space Race
The sixth and newest space player

#### NATION BUSINESS

#### **CULTURE**

» Running for Fun
The race to healthier living

#### **FORUM**

» Caring More About Child Safety
Buckling up babies

#### **EXPAT'S EYE**

» A Culture of Gratitude

Giving thanks in Chinese



### Better Access to Court Rulings

Judicial transparency goes online

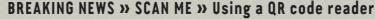


**Taking Center Stage** 

China topic at Davos forum

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#### THE DESK



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Photo Editor: Wang Xiang Photographer: Wei Yao Art: Li Shigong Art Director: Wang Yaiuan

Chief Designer: Cui Xiaodong Designer: Zhao Boyu Proofreading: Qin Wenli, Ma Xin

Distribution Director: Hu Kegiang Human Resources: Hou lin

International Cooperation: Zhang Yajie Marketing/PR Director: Pan Changging

Legal Counsel: Yue Cheng

North America Bureau Chief: Huang Wei Deputy Chief: Xu Tao Tel/Fax: 1-201-792-0334 E-mail: hw@bjreview.com

Africa Bureau

Chief: Li lianguo

Africa Managing Editor: Francisco Little

Tel: 27-71-6132053

E-mail: casa201208@hotmail.com

#### General Editorial Office

Tel: 86-10-6899625 Fax: 86-10-68326628 **English Edition** Tel: 86-10-68996259

**Advertising Department** Tel: 86-10-68995810

E-mail: ad@bjreview.com.cn Distribution Department Tel: 86-10-68310644

E-mail: circulation@bireview.com.cn

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Tel: 86-10-68413849, 1-416-497-8096 (Canada)

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**EDITOR** 

## Making the Yuan More Flexible

The exchange rate of the Chinese yuan against the U.S. dollar reached new peaks 41 times throughout 2013, appreciating by nearly 3 percent in terms of central parity. During the past year, while currencies of all other BRICS economies depreciated against the dollar, China's yuan showed strong momentum and the trend is expected to continue in 2014.

The internationalization of the yuan requires its moderate appreciation to attract attention from the market. An excessively rapid rise of the yuan is not a good thing.

Normally a country's currency appreciates when its economy poses strong growth, resulting in the currency's rising role in the international monetary market. In 2013, the Chinese economy had been sluggish until stabilizing in the third quarter, and China's voting share in the International Monetary Fund didn't increase within the year, which couldn't explain the yuan's fast appreciation.

The appreciation of the yuan has significantly weakened China's role as "the world's factory." Many export-oriented enterprises experienced dramatic profit drops, with many even suspending their production. While export demand shows moderate recovery, the export registered negative contribution to China's economic growth in 2013.

China's export-oriented companies are mostly labor-intensive. If the yuan exchange rate continues its upward momentum in 2014, China's exports could suffer enormously, which could further affect the employment situation and even economic and social stability. As the yuan is not convertible under capital accounts, so the domestic market didn't show much response to the yuan appreciation.

China will comprehensively promote reforms this year, as decision makers focus on how to enhance national interests and protect people's interests during the exchange rate reform. The main priority is to increase the flexibility of the exchange rate through reforming the exchange rate formation mechanism.



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2 **BEIJING REVIEW** FEBRUARY 13, 2014 http://www.bjreview.com



## SOCHI, SO GOOD

Chinese President Xi Jinping meets with his Russian counterpart Vladimir Putin in Sochi on February 6.

Xi paid a three-day visit to the Black Sea city and attended the opening ceremony of the 22nd Winter Olympic Games from February 7-23. It was the first time for a Chinese head of state to attend the opening ceremony of a major overseas sports event.

Sochi's hosting of the Winter Olympics serves as a symbol that Russia is on its way to prosperity under the leadership of Putin, Xi said.

During their meeting, the two leaders also reviewed achievements in China-Russia ties in the past year, made strategic plans for cooperation in the new year and reached important consensus on bilateral coordination on major international and regional issues.

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### **Moto Acquisition**

A Flextronics plant that will be building the new Motorola smartphone Moto X in Fort Worth, Texas.

Lenovo will buy Motorola Mobility from Google for \$2.9 billion, in a bid to boost its smartphone business in the Americas and Western Europe, as well as access thousands of patents, the Chinese company announced on January 30.

Under the deal, Lenovo will pay \$1.41 billion in cash and its ordinary shares. The remaining

\$1.5 billion will be paid over three years.

"With the deal, we expect to become the No.3 smartphone manufacturer in the fast-growing global market," said Yang Yuanqing, Lenovo's Chairman and CEO, adding that the company has set the goal of selling 100 million smartphones in 2015.

The acquisition will enable Lenovo to enter key markets and receive over 2,000 patent assets and the iconic Motorola Mobility brand, Yang said.



#### **Political Meetings**

Journalists from China and abroad have been invited to cover two major political events in Beijing in March.

The Second Session of the 12th National People's Congress (NPC), the national legislature, will open on March 5.

The Second Session of the 12th National Committee of the Chinese People's Political Consultative Conference (CPPCC), the national advisory body, will open on March 3.

The general offices of the NPC Standing Committee and the CPPCC National Committee announced on February 1 that a media center for the two meetings will open from February 26 at the Media Center Hotel. Journalists are required to submit applications for reporting passes to the media center before February 28.

Two websites have also been launched to help domestic and overseas journalists cover the sessions.

The websites—www.npc.gov.cn/pc/12\_2 for the NPC session and www.cppccpeople.com.cn for the CPPCC session—will post information related to the events, the offices said.

#### **New Banks**

China will allow private investors to establish rural commercial banks to inject more funds into the countryside and boost rural development, according to the China Banking Regulatory Commission.

Private investors have long been shareholders in rural commercial banks, but they have not been allowed to start them.

The commission said that China is committed to financial innovation in rural areas to better serve agricultural development.

China had set up a variety of small and medium-sized financial institutions in rural areas by the end of 2013, including 468 rural commercial banks, 1,803 rural credit cooperatives and 1,071 village- or town-level banks.

#### Price-Linked Aid

Low-income people in China will receive government help if inflation is too high and lasts too long, according to a joint statement released by five ministries.

Local governments should link social assistance for low-income

residents with the consumer price index (CPI), a key gauge of inflation, said the document. It was jointly issued by the National Development and Reform Commission, ministries of civil affairs, finance, human resource and social security, as well as the National Bureau of Statistics, on January 31.

Temporary help will be given to the needy when CPI rises 3 to 4 percent or the grain price increases by 10 percent on a year-on-year basis for three consecutive months. Local governments should set the threshold according to regional conditions.

The mechanism will be managed by provincial- or city-level governments and the amount will be calculated monthly and distributed quarterly, the document said.

It added that the subsidy will be included in local governments' fiscal budget and the Central Government will enhance financial support for the low-income community.



A man takes pictures of illuminations during a lantern fair in Shenyang, Liaoning Province, which kicked off on February 6 in celebration of the traditional Lantern Festival due on February 14

#### **Landing Tumble**

A passenger plane with 44 people aboard nose-dived to the ground during taxiing due to a landing gear fault in Zhengzhou, central China's Henan Province, airport sources said on February 4.

All the 37 passengers and seven



4 BEIJING REVIEW FEBRUARY 13, 2014 http://www.bjreview.com



A Beijing resident writes down her welcome to the city's first snowfall in this winter on a snow-blanketed road on February 7. The snow brought an end to a dry spell lasting 107 days

crewmen were safe and they were evacuated after the accident, authorities said.

The China-made Xinzhou-60 plane's front landing gear withdrew accidentally as the aircraft was sliding, causing the nose of the plane to touch the ground, according to an official with the Central and South China Bureau of the Civil Aviation Administration of China.

Work safety authorities have launched an investigation into the accident.

#### Safety Certification

From September 1, China will require child safety seats to pass compulsory safety checks before distribution, the top quality watchdog and accreditation regulators said.

Thereafter, child safety seats without China Compulsory Certification (CCC) will not be sold, imported or used, according to a decision made by the General Administration of Quality Supervision, Inspection and



Quarantine and the Certification and Accreditation Administration.

China has a low rate of child safety seat use, despite their reduction of harm to children in traffic accidents.

CCC is the statutory compulsory safety certification system and a basic approach to protecting consumers' rights and interests that came into force on May 1, 2002.

#### Int'l Medical Zone

The Beijing Municipal Government is seeking central government support to lead China's experimentation with building wholly foreign-owned medical establishments, according to Han Xiaofang, chief of the city's medical reform office.

Citing a municipal government document issued in early January on

establishing an international medical service zone in Beijing, Han said that preferential treatments proposed by Beijing also involved looser foreign shareholding restrictions, lower thresholds for total investment and longer investment periods when it comes to the setup of medical joint ventures.

Under the existing national regulations, Chinese investors should possess no less than 30 percent of the equity stakes in a medical joint venture. The total investment for such operations must be at least 20 million yuan (\$3.3 million) while the cooperation period is limited to 20 years.

The international medical service zone situated in Tongzhou District of Beijing covers a land area of 15 square km. The municipality hopes to develop it into a world-leading medical industry base by 2030.

#### **Coal Liquefaction**

China's first direct coal-to-oil project, operated by the country's leading coal producer, Shenhua Group, produced 866,000 tons of oil products last year.

The direct coal liquefaction line is located in Ejin Horo Banner of Ordos, Inner Mongolia Autonomous Region. It produces 3,000 tons of oil products with consumption of nearly 10,000 tons of coal per day, said Shenhua Coal Liquefaction and Chemical Co. Ltd.

With an investment of 12.6 billion yuan (\$2.06 billion), Shenhua Group began construction of the project in 2004, using self-developed technologies.

The project began trial production at the end of 2009 with an annual design capacity of 1.08 million tons of diesel, naphtha and liquefied petroleum gas.

Proven coal reserves around Ordos are estimated at 160 billion tons, or 11.4 percent of the country's total coal reserves.

As part of its clean energy strategy, China has launched a number of direct or indirect coal liquefaction and coal gasification projects in Inner Mongolia, Shaanxi, Ningxia, Xinjiang and Liaoning in the past three years.

#### Anti-Corruption Audits

China will impose stricter audits in key areas to intensify its crackdown on corruption, according to the National Audit Office.

The audits will focus on five areas, including fiscal fund management, public project construction, extension of bank loans, land transfer and state asset management, said the office in a recently issued work plan for 2014.

Auditors nationwide spotted over 1,400 signs of possible malpractice in the first 11 months of last year and transferred the cases to judiciary or discipline inspection organs for further investigation.

### **Pricing Reform**

China will sever the link between produce prices and government subsidies to build a price mechanism that benefits both customers and farmers, according to the National Development and Reform Commission.

The reform will subsidize consumers when the market

price is too high while giving farmers allowances when the market price is below the target, the commission said in a statement on January 31.

It added that the target price will factor in overall cost, margins for farmers and price gaps between domestic and overseas markets.



## THIS WEEK WORLD



**JAPAN** 

Visitors walk beside a Hello Kitty statue during the 65th annual Sapporo Snow Festival on February 5. The weeklong event showcased a total of 198 snow statues







#### **AFGHANISTAN**

A boy waves flags bearing the image of former Foreign Minister and presidential candidate Zalmai Rassoul during a gathering in Kabul on February 3. Afghans are scheduled to elect a new president on April 5



#### THE UNITED STATES

A clerk stands at the cigarette counter of a CVS drugstore on February 5 in Washington, D.C. CVS, the second largest U.S. drugstore chain, announced that day it will stop selling cigarettes by the end of the year



6 **BEIJING REVIEW** FEBRUARY 13, 2014 http://www.bjreview.com





Residents of the besieged Yarmouk Palestinian refugee camp, south of Damascus, receive food parcels from the UN on January 31



A man fishes in the flooded St Mark's Square in Venice on February 1. The flooding was caused by wind and rain combined with the lagoon city's periodic tidal phenomenon







#### TOGO

Recently seized ivory is displayed at the Togolese Security Ministry in Lome on February 4. Togo is intensifying its efforts to crack down on ivory trafficking, warning smugglers that the country will no longer be a staging post for the illegal trade **COVER STORY** 

## STRONGER YUAN AROUSES CONCERN

Unilateral appreciation of the renminbi goes against China's sound economic growth By Lan Xinzhen

ur exports last year were 4 percent higher than those in 2012, but we didn't make much money," Li Haifu, owner of Beijing Haifu Trading Co. Ltd., told *Beijing Review*.

Sitting in Dahongmen area, Haifu is mainly engaged in the production of curtains and beddings, with most of its products being exported. According to Li, for exported products, the U.S. dollar is used at all stages from ordering to settling, and it takes four months for the company to collect the payment for goods. Owing to fierce competition in the textile market, the prices charged cannot be too high. When making quotations, Li's company aims to earn only a small profit, but when collecting money, they have found that because of the yuan's appreciation and price hikes in raw materials, the profits were much lower than they had anticipated when receiving orders.

"Last year we exported two batches of products, with one batch only covering the costs but making no profits," Li said. However, to maintain his business, he has to receive orders even if profits are nonexistent.

Substantial appreciation of the renminbi has dampened the competitiveness of Chinese export-oriented companies. According to figures released by the Bank for International Settlements on January 15, the effective exchange rate of the renminbi rose 7.89 percent throughout 2013. That is to say, if a company received an order of export at the beginning of the year and collected money at the year's end, they would lose 7.89 percent of the profits owing exclusively to exchange rates.

Zhang Monan, an associate researcher with the State Information Center, said exchange-rate liberalization is an important step on the road to the renminbi's interna-

tionalization. However, this stage progressed too rapidly in 2013. Over the year, the renminbi exchange rate against the U.S. dollar hit record highs 41 times, which was unprecedented since China initiated the exchange rate reform in 2005.

Zhang thinks the renminbi will continue to appreciate in 2014 for two reasons. Firstly, the continual liquidity expansion of offshore renminbi will further increase the yuan's appreciation. Secondly, the tightened money supply within China's financial system since last year will cause earning-rates differences between Chinese and U.S. treasury bonds to continue expanding, which will also help push the renminbi to appreciate.

That means in 2014, Li and bosses of other export-oriented companies will continue to suffer from the pressure brought about by the renminbi's appreciation.

#### **Unilateral appreciation**

The renminbi's appreciation is easy to understand against the backdrop of the quantitative easing policy introduced by the U.S. Federal Reserve (Fed). But after the Fed announced it would begin a drawdown of quantitative easing in December last year, it is hard to say if a stronger yuan will bring joy or sorrow to the Chinese economy.

One of the goals for China's exchange rate reform was to ensure that the renminbi was no longer pegged to the U.S. dollar but instead to a basket of currencies. Viewing the current situation, this goal seems to have been reached: In 2013, the renminbi exchange rate did not fluctuate because of changes in U.S. dollar supplies or fluctuations of the U.S. dollar's exchange rate against those of other currencies. Overall, the U.S. dollar seems to be imposing a reduced influ-

ence on the renminbi exchange rate.

A commonly accepted opinion among industrial insiders is that the growing demand for renminbi in the international market and the improving Chinese economy are the main reasons for the renminbi's appreciation.

According to a report released on January 23 by the Society for Worldwide Interbank Financial Telecommunication (SWIFT), in both November and December of 2013, the Chinese currency was one of the top 10 most-used currencies for payments in terms of value. In December 2013, the yuan's market share was 1.12 percent, ranking eighth, while in January 2012, its market share only ranked 20th at 0.25 percent.

"The fact that between November and December 2013, other currencies grew 7 percent whilst the renminbi grew 15 percent, however, might suggest that use of the Chinese currency is becoming business as usual for the world's financial institutions and corporations," said Franck de Praetere, head of Payments and Trade Markets, Asia Pacific, at SWIFT.

#### Adverse impact

All of the above begs the question of whether or not China will benefit from the yuan's continual appreciation in the international market. Li said he is a "victim" of the renminbi's appreciation, therefore he doesn't wish for the renminbi to increase its value.

Wang Yong, a macroeconomic researcher with CITIC Securities Co. Ltd., also thinks the competitiveness of Chinese exportoriented companies will be attenuated and that China's position as the workshop of the world will be weakened by the renminbi's appreciation. To address the increasing costs,

8 **Beljing review** February 13, 2014 http://www.bjreview.com

many manufacturing companies have begun to move their factories from the coastal areas of south China to the inland areas or even other countries such as Cambodia, Bangladesh and Viet Nam.

Global Sources Ltd. conducted a survey last December with over 500 Chinese companies. The result shows that renminbi appreciation is the most pressing challenge they face in 2014. In comparison, in the 2012 survey, the exchange rate problem ranked only fourth on the list, coming after rising costs, price wars and the decline in orders from Europe and the United States.

Continual appreciation of the renminbi also imposed heavy pressure on domestic consumer consumption. Fuelled by expectations of renminbi appreciation, the international hot money market has engaged in a veritable frenzy of yuan speculation. This money has entered China through its capital market, resulting in increased inflation. In recent years, the Chinese Government has formulated measures to control prices, which have to date had taken some effect. However, since the renminbi is still in the process of appreciation in the international market, there is still space for hot money to speculate in renminbi. Particularly after the Chinese economy has recovered, the new round of price hikes will further knock down the domestic purchasing power of the yuan.

Wang said China should watch out for the unilateral appreciation of the renminbi. A cautionary example is Japan after the Plaza Accord in 1985. The accord made the Japanese yen's exchange rate against the U.S. dollar rise remarkably, and the Japanese economy then promptly entered into recession for more than two decades. The United States has long claimed that the renminbi is artificially undervalued, but this remains a very aberrant opinion.

Ye Shumei, a manager of Beijing Youth Travel Service Co. Ltd., welcomes the yuan's appreciation. "The number of outbound travelers hit record highs again in 2013, and many Chinese go abroad for shopping. This is because of the appreciation of the renminbi." Ye said.

She thinks if the renminbi continues appreciation against the U.S. dollar in 2014, she will yield even better results.

Wang thinks the biggest benefit of the yuan's appreciation is that it contributes to the currency's internationalization. In the last decade, China has been making the renminbi a more international currency. Owing to its continual appreciation, the yuan has become more attractive in the international market, particularly while the U.S. dollar continues to depreciate. To date, China's central bank has signed bilateral currency swap contracts with



**FLOATING CURRENCY:** Pictured is the exhibition hall of the Ninth Beijing International Finance Expo held from October 31 to November 3, 2013

22 countries and regions with a total value of nearly 3 trillion yuan (\$491.8 billion).

#### Flexibility needed

Starting this year, China will comprehensively deepen reforms. Various reforming measures, including exchange rate reform, will also be further accelerated. How to guarantee national interests and avoid damaging people's interests during the reform process is a big challenge for decision makers.

Zhang said that unilateral appreciation of the renminbi indicates that China is still unfamiliar with the operations of the international monetary market and has no targeted measures. When China's trade surplus shrinks and its economic growth slows down, massive inflow of hot money has become the most powerful force pushing up the renminbi exchange rate. This also means the appreciation of the renminbi carries hidden risks.

Unilateral appreciation has not occurred because the yuan's influence in the international market has increased. In the past year, the renminbi appreciated with the price of damaging China's national interests as well as those of export-oriented companies and Chinese people in general. Export-oriented companies have enough grounds to demand that decision makers adopt powerful measures ensuring a stable exchange rate for the renminbi.

Zhang thinks that in the short term, China should make the renminbi exchange rate more flexible.

On the other hand, China should also

accelerate the launch of derivatives such as renminbi exchange rate futures and options, establish a market-oriented price formation mechanism for the renminbi exchange rate, adopt a uniform exchange rate between offshore and onshore renminbi and avoid speculation caused by the long-term price distortion in the offshore and onshore markets. Zhang added.

In the middle and long term, China should reconsider its strategy for renminbi internationalization that relies on the offshore market, Zhang thinks. Capital export, such as overseas investment, trade credit and issuance of renminbi bonds by foreign institutions, may be a better way to export renminbi.

Zhang Ming, Director of the Department of International Investment of the Institute of World Economics and Politics under the Chinese Academy of Social Sciences, said the Chinese Government is expected to continue its reform of the renminbi exchange rate formation mechanism this year, and the central bank may announce its decision in the first half to expand daily fluctuation of the yuan exchange rate against the U.S. dollar from 1 percent to 2 percent or even higher.

This means that the central bank will further relax intervention with the renminbi exchange rate, thereby allowing fluctuations to better reflect changes in market demand. Robust appreciation of the renminbi in 2013 may yet be avoided.



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**COVER STORY** 

# THE RENMINBIAS GAME CHANGER

Why the yuan could soon emerge as a viable alternative to the U.S. dollar as a reserve currency? By Ann Lee



The author is an adjunct professor at New York University and also the author of What the U.S. Can Learn From China

he announcement of the Shanghai Free Trade Zone, which heralds China's plans to liberalize the financial economy, has been seen as a welcome indication by most Western financial firms who have been pressuring China for years to allow unrestricted convertibility of its currency, the renminbi. This announcement follows a historical pattern of U.S. policy pressure on other countries' monetary management such as when the United States pressured Japan to float its currency in 1973 after the U.S. unilaterally abandoned the gold standard in 1971.

A free floating currency, especially from an economy as large as China's, is conventionally seen by financial mavens as the last great frontier for rapid profits from foreign exchange trading. Wall Street is salivating and cannot wait for this market to reach takeoff. But while the financial benefits that will accrue to Western financial firms in the short term will be unmistakable, China's move to internationalize the renminbi could actually rival the U.S. dollar in our lifetime.

Since the end of World War II, the U.S. dollar has enjoyed the primacy of being a world

reserve currency and continues to do so. About two thirds of all international transactions are conducted in U.S. dollars and a large number of nations rely on financing from U.S. credit. Thus, many countries shudder at the thought of the U.S. Federal Reserve's tightening since the easy credit that flows to their shores can suddenly dry up and cause a credit crunch that in the past has resulted in the Asian crisis, the Russian crisis, and more recently the 2008 global financial crisis.

However, reliance on the U.S. dollar is slowly being eroded as countries seek to avoid being vulnerable to such credit shocks. The growing use of the renminbi in many parts of the world for trade settlement and even loan growth will slowly marginalize the U.S. dollar. Thus, when the Fed finally implements the tapering off of its extraordinarily loose monetary policies, instead of creating another Asian crisis as it did in 1997 or other similar panics, these nations will likely find alternative sources of credit in the form of China's renminbi to keep their economies running smoothly.

While the other alternative reserve currency, the euro, can also function as an alternative source of credit, the European Union will face considerably more challenges in getting consensus on European-wide bank regulation given the highly variable political challenges across the member states. China, on the other hand, can act more quickly and decisively as one nation in the credit markets should another international financial crisis befall the world, and this ability could quickly challenge the supremacy of the U.S. dollar in international transactions.

Many argue that the U.S. dollar's status as the world reserve currency is guaranteed for the foreseeable future given the strong fundamentals of the U.S. economy and its military that is second to none. Though no one denies U.S. military superiority, the fundamentals of the U.S. economy are far more questionable if one examines its long term prospects.

First, the political will needed to reign in deficit spending is nonexistent. With annual tax revenues of \$2.2 trillion, but transfer payments for such entitlement outlays as pension and unemployment amounting to \$2.4 trillion every year, the United States is already \$200 billion in the hole without spending a single dime on any of the other government services. Once the other government spending such as military is added to the annual budget, the United States will face deficit spending north of \$1.3 trillion every year.

With U.S. total debt exceeding \$60 trillion, no one actually believes that the United States will ever pay its debt obligations. The avoidance of much needed infrastructure spending such as a high-speed train between Boston and Washington D.C. that can improve American productivity compounds American slippage in competitiveness.

Finally, the much discussed problems in America's K-12 public education as well as the uselessness of many college degrees from many U.S. colleges and universities undermines the ability of American labor to keep up with competition from global talent. The long held view that U.S. innovation will be America's trump card may also turn out to be a case of

10 **BEIJING REVIEW** FEBRUARY 13, 2014 http://www.bjreview.com



MORE EXPENSIVE YUAN: A staff member of the Nanchong Branch of Bank of China in southwest China's Sichuan Province counts yuan banknotes. By the end of 2013, the renminbi had appreciated 35.7 percent since China's 2005 exchange rate

RMB Monthly Average Exchange Rate Against U.S. Dollar, 2013



the emperor with no clothes. America's social media websites does little to improve the welfare of citizens; Apple products are losing their allure without Steve Jobs; and Tesla's electric cars may prove to be nothing but toys for the wealthy. Even fracking shale gas will have its limits. The only way to ensure that natural gas will continue to be produced in the United States is if there is enough demand to absorb the huge supply. Creating enough demand will require the United States to export natural gas

by liquefying it into LNG and making it usable at the destination. However, the process of creating LNG adds so much additional cost to U.S. natural gas that other nations will no longer see it as a compelling source of energy.

Without strong economic fundamentals, more and more polite company will agree that the U.S. dollar is highly overvalued and at risk of going into freefall.

Of course, the U.S. buildup of its military is intended in part to coerce nations from aban-

doning the use of the U.S. dollar. The threat of military action on the part of the United States to maintain the status quo is no different than the coercive tactics used by imperial colonialists of earlier centuries to extract goods and services from developing countries without reciprocal exports. Everyone knows that the United States imports far more than it exports, and this trend shows no sign of reversing course as U.S. manufacturing continues to decline rapidly toward the single-digit percentage of GDP. The problem of relying on its military threat, however, may be effective against smaller nations, but would be suicidal against China. With China's trading partners and allies spanning the entire globe, U.S. military retaliation against China could easily invite the wrath of the entire world. No matter how superior the U.S. military is, it cannot wage war against billions of people and be certain of success.

Certainly no one wishes the U.S. dollar to depreciate suddenly and massively. Such a calamity will stop cross-border trade instantaneously and would inflict more harm than Lehman's collapse. Even the Chinese, who hold over \$1 trillion in foreign reserves largely in U.S. Treasuries, hope never to see that day. But the fact that the Chinese recognize that such a scenario is not impossible, they certainly now see the need to accelerate the internationalization of the renminbi as serving their own interests as much as it serves the interests of Wall Street.

By providing the world with an alternative credible currency with the economic fundamentals to support its use, Chinese credit could displace the use of U.S. credit in a material way for the first time since Pax Americana. If that happens, the days that the United States can maintain consumption levels at 70 percent without inflation will be numbered.

yushujun@bjreview.com

http://www.bjreview.com



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青岛:阳光百货二层 电话:+86 532 86677199 哈尔滨:中央大街73号2楼 电话:+86 451 84689588 沈阳:新地阳光百货一层 电话:+862422561566

