Nov. 22, 2013

Mr. Dollar Leaves China

With 3.7T more right behind him

- **'No more dollars, please' ...**
- **Pricing oil in yuan? ...**
- **Dreamlifter not in Kansas anymore ...**

Wall Street must have left work early today. Markets were very quiet, and might stay that way through the holiday next week.

However, traders who stayed on the job still managed to push both the Dow Jones Industrial Average and the S&P 500 to new record closes.

Today I want to focus on China. Some important developments over the last few weeks could have **serious long-term impact** on the U.S. economy. **The greenback's reign as global reserve currency may be one step closer to its end.**

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Last week the **Chinese Communist Party** released an important "communiqué" from the Third Plenum of its 18th Party Congress.

The communiqué announced social and economic reforms, including changes to the country's one-child policy. It also suggested fewer investment restrictions, more transparent tax policies and greater freedom for the private sector.

Those all sound great in theory, but China-watchers are still not sure what it means. The communiqué expressed only broad principles. The Communist Party is not giving up control of the economy, but changes may be coming.

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Some other news from the People's Bank of China may be more important than the Plenum. The PBOC is China's state-run central bank.

Yi Gang, a PBOC deputy governor, said in a speech this week that the bank would stop increasing its foreign-currency reserves, which are currently almost **3.7 *trillion* U.S. dollars.**

The PBOC apparently thinks $3.7 trillion is enough. To stop accumulating more, they will have to let their own yuan currency's value float in a wider range.

Is this a problem for the U.S.? Not yet, but it could become one.

Part of those excess dollar reserves represent cash loaned to the U.S. Treasury. The Chinese help finance our government's deficit spending. For now, they seem happy to hold their T-bonds to maturity. If they decide to sell them — or the U.S. can't find other buyers for its government debt — we could face higher interest rates over here.

In other words, the PBOC may beat the Fed to the punch. Our own central bankers keep saying they have no plan to raise interest rates. Maybe the PBOC will do it for them.

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Could China wrest control of the world's reserve currency away from the U.S.? I think it's a real possibility.

It won't happen tomorrow, but the pieces are gradually falling in place — like this headline from Reuters:

China's planned crude oil futures may be priced in yuan - SHFE

SHANGHAI | Thu Nov 21, 2013 7:28am EST

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Nov 21 (Reuters) - The Shanghai Futures Exchange (SHFE) may price its crude oil futures contract in yuan and use medium sour crude as its benchmark, its chairman said on Thursday, adding that the bourse is speeding up preparatory work to secure regulatory approvals.

Most commodities, including crude oil, trade in U.S. dollars everywhere in the world. This is one benefit of being a reserve currency; everyone else has to play by our rules.

China wants to change the rules.

Last month **Rudy Martin** wrote this about the Shanghai Free Trade Zone.

The 11-square-mile new free-trade economic zone will cut red tape and encourage foreign investment in the country's tightly controlled service industry.

At the zone's opening ceremony, Commerce Minister Gao Hucheng said it would act as "an experimental field to conduct economic reform." He added that the zone should promote economic development nationwide as well as in Shanghai. That means this is only the first part of a bigger plan.

Changes in China's economy frequently start as small moves that expand rapidly after demonstrating tangible results. ***I believe Shanghai's free trade zone is a precursor of a major shift to a freer economy.***

Pricing crude oil in yuan is definitely a "major shift."

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Last summer Mr. Dollar left China. Fortunately, it was ***David*** Dollar, not the U.S. Dollar ... for now, at least.

Mr. Dollar was the Treasury attaché at the Beijing U.S. embassy. His job was to coordinate economic issues between the Chinese government and the U.S. Treasury Department. It's an important position and he had the perfect name for it.

The new Treasury attaché will be **Michael Hirson**, a Mandarin-speaking international economist. I am sure he will step right in to Mr. Dollar's shoes.

Can he keep the U.S. dollar alive in China? I'm not sure he can.

Speaking of Mandarin, my 19-month-old son is now learning both English and Mandarin. So far he has learned five words in Mandarin: open, good, outside, milk and eat.

My wife and I have not had quite as much luck with English yet. But we are hopeful that maybe he will be able to sort out the debt mess one day. I suspect that having a mastery of both languages will be a big part of it.

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In the U.S., we replace our leadership every few years. In China, the faces change but the long-term strategy stays the same.

China is working steadily, little by little, to take control of the global economy. They can't do it as long as world trade depends on dollars.

If the Shanghai Futures Exchange builds a successful non-dollar crude oil market, the U.S. will have a very serious problem on its hands. I don't know if we can stop it. Investors need to think about what it will mean for their portfolios