ISS Risk Special Report:
China's Challenge to the World Economic Order

December, 2016

By Erik Hakans and Phill Hynes

Intelligent Security Solutions Holding Limited
Room 501, 5/f, Chung Ying Building
20 Connaught Road West
Sheung Wan, Hong Kong
Hong Kong Phone: +852 5619 7008
Thailand Phone: +66 97 120 6738
www.issrisk.com

Table of Contents

Executive Summary

Now well into the second decade of the 21st century, the world is witnessing the true extent of China's economic, political, and growing military reach. This reach and integration into the globalized world has been gradual, incremental, and quiet over the past three decades. In the shadows, China has accelerated significantly in the past 10 years. What does this mean for the established global order? This paper is a roadmap looking to join the dots on that journey.

China has experienced unprecedented success in recent years in its opposition to the Western-dominated international economic order. These successes, from the establishment of the Asian Infrastructure Investment Bank (AIIB) and the BRICS New Development Bank (NDB) to the rolling out of the One Belt One Road (OBOR) initiative and the internationalization of the Renminbi (RMB) are all part of a grand strategy to achieve economic hegemony.

Our key takeaways are as follows:

- The domestic economic realignment, very much misinterpreted and still an ongoing process, will assist the country in securing internal confidence to support external aspirations.

- The BRICS block (Brazil, Russia, India, China, and South Africa) is moving towards veto power in the IMF starting in 2017. Coupled with China's range of economic initiatives intertwined with their OBOR and globalization strategy and the coupling of China initiated financial mechanisms towards integration of regional economies, China sits in a prime position of influence, power and patronage.

- The sweeping changes pursued by China today are intended to contribute to the rebalancing of world economic order. They essentially seek to challenge US hegemony and bring about a Eurasian century.

- The RMB is being positioned to overtake the USD over the next few years as China works from within and without the existing world community to establish a new economic order that it sees as more equitable than the current US-dominated order. If they are prepared, investors do not need to fear this new order.

Introduction

2015 and 2016 have proven to be monumental years in China's challenge to the global economic order. The approach taken by the sovereign differs dramatically from virtually all other post-communist economic system reform paths seen to date.

As the developing countries of the world have entered into an increasingly globalized market under the rules dictated by the post-Bretton Woods monetary institutions, such as the International Monetary Fund (IMF), the World Bank and, increasingly, the Bank of International Settlements (BIS), each has had to navigate a system composed of rules and regulations of which they had little say in the establishment and in which they enjoy limited influence at best. China stands out as arguably the most successful country at navigating this system, and its four decades of breakneck growth are evidence of this fact.

The Chinese system consists of a peculiar blend of state institutions with strong directional credit towards industry, a growing service sector composed of successful private companies, and Peoples Bank of China and other key banking institutions that remain fully state-owned. While China's economy has liberalised in many areas, money supply, credit and bond issuance remain mostly a state affair. The Finance Ministry's approach sheltered the country when hedge fund speculative attacks destabilized the Tiger economies in 1997, and then unexpectedly triggered a default on Russian sovereign bonds in 1998. It was the same type of crisis that previously provoked currency crises in the United Kingdom and Sweden against which the Chinese successfully defended themselves.

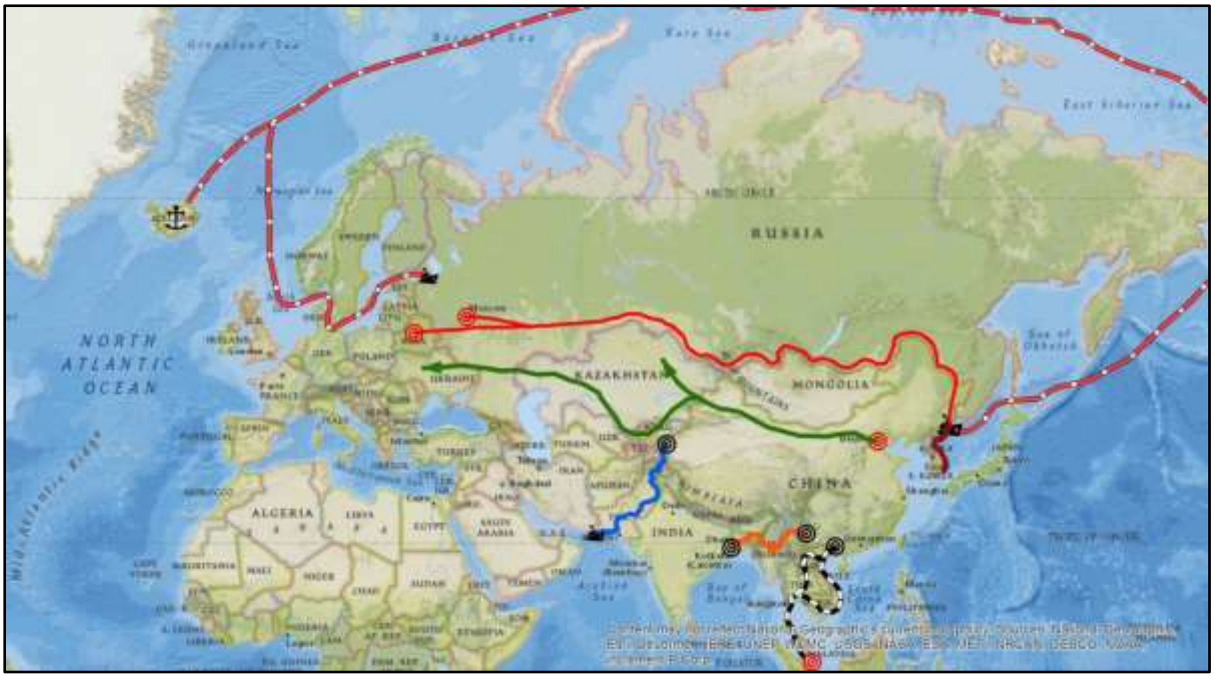
The United States is a key enabler of China's unprecedented economic success, and yet also remains its greatest opponent as the Asian giant seeks to enter global markets. The rivalry is observed in US commentary on Chinese financial policy and currency valuation, what appear to be multiple ongoing 'proxy' energy conflicts in Africa and Washington's outspoken resistance to Chinese participation in Bretton Woods institutions.

As always, China remains committed to a long-term strategy, and this strategy has brought the country critical successes in 2016, the significance of which are little understood outside the financial industry. Importantly, many of China's successes within the framework of its globalization strategy are interconnected more than most realize. The choreographing of China's strategy is culminating in what the government has termed the One Belt One Road initiative, comprising the land-based Silk Road and Belt (SREB) and the Maritime Silk Route. This initiative has tightly integrated China's conceptual approach, whilst simultaneously underpinning the country's all-important domestic economic realignment.

The SREB and its multiple nodes run through the continents of Asia, Europe and Africa, connecting Eurasia's Pacific and Atlantic coastal rims via the establishment of economic trade corridors. At one end lies the developed European economic region, at the other the engine of global growth for the next half century - Asia. More specifically, the Silk Road Economic Belt focuses on economically integrating China, Central Asia, Russia and Europe (the Baltics) through trade, thus linking China with the Persian Gulf and the Mediterranean Sea through Central Asia and the Indian Ocean. In tandem with the SREB, the 21st-Century Maritime Silk Road is designed to connect China to Europe with one lane passing through the South China Sea and Indian Ocean, and the other from China's coast through the South China Sea to the South Pacific.

Chinese President Xi Jinping first announced the SREB concept publicly during a September 2013 visit to Kazakhstan. In a speech delivered at Nazarbayev University, Xi suggested that China and Central Asia cooperate to build a Silk Road Economic Belt. This was the first time the Chinese leadership had shared publicly its strategic vision.

The Big Picture



China's strategic concept has, as one might anticipate, evolved and mushroomed since its 2013 announcement. The foundations of the strategy, however, remain firm. The Silk Road initiative intends to enable not only the linkages discussed above, but also China's overarching challenge to the contemporary world order. China has laid the groundwork to achieve this goal incrementally over the last two decades. The world is currently witnessing the galvanization and culmination of those plans. This report seeks to connect the dots that have appeared over the years and explain where this strategy is ultimately heading in regard to Beijing's game plan for achieving economic hegemony.

The following milestones illustrate just how far China has already come in its plans:

- 2001 – China granted WTO membership
- 2002 – Beijing initiates Go West Program to develop its Western regions
- 2009 – RMB internationalization begins.
- 2010 – Offshore RMB markets open in Hong Kong.
- 2012 – Chinese companies start using RMB for trade finance.
- 2013 – Chinese RMB trade stands at 8% of global currency trading volumes. Over RMB 270 billion in bonds are issued (Dim Sum Bonds), with RMB bank deposits reaching over RMB 100 billion in Hong Kong.
- 2015 – The initiation of the harmonization of the financial institutions of the Shanghai Cooperation Organisation (SCO).
- 2015 – An estimated one-third of all Chinese trade is settled in RMB. RMB became the third most traded currency in the world after EUR and USD.
- 2017/18 – RMB to become a fully-convertible currency. Shanghai is on a clear path to becoming a truly global financial centre.

Contextualizing the path to growth – what petro-dollars' dynamics finally meant for China

In order to comprehend China's actions and aspirations related to the global economic system, it is important to understand the system as it currently stands, as well as how this system came into being and China's role in the system.

China started to liberalize its economy in the 1970's, coinciding with a crucial time in United States economic history. Much attention has been paid to the geostrategic reasons for the US engagement with China vis-a-vis the Soviet Union, but relatively few analysts acknowledge the role economic considerations played in the historical events of that period.

After the US defaulted on the gold exchange window established at the Bilderberg conference in 1971, then-Secretary of State Henry Kissinger and his team set their sights on a new petro-dollar standard. Conspiracy theories abound regarding the US government's alleged role in orchestrating the oil supply shock of the 1970s and other catastrophes in order to strengthen the US dollar to support spending on the Vietnam War efforts. An examination of these theories falls beyond the scope of this paper. It is important to note, however, that, regardless of whether or not there is any truth to such claims, the US is widely held in non-American circles to have acted less than virtuously in creating and preserving the current economic order.

This is where China comes in. In order to realise its strategy, the US needed to increase the recycling capacity of the petro-dollar, and this required a much larger market. With the largest untapped pool of cheap labour on the planet, China was exactly what the Nixon administration was looking for. By moving low-skilled production from the US to China, multinational corporations could keep their domestic market filled with goods while greatly increasing margins and, consequently, profits.

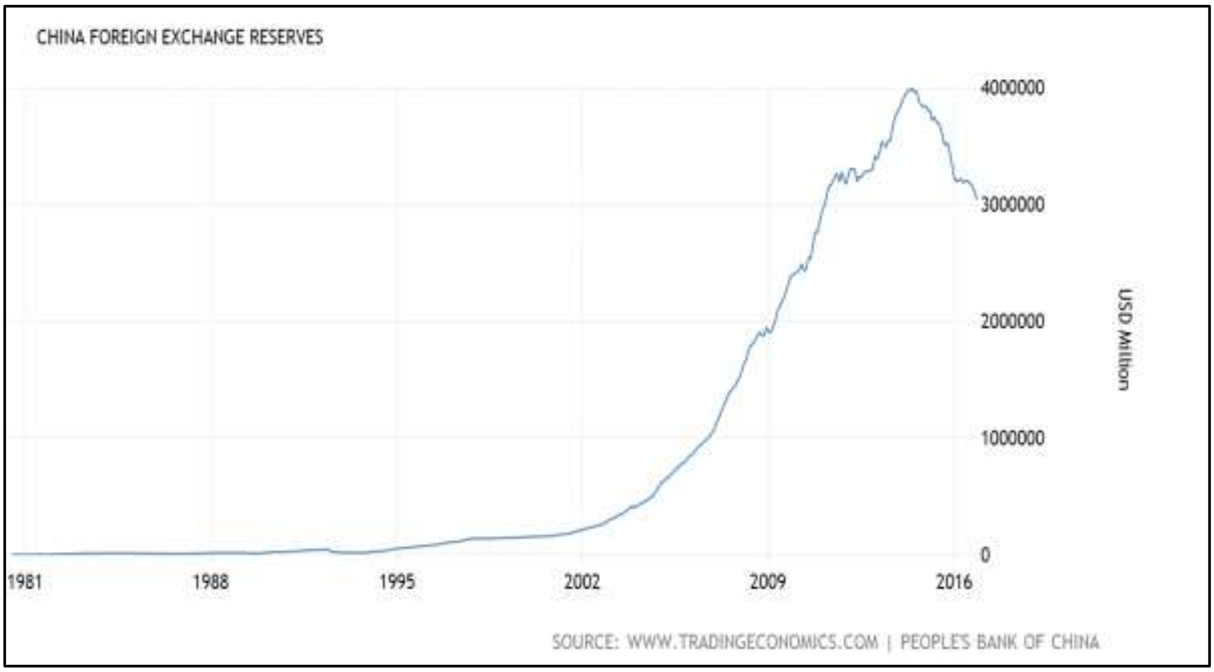
The initial support and change by the communist regime was slow; however, Secretary of State Kissinger saw potential:

> ***No doubt, in time, there will be profound changes in this vast social experiment, perhaps the most extensive one in human history, but there are no present indications to that effect.***[1]

Kissinger's observations could not have been more astute. The transformation of communist China from largely an agrarian economy to an autocratic capitalist state, while slow-moving at first, rapidly accelerated in the 1990's. Small villages throughout the country transformed into megacities, and unprecedented achievements in geo-engineering, commerce and poverty reduction occurred at a rate that outside observers still struggle to grasp. However, this progress came at a cost. The export revenues from the United States came in the form of US Treasury Bonds. This remains the case today, meaning that China has exported its undervalued production in exchange for paper notes for almost four decades, while the majority of profits have remained abroad.

The build-up of Chinese foreign exchange reserves peaked in 2014 around the unprecedented USD 4 trillion mark.

1https://wikileaks.org/plusd/cables/1973PEKING00848_b.html, August 1973, Proposal for exchange of exhibitions with PRC in 1976.



Backed by an aggressive military posture, the United States' petro-dollar standard has long given it what former French President Charles de Gaulle termed “the exorbitant privilege.”[2] The ability to recycle the Petro Dollar remains one of the top priorities of US foreign policy. Many of Washington's most controversial foreign policy positions have been, many believe, in part motivated by an effort to preserve the USD's world reserve currency status. Examples include US opposition to Venezuelan President Hugo Chavez's plan to trade oil in Euros, to Iraq's establishing trade ties directly in Euros during the lifting of the failed Oil-for-Food program in the 1990’s, and to the attempt of Muammar Gaddafi's Libya's to establish the Gold Dinar in the African Union.

In an email made public by Wikileaks, former Secretary of State Hillary Clinton expressly mentioned the Gold Dinar as the primary reason for invading Libya, as it had the potential to unleash strong economic development in the region. The fact that today's Libya is a failed state drives home, in the minds of China's leadership, the very real consequences of US realpolitik regarding the petro-dollar and the importance of China's own financial reform strategy.

The great financial crisis, a Chinese policy reversal

> ***It is true as it is funny. That deficits increase our money.***
> ***In understanding this there lies, the power of States to Stabilize***.[3]

2 Currency internationalisation: Analytical and policy issues, Hans Genberg. BIS paper No. 61.
3 Boulding Kenneth. 1950, A reconstruction of economics.

China suffers from the Triffin Dilemma, also known as the exorbitant privilege. One of the great ironies of exorbitant privilege is that it cannot be sustained without a permanent deficit economy. Deficits literally create money (credit) – an absolute necessity if it is the currency to be used for world trade. But a permanent deficit economy will eventually default, hyper-inflate, or both; there can be no other outcome long-term. In practice, exporting debt is the export of inflation. Once the flow of currency returns home, given the trade imbalances, the source nation has no choice but to monetize the debt or default.

The United States is no different in this regard, but this simple economic reality is poorly understood and even ignored among financial analysts. This ignorance works in the favour of policymakers, as easily accessible economic debates of such a stark reality in the public sphere could eventually spark a confidence crisis. Historical precedent shows that lack of confidence is often the ultimate tinder that induces debt default. The United States will do all in its power not to let go of its exorbitant privilege voluntarily.

The 2008 global financial crisis that started in the United States and quickly sent shook the entire world had been brewing long before the collapse of the Lehman Brothers, but then the world only became fully aware of it as equity markets collapsed and liquidity in the money markets evaporated. China's central bank felt pressured to respond to this alarming economic development.

In 2009, Xiaochuan Zhou, Governor of the People's Bank of China (PBOC) issued a statement now famous among central bankers, calling for "an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit based national currencies."[4] The reserve currency Zhou referred to is the International Monetary Fund's Special Drawing Right (SDR).

Banking officials in China recognized that the country's enormous domestic foreign exchange reserves faced the real risk of never being honoured. The exorbitant privilege conundrum was being laid bare, and China had to act. In order to counter this risk, Beijing has undertaken concerted efforts in multiple economic sectors to support the OBOR project and to challenge USD hegemony. These include:

- Payment system reform
- Multilateral development banks

4 Bank of International Settlements, Working Paper, No 444, March 2014.

- Bilateral non-USD denominated trade agreements
- Accumulation of gold reserves and the establishment of the Shanghai Gold Exchange
- Positioning in the IMF and currency reform

The financial policies pursued by China, as with any country, may often differ substantially from predictions of the mainstream press. This is due, in part, to the independence of central banks which sometimes act in direct contradiction to leading government officials. The sweeping changes pursued by China today are intended to contribute to the rebalancing of world economic order. With this objective in mind, each of the five economic steps listed above aims to help bring about reforms in one of the organizations standing in the way of this global rebalancing, the IMF. They essentially seek to challenge US hegemony and bring about a Eurasian century.

A new payment system: China Unionpay & CIPS, a response to Russian sanctions

One of China's recent accomplishments in its task of rebalancing the global economic order lies in the realm of payment system reform. In 2002, China Unionpay was established as an alternative to US-owned card payment networks such as Visa and MasterCard. Unionpay quickly grew to become the largest card payment scheme in the world, having surpassed Visa in number of issued cards in 2010. While relatively unheard of in the West until recently, the scheme has seen fast-growing acceptance worldwide, and the Unionpay logo is now seen on main street ATMs throughout the world. International coverage does not compare to the Visa/Master Card acceptance network at this stage, but this only means that there is further room for growth as banks adopt Unionpay and become network issuers within the network in their own right within their domestic markets.

Consumer payments are an important factor in payment networks but, for international banking, only one network reigns supreme. The Belgium based private network SWIFT is the spider in the web of international finance. International bank wires require a SWIFT identification number or BIC code.[5] The organization is so crucial to world finance, that sanctions issued by world government bodies like the UN are technically managed through SWIFT. The importance of this is nowhere more apparent than in the pressure the US and UK governments placed on the SWIFT organization to block Russia from using its network. Had SWIFT given into their pressure, the resulting financial crisis would have been

5 SWIFT is not the only clearing network. Fedwire routes all USD denominated transactions in cooperation with SWIFT and UK has CHAPS .

devastating. Russian President Vladimir Putin declared that it would be akin to a declaration of war. In response to this incident, Russia began creating a domestic clearing system and a SWIFT alternative.[6] Additionally, Russia mandated domestic switching of Visa and MasterCard payments, coupled with a USD 3.8 billion security deposit as a requirement prerequisite for these two organizations' continued operations in the Russian market.[7] Though not referred to as such, this was in practice a ransom to keep the payment networks in line if they wished to continue to service the Russian domestic market, at least until their government's domestic alternative was ready. Should Putin not have mandated the switch, the potential damage to Russian GDP could have been catastrophic.

Seeing what happened to Russia and understanding the possibility of such tactics being used against them at some time in the future, China's leaders followed suit with the creation of the Cross Border Inter-bank Payments System (CIPS). CIPS is currently operational, and in 2015 it launched a trial with Russia. Success of this network will allow China to sidestep one of the most powerful western tools to control international finance, SWIFT. CIPS and SWIFT signed a Memorandum of Understanding on 25[t] March 2016, with a goal of connecting CIPS to the international payments network while it is expanding.[8] As China remains the top trading partner for huge swaths of countries in the Asia-Pacific, the CIPS interbank network is aspiring to become a viable alternative for exchanging Chinese RMB in trade-related payments.

Countries with a "positive attitude towards Chinese business" are now being handsomely rewarded for their perspective. Lithuania, a small Baltic state with a population of less than 3 million, landed an agreement with China to become a hub for CIPS. It will act as a settlement centre between China and Europe. Lithuania, not famous for its international banking capabilities, obtained this reward due to the "flexible and broad attitude of Lithuanians, friendly bureaucrats and recommendations of Chinese companies investing in Klaipeda."[9]

The importance of these above developments should not be understated. With this first phase completed, the second phase is for CIPS to be the operating window towards the Special Drawing Right issued by the IMF. The implications of this are simple - second phase completion will affect the reduction of dependency on the US economic domination with the diversification of clearing and thus trading mechanisms. At the risk of being overly simplistic

6 http://journal-neo.org/2015/12/14/china-carefully-moving-to-displace-dollar/
7 https://www.theguardian.com/world/2014/may/06/russia-security-deposit-visa-mastercard-sanctions-ukraine
8 https://www.swift.com/insights/press-releases/swift-and-cips-co_sign-memorandum-of-understanding-on-cross-border-interbank-payment-system-cooperation
9 http://www.baltic-course.com/eng/good_for_business/?doc=124793

it will deliver an insurance on bank clearing, an infrastructure China has not had until now. For an SDR reform to be effective in China, a customer eligible for SDR holdings is required in the form of multilateral banks.

China's multilateral banks: AIIB and BRICS New Development Bank

On 12 March 2015, the Chancellor of the Exchequer announced the United Kingdom's intention to become a founding member of the Asian Infrastructure and Investment Bank (AIIB).[10] The announcement was a complete surprise and in direct defiance to the US, which had been trying to kill the project from behind the scenes. This was, without question, a strategic victory for China, as UK membership provides substantial global influence. However, given the UK's tradition to intermittently switch allies according to its self-interest in what the UK refers to as the "great game," it should not be seen as extraordinary decision.

Despite the heavy-handed but doomed opposition by the US, the foundation was a success and, as of December 2016, 57 member nations have ratified the AOA to join the bank.[11]

The bank's goal is to engage in "green" infrastructure and development projects, and it has not wasted any time in this regard. On 1 June 2016, the first project was approved in Indonesia, bringing the total to eight authorized projects thus far. An additional six projects are scheduled to be proposed to the board between now and next year.

As a multilateral organization, the AIIB enjoys certain aspects of immunity from nation states and operates internationally in the same manner as the World Bank, European Bank for Reconstruction and Development (EBRD) and others. Each of these forms part of a global network of supranational shareholder-based banking vehicles that hold a key stone in the next phase of global finance governance.

Some commentators propose that AIIB is a direct competitor to the IMF. However, the two organizations are actually very different. The IMF's structure is towards payments of balance (currency support for countries running deficits), whereas AIIB runs on an infrastructure project basis.[12] There are, however, rumours from people in "the know" that the US was not even invited to participate in the AIIB as a founding member, but there is currently no way to validate this. However, if even partially true, this would imply a Machiavellian approach to the

10 https://www.gov.uk/government/news/uk-announces-plans-to-join-asian-infrastructure-investment-bank
11 http://www.aiib.org/html/aboutus/introduction/Membership/?show=0
12 Author's conversations with the Swedish Finance department re: AIIB further confirms this position.

Chinese economic aspirations far beyond Beijing's current stated goals.

The AIIB is a Chinese-led bank, and China currently holds 28.79% of the voting rights.[13] This percentage is by no means arbitrary. Voting in these types of institutions, including the IMF, is based on a simple or qualified majority, depending on the situation. Simple majority is required for most common decisions while for material votes, such as decisions regarding voting rights, capital allocation and the like, a qualified majority is required. To achieve this, 75% of all votes must be behind a proposal. With China holding 28%, it effectively holds a veto on any decision. This mirrors the position the US currently enjoys in the IMF. It is also noteworthy that 21% of the AIIB's shares are held by non-regional members. Some of the more notable ones are the UK, Germany, Austria, Scandinavia, France, Poland and Egypt.[14]

In addition to China's AIIB, the BRICS bloc (Brazil, Russia, India, China and South Africa) founded the New Development Bank, which is a powerful alliance between countries representing five regions that, combined, reserve 40% of the world population and a third of the world's landmass.[15] Launched in 2014, each founding BRICS member took a subscription of 100,000 shares totalling USD 10 billion, whereof 20% is allocated to capital. The difference in share allocation between these two banks is noteworthy. The BRICS Development Bank is built on equitable balance, a rare occurrence in these types of institutions. The organization has fallen into public obscurity as Brazil has entered into recession and the news has calmed significantly in regard to its formation and potential. This bank represents, however, a challenge to the existing world governance, which former US President George H.W. Bush famously referred to as the New World Order in 1991. The lending undertaken by NDB and AIIB is pursued without conditions. The IMF refers to the conditionality dictum as austerity. The purpose, though not stated as such, is to engage nations in unsustainable debt and recover proceeds through national assets. Greece is a good example to study for more recent evidence of this modus operandi

Together, these two banks are pushing for reform of the IMF in terms of operation procedures and voting rights. Chinas message to the world could not be any more evident.

China's growing SWAP agreement infrastructure

While China has been actively reforming its payments and banking infrastructure, it has not been idle on Swap and trade agreements. Swap agreements hold significance for China.

13 Asian Infrastructure Investment Bank Subscriptions and Voting Power of Member Countries, 22 September 2016.
14 IBID.
15 http://www.globaltimes.cn/content/1011813.shtml

Since Xiaochuan Zhou's speech in 2009, the RMB has taken several steps towards internationalization. Various moves included the first pilot scheme between Hong Kong and China for cross border trade settlement. In 2010, foreign financial companies were allowed to invest the RMB surplus into the affectionately named "Dim Sum Bonds." These, along with other steps undertaken in recent years have led many observers to wonder, whether they will eventually lead to the exchange rate floating on a basket of currencies, liberalization of the equity investment market, and more.[16] The role of the CIPS payment system for the above liberalization of the economy is obvious.

Swap agreements are an ominous sign for the USD. In practice, they are quite straight-forward. PBOC and a foreign central bank, like the ECB, enter into an agreement to freely access up to a fixed amount of respective currency.

This is significant because world trade provides a balance of payment challenge. When a company exports goods for say USD 100,000 over one year, they end up with a large USD asset on their balance sheet. Some of it is required for continued operations such as buying raw materials, energy, or outside services. However, domestically, the USD holds little function for a company so they exchange it for local currency to service salaries and operating expenses. The surplus exchanged ends up on the central bank's balance sheet. This is what is referred to as foreign exchange reserves. So why not simply use the foreign currency domestically?

Having foreign currency commonly traded or crowding out the domestic currency would provide a direct challenge to the central bank's sovereign power. Countries that endure this process and become dollarized, essentially end up being modern day vassal states economically subservient to and reliant upon the benevolence of foreign banks. All dollarized countries suffer immensely from economic stagnation. The USD will never hold a place for common trade in everyday activities in China. This is why it always ends up as a reserve rather than domestically stimulating economic activity.

In world trade today, the majority of contracts are denominated in USD. This is true of oil, export agreements, supply agreements, commodities, and most other economic activity. Multinationals must have access to USD in order to buy the services and goods that they need, particularly oil. However, if there is a swap agreement in place, the need for pricing in USD is limited.

When Russia and China enter into a swap agreement, foreign exchange reserves at each

16 http://www.chinausfocus.com/finance-economy/the-rise-and-role-of-the-renminbi-as-an-international-reserve-currency

Central bank increase with their respective currency. Two companies engaging in cross border business are no longer required to engage in trade denominated in USD as their respective central banks guarantee clearing of the payments at a set rate, thus making the trade more efficient. Essentially, it is like a credit card where instant funding is available for trade. Note that in this scenario the USD has no place. Swap agreements are in practice an effort to decrease the USD global recycling capacity and increase the internationalization of the RMB.

The efforts have been successful. The following chart from Federal Reserve Bank of San Francisco shows the growth of the swap agreement network. [17]

Figure 1: China's bilateral currency swap agreements with other central banks

Regional to International …

The Regional Comprehensive Economic Partnership (RCEP) is the South East Asian version of what most western media knows as the TPP, a free trade agreement that encompasses the world's largest population. Though not complete at this stage, it essentially mirrors the western alternatives that provide supranational support to corporations and puts trade ahead of national borders. All current trade agreements are about transferring power to

17 http://www.frbsf.org/banking/asia-program/pacific-exchange-blog/banking-on-china-renminbi-currency-swap-agreements/

global multinationals. The efforts are led by the G20 block. Since the deal is still in progress and negotiations continue to be secret, it is better not to explore this agreement in depth.

China's gold: pet rock or global strategy?

In 2015, the Wall Street Journal famously declared "Let's get real about gold: It's a pet rock."[18]

There is no asset hated more in mainstream media today than gold and silver, also known as the precious metals. Several assassination pieces on the metal have emanated from the leading financial press over the past few years. As always, when media make concerted and collaborative efforts to promote or discredit certain events, be it fake news, the red scare, or the threat of terrorism, there is another motivating factor in the background. This is particularly true about investing. Nobody needs a crowded trade when there is a bargain in the making.

During a testimony with the Bank and Currency Committee of the House of Representatives, J. P. Morgan responded to the following question:

Q. But the basis of banking is credit, is it not?

A. Not always. That is an evidence of banking, but it is not the money itself.

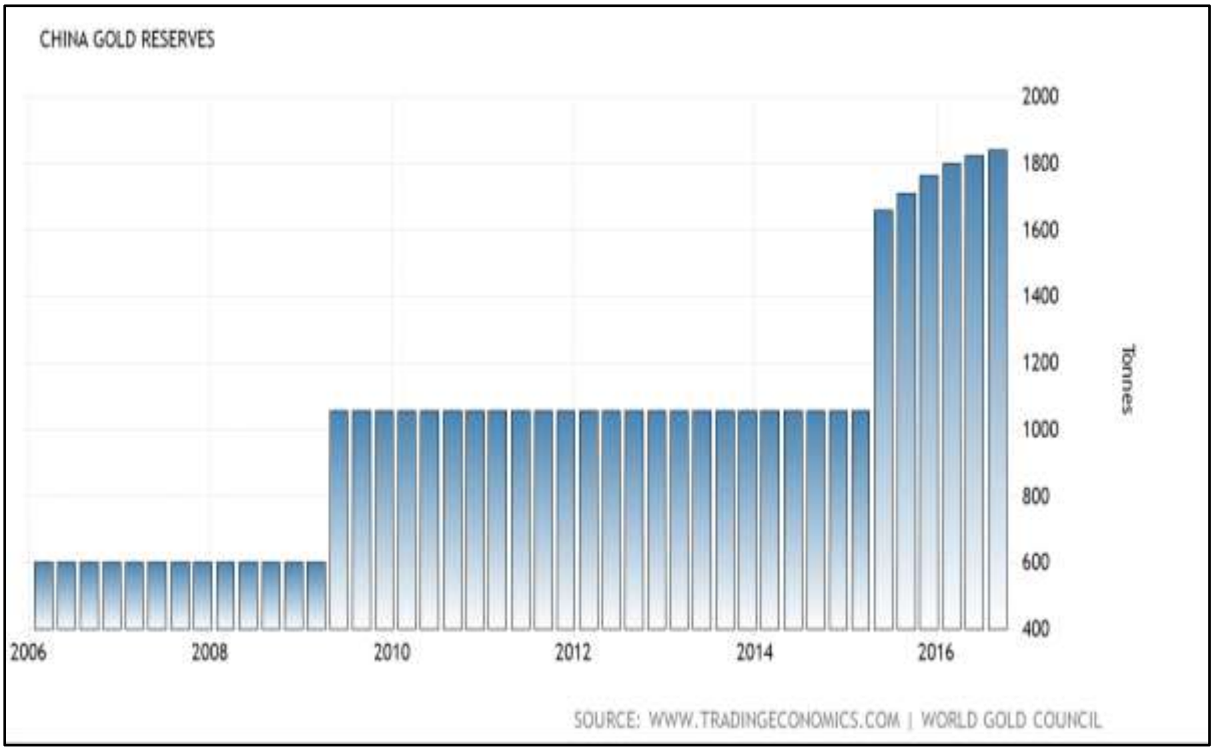
Money is gold, and nothing else.[19]

There is no debate among central bankers whether gold is money or not. Gold always has been and always will be money in its purest form. It does not degrade, is sufficiently scarce, universally accepted, and is easily divisible into practical units. The foremost quality however is that it bears no counterparty risk. In financial speak, it is unencumbered. This quality ensures it will remain the ultimate insurance for wealth preservation. As such, there is not a reputable central bank in the world that does not hold the asset on its balance sheet with one notable exception – Canada.

According to the World Gold Council, China's official reserves as of December 2016 sit at 1,842.6 metric tonnes. It is well established that this does not reflect China's true gold holdings. The statistics for Chinese gold reserves did not update monthly until June 2016. After the great financial crisis, China's gold holdings suddenly surged and then remained

18 http://www.wsj.com/articles/lets-get-real-about-gold-its-a-pet-rock-1437174733
19 J. P. Morgan's testimony, The justification of Wall Street. 18th December 1912

unchanged until mid-2016.[20]



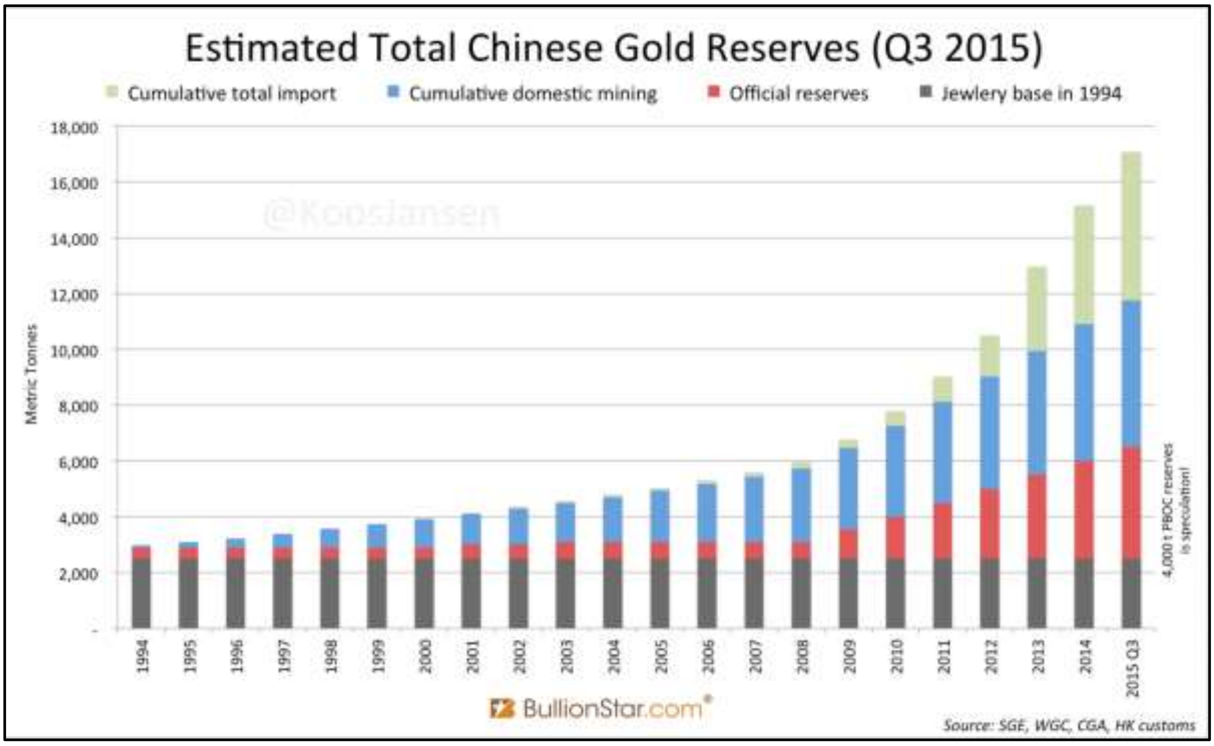
Determining the true size of China's gold wealth is speculative in nature. Jim Rickards, in his book the *New Case for Gold*, estimates China's true gold holdings in the region of 4,000 metric tonnes. This is based on import statistics from Hong Kong, Chinese mine production, and similar sources. This would set China as the world's second biggest gold holder after the United States with 8,100 metric tonnes. Bullionstar, a Singaporean bullion dealer, frequently posts research on China and its gold holdings. They estimate that the size of the Chinese gold market (not PBOC holdings) is in the region of 16,000 tonnes.[21]

However, more speculative reports suggest the true holdings to be in the region of 25,000 to 30,000 tonnes. Whatever the real number is, it is no secret that China is importing as much gold it can get a hold of while also becoming the world's biggest gold producer. Chinese state media is encouraging gold ownership among the populace as a method to secure wealth.

The Shanghai Gold Exchange started actively trading in 2016. It has one seemingly technical detail that sets it apart from its London and New York counterparties. In order to trade on the Shanghai Gold Exchange, you need to deliver physical gold to the marketplace. This means that in order to have price discovery, you have to first acquire gold, deposit it in

20 Graphics: www.tradingeconomics.com
21 https://www.bullionstar.com/

Shanghai, and participate. LBMA and Comex are highly leveraged paper markets where over 90% of all trades are settled in cash. The derivative contracts give the option of settling in physical trades of gold, but this rarely take place. Just like a bank, paper markets can easily suffer a run on the exchange in the same manner as the peculiar Camel market crash (Souk Al-Manakh Stock Market) in Kuwait.



With the exchanges working so differently, we should expect a divergence of pricing, also known as arbitrage. As supply is scarce in the Shanghai market compared to the paper counterparties, the price should be higher in Shanghai. If the arbitrage grows too wide, opportunists will invest on the trade, withdraw gold from Comex and LBMA, turn around and sell it on the Shanghai exchange. This would be a serious threat to western power of gold pricing. For this to happen, the arbitrage is required to be sufficiently high to cover for the actual movement of the metal.

Seeking Alpha, an established finance blog, published a piece displaying the arbitrage opportunity. It showed that on the 1st of December 2016, the Shanghai gold was trading USD 37.50 higher than London.[22]

22 http://seekingalpha.com/article/4028130-gold-price-discovery-shifting-physical-shanghai-gold-exchange-prices-diverge-vs-lbma

China's tango with the IMF

The RMB's position as the third-most used currency and its subsequent inclusion in the IMF's Special Drawing Rights (SDR) has shifted the balance within the existing framework, which had been in place essentially since the end of World War II. John Meynard Keynes and Harry Dexter White were the authors of the famous Bretton Woods agreement, named after the luxury hotel where the agreement was signed. Ironically, the Soviet Union never participated in the new USD Gold Standard despite being part of the negotiations. The agreement marked the terminal end of the "as good as sterling" era and provided the building blocks for the ascendance of the USA's hegemonic period.

Keynes had envisioned a one-world currency called the Unitas but he lived before its time. Instead, the compromise of the technocratically named Special Drawing Rights (SDR) was spawned in the IMF. The SDR is a basket flat currency, synthetic in nature and issued by the IMF. The last issuance of the SDR, or world money, was in relation to the financial crisis of 2008. The SDR is not accessible to the average person, but can be mimicked by buying a composition of the currencies in the basket.

On 1 October 2016, China became a member in the global SDR currency basket. This demarks a pivotal achievement by the nation state. A few weeks later, Paul Ryan, Speaker of the US House of Representatives, entered a provision in the US budget bill on increased voting rights for China in the IMF. Outside of financial circles, the news was generally met with a yawn.

The weighting of SDR currencies prior to the inclusion of the Renminbi was as follows:

- USD – 41.9%
- EUR – 37.4%
- GBP – 11.3%
- YEN – 9.4%

And after 1 October 2016, it became:

- USD - 41.73%
- EUR - 30.93%
- RMB - 10.92%
- YEN - 8.33%

- GBP – 8.09%[23]

The RMB is now the third-largest currency in the SDR currency basket, a pivotal achievement as envisioned by Xiaochuan Zhou in 2009. Technically, the RMB does not qualify for SDR inclusion, as it is not yet a world reserve currency, so the inclusion was clearly political. The wide sweeping reforms planned for the global economy cannot be implemented without the support of the world's biggest export economy, China.

A qualified majority in the IMF requires support from 85% of IMF members. The United states currently hold 16.54% of voting rights and effectively a veto in the organization.

As of the 20th of December 2016, the BRICS nations hold respectively:

- Brazil – 2.23%
- Russia – 2.60%
- India – 2.64%
- China – 6.09%
- South Africa – 0.64%

The total voting rights of the economic block represent 14.2%. Worded differently, they only need 0.8% in increased voting power in the next voting reform in order to establish a veto power as an economic block. That change is closer than most realize.[24]

The final communiqué from the 2016, the G20 summit in Hangzhou, China states:

> We welcome the entry into effect of the 2010 IMF quota and governance reform and are working towards the completion of the 15th General Review of Quotas, including a new quota formula, by the 2017 Annual Meetings. We reaffirm that any realignment under the 15th review in quota shares is expected to result in increased shares for dynamic economies in line with their relative positions in the world economy, and hence likely in the share of emerging market and developing countries as a whole.[25]

An IMF technical paper, it further states:

> Board of Governors Resolution 66-2 states that "Any realignment under the 15th review is expected to result in increases in the quota shares of the dynamic economies in line with their relative positions in the world economy, and hence likely in the share of emerging market and

23 IMF Annual report 2016, P15.
24 https://www.imf.org/external/np/sec/memdir/members.aspx
25 http://www.g20.org/English/Dynamic/201609/t20160906_3396.html

developing countries as a whole."[26]

In other words, the BRICS bloc is moving towards veto power in the IMF in 2017.

The SDR inclusion of the Renminbi coupled with the BRICS voting block veto will structure a world order wherein which the United States must seek common ground with other trading blocs in order to enact or oppose policy.

Coupled with China's range of economic initiatives intertwined with their OBOR and globalization strategy and the coupling of China initiated financial mechanisms to integration of regional economies, then China sits in a prime position of influence, power and patronage.

Welcome to the new world order, and China is driving

"Equitable" will be the cornerstone word guiding where world finance will travel in the next two years. The Economist boldly predicted a one world currency by 2018 in its iconic cover from 1988, "Phoenix rising." Their penchant for mythology implies that a world financial crash, or reset, will spawn a one-world currency. Although some time off, it is difficult to imagine a new world economic order where Russia and China would not have equitable balance.

A global monetary reset is inevitably on the table; however, this paper is focused on identification of the complex shifts taking place leading to such an event, not the event itself. Christine Lagarde, the head of the IMF, spoke about this at length in one of her Bloomberg interviews from the World Economic Forum in Davos.[27] Lagarde talks about the option of a 'structured reset,' not one forced by macroeconomic activity. However, resets are panic-based and responsive; reforms do not hold popular support.

It is evident in both action and public statements that Russia and China are moving together towards displacing the USD as the world's reserve currency and ending the latter's exorbitant privilege. If the recycling of the petrodollar is finally greatly reduced, a dramatic and painful adjustment must take place in the US economy. An end to the petrodollar would mean increased inflation in the United States as trade could no longer be sustained by the endless demand for USD treasury notes. Reduced deficit spending and higher confiscation of personal wealth remain the only two options. It is a bleak future for the US consumer and corporations. The interim period as the US fights its corner is also a difficult period for developing and emerging markets. The shelves are bare of alternatives, but that is changing;

26 https://www.imf.org/external/np/pp/eng/2016/080916.pdf
27 https://www.bloomberg.com/news/videos/b/85e29297-56a2-45a9-b825-b924b861067a

new stock is arriving.

The military approach previously used by the United States to ensure USD dominance in world trade may prove costly. The China-Russia power block is simply too formidable of an enemy to secure a victory within the bounds of acceptable losses. However, it is certain that the United States will not relinquish its reserve currency power status voluntarily. Their hand will have to be forced. Consequently, we expect increased instances of staged crisis events such as the private funded democracy store fronts used to destabilize BRICS governments. We also expect agitation and multiple provocations on various fronts for China, similar to the umbrella movement in Hong Kong, the Maidan square coup in Ukraine, and recent political turmoil in South Africa. The struggle for world power is only warming up.

Lateral thinking: an abbreviated analysis of what is likely to transpire, or challenging conformity

The primary option for China and the G20 countries is a global bank regulatory framework organized around regulation from Bank of International Settlements (BIS), worldwide taxation governed by the OECD organization and the BEPS project. The game plan for the next financial crisis is the ‘Bail in plan and Stay powers’ outlined in detail in the Geneva report, the ‘Financial Stability Board’ and other world government bodies already in late stage of completion among the G20 participants. The resolution mechanism, activated on multiple occasions in Europe, will be a sombre awakening for the average saver as their pensions and savings are ‘utilized’ by the worldwide banking system.

If the SDR is to become the mechanism for a one-world currency then drastic reform would then need to be undertaken in the IMF. For now, the United States has veto power and can refuse or only accept a compromise where they retain ultimate control of the organization. Should this happen, the SDR reform will fail. Even with a US concession, the lack of an anchor (i.e. gold) in the SDR may not restore confidence in world finance in the next global reset. Should the reform be successful, the USD will be relegated to a trade currency among others, forcing a new world order with balanced trade deficits compared to runaway spending as it stands today. US President-elect Trump’s emerging confrontational strategy and position with China on trade may be the first volley in the salvo that is to come. No pun intended, but American protectionism and aggressiveness towards the looming hegemonic challenge may ‘trump’ global stability.

The consequences could be dire beyond the remit of this paper. Nevertheless, China will respond with typically Chinese characteristics. It is imperative to look at these Chinese actions through the prism of Chinese, not Western, lenses.

Trump's canning of the TTP presents China with additional opportunities in the short-term, but it is all really about timing, the real question is how much of an opportunity does it present and how they execute that opportunity. Within the 19th Party Congress there exists the opportunity to pursue with vigour the outstanding pieces of the domestic economic realignment puzzle in China. The events of the past four years in China since Xi's ascendency are significantly misunderstood, and massively over simplified by the West. The end game is unquestionably one of control, but the motivation for that control is perhaps what is most misunderstood in the bigger scheme of things. Like a cancer patient the country is riddled with it, but this cancer is corruption, to attain the goal of sustainability the procedures for eradication were severe, and the treatment has yet to conclude. But, it is beyond merely surviving, it is about resurgence after survival. It is about taking up your rightful place before the cancer took hold. Everything happens for a reason. With the Chinese, everything happens for multiple aligned reasons, they do not act on a singular impulsive or reactionary motive, and it is strategic thinking at its best.

What if the interconnectivity of the Chinese strategic thinking is so aligned that even events such as the massive structural reforms in the energy sector and the banking sector, which will unforgivingly kick in in 2017 are actually tied to the abovementioned milestones and mechanisms to attain their global economic positioning? How do they do this? More importantly, what is the relevance to events in the coming few months pertaining to global economic positioning and posturing? Of course they are interconnected. Their responses to US reactions to BRIC ascendency to veto position within the IMF are also interconnected.

There are several tools at China's disposal should the US stall IMF reforms or a deal is struck that does not meet the Chinese / Russian standards of equitable reform. What if China can announce a gold denominated short-term trade bond used for world trade? This move would shock world economic markets, but can only be successful if the supply (liquidity) of the instruments is on such a scale to support world trade. For this, you need a mechanism to control the world gold price. Enter the Shanghai Gold Exchange. It will be a rudimentary process for China to increase the price of gold as to cause an arbitrage run and eventual default of the western paper gold markets. In such a crisis, the price of gold will run away and anyone not prepared will see the value of his or her paper holdings devalue in a rapid fashion.

What if China and Russia make a surprise announcement of rapidly increased gold reserves to cement confidence in their national currencies? They can also propose a new IMF structure based on the New Development Bank, built on an equitable foundation, as the worldwide solution to monetary order. Of the world's top gold producers, BRICS represent:

- Brazil – Number 11
- Russia – Number 3
- India – Not a significant amount
- China – Number 1
- South Africa – Number 6

With rapid inclusion of key member states, the New Development Bank can become a credible alternative to world financial order or a parallel financial system to the traditional western one.

As pointed out above, Gold always has been and always will be money. For the unprepared and distracted by political theatre, this lesson will be detrimental as we progress towards a global economic order.

Summary

This paper has been written as a roadmap for the uninitiated to what China is planning for its place in the world order. As such, the financial history of China and events leading up to today have been heavily abbreviated. The New World Order is unquestionably in play, but the rules of the game are not being dictated by the writers of the last episode in history. The new contenders in the 'Great Game' are defining their own rules. This paper has sought to connect the dots to deliver a narrative of what we see developing. The dots, thus connected, are loosely:

- 2001 – China granted WTO membership
- 2002 – Go West Program initiated in China
- 2009 – RMB Internationalization begins
- 2010 – Offshore markets start in Hong Kong
- 2012 – Chinese companies start using RMB for trade finance
- 2013 – Chinese RMB trade stands at 8% of currency trade. Over CNY 270 billion in bonds are issued (Dim Sum Bonds), RMB bank deposits reach RMB 100 billion in Hong Kong.

- 2015 – The initiation of the harmonization of the financial institutions of the Shanghai Cooperation Organisation (SCO).

- 2015 – Estimated that 1/3 of all Chinese trade settled in RMB. The RMB became the third most traded currency in the world after Euro and Dollar

- 2017/18 – RMB to become full convertible currency Shanghai on a clear path to becoming a truly global financial centre

The critical dots to add:

- **IMF – Inclusion of the SDR / Voting rights**

- **Regional Comprehensive Economic Partnership (read Eurasia or Globalisation strategy under the auspices of OBOR)**

- **Full convertibility of the RMB**

- **Gold – Shanghai Gold Exchange**

The timing of the convertibility of the RMB will tell its own tale. The release of so much RMB on the world investment market will be a critical game changer, but where will this unrivalled level of surplus money migrate to? Again, it is all about the timing, as the Silk Road and Belt takes hold and embeds that timing will be critical to attract second level investment to the program, no doubt the Chinese government will encourage a 'close to home' approach and support the 'motherland' approach, the delay in full convertibility may actually be more orchestrated than first thought.

The end goal of China's economic policy is increasingly evident. It seeks not to dominate the current petro dollar reserve currency system, but rather have an influential position in the next monetary world order. All the above described efforts are conscious policy to be ready for the next phase in world economic globalization. If China stays on track with its focus on equitable common goal of building the world economy, we may not need to fear China's new economic order. Perhaps how the United States reacts to this challenge is where the fear should be directed.