CHINESE PUZZLE

There is really just one question about China, the Western mindset's "enigma wrapped in mystery". How could the Chinese have made the colossal mistake of investing their hard-earned savings in the debt of the U.S. government — to the tune of $ 1 trillion, the largest sum one country has ever loaned another in all history. (There is only one other puzzle greater than this: How could the U.S. government *in good faith* allow its debt to accumulate in Chinese hands? But we leave that question for another occasion to discuss.) U.S. debt is easy to buy but hard to get rid of. The harder, the larger are the sums involved.

It is true that a huge bull market in bonds has been rolling on for the past 30 years — since 1981. But putting all of China's eggs into the same basket was a terrible mistake even if we ignore the reckless fiscal and monetary policy the U.S. government has been pursuing since 1971. Belatedly, the Chinese are trying to correct their mistakes through diversification.

China could have learned from Japan's sad example. Before the Chinese appeared as buyers, Japan was the largest investor in U.S. debt. In 1971 Japan was running an unprecedented trade surplus *vis-à-vis* the U.S., and the exchange rate of the Japanese yen was 300 to the dollar. American policymakers and money doctors put enormous pressure on Japan to let the yen float upwards, as this was the "in-thing" to do after the Nixon-Friedman conspiracy made the U.S. default on its foreign gold obligations "respectable", on the spurious theory that this would first ease, then eliminate the American trade deficit.

Japan, in effect still an occupied country, yielded to the American pressure and the yen rose so that by 1981 only 100 yens were needed to buy one dollar. This was a 3-fold appreciation of the yen, but it did not bring about an improvement in the American trade deficit with Japan, as promised by Friedmanite propagandists. Instead, *there was a 10-fold further deterioration!* Yet the Americans did not revise their policy recommendations, and continued to insist on floating the yen upwards. It appeared that the Americans had a hidden agenda that was *not* the elimination of the American trade deficit. Could it have been abatement of the American debt? Indeed, the yen-value of Japan's foreign exchange reserves held in dollars was cut by two-thirds as a result of foreign exchange policy forced upon Japan.

The Chinese should have seen the writing on the wall: buying dollar-denominated assets was tantamount to kissing good-by to your savings. In terms of the Nixon-Friedman conspiracy this was extortion, an underhanded way of secretly siphoning off the savings of America's trading partners running surpluses, disguised as exchange-rate policy.

Worse still, when the Japanese wanted to draw on the remnants of their savings held in American banks to tie them over temporary cash shortages, they found that the money wasn't there. The American money-doctors were ever-ready to come up with a solution. The Japanese government had excellent credit rating and no debt to foreigners. Why not borrow the money it needed? Once more, the Japanese meekly complied. They swapped their *temporary* need for dollars for *permanent* government debt in yens. By now the Japanese government has the worst indebtedness on record: it would take 2 years of Japan's GDP to pay it off. See the vicious combination: *selling* bonds in an *appreciating* currency while *buying* bonds in a *depreciating* currency? A free one-way ticket to the poorhouse.

China should have seen the trap. The Americans want them to buy all the dollar-denominated bonds. Then they would start twisting arms to let the yuan float upwards, ostensibly as a valid exchange-rate mechanism to rectify trade imbalances. Clearly, it is not a valid mechanism because, well, it does not work. It only makes the trade imbalance worse. Neither are the Americans shooting for elimination of their trade deficit. They are shooting for an abatement of America's debt. They know that higher exchange rate for the yuan means imperceptibly siphoning off China's savings. An indigent country, China, underwrote with its savings the profligacy of an affluent country, the U.S. Unbelievably, China appears to be caving in to American demands and let the yuan float upwards..

If the Chinese wanted to draw on the remnants of their savings held in American banks, they might just find out, as the Japanese did before them, that the money isn't there.

It can be safely predicted that the American debt-mongers would again be on hand to come up with the solution. China has excellent credit rating and zero debt to foreigners. The Chinese should borrow the dollars they needed, to tie themselves over, rather than liquidate their dollar holdings. Like Japan earlier, China, too, could swap its *temporary* dollar shortage for *permanent* government debt in the domestic currency. This is debauchery: Mephistopheles trying to corrupt the uncorrupted. This is lacing foreign banking systems with toxic debt.

The Chinese puzzle can be stated as follows. The irrational and masochistic behavior of the Japanese can be explained by the fact that Japan is still an occupied country. But China is not. China could refuse to listen to the siren-song of the American exchange-rate manipulators and debt-mongers. Why doesn't China stand up to this corruption? "Just say no" to the drug of indebtedness, and expose the debauchery behind it!

Here is the explanation of the Chinese puzzle from a non-Chinese perspective. The 1972 popping up of Nixon in China (which was worth composing an opera on the theme) started the pilgrimage of young uncorrupted Chinese scholars to American universities. Well, at least those among them who were economists, monetary scientists, and banking experts have been thoroughly corrupted and brainwashed. Keynesian and Friedmanite theories have been pumped into them through force-feeding. They have never been told that there is a coherent and respectable body of economic knowledge refuting, point-by-point, the false and corrosive economic theories of Keynes and Friedman. China utterly lacks scholars who are well-versed in Austrian economics and in valid monetary theory, to provide antidote for the Keynesian and Friedmanite poison. China was made a fertile ground for American debauchery.

Friedman's theory of deliberate use of foreign exchange rates as a tool of balancing foreign trade is vicious, false, and fraudulent. It has never worked. It never will. It is motivated by American self-interest, ready to wage a new opium war on China, to reduce the indebtedness of the U.S. through a disguised devaluation of the dollar, at the expense of its trading partners, and to push the responsibility for the trade imbalance on the surplus countries.

The correct solution to the trade problem is not the flotation of currencies up and down. Quite to the contrary: the solution is the *stabilization* of foreign exchange rates! China badly needs advisors who are able to show the way in this direction.

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SEMINAR

Basis, Co-basis, Permanent Backwardation of Gold and Silver and What It Means

March 14, Monday

The New Austrian School of Economics is the only place in the world where you can learn about the gold and silver basis, co-basis, permanent backwardation, and their importance. In 2008 we offered a successful Seminar on the basis in Canberra, Australia, that was followed by a second Seminar in 2009. This will be the third in the series, where the latest results of the ongoing research on the gold and silver basis and co-basis will be discussed by our star research fellow, Sandeep Jaitly, followed by an open-ended discussion.

No prerequisites are needed: we start with an introductory lecture on the basis and co-basis, with reference to permanent backwardation, by Professor Fekete.

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