China:

American Financial Colony or Mercantilist Predator?

The perverse effects of the world dollar standard.

By Lewis E. Lehrman

CHINA IS AN IMPORTANT trading partner of America. But it may also be a mortal threat. And not for the conventional reasons usually cited in the press. Ironically, it is a threat because China is in fact a financial colony of the United States, a colony subsidized and sustained by the pegged, undervalued, yuan-dollar exchange rate. Neither the United States nor its economic colony seems to understand the long-term destructive consequences of the dollarization not only of the Chinese economy but also of the world monetary system. While the Chinese financial system has been corrupted primarily by tyranny, deceit, and reckless expansionism, it is also destabilized by the workings of the world dollar standard. Neither the United States nor China has come to grips with the perverse effects of the world dollar standard.

The social and economic pathology of 19th-century colonialism is well studied, but the monetary pathology of its successor, the neo-colonial reserve currency system of the dollar, is less transparent. In order to remedy this pathological defect, the United States must rid itself of its enormous Chinese financial colony, whose exports are subsidized by the undervalued yuan in return for Chinese financing of the U.S. twin deficits. Both China and the United States must also free themselves from the increasing malignancy of the dollar reserve currency system, the primary cause of inflation in both China and the United States.

In the end, only monetary reform, including an end to the reserve currency system, can permanently separate the dollar host from its yuan colony. Without monetary reform, the perverse effects of the dollar reserve currency system will surely metastasize into one financial and political crisis after another—even on the scale of the 2007–2009 crisis.

It is, of course, a counter intuitive fact that China has been financially colonized by the United States. But why is this a fact? Simply because China has chained itself to the world dollar standard at a pegged undervalued exchange rate, choosing therefore to hold the exchange value of its trade surplus—that is, its official national savings—in U.S. dollar securities. It is true that the dollar-yuan strategy of America's Chinese colony has helped to finance a generation of extraordinary Chinese growth. But China now holds more than 3 trillion dollars of official reserves and more than a trillion dollars in U.S. government securities. These Chinese dollar reserves directly finance the deficits of the American colonial center. This arrangement clearly resembles the imperial system of the late 19th century. The value of a British colony's reserves were often held in the currency of the imperial center, then invested in the London money market. Thus, the colony's reserves were entirely dependent on the stability of the currency of the colonial center. While China is America's largest financial colony, most other developing countries are also bound to neo-colonial status within the reserve currency hegemony of the dollarized world trading system.

China's dollarized monetary system reminds us of nothing so much as the historic colonial financial arrangements imposed by the later British Empire on India before World War I—India actually remaining a financial colony of England long after its independence in 1947. How did the sterling financial empire work? The imperial colony of India, beginning in the late 19th century, held its official Indian currency reserves (savings) in British pounds deposited in the English money market; independent developed nations at that time, like France and Germany, held their reserves in gold. That is, France, Germany, and the United States settled their international payment imbalances in gold—a non-national, common, monetary standard—holding their official reserves, too, in gold. But the London-based reserves of colonial India were held not primarily in gold, but in British currency, helping to finance not only the imperial economic system, but also the imperial banking system, imperial debts, imperial wars, and British welfare programs. Eventually, as we know, both the debt-burdened British Empire and its official reserve currency system collapsed.

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For more than a generation now, a similar process has been at work in China. China is America's chief colonial appendage. The Chinese work hard and produce goods. Subsidized by an undervalued yuan, they export much of their surplus production to America. But, like the Indians who were paid in sterling, the exports of Chinese colonials are substantially paid in dollars, not yuan—because bilateral and world trade, and the world commodities market, have been dollarized. And thus it may be said that the world financial system is today an unstable neo-colonial appendage of the unstable dollar.

China, like its predecessor the British colony of India, has chosen to hold a significant fraction of what it is paid in the form of official dollar reserves (or savings). These dollars are promptly redeposited in the U.S. dollar market, where they are used to finance U.S. deficits. Every Thursday night, the Federal Reserve publishes its balance sheet, and there we now read that more than $2.5 trillion of U.S. government securities are held in custody for foreign monetary authorities, 40 percent of which is held for the account of America's chief financial colony, Communist China. It is clear that without financial colonies to finance and sustain the immense U.S. balance of payments and budget deficits, the U.S. paper dollar standard and the growth of U.S. government spending would be unsustainable.

It is often overlooked that these enormous official dollar reserves held by China are a massive mortgage on the work and income of present and future American private citizens. This Chinese mortgage on the American economy has grown rapidly since the suspension of dollar convertibility to gold in 1971. China—poor and undeveloped in 1971—was at that time very jealous of its sovereign independence, sufficiently so to reject its alliance with the Soviet Union—even earlier to attack U.S. armies on the Chinese border during the Korean War. In an ironic twist of fate, China surrendered its former independence and, as a U.S. financial colony, joined the dollar-dominated world financial system. China's monetary policy is anything but independent. It is determined primarily by the Federal Reserve Board in America, the pegged yuan-dollar exchange rate serving as the transmission mechanism of Fed-created excess dollars pouring into the Chinese economic system. Perennial U.S. balance of payments deficits send the dollar flood not only into China but also into all emerging countries. The Chinese central bank buys up these excess dollars by issuing new yuan, thereby holding up the overvalued dollar, and holding down the undervalued yuan. Much of these Chinese official dollar purchases are then invested in U.S. government debt securities. So even though America exports excess dollars to China, China sends them back to finance the U.S. budget deficit—much like marionettes walking off one side of the stage, merely to reappear unchanged on the other side.

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This is the little-understood arbitrage mechanism of the pegged exchange rate system by which Fed-created excess dollars are bought and held as reserves by the Chinese central bank, in exchange for which newly created yuan are issued, thereby supercharging inflation in China. The Chinese dollar reserves, which are reinvested in the United States, help to ignite inflation in the United States. It is clear that the workings of the official dollar reserve currency system cause purchasing power to be multiplied, or at least doubled, in both countries. But these central bank issues of new money are unassociated with the production of new goods and services during the same market period. Thus total spending, or purchasing power, exceeds the total value of goods and services at prevailing prices. When total demand exceeds total supply, the price level must rise.

But just as the subservient, colonial Indians were constrained not to sell their sterling reserves too quickly, so the Chinese are constrained—by politics, diplomacy, and self-interest—not to dump their depreciating American dollars. The Indians had to consult their imperial bankers, even though the English were debtors to their Indian colony, because the Indians did not wish to anger the colonial center, nor to precipitate a sterling crisis. From time immemorial, creditors with too large a stake in an over-sized debtor often beg leave of their debtor to get their money back.

China is frustrated by circumstances similar to those of a colony of imperial Britain. Hostility has arisen in the debtor—the United States. Fear of setting off a dollar slide haunts the hostile creditor, China. The difficulty of finding a suitable portfolio of alternatives for a trillion dollars in U.S. government debt annoys the outspoken Chinese financial colony, as it calls for a new world monetary system. But there seems to be no genuine alternative to the very liquid dollar market. De facto illiquidity of official Chinese dollar reserves is enforced by political sensitivities, not by market salability. The debtor, as the saying goes, is "too big to fail." Thus arises an unstable stalemate, a yuan-dollar pegged exchange rate regime constantly on the edge of a crisis.

The "exorbitant privilege" of the dollar is matched by the insupportable burden of America's overvalued reserve currency role, which has tended to deindustrialize the colonizer, gradually increasing social inequality by reducing the standard of living of lower- and middle-income American families. The reserve currency country then feels compelled, as the Fed does today, to depreciate the dollar in the vain hope of eliminating the trade deficit and the balance of payments deficit—by becoming more competitive abroad as it becomes poorer at home. The perversity of the official reserve currency system is endless as China now endures high inflation engendered by its colonial status in the world dollar system.

The floating, pegged exchange rate system based on the dollar has been slowly decaying since the end of World War II. But the dollar-based reserve currency system, because of the unmatched scale and liquidity of the dollar markets, could last another generation. When it will collapse cannot be predicted. That it will collapse, without systemic reform, I think inevitable. Few predicted the timing of the collapse of the pegged dollar system of Bretton Woods.

But it did collapse in August of 1971, followed by America's worst decade since the Great Depression.

Ultimately America, the leader of the unstable world financial system, must choose between two options.

1. The United States can wait for the eventual demise of the world dollar standard under chaotic conditions, similar to the final sterling collapse and the subsequent collapse of Bretton Woods in 1971. This option is analogous to the intrepid daredevil who leaps from his 10th floor window, secure in the fact that he is still unhurt two floors from the street level.

2. Or, America could take the lead in reforming the official reserve currency system based on the dollar. Such a monetary reform program would entail a careful windup, by agreement, of the world dollar standard. At the same time America would reestablish by statute a dollar convertible to gold, i.e., a dollar defined in law as a weight unit of gold. Gold would replace the dollar as the world's reserve currency.

The reform would, first and foremost, establish a tested, non-national, neutral monetary standard as the basis of a stable dollar—one which reasonable sovereign trading partners could accept. Gold would become the international settlements currency and thus would replace the dollar as the basis of world trade and finance. Inasmuch as monetary history shows that no unstable national currency can permanently serve as the crucial world reserve currency, it follows that neither can an unstable basket of national currencies, nor can a fiction such as the SDR—the reserve asset created by the International Monetary Fund to supplement member countries' reserves.

But we are left with the question: what does the evidence of American history suggest as the basis for a stable dollar?

The stability of the U.S. dollar has varied widely in its history. This variation is explained by two factors: the monetary standard chosen for the dollar, and whether other countries have simultaneously used cash and securities payable in dollars as their own reserves, even as their monetary standard itself (i.e., official reserve currencies in place of gold).

The United States has alternated between two kinds of standard money: inconvertible paper money and some precious metal (first silver, then gold). The dollar was an inconvertible paper money during and after the Revolutionary War (1776–92), the War of 1812 (1812–17), the Civil War and Reconstruction (1862–79), and again from 1971 to the

present. The dollar was effectively defined as a weight of silver (and gold) in 1792–1812 and 1817–34, and as a weight of gold in 1834–61 and 1879–1971. The minted gold eagle, set equal to 10 dollars, and subsidiaries thereof, was provided for in the Coinage Act of 1792. The dollar was not used by foreign monetary authorities as an official monetary reserve asset before 1913, but the dollar has been an official "reserve currency" for many countries since World War I (along with the pound sterling). The dollar has been the primary official reserve currency for most countries since 1944.

Applying two criteria divides the monetary history of the United States into distinct phases. We can compare the stability of these monetary regimes by examining the variation in the Consumer Price Index (as reconstructed back to 1800) by two simple measures: long-term CPI stability (measured by the annual average change from beginning to end of the period of each monetary standard) and short-term CPI volatility (measured by the standard deviation of annual CPI changes during the period).

Weighting these criteria equally, the classical gold standard from 1879–1914 was the most stable of all U.S. monetary regimes (as the table shows).

U.S. Consumer Price Index

(Long-term stability and short-term volatility, by period and monetary system: 1800-2009)

	Long-Run Stability *(Average Annual Change)*	Short-Run Volatility *(Std. Deviation Annual Change)*	Maximum Price Change *(High vs. Low)*	Stability Rank *(Weighing Both Criteria Equally)*
1800-1834 Domestic Silver Standard *(Interrupted 1812-17 by domestic paper standard)*	-1.5%	5.2%	76%	4
1834-1861 Domestic Gold Standard	-0.4%	3.5%	36%	2
1862-1879 Domestic Paper Standard	+0.1%	8.8%	74%	3
1879-1914 International Gold Standard	+0.2%	2.2%	20%	1
1914-1944 Interwar International Gold-Dollar-Sterling Standard	+1.9%	7.2%	99%	5
1944-1971 Bretton Woods International Gold-Dollar Standard	+3.1%	3.1%	130%	4
1971-2009 International Paper Dollar Standard	+4.5%	2.8%	432%	4
(1971-1981)	*(+8.5%)*	*(+2.7%)*	*(125%)*	
(1981-2009)	*(+3.1%)*	*(+1.2%)*	*(137%)*	

Source: John D. Mueller, *Redeeming Economics: Rediscovering the Missing Element* (ISI Books, 2010) Table 16-1

[Table commentary by John D. Mueller, *Redeeming Economics* (ISI Books, 2010). Edited and shortened by Lewis E. Lehrman from the original.]

After the failures of several generations of unhinged paper currencies, pegged and floating exchange rates, America should embrace a stable monetary system tested in the laboratory of human history—the cornerstone of which the elites have rejected for a century. It is now time to restore that cornerstone—the true gold standard, shorn of the economic pathology of official reserve currencies. Now is the time to restore the American monetary standard authorized by the Founders in the Constitution—Article I, Sections 8 and 10. Now is the historical moment for America to take the lead and again give the world a real money, the Founders' gold dollar of the Coinage Act of 1792. What the Founders learned from the paper money inflation of the Revolution, the recent past has taught us again. America and the world need a monetary standard which, unlike the paper-credit dollar, cannot be created at zero marginal cost with which to dispossess the prudent and to subsidize the U.S. government and insolvent financial institutions at near zero interest rates.

For America to establish the gold standard would provide the least imperfect monetary solution to the problems of a century of financial disorder—engendered over and over by central bank-manipulated paper money, official reserve currencies, and floating-pegged exchange rates. Only a stable dollar, a dollar defined by statute as a weight unit of gold, can pin down the long-term price level, restoring the incentive to save and ruling out extreme inflation and deflation. Such a dollar convertible to gold would reopen the road to confidence in the long-term value of the U.S. monetary standard. This is the durable road to economic growth and prosperity—financed by increased long-term savings, increased long-term investment, and rising demand for labor at rising real wages.

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