

China Warns Foreign Exchange And Hedge Fund Speculators

by Mary Burdman

The disastrous financial losses suffered by China Aviation Oil (CAO) in Singapore from speculation on oil price derivatives, have set alarms ringing in China. Just at the time that the Chinese leadership is making unprecedented public statements demanding that the United States take measures to deal with the dollar crash, and warning that they will not give in to pressure from either international financial speculators, or the U.S. and Japanese governments, to up-value China's international currency, the renminbi, against the dollar, came the bad news from Singapore. On Nov. 30, CAO, which is 60% owned by the state enterprise China Aviation Oil Holding Company, had to announce that it had lost some \$554 million on derivatives speculation, and needed court protection from its creditors. CAO Singapore supplies most of the jet fuel used in China.

Now-fired CEO Chen Jiulin had been speculating on a fall in oil prices, just as the prices soared in October. This is one of the biggest derivatives trading disasters since Britain's Barings Bank collapsed in 1995 with \$1.2 billion in losses. The CAO disaster is hardly an isolated case. There are much bigger derivatives collapses just waiting to happen, and some financial analysts point to the really big traders in oil derivatives as "in distress." Chen's speculation risked potential losses of \$3.58 billion in oil futures trading.

Beijing is taking warning, and naming names. A lead commentary in the official *People's Daily* Dec. 11 stated that Chen Jiulin was involved in derivatives trading—"which is just like gambling"—with Japan's Sumitomo Mitsui Banking Co., Britain's Barclays Capital PLC, and Australia's Macquarie Bank. Chen himself told the Singapore court that the French Société Générale "encouraged him to engage in futures transactions with loans on very favorable terms." The whole operation, *People's Daily* emphasized, was against Chinese law.

Dealing in futures for such commodities as grain, oil, and some metals is allowed, but only that.

Chen Jiulin was speculating in oil futures against "an international financial giant 'Hedge Fund,' " the paper quoted Zhou Tianyong, deputy director with the economic research center of the Party School of the Central Committee of the Chinese Communist Party, a leading think-tank. This goes beyond reports in Western press, which said that Deutsche Bank had bought a 15% stake in CAO on Oct. 20, and then immediately sold it to hedge funds.

In Beijing Dec. 13, the state-owned Assets Supervision and Administration Commission (SASAC) changed the agenda of its annual meeting of 310 national company executives to a seminar on financial risks, to discuss the disasters at Enron, WorldCom, Barings Bank, and Yaohan (a Japanese retail group which expanded dramatically outside Japan, especially into the People's Republic of China, but went bankrupt in 1997 during the speculator-provoked Asia financial crisis). As the *People's Daily* commentary concluded, dealing with the current world financial system, without "a perfect supervision and management system, is equal to jumping with open eyes into the fire made by the antagonists for Chinese enterprises."

The speculative oil derivatives trading by CAO was outlawed by an Aug. 1, 1998 directive of China's cabinet, the State Council. This was a critical time, at the height of the financial crisis directed against Asia, when China was preparing for the battle against international currency speculators which it, alone of all Asian nations, was able to win in the spectacular "Battle of Hong Kong" of Aug. 28, 1998. In June 1999, another measure forbidding "over-the-counter futures transactions" was added by the State Council. But the CAO case demonstrates that these measures were not

being enforced, *People's Daily* acknowledged, warning of "the lack of state supervision over its national property and managers."

There is much more at stake for China now than derivatives losses, however spectacular. On Dec. 10, the State Administration of Foreign Exchange (SAFE) announced that speculation on the appreciation of the renminbi will not be tolerated. The SAFE had already been issuing strong warnings since October. "We now seriously warn all speculators engaged in illegal speculative activities that the SAFE . . . will not ignore any activities and evidence of misdeeds that play havoc with the order of our foreign exchange market," a spokesman said in an interview, responding to media reports that as much as \$1 trillion in "hot money" might have gotten into China, speculating on an appreciation of the RMB (renminbi). The RMB has been pegged to the U.S. dollar since 1994.

The Coming Crucial Year

Beijing is trying to navigate the nation's way through the "very crucial" year of 2005, while this turmoil is going on. On Dec. 3-5, the national leadership held their annual Central Economic Work Conference, for the last year of the 10th Five-Year Plan (2001-05). Key issues discussed were continuing the national "macro-economic control policy," including the sensitive "relationship between the market mechanism and macro-control," and stability of the world's most populous nation. As a *China Daily* commentary of Nov. 23 stressed, with all the international focus on China's economic boom, "economic growth alone cannot clearly show the real picture of a country's development. China has a population of 1.3 billion. Any small difficulty in its economic and social development, multiplied by this figure, could become a huge problem." Per capita, China "is still a low-income developing country, ranking 100th in the world. . . . All China's efforts to resolve problems of development are mainly devoted to creating better lives for its large population. . . . This goal alone will keep several generations of Chinese people quite busy."

China is up against the severe limits of its infrastructure, especially energy and transport, which, despite the nation's "New Deal" policy since 1998, still requires massive investment. An early-December report by the National Reform and Development Commission documented that China is facing its worst energy shortages since the late 1980s. It is now importing almost 40% of its oil, and remains dependent on coal for a full two-thirds of its energy. One result is that China's inadequate railroad system is more and more choked by increased coal transport; worse, China's coal mines, which had always under-invested in safety measures, are death traps, where more than 300 miners have died since late October amidst increasing pressure to produce more and more coal. The real solution, nuclear energy, is only beginning to be developed on any significant scale in China.

China Not Yielding

The crash of the U.S. dollar and Washington's refusal to even attempt to prevent that, has elicited unprecedented statements from Chinese leaders. China had built up a record \$514.5 billion in foreign exchange reserves by end-September, up \$111.3 billion from the beginning of 2004. This is because of its efforts to sustain the dollar peg, while doubling its international trade in the three years since it entered the World Trade Organization (WTO), to a level of \$1 trillion. In addition, funds have flowed in since 2001, when the U.S. Federal Reserve cut interest rates, to below Chinese rates.

The sinking dollar puts the value of these reserves at severe risk. At the same time, the RMB has fallen against the yen and euro, causing complaints of "unfair" advantages in world trade and demands that China up-value the RMB, as Japan did in the 1985 "Plaza Accord." This led to huge financial bubbles, a crash, and 25 years of recession in Japan—as China is fully aware.

China's leaders are not yielding. Prime Minister Wen Jiabao took Washington on, with the strongest challenge to date, at a press conference in Vientiane, Laos, Nov. 28. "We have to ask a question," Wen said. "The U.S. dollar is depreciating and it is not managed. What is the reason for that? Shouldn't the relevant parties adopt measures?" Wen pointed out the contrast of Chinese policy: "China is a responsible country," he said. "In 1997, during the financial crisis, we maintained the basic stability of the yuan and made the kind of contribution that we should."

"Honestly speaking, the more speculation [about a RMB revaluation] there is in society, the more unlikely it is that the necessary measures can be undertaken," Wen said. "You must consider the impact on China's economy and society and also consider the impact on the region and the world. . . . The most important thing is that we need a stable macro-economic environment, a healthy market mechanism, and a healthy financial system."

Wen Jiabao's statements followed the unprecedented remarks Nov. 23 by Li Ruoguo, deputy governor of the People's Bank of China, the central bank, in an interview with the London *Financial Times*. "China's custom is that we never blame others for our own problem," Li said. "For the past 26 years, we never put pressure or problems on to the world. The U.S. has the reverse attitude, whenever they have a problem, they blame others." Revaluation of the RMB will not solve U.S. economic problems, Li noted. Also, China cannot move "under heavy speculation" and "heavy external pressure." The banking system is not prepared, he added: "Few people even in the banks know derivatives and how to use them."

In what was undoubtedly an ironic assessment of the consequences of Washington's globalization policy, which it has imposed so ruthlessly since the end of the Cold War, Li proposed: "We don't want to run into the U.S. situation of having a trade deficit of 6% of GDP. That is not sustainable. The

appreciation of the RMB will not solve the problems of unemployment in the U.S. because the cost of labor in China is only 3% that of U.S. labor—they should give up textiles, shoemaking, and even agriculture, probably. They should concentrate on sectors like aerospace and then sell those things to us and we would spend billions on this. We could easily balance the trade.”

In more realistic, and much more effective measures, China is expanding its investment abroad as rapidly as possible, as demonstrated by its recent agreements with Argentina and Brazil. This will help the real economies of China and its partners, and bring down the dangerous level of its foreign reserves.

Hot Money

Estimates of speculative funds getting into China—ranging from \$25-100 billion and even \$1 trillion—are being published every week. Despite its capital and currency controls, which saved China during the Asian crisis, some “hot” funds are getting in. The speculators’ goal is to make a killing on an up-valuation of the RMB, with some making wild claims that a “floated” RMB would shoot up 40% against the dollar. Chinese interest rates are also higher than those in the U.S., but China does not have the derivatives, futures, or other such financial markets which brought the sharks into the so-called Asian “tiger” economies in the 1990s, and its capital controls would make fleeing the country difficult. But the hot money could do a lot of harm, including setting off inflation, and the authorities are taking action.

A spokesman for the Foreign Exchange Administration, in an interview published in the *People’s Daily* Dec. 14, admitted: “We’ve discovered that there are some false reports of import and export prices,” forgeries of payments for trade goods, and “abnormal phenomena” such as “excessive loans and the manipulation of the real estate market,” all of which “have characteristics of speculative arbitrage.” Foreign funds are also going into real estate in the east coast cities. The SAFE will now monitor capital flows more carefully and restrict foreign exchange administration, he told *People’s Daily*. The SAFE also took the opportunity to refute the reports, circulated widely in Western media, that China had decreased its holdings of U.S. assets.

The question whether these dollar reserves do not pose more risks than benefits, has been a big issue in China since the crisis engendered by currency speculators hit Asia in the late 1990s. It has been debated at the highest levels, that China’s real safeguards are its financial controls, not reserves. Currently, the Foreign Exchange Administration indicated that Beijing maintains the view that these reserves are useful to meet “unexpected events,” and prevent “systemic financial risk.” The systemic crisis is already here, in the ongoing crash of the dollar. What China and every other nation needs, is not more prevention, but creation of a new economic system, so that the world can rebuild from the ashes.