



China's Dragons: Oil, Gold, and the US Dollar

By Ron Hera

October 23, 2009

©2009 Hera Research, LLC

The end of the de facto [petrodollar standard](#) has profound and lasting implications for the US dollar, oil, and gold. The US is the epicenter of the global financial crisis and economic downturn, but the US continues to exercise disproportionate control of the oil trade and to enjoy the unique status of the US dollar as the world reserve currency. The inflationary policies of the US government and Federal Reserve have damaged the US dollar to the point that it is increasingly seen as a destabilizing force in the world economy. To make matters worse, it was principally the US that manufactured the financial derivatives that still menace the global financial system ([China has opted out](#)). There is growing recognition that the US economy is on an unsustainable course and this fact has fueled an international movement towards a new world reserve currency.

China has emerged as a major player in the currency chess game and in the gold market, and China is the second largest consumer of oil. China is the largest US creditor holding [\\$797.1 billion in US Treasury debt](#) and a net creditor nation with reserves equal to \$2.273 trillion. Nonetheless, China is leading the charge against the petrodollar standard and the US dollar's privileged status as the world reserve currency. China is not merely seizing the opportunity presented to it by the global financial crisis but is pursuing an ongoing economic strategy that includes a larger domestic market for its own goods and services, greater influence over the global economy, a stronger yuan, and a secure energy supply.

机会

“The good fighters of old first put themselves beyond the possibility of defeat, and then waited for an opportunity of defeating the enemy. To secure ourselves against defeat lies in our own hands, but the opportunity of defeating the enemy is provided by the enemy himself.” – Sun Tzu, The Art of War, circa 610 BCE

Developing and implementing a new world reserve currency is a nontrivial proposition and it will take time. However, in practical terms, the key factor that stands in opposition to a new reserve currency is the petrodollar standard. The petrodollar standard allowed the US to print vast quantities of US dollars without high domestic price increases because steady international demand strengthened the US dollar, thus moderating prices in the US, e.g., the prices of oil and of gold. The petrodollar standard, which can be undone in a relatively short period of time, is the Achilles' heel of the US dollar's world reserve currency status. What is more important, however, is that ending the petrodollar standard will put massive upward pressure on prices in the US: a fact that few have recognized.

While the US monetary base has roughly doubled since the start of the financial crisis in 2008, the money created to recapitalize US banks remains in the banking system and has yet to influence prices in the US (aside from the prices of inflation hedges such as gold and silver, which are in high demand). The most broad measure of the US money supply (M3), no longer

officially measured, has actually declined according to Berkeley, California-based [Shadow Government Statistics](#). Thus, the most useful monetary inflation analysis is that of Paul van Eeden, President of Cranberry Capital, Inc. Mr. van Eeden's [Actual Money Supply](#) (AMS) model indicates a 12-month moving average of 8.44%.

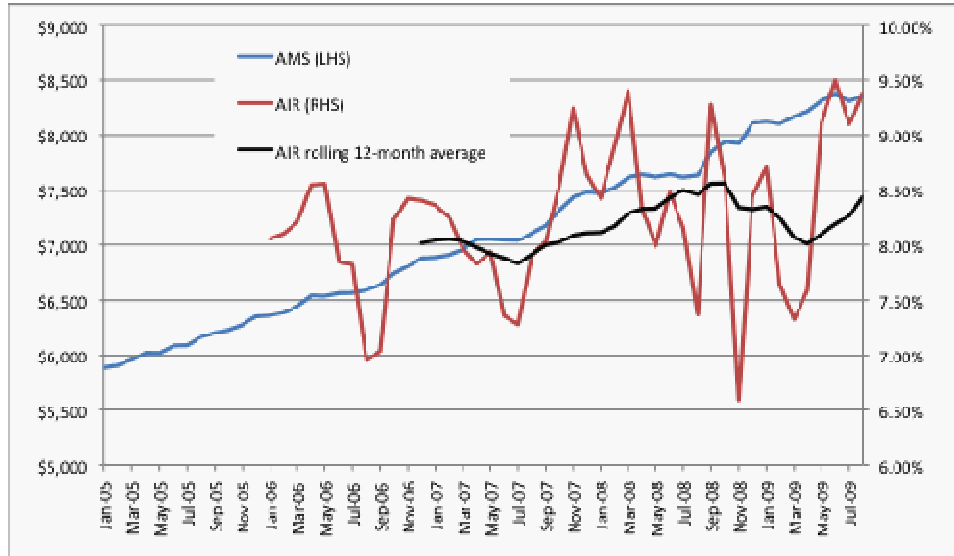


Chart courtesy of [Paul van Eeden](#)

The average monetary inflation rate, estimated at approximately 8% per year over the past 38 years, compounded annually, shows that the US money supply increased by roughly 1,863% since 1971. However, according to the US government, prices in the US have increased only 533% since 1971, a 1,330% differential. The number of US dollars exploded on a global basis to accommodate the growth in US dollar transactions, i.e., international trade, especially oil, and currency reserves.

China is the second largest US trading partner and the primary source of the chronic US trade deficit. As trading partners, the Chinese and US economies are linked by the US dollar, but compete for oil, currently priced in and purchased with US dollars. China needs more oil and wants to buy it with Chinese yuan. By buying gold and encouraging gold ownership, the Chinese government is betting against the US dollar and positioning the yuan to become a universally accepted transaction medium. China is quietly diversifying out of US dollars, buying resources and hard assets. Ending the petrodollar standard will allow China to buy oil in yuan and make the yuan a more viable currency internationally while, at the same time, clearing the way to take on a larger role in the global economy.

Currencies are being debased throughout the western world in the hope of saving banks, stimulating economic activity and restoring trade. Until the US reverses course, or until a new reserve currency is in place, gold will continue to shine. Gold investment and central bank demand will likely remain strong because gold can function as a commodity, as a currency and also, unlike the US dollar, as a store of value immune from the hazards of currency devaluation caused by monetary inflation. As the only financial asset without counterparty risk, the historical reasons for holding gold, all but forgotten during the 1990s, have never been more clear.

The end of the petrodollar standard and eventually of the US dollar's world reserve currency status combined with increased demand for oil and gold, particularly on the part of China, is a fundamental restructuring of the global economy already in progress.



US Dollars, Asian Tigers

While commodity prices, measured in US dollars appear to be rising, one of the fundamental forces behind the upward trend is the decline of the US dollar. Commodity prices are not rising as much in real terms as is suggested by their nominal prices because the US dollar is declining in value. As the US dollar falls, the prices of commodities, measured in US dollars, rise.

The perfect storm for the US dollar comprises the consequences of past decades of monetary inflation punctuated by the dot-com and housing bubbles; excessive levels of debt in the US economy (hampering a US economic recovery); the poor condition of US banks whose balance sheets, still burdened with toxic assets, continue to deteriorate; an expanding Federal Reserve balance sheet that includes toxic assets; extraordinary spending by the US federal government driven by Keynesian economic policies and by what are most probably economically unworkable socialist programs; rapidly declining foreign appetite for US debt; quantitative easing (“money printing”); near 0% interest rates and a growing US dollar carry trade; not to mention the imminent end of the petrodollar standard, and the eventual end of the US dollar’s status as the world reserve currency. At the start of the global financial crisis and economic downturn, the US dollar rallied in a global flight to the then perceived safety of US dollars and US Treasury bonds. However, pressures on the US dollar have mounted and it has begun a precipitous decline.



What is important about the US Dollar Index (USDIX) is that other currencies in the basket (the Euro, the Japanese yen, the British Pound, the Canadian dollar, the Swedish krona, and the Swiss franc) are also losing value as a result of inflationary central bank and government policies, but not as quickly as the US dollar.

The USDIX was created in 1973, two years after the US dismantled the Bretton Woods system (where the value of the US dollar had been pegged to the price of gold and other currencies were pegged to the US dollar) and one year after former US President Richard Nixon opened relations

between the US and China. Today, the sleeping giant, noted by Napoleon, is wide awake, and [Asian currencies are rising](#) against the US dollar. [China is issuing yuan denominated bonds](#) and growing Asian demand for key commodities, particularly oil, can be expected to maintain upward pressure on prices measured in US dollars.

The economic might of the four Asian Tigers (Hong Kong, Singapore, South Korea, and Taiwan) would have been inconceivable when the USDX was created. Today, the Group of Twenty (G-20) Finance Ministers and Central Bank Governors includes representatives from China, India, Japan, South Korea, and Indonesia, and the International Monetary Fund (IMF) includes the so-called BRIC countries (Brazil, the Russian Federation, India, and China) in addition to Japan and oil producers Saudi Arabia and Venezuela. Whether the USDX remains today an accurate or meaningful measure of US economic power from a global perspective is unlikely. In any case, US and European economies and banks are currently in quite poor condition compared to those of Asia; a fact that does not support rising currency values for western countries.

China's population of 1.333 billion, compared to roughly 308 million in the US, represents the largest emerging market in the world, and China's already substantial consumption of resources is growing rapidly. With a population 4.3 times larger than that of the US, Chinese consumption need reach only 23% of that of the US, on a per capita basis, to equal total US consumption. Conversely, if the Chinese were to consume half as much as Americans on a per capita basis, total Chinese consumption would be more than twice that of the US. Changes in the behavior of Chinese consumers already have the potential to create disruptive shifts in commodity markets on a global basis, and China's rising influence is only just beginning to be felt, e.g., in the gold market.

The S&P Goldman Sachs Commodity Index (GSCI), which contains 24 commodities (including energy, industrial and precious metals, agriculture, and livestock), is designed to minimize the impact of events that affect individual commodities and to respond in a stable way to world economic growth.



Interestingly, from a technical perspective, the GSCI chart exhibits a clear inverse head and shoulders pattern followed by a breakout to the upside. Spurred by the financial crisis, China

began putting its massive reserves to work in wide ranging [global investments](#), systematically [trading its US dollars for resources](#) and other hard assets.



China's Seven Dragons

The five dragons of the ancient Chinese zodiac (fire, earth, metal, water, and wood) are suggestive of China's tremendous natural resources, which include coal, iron ore, oil, natural gas, mercury, tin, tungsten, antimony, manganese, molybdenum, vanadium, magnetite, aluminum, lead, zinc, uranium, as well as the world's largest hydropower potential.

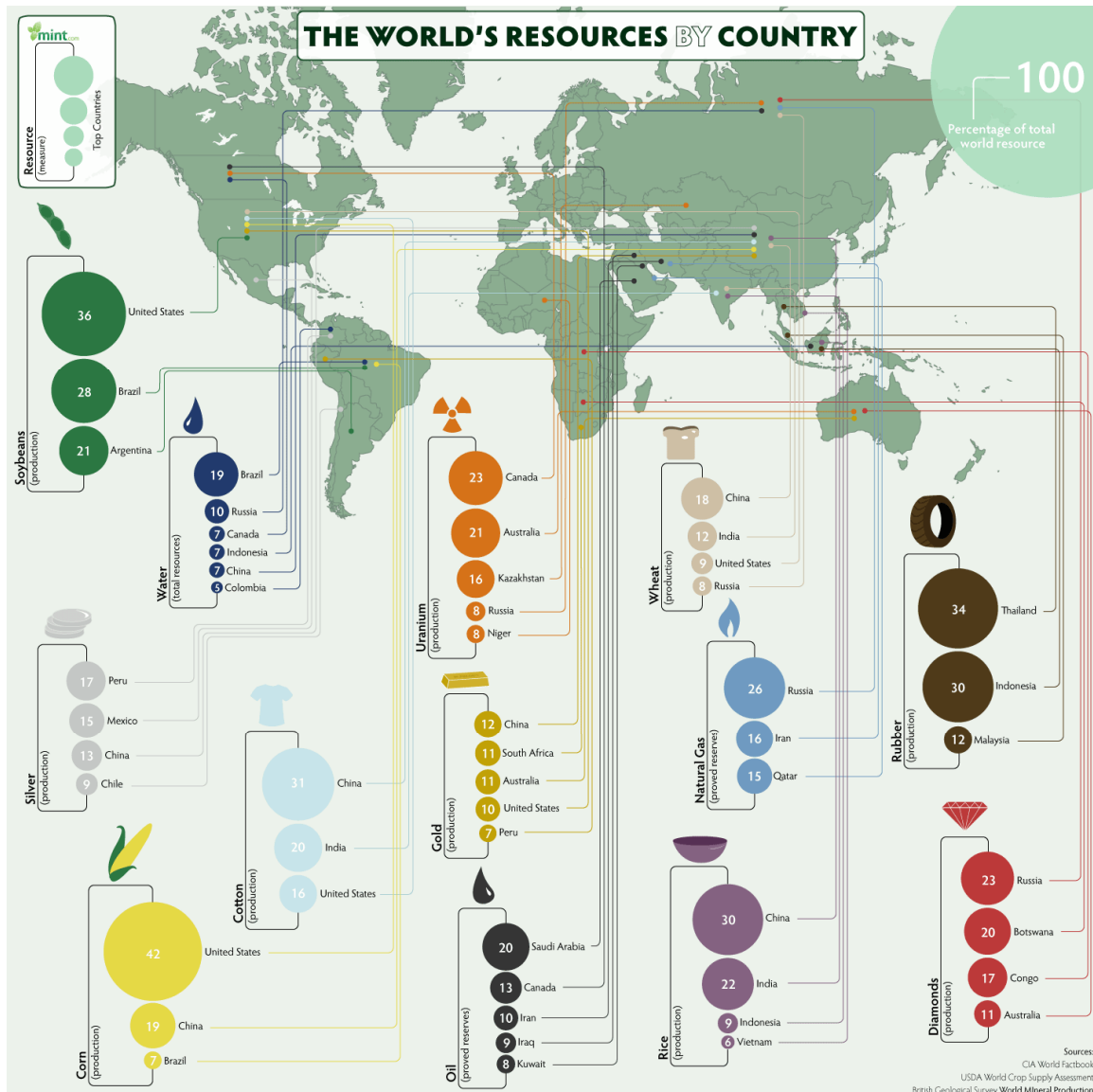


Chart courtesy of [Mint Software, Inc.](#)

Sources:
CIA World Factbook
USDA World Crop Supply Assessment
British Geological Survey World Mineral Production

Together, Asian countries account for 60% of the earth’s human population and control major portions of world resources such as corn, cotton, gold, rice, rubber, silver, water, and wheat to name only a few.

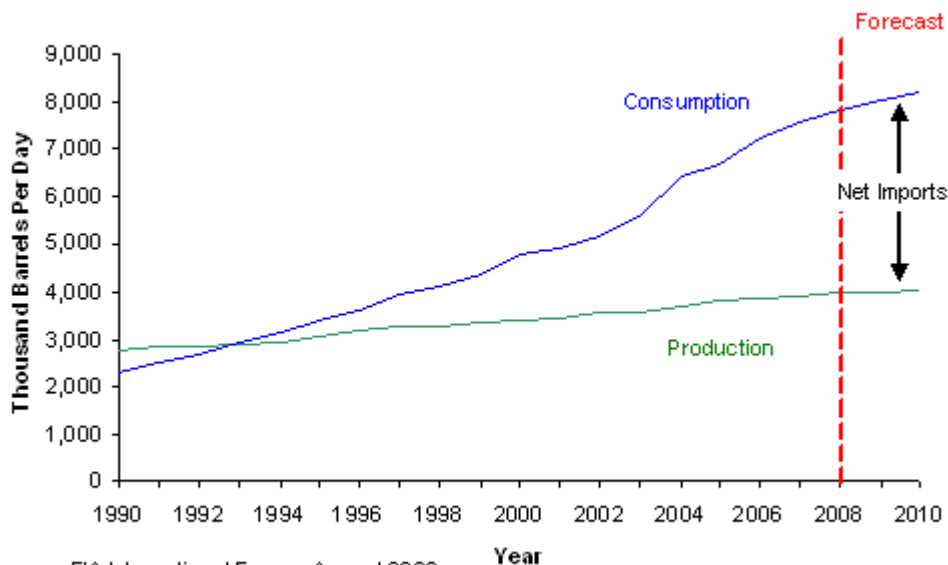
If the Chinese calendar had been invented more recently it might include more specific varieties of each animal, such as a gold dragon in the metal category and an oil dragon in the earth category, thus there would be seven celestial dragons rather than five.



The Oil Dragon

Total Asian demand for oil, lead by China’s 7,880,000 bbl/day, exceeds US consumption. In fact, the consumption of just China, Japan, and the four Asian Tigers is greater than that of the entire EU. Taken as a whole, Asian demand for oil is more significant for the price of oil than the US or the EU. The price of oil in 2009 has risen as Asian economies began to recover, despite [lower US consumption](#). Rising Chinese demand for oil is now a fixed feature in the otherwise changing global economic landscape. A weaker US dollar and a stronger Chinese yuan serve to guarantee that China will have the oil it needs.

China’s Oil Production and Consumption, 1990-2010*



Source: EIA International Energy Annual 2006;
Short-Term Energy Outlook (July 2009)

*forecasted

Although not as hard hit by higher oil prices as less developed countries (which could be [priced out of the market](#) entirely) would be, the US economy could be crippled by high oil prices. As shown by the West Texas Intermediate Crude Oil index (WTIC), the price of oil is rising sharply.



Both the US and China import roughly [twice as much crude oil](#) as they produce. With a weaker dollar, US oil imports, currently roughly \$400 billion annually, will represent a larger external drain on the US economy, which could prove to be disruptive. The reactionary US strategy is to increase domestic oil production and to develop alternative energy sources in order to reduce dependency on foreign oil. Unfortunately, US oil production cannot increase quickly enough or to high enough levels to ameliorate the impact of much higher oil prices. Presently, there is no alternative energy technology that can supply enough energy at a low enough cost to have a significant impact on US oil consumption in the near term. An anemic US economy combined with a weaker currency means that the US is ill equipped to absorb inevitably, much higher oil prices.



The Gold Dragon

Oil is the most important factor of the US dollar's value for two reasons. Since the founding of the Organization of the Petroleum Exporting Countries in the 1960s (currently Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela), oil has been priced in and sold in US dollars worldwide. Since the Bretton Woods system ended, the effect of the OPEC cartel's price fixing actions has been to establish an implicit commodity-based value for the US dollar. In other words, after the Bretton Woods system, the value and the world reserve currency status of the US dollar was implicitly supported by oil rather than gold. Any nation accepting US dollars in trade knew what the value of US dollars was measured in oil.

Once oil is no longer priced in US dollars, the US dollar, in practical terms, will no longer be the world reserve currency, i.e., US dollar transactions will decline sharply on a global basis. This conclusion has already been recognized by central banks. In the second quarter of 2009, US dollars accounted for only [37% of new central bank assets](#), compared with 70% in the past. Rather than US dollars, [central banks favor Euros, Yen, and gold](#). [Central banks have also become net buyers of gold](#) or are [repatriating gold reserves](#).

Following the replacement by Iran (the third largest oil producer) of the US dollar with [Euros for foreign trade](#) in September, 2009, [rumors emerged of secret talks](#) between Arab states, China, Russia, Japan and France, allegedly regarding replacing the US dollar with a basket of currencies including the euro, Japanese yen, Chinese yuan, and gold. Talks between Russia and Iran regarding conducting oil transaction in rubles were [officially acknowledged](#) a few days later by Russian Information Agency Novosti (RIA Novosti). Neither development is at all surprising because world leaders have been calling for the replacement of the US dollar as the world reserve currency since 2008. It's safe to say that all of the BRIC nations, especially China and Russia (the world's 8th largest oil producer), oppose the petrodollar standard and are in favor of a new reserve currency (Brazil's largest trading partner, formerly the US, is now China).

It seems unrealistic to imagine that currencies tied to growing economies with higher production and lower levels of debt would not be preferred over those of stagnated economies. If political strength follows economic strength, the petrodollar standard will soon take its place in history alongside the defunct Bretton Woods system.

Setting aside all other considerations, the price of gold would be \$815 per ounce today based only on US dollar monetary inflation using Paul van Eeden's AMS model, i.e., 30% below the spot price (approximately \$1,060 US at the time of this writing). Mr. van Eeden has accounted for the increase in gold over time.



It is worth noting that the price of gold, when adjusted for inflation, is nowhere near its 1980 peak. The current situation is fundamentally different from the brief but acute 1980 gold price bubble. John Williams of [Shadow Government Statistics](#) maintains that the US government has understated inflation and recently said that “If the methodologies of measuring inflation in 1980 had been kept intact, gold [adjusted for inflation] would have to hit [\\$7.150 to be the equivalent of the 1980 record](#).”

According to data from the [World Gold Council](#) (WGC) and metals consultancy GFMS, demand for gold is currently greater than the supply by as much as 1000 tons per year. The WGC and GFMS have correctly identified two distinct economic spheres comprising gold supply and

demand. In the western economies, jewelry and industrial demand are weak, but investment demand is strong, while outside the western economies broad gold demand continues to grow. India remains the largest buyer, while gold demand in China is rising. China has been aggressively [adding gold to its reserves](#) and has not only made it legal for Chinese citizens to own gold but is encouraging gold ownership. The potential influence of increased, long-term Chinese demand on the price of gold cannot be ignored.

Monetary inflation and supply and demand considerations are not the whole picture. There is a much deeper reality. For nearly four decades, gold, priced in US dollars, was implicitly linked to oil and the resulting demand for US dollars moderated the affects of monetary inflation on prices in the US. The end of the petrodollar standard and the resulting global decline in demand for US dollars will cause the price of gold to rise significantly. The value of the US dollar changed *qualitatively* after 1971 when it became an irredeemable pure fiat currency, no longer backed by gold; a fact that has been masked by the petrodollar standard.

Higher demand for gold also reflects a growing recognition that the US dollar and other currencies currently being devalued are not reliable stores of value. In fact, the US dollar has not been a store of value at all for 38 years during which massive quantities of fiat money, including trillions of petrodollars, flooded the global economy. The weakness of the US dollar exposed by the financial crisis, i.e., its inability to function as a reliable store of value regardless of its utility as a transactional medium, points exactly to the strength of gold. The decline in international demand for US dollars, rejected as a failed store of value, indicates strong demand for gold in the foreseeable future.

18th-century French philosopher and writer Voltaire once said that “paper money eventually returns to its intrinsic value - zero”. Understandably, Voltaire failed to consider a world where all money was purely transactional rather than a store of value, and where the relative values of currencies were managed in a loosely coordinated manner by central banks and governments through manipulation of the money supply, interest rates, etc. In theory, such a world could function indefinitely provided that currencies were relatively stable; provided that currencies were widely accepted and interchangeable; provided that large trade imbalances did not destabilize the system; and provided that currencies were not debased excessively, i.e., in a reckless or irresponsible manner, which would lead to a variety of economic problems. However, Voltaire’s inability to imagine such a world may be insufficient cause to dismiss his observation.

It seems possible that Voltaire’s superficially antiquated understanding was precisely that “paper money” can never function in the long run as a store of value, i.e., that it will inevitably, either by accident or by design, be mismanaged, and that it will always, eventually, be rejected, thus rendering its intrinsic value clear. History certainly supports Voltaire’s view in that fiat currencies tend to perish. As recently as 1999, referring to the sale of British gold reserves, Alan Greenspan, then Chairman of the US Federal Reserve, said that “Fiat money paper in extremis is accepted by nobody. Gold is always accepted.” As the Chinese discovered in the 11th century, money has a qualitative dimension and for “paper money” that dimension is *confidence*. In contrast, because it is a tangible asset that required an investment of human labor and other resources to produce, the value of gold does not ultimately, in extremis, depend solely on the unreliable subjective feeling of confidence.



Xiangqi (Chinese Chess)

There is increasing international recognition of the fact that there is no foreseeable end point to the devaluation of the US dollar. The inflationary policies of the US federal government and Federal Reserve have all but exhausted confidence in the US dollar both at home and abroad, above all as the world reserve currency. This entirely rational loss of confidence is the root cause of expanding multinational efforts to end the petrodollar standard and to eventually establish a new world reserve currency.

A reversal of the escalating challenge to the petrodollar standard and the movement away from the US dollar as the world reserve currency would require oil producers and industrialized nations, including China, to rally in support of the US, but it is precisely this group (a group that includes OPEC members, the BRIC countries, members of the G-20, and voting members of the IMF), that is seeking to free itself from US dollar hegemony. Rather than attributing the petrodollar standard and the status of the US dollar as the world reserve currency to the wealth, power and influence of the US, critics assert that the wealth, power and influence of the US is illegitimate and that it is the result of undeserved privileges; privileges that have been abused at the expense of nations that do not enjoy unfair advantages and that must now be forfeited.

Skeptics regarding the rise of China as a major economic power doubt that China can profit from a weaker US dollar through a stronger yuan or develop a sufficient domestic consumer market quickly enough to offset reduced exports. However, while China contributes to US consumption as an export-dependent supplier, as well as a financier, their exposure to losses resulting from a declining US dollar is limited. A stronger yuan would mean that, after a period of adjustment, China would import more goods and services and that, in real terms, wages of Chinese workers would increase, thus supporting a higher standard of living. What is more important is that a stronger yuan, implicitly backed by growing gold reserves (not to mention by a [large and fully modern navy](#)), is exactly what will guarantee China's oil supply.

The struggling US economy, burdened with excessive levels of debt, cannot support a sustained rise of the US dollar against the currencies of growing economies in Asia. Growing demand for resources, especially oil, as well as gold, contrasted with the inflationary policies of the US, will maintain the upward trajectory of commodity prices measured in US dollars indefinitely. In the near term, the end of the petrodollar standard will cause a sharp decline in the value of the US dollar and a marked increase in the prices of oil and of gold measured in US dollars.

###

About Hera Research

Hera Research, LLC, provides deeply researched analysis to help investors profit from changing economic and market conditions. Hera Research focuses on relationships between macroeconomics, government, banking, and financial markets in order to identify and analyze investment opportunities with extraordinary upside potential. Hera Research is currently researching mining and metals including precious metals, oil and energy including green energy, agriculture, and other natural resources. The [Hera Research Monthly](#) newsletter covers key economic data, trends and analysis including reviews of companies with extraordinary value and upside potential.

###

Articles by Ron Hera, the Hera Research web site and the Hera Research Monthly newsletter ("Hera Research publications") are published by Hera Research, LLC. Information contained in Hera Research publications is obtained from sources believed to be reliable, but its accuracy cannot be guaranteed. The information contained in Hera Research

publications is not intended to constitute individual investment advice and is not designed to meet individual financial situations. The opinions expressed in Hera Research publications are those of the publisher and are subject to change without notice. The information in such publications may become outdated and Hera Research, LLC has no obligation to update any such information.

Ron Hera, Hera Research, LLC, and other entities in which Ron Hera has an interest, along with employees, officers, family, and associates may from time to time have positions in the securities or commodities covered in these publications or web site. The policies of Hera Research, LLC attempt to avoid potential conflicts of interest and to resolve conflicts of interest should any arise in a timely fashion.

Unless otherwise specified, Hera Research publications including the Hera Research web site and its content and images, as well as all copyright, trademark and other rights therein, are owned by Hera Research, LLC. No portion of Hera Research publications or web site may be extracted or reproduced without permission of Hera Research, LLC. Nothing contained herein shall be construed as conferring any license or right under any copyright, trademark or other right of Hera Research, LLC. Unauthorized use, reproduction or rebroadcast of any content of Hera Research publications or web site, including communicating investment recommendations in such publication or web site to non-subscribers in any manner, is prohibited and shall be considered an infringement and/or misappropriation of the proprietary rights of Hera Research, LLC.

Hera Research, LLC reserves the right to cancel any subscription at any time, and if it does so it will promptly refund to the subscriber the amount of the subscription payment previously received relating to the remaining subscription period. Cancellation of a subscription may result from any unauthorized use or reproduction or rebroadcast of Hera Research publications or website, any infringement or misappropriation of Hera Research, LLC's proprietary rights, or any other reason determined in the sole discretion of Hera Research, LLC. ©2009 Hera Research, LLC.