

## KARAT Commodities

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### **GOLD:** CHINA INCREASES GOLD HOLDINGS

Based on indicators of improving Chinese manufacturing activity, commodity and stock markets have surged in the Pacific Rim. It appears that China's recession-fighting policies are being judged successful. The +41% rally in Chinese stocks in 2009 from the 2008 lows dwarfs the single digit rallies in the U.S. and Europe. Western economies still sluggish and eyes are turning eastward for solutions to the global economic riddle. As such, recent hints at the direction of Chinese monetary policy should be closely regarded.

At the recent G-20 London meetings, China called for a new international monetary order with a gold link; this echoes the thoughts of Middle Eastern countries who are working towards their own gold backed currency, the Khaliji, which we have covered in previous issues of Karat. There was then the sudden disclosure that China had used part of its huge gold output to boost its own reserves by some 600 metric tons, a +75% increase in total holdings since 2003. In his first hundred days in office, President Obama's administration has injected nearly USD 40 billion each day into the U.S. economy. Given the inflationary impact that such a torrent of new cash will spark, it is logical that the Chinese hedge their USD1trn position with a more reliable store of value.

International money continues to flood towards the Chinese economic sphere, leaving the "old" industrial economies of America and Europe out in the cold. The cause is quite simple - the economies of America and China are mirror images of each other. The China-centric countries are producer-dominated and America is consumer-dominated. Over time, this dichotomy is and will continue to produce massive shifts in global wealth.

For a century, American administrations have relied on the inflationary powers of paper money to finance consumer growth. The fact that the USD is the world's reserve currency enabled this scheme to persist for longer than would have been tolerated otherwise. The Bush-Obama "stimulus and bailout" agenda is the same practice on overdrive. While driving the country further into debt, it also ensures that it will be progressively less competitive in the global economy.

China, on the other hand, is the world's largest producer and one of the top three exporters, piling up vast current account surpluses, especially in USD. In order not to boost its currency to levels that would make its exports less competitive, China maintained its surpluses in USD, investing the bulk, almost USD1trn in U.S. Treasuries. This acted as "vendor financing" for its exports to America.

To combat the global recession, China spent some USD700bn on a stimulus package, primarily focused on infrastructure and it now appears that China's stimulus package is having positive results. Increased economic activity in China will benefit American companies with China-sourced sales. But the majority of the American economy remains oriented toward the American consumer and his/her ever-increasing ability to take on debt. This is obviously no longer sustainable.

The outlook for America is for hyper-stagflation, or continued economic recession accompanied by rapidly rising prices. This calls into question the continued role of the USD as the world's reserve currency. Surplus nations, particularly China, are voicing their growing concern. They are exploring other less volatile arrangements. They may be considering a return to the bastion of monetary stability, gold.

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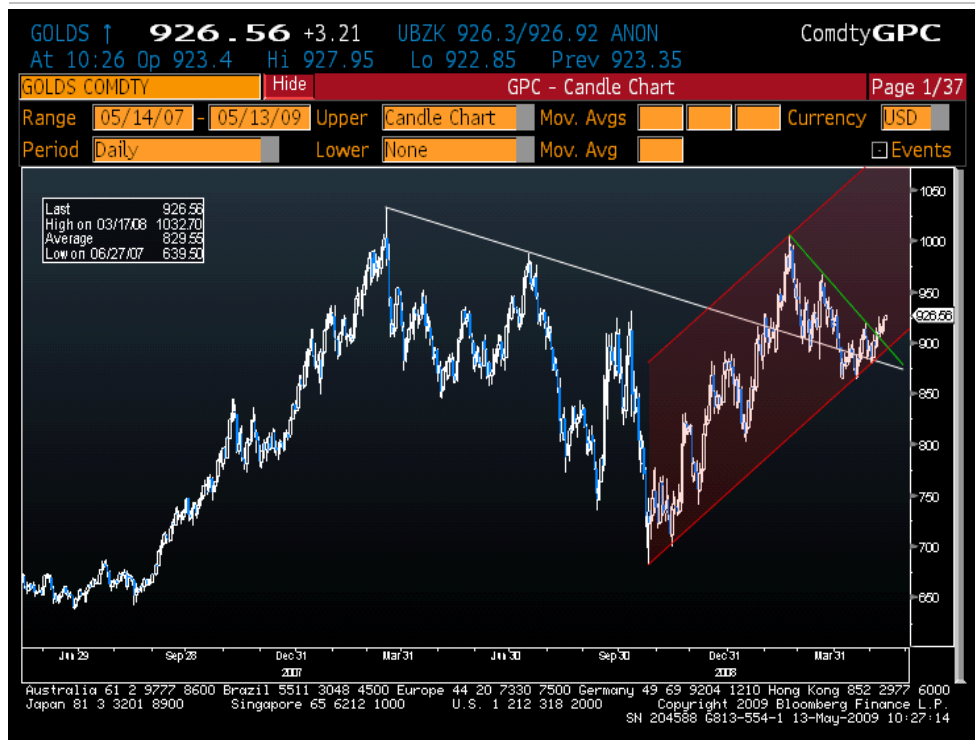
Now the world's largest gold producer, China would benefit tremendously from a shift away from the USD and towards gold. China is clearly interested in world leadership, but would never dream of challenging the U.S. militarily. However, in the 21st century, the weight of economics renders martial might largely irrelevant. Still, China cannot afford to act irresponsibly.

There are a few considerations that should temper China's ambitions. Even with the 600 metric ton increase over the past five years, China's gold holdings amount to only 1.6% of its total monetary reserves. Also, at 1,050 metric tons total, China's holdings are still dwarfed by the 8,132 metric tons held by the USA.

Nevertheless, the Chinese call for a new, gold-linked reserve currency, combined with the near doubling of their own gold reserves, points to a major strategic trend that can be expected to spread to other surplus nations. The biggest winners, personal or governmental, will trade their dollars for gold before there's a rush for the door.

Gold prices have risen over the last few weeks, price action has risen +7% from its low of USD865. Buoyed by weakness in the USD gold has managed to regain footing above the all important white trendline and further strength should be seen in the short term.

Gold Spot Price Chart 2007 to date (USD)



Source: Bloomberg