Part 1: Chinese gold purchases, in preparation for the adoption of the gold standard, are starting to have a dramatic impact on the gold price

China continues to hoard gold en masse. Chinese gold consumption is up 50% to 706 metric tons (hereafter tonnes) in 1H13 and is most likely to overtake India as the largest gold consumer in 2013

As with all the other hard commodities, where China accounts for some 40% of sales, China is now also becoming the dominant and swing factor in the gold trade, i.e. physical gold (the only real gold, **paper gold is no gold!**). On August 12 the China Gold Association (CGA) announced that China's consumption of gold in the first six months of 2013 surged to 706 tonnes, up 54% from 460 tonnes in the first half of 2012, as strongly declining prices of the metal lured buyers. Investors rely on data from trade groups such as the CGA and import custom numbers from Hong Kong - a key supplier to China - to forecast demand. The CGA also said output in China, the world's biggest gold producer, reached 193 tonnes in the first half, up 9% from a year ago.

Large-scale selling by investors triggered a 26% slide in gold prices from the start of the year to a near three-year low of $1,180 a troy ounce in June. In April, gold witnessed its biggest two-day fall in 30 years falling by 15% from $1,570 to $1,330. Gold prices reached a low of $1,180 in June falling from $1,800 in October 2012 after 12 years of gains. Being price sensitive the much lower gold prices triggered strong physical demand across the world and particularly in India and China, where gold is an essential part of weddings and gift giving. “China's demand in April and May was unmatched” according to a trader. The “bargain” gold was also bought for the weddings and the festivals. Next to the buying for weddings and festivals many people in India and China, alarmed by the government’s inability to keep prices under control, have been putting money into gold against inflation (money devaluation or reduced purchasing power). The Chinese aunties, as they are called, buying of gold is typically a sign of their lack of confidence in their own economy. Moreover there are a lot of unfinished empty city projects because the municipalities have run out of money. **At present the Debt (government, corporate and household) to GDP ratio in China is 200% with total debt standing at an astounding $16.3trn whilst forex reserves are $3.5trn in order to put it in perspective!** Gold is one of the few investments the Chinese are now allowed to own (the government outlawed gold as an investment in China from 1949 till 2006) with which they can protect themselves against the mishaps of the system! That is if it won’t be confiscated, as was the case in the US in 1933 under Roosevelt. In that case you would have won the battle and lost the war. Hence why I like silver so much as the best proxy to gold. Silver is not present in most central bank vaults and therefore less likely to be used as an anchor of the next financial system whilst silver though was the official currency in China till 1933. The Chinese word of bank means “storage of silver”.

For the whole year of 2013 China is forecast to purchase some 1,000+ tonnes of physical gold, which would be an increase of “only” 20% (surely the strong 54% increase in 1H13 was the result of a lot of pent up demand following very low prices) from 832 tonnes in 2012. In that case China would overtake India, which imported 860 tonnes in 2012, as world’s largest gold importer. **As mentioned before the Chinese government does not release data on gold consumption or imports and therefore we have to rely on CGA and Hong Kong import figures. The same applies for the gold reserves the Chinese hold in their official reserves, the latest official figures date back to 2009 when they published their 2008 reserves.**

China is world's largest gold producer with 403 tonnes in 2012

China is the world's #1 gold producer. China's gold production in 2012 rose for a sixth consecutive year and increased by 11.7% to 403 tonnes. The CGA reported that mine output in China in the first half of 2013 reached 193 tonnes, up 9% from a year ago.

China has seen its gold demand jump in recent years as an increasing affluent population turns to gold as a hedge against inflation and corruption in China. In 2007 China overtook South Africa as the world's top bullion producer and its gold output has doubled since 2003 from 200 tonnes to 403 tonnes in 2012 showing a compound annual growth rate of 8%. Over that period China produced some 3,000+ tonnes of gold with official gold reserves still remaining static at 1,054 tonnes! China has said that it aims to produce between 420 and 450 tonnes of the precious metal by 2015.

I think it is highly unlikely that China's own production hasn't fuelled China's official gold reserves. **The only way that China can significantly increase its gold reserves without driving the price of gold sky-high is through buying up its entire domestic production.** What is the more remarkable is that China has been able to dramatically increase its gold production, while all the other major gold-producers are reporting flat or declining production.

China's official gold holdings "have been static" since 2008 at 1,054 tonnes, for obvious reasons. Estimates of China's current gold holdings range between 5,000 tonnes-10,000 tonnes

In April 2009 China showed it had increased its official 2008 gold reserves to 1,054 metric tonnes, according to a report by Xinhua News Agency, which cited Hu Xiaolian, head of the State Administration of Foreign Exchange. Hu said that China's gold reserves had risen by 454 metric tonnes since 2003 to 1,054 tonnes in 2008 and that the total was being reported to the IMF per the organization's rules. And at present China is still reporting "official" gold reserves of 1,054 tonnes (World Gold Council April, 2013) whilst it has domestically produced in China alone approximately 3,000+ metric tonnes of gold since 2003. Next to that in recent years it has strongly increased its gold imports though Hong Kong.

According to the latest official reporting the U.S. is No. 1 with about 8,134 tonnes, followed by Germany with 3,391 tonnes and the Washington-based IMF with 2,814 tonnes. Italy, France, China and Switzerland are fourth through seventh. China is only ranked nr 6, which is an anomaly as we have argued here above. While gold accounts for 9.5% of Russia's total reserves (that is in April 2013), gold accounts for more than 69.5% of the total reserves of the U.S., Germany, Italy and France, as reported by the IFS table here below showing an overview of world's top 10 official gold holdings as per April 2013.

A much better and reliable overview would of course be a summary of physical gold reserves that have been independently accounted for! The last audit, and the last public visit, was in 1953, just after U.S. President Dwight Eisenhower took office. Apparently no outside experts were allowed during that audit, and the audit team tested only about 5% of gold there. So, there hasn't been a comprehensive audit of Fort Knox in over 60 years.

In 1974 six Congressmen, one Senator and the press were allowed to enter Fort Knox to see for themselves if the gold was there or not. The tour showed that there was gold in Fort

Knox but, all the same, it sparked even more controversies. Only a small fraction of the gold reserves were made available for viewing, and one Congressman published a report saying that the gold bars held in the fort may have been less heavy than would have been expected.

During the past two years, several US politicians have claimed that there is a high chance that neither Fort Knox nor the FED have any gold, or perhaps only a very small amount, and have demanded a full and public inventory and testing, but the FED have resolutely refused. And as said before in my point of view you don't really own your gold till you have it in your possession. Think the Bundesbank getting 300 tonnes of its own gold, stored at the NY Fed, delivered only by 2020! Members of the German parliament the Bundestag also didn't get any satisfactory answers when they visited the NY Fed's vaults to see the German gold with their own eyes. They were continuously stonewalled. Why! Anyway I don't understand why people don't want to believe that there is something sincerely wrong! Why is this issue, which lies at the core of our financial system, not getting more attention, probably because the timing for the awareness to kick in is not right yet?

WORLD OFFICIAL GOLD HOLDINGS

International Financial Statistics, April 2013*

		Tonnes	% of reserves**
1	United States	8,133.5	75.1%
2	Germany	3,391.3	72.1%
3	IMF	2,814.0	1)
4	Italy	2,451.8	71.3%
5	France	2,435.4	69.5%
6	China	1,054.1	1.6%
7	Switzerland	1,040.1	10.0%
8	Russia	976.9	9.5%
9	Japan	765.2	3.1%
10	Netherlands	612.5	58.7%

China's gold imports from Hong Kong more than trebled from 119 tonnes in 2010 to 428 tonnes in 2011. Next to that in 2012 alone, Mainland China's gold imports had soared to 834 tonnes. China's imports through Hong Kong – believed to be the principal route by which gold bullion reaches the Middle Kingdom – have already been increasing dramatically in the first 6 months of 2013, culminating in imports of 706 tonnes up from 460 tonnes. On the basis of these facts in addition to its own domestic production China could have easily built up gold reserves of between 5,000 tonnes to 10,000 tonnes from the 1,054 tonnes last reported for 2008.

Graph of China’s net gold imports through Hong Kong

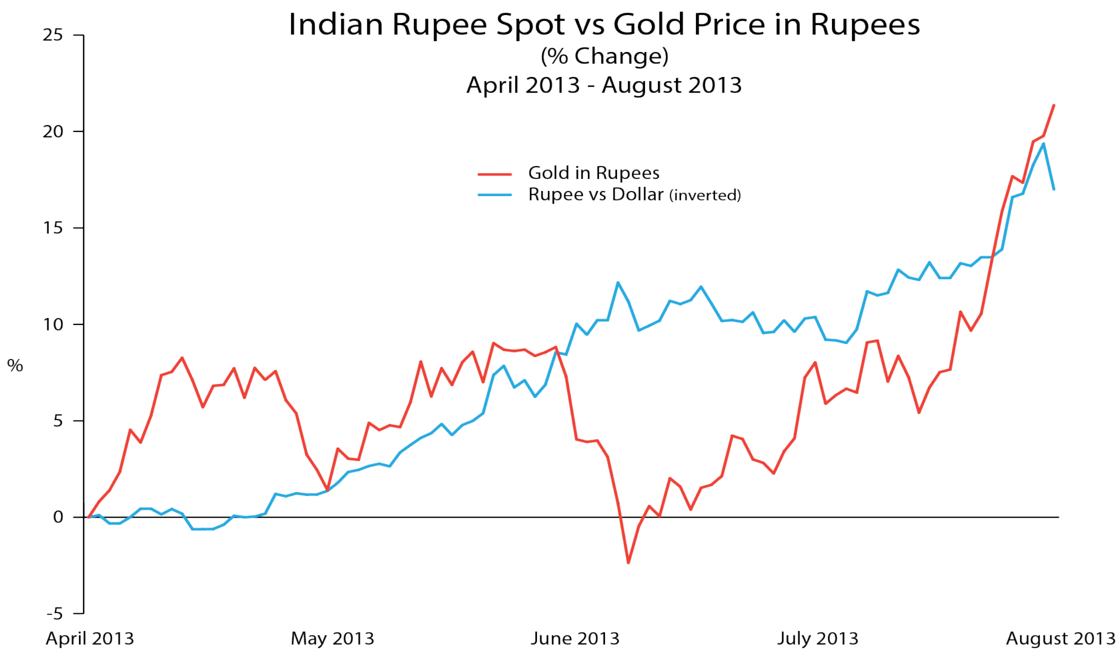
China is most likely not disclosing its real holdings because it doesn’t want to up the gold price as long as possible because the moment the public becomes “aware” that China is amassing gold the sky is the limit. Still, considering its considerable purchases, people wonder how long the Chinese can keep on accumulating gold without triggering a strong gold price? Where is the inflexion point? Or are we already witnessing the impact of Chinese gold buying on the gold price? I should emphasize that it is not unthinkable that China has also set up several hedge funds in hedge fund jurisdictions that anonymously acquire physical gold for China.

India’s import tax of 10% on gold is not really slowing down demand

In the context of the main gold buyers it is also important to mention India, Russia and Singapore and Indonesia with a population of 240m and a strongly developing middle class with an increasing penchant for gold. The large-scale shift of gold out of western trading hubs towards Asia has led to a spike in business for traders and refiners.

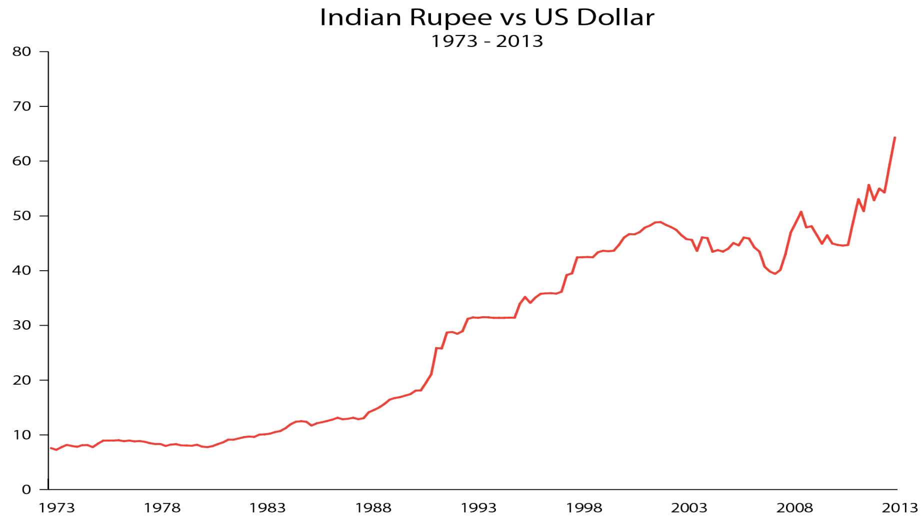
The London Bullion Market Association (LBMA) saw the daily cleared trading volume hit a 12-year high of 900 tonnes following “strong physical demand, particularly from China and India”. The same applied for the Swiss gold refiners, melting large 400oz bars reprocessing them into sheets that are preferred by Asian buyers. The same strong increase in activity we witness in Dubai and Singapore. A lot of investors seem to move their physical gold to the Freeport storage facility in Singapore a jurisdiction that is felt to be a safe haven against the upcoming confiscation of physical gold and or any other punishing pressures.

In India it is mainly the citizens that buy gold not the central bank. India's consumption this year is expected to be “lower” than last year's 860 tonnes as the government is trying to curb imports and reduce its trade deficit by increasing import duties for gold. Though despite hurdles including a new 10% import tax, aimed to reduce the nation's account deficit, India's imports have been rising. According to Reuters: "Indians bought more gold in July than June despite a series of moves by the Reserve Bank of India to strangle supplies.” India's gold imports hit $2.9 billion in July; up from $2.45 billion in June confirming Finance Minister P. Chidambaram's fears that despite hikes in import duties and steps by the Reserve Bank of India to stem supply, demand is on the rise again. India has historically accounted for approximately 30% of mine production, which was 2,700 tonnes in 2012.



Source: Bloomberg

On Wednesday, August 28, the Indian rupee hit a fresh record low against the U.S. dollar, as efforts by Prime Minister Manmohan Singh to calm investors failed to prevent further selling. The Indian currency traded at 69.1 rupees against the dollar, according to FactSet, marking an almost 20% decline on the year. The weakness in the rupee comes amid increasing worries about how India will adapt to tighter global monetary policy, especially in anticipation of the Fed's tapering.

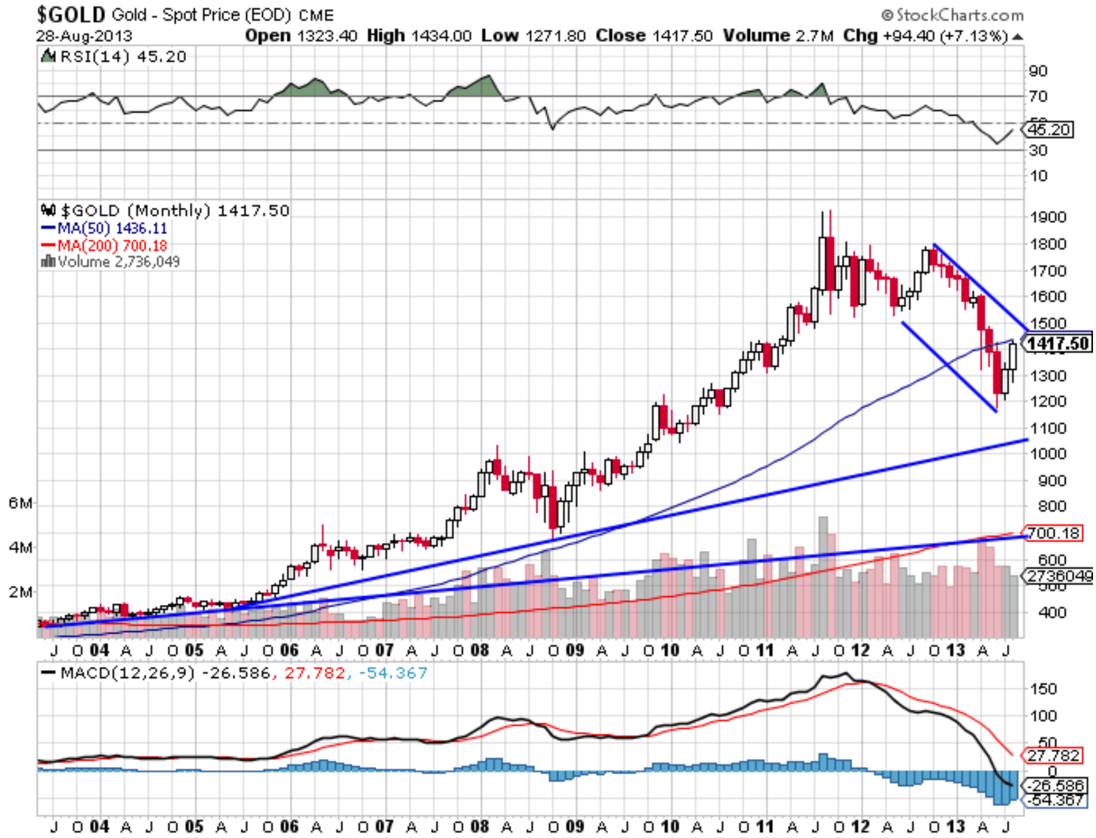


Source: Bloomberg

Whilst under normal circumstance gold demand and the gold price measures in rupees enjoy a high price elasticity I believe that people are now trying to hedge themselves for the weakness in the economy and the vulnerable outlook for the rupee. The Indian government concern is that its citizens are exchanging their rupees for gold in droves, which is exacerbating the slide in the rupee because rupees are offered in exchange for dollars needed to buy gold. Demand for gold in India is being partly met through unofficial channels such as smuggling. Indians are bringing in gold through neighboring countries, such as Pakistan, Nepal, and Sri Lanka, pushing their imports sharply higher as well and prompting action by their governments. In an attempt to address steep devaluation of the rupee against the dollar, Pakistan recently temporarily banned import of gold to save the precious foreign currency reserves.

Premiums at record levels

Demand is so high and product is so scarce that gold premiums in India, the world's largest consumer market last year, may extend their advance to a record, according to Bloomberg. "The fees paid by jewelers to banks and other suppliers have jumped to about $40 an ounce over the London cash price from $30 in the week ended Aug. 2, said Haresh Soni, chairman of the All India Gems & Jewelry Trade Federation. Premiums may surge to $100 if the government doesn't ease the rules, said Bachhraj Bamalwa, a director at the federation, which represents about 300,000 jewelers and bullion dealers."



And if a stock market correction in the West happens following tapering by the **Federal Reserve** or because of other factors, western capital might follow suit in a flight back to quality and into gold. Surely what else is there left to invest in that will keep its value! Hence why also the Russians under Putin have been steadily increasing their gold reserves.

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