Part 2: Chinese gold purchases, in preparation for the adoption of the gold standard, are starting to have a dramatic impact on the gold price

Russia, world's 4th largest gold producer, is also converting petro-dollars into gold

According to a Bloomberg story when Vladimir Putin says the U.S. is endangering the global economy by abusing its dollar monopoly, he's not just talking. He has putting money where is mouth is.

Russia, world's largest oil producer, also is one of world's largest gold buyers. Russia's central bank has added 570 metric tonnes of the metal in the past decade, now totaling some 1,000 tonnes. During 2012, the Russian central bank increased its holdings by 8.5% or 75 tonnes to 958 tonnes.

"The more gold a country has, the more sovereignty it will have if there's a cataclysm with the dollar, the euro, the pound or any other reserve currency," Evgeny Fedorov, a lawmaker for Putin's United Russia party was quoted saying.

During a tour in 2005 of the Magadan region in the Far East, where Polyus Gold International Ltd. and Polymetal International Plc. have operations, Putin told Bank Rossii not to "shy away" from the metal. "After all, they're called gold and currency reserves for a reason," Putin said, according to a Kremlin transcript. At the time, gold was at an 18-year high of $495 an ounce and the Moscow-based central bank held 387 tonnes, or 2.2% of its $165 billion total reserves. Putin intention was clear.

At present Russia's forex reserves are approximately $520bn of which 8% or $45bn (1,000 tonnes x 32,150 ozs x $1,396) is what their gold is valued at. Russia has the world's eight-largest bullion holdings.

Technically, state metals depositary Gokhran has the exclusive right to buy all gold mined in the country. In practice, it lets commercial banks buy from producers directly, usually in the form of project financing, said Sergey Kashuba, chairman of the Russian Union of Gold Producers in Moscow. A great way of promoting mine development whilst at the same time controlling the off-take!

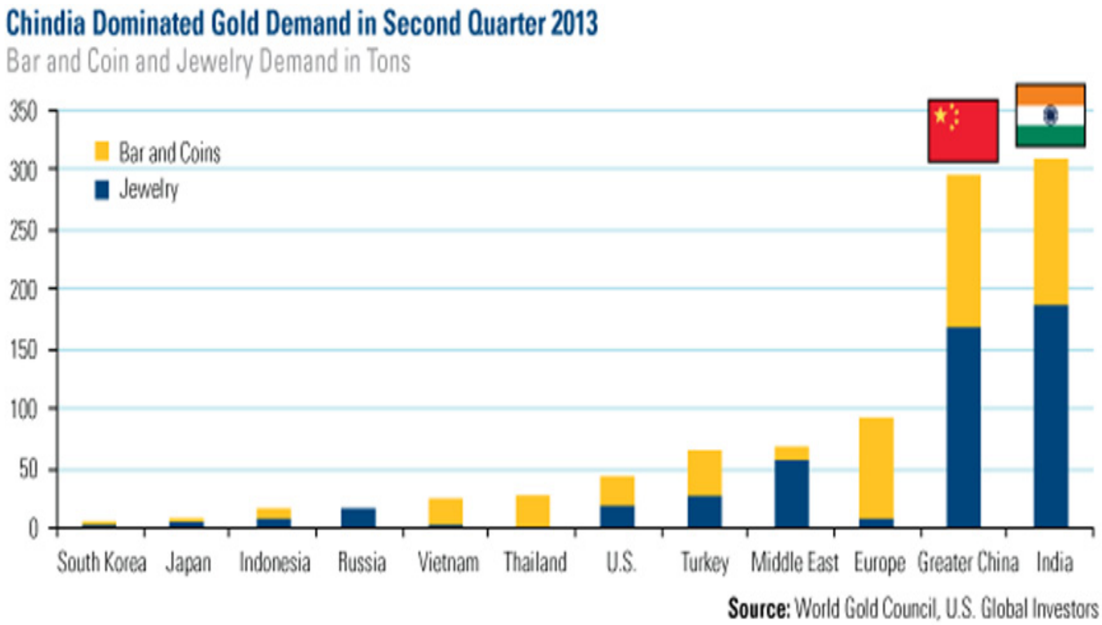
When the central bank buys gold, it's from those commercial banks, led last year by Sberbank, Nomos Bank, VTB Group and Gazprombank. Russia produced 205 tonnes of gold in 2012, making it the fourth largest gold producer after China (370 tonnes), Australia (250 tonnes) and the U.S (230 tonnes).

Security is tight along the entire production chain. Just two organizations are allowed to move partially refined gold from miners in the Far East and northern Siberia to processing facilities in other parts of the country. One is FeldSvyaz, a courier service that reports directly to Putin. The other, SpetsSvyaz, was split off from Stalin's NKVD secret police in 1939 to transport precious metals and state secrets, according to its website. It shows gold's imminent importance for Russia and Putin's secret service background. Next to that, considering the Russian domestic production of 205 tonnes in 2012 one should also question if Russia's gold reserves are not much bigger than reported as is the case for China. Moreover one has to ask oneself why these countries would ruin their own purchase prices admitting that they have much bigger reserves! Surely domestic production greatly meets this goal of amassing gold inventories whilst not ruining the purchase price of gold when one has to buy it in the open market.

With demand from China, India and Russia good for 69% of world mine production the seasonal strong 2H could be very interesting for gold prices!

With China's economy showing signs of shaking off a slowdown or being in dire straits, depending on which statistics you believe, and India's love for gold still entrenched in its culture, Asian demand will play a key role going forward, especially during gold's seasonably strong fall months. Next to that it is alleged that a lot of the Comex gold inventories were recently shipped from so called weak hands (futures) to Asian buyers, strong hands (physical). Short-term investors in general pursue futures or paper gold whilst long-term investors normally pursue physical gold.

Mine production for 2013 is forecast at some 2,750 tonnes, up 3% from 2012 2,700 tonnes, in other words demand from China (1,000 tonnes), India (825 tonnes) and Russia (75 tonnes) would account for a whopping 69% with China good for 1,000 tonnes/2,750 tonnes or 36% of total world mine production. If China's demand in the second half would be as strong as in the first half Chinese 2013 demand would be 1,285 tonnes or account for 47% of forecast 2013 mine production! Demand from China, India and Russia in that case would account for almost 80% of total mine production; imagine what could happen to gold prices!



China has no option but to hedge its US $ reserves and thus protect the Yuan though gold purchases. The gold standard pursued by China could be around the corner!

Central banks of developing countries are buying gold whilst those of developed countries are selling gold! The Gordon Brown syndrome?

Central banks, mainly those of emerging or the BRIC countries, bought more gold in 2012 than at any time in the past 50 years, a net 536 tonnes. This trend of central banks buying gold instead of selling gold, which started in 2009, is a 180-degree reversal from the original intention of the Washington Agreement whereby **central banks gold disposals** were coordinated to ensure orderly price forming. The main buyers in 2012 were the central banks of Russia, China and Turkey. One should wonder why central banks are so eager to purchase “a barbaric relic” which is the opposite of their own creation, paper money. You know why! Because people are finally waking up that physical gold is the only currency with real value that can’t be printed whenever it suits politicians. I fact taking inspiration from Germany and Switzerland, a movement to repatriate the Polish gold reserves totaling 70 tonnes stored at the Bank of England vaults in London is now emerging in Poland.

While Putin and China are leading the gold rush in emerging markets, developed nations are liquidating, exactly the opposite of what they should do in order to hedge against the continued currency devaluations and increasing debts following unsuccessful QE measures (printing money). In my point of view it can be seen as a kind of a Gordon Brown act, selling gold at the bottom of the market. Switzerland unloaded the most gold in the past decade, 877 tonnes, according to International Monetary Fund data through November 2012. France was second with 589 tonnes, while Spain, the Netherlands and Portugal each sold more than 200 tonnes. My advice would be to the central banks don’t sell your gold it is your last resort rescue!

The US allegedly has 8,134 tonnes of gold inventories that is if they indeed physically have it in possession and without lien. Though a lot of people believe that most of that gold has been leased out or sold and is no longer in inventory. Surely that fits in with the US intention to de-monetize gold as a currency and to promote the US dollar as THE reserve currency. The last audit of gold stored in Fort Knox took place in 1953. Don’t you just love the transparency? Especially because the gold belongs to the citizens of a country.

The US can’t buy gold without severely discrediting the US dollar whilst China doesn’t have this problem

And as I have mentioned in my blog article http://www.groenewegenreport.com/2013/05/part-ii-the-gold-manipulation-is-playing-in-the-hands-of-the-chinese-with-far-reaching-consequences-for-the-reserve-currency-status/ the US is between a rock and a hard place because the US can’t buy any gold without severely discrediting it currency, the US dollar, whilst China can! China doesn’t have to defend the credibility of the reserve currency, the US dollar. China doesn’t discredit its own currency when it buys gold, the US does.

China is aiming to create the next reserve currency, the Yuan, by backing it with physical gold, which could break the buck. China will de-link the Yuan from the peg to the US dollar and fix it to gold instead. This could have far-reaching implications for the global financial system, creating further dislocations and a crisis on a global scale.

The Chinese authorities have been pushing for a more international role for their currency and as an alternate reserve currency to the embattled dollar and euro. Even the very conservative Bundesbank recently acknowledged that the Yuan was becoming a global reserve currency.

The gold accumulation of the Chinese meets the necessity for an US dollar hedge and the Yuan backing.

As indicated before undeniably there is a wider plan behind the Chinese strong demand for gold. The Chinese want to own gold to protect themselves against the collapse of the highly indebted US dollar complex, which continues to lose purchasing power. It's a rotation out of US paper, which bears counter party risk (reduced purchasing power) into gold, a tangible asset with intrinsic value and without counter party risk when monetary policies fail. It should be emphasized that the backing of the currency by gold wouldn't be such an issue if the US dollar, the world currency, wouldn't have been weakened so much by so much debt issuance and the mismanagement of government revenues and expenses. If the US Dollar would be strong and healthy because of a strong economy and low debt levels gold wouldn't have "to come to the rescue" of the financial system!

Yao Yudong, a member of the People's Bank of China's Monetary Policy Committee, recently wrote an article in the China Securities Journal, in which he called for a new Bretton Woods system stabilizing global exchange rates. In other words he is basically calling for a return to the gold standard. As mentioned it is no secret that China would like to float the Yuan to become an international reserve currency. It would most likely bring stability to the Chinese economy crucial in order to keep unrest at bay. Besides the heyday of Chinese growth is over.

Under the old Bretton Woods system, the US dollar was the global reserve currency, fixed and convertible into gold at US$35 per ounce. In other words the paper money was validated through the gold backing and conversion. This is known as the gold standard system, based on which paper currencies were issued. But President Richard Nixon ended this gold standard in 1971 by floating the US dollar outright. During the regime of the French President Charles de Gaulle up to 1970, France reduced its dollar reserves, trading them for gold from the U.S. government. This, along with the fiscal strain of Lyndon Johnson's Great Society expenditures and the Vietnam War, led President Richard Nixon to eliminate the fixed gold price in 1971.

By leaving the gold standard, the world moved into the so-called fiat currency system – or paper money system, the opposite of a gold backed system, which enabled debt creation to spur economic growth. A fiat currency (paper money declared legal tender by order, fiat) is not convertible or exchangeable in something of real value such as gold or silver. Adherence to the gold standard leads to more disciplined debt creation and leads in general to more stable long-term economic growth rather than the boom and bust cycles we have seen in recent years. Beijing's possible move to back the Yuan with gold could be seen as a strategic move in order to, lessen the risk of inflation, a serious problem for China (and India) and a potential cause of major unrest because people's purchasing power is being reduced.

On the other hand the Yuan would suffer dramatically if the US dollar collapses because approximately 60% of China's forex reserves totaling $3.5trn are invested in US dollar denominated assets consisting mainly of treasuries and corporate debt. And thus in order to protect its own currency against reduced US dollar purchasing power China foremost needs to hedge its forex reserves.

In this context it is the more and more understandable that China is serious about backing the Yuan with gold. In my point of view their large gold purchases and the nonreporting of their gold reserves since 2009 are facts that clearly demonstrate that the gold standard is what they are moving towards. How much evidence does the West need? Such a move by China is the more likely as China seeks to become a superpower and lessen and undermine U.S political dominance. The reserve currency and the world dominant power are often interwoven. If China pegs the Yuan to gold, and I think China doesn't have any option but to so, it will lead to huge volatility in the foreign exchange markets. US debt would plunge with interest rates going through the roof especially if the US can't account for 8,153 tonnes, which most likely would lead to a severe international monetary crisis. In other words the next financial crisis could be caused and fuelled by a central bank crisis with gold as the main issue whilst central banks are supposed to monitor and prevent financial crises. What an irony that would be!

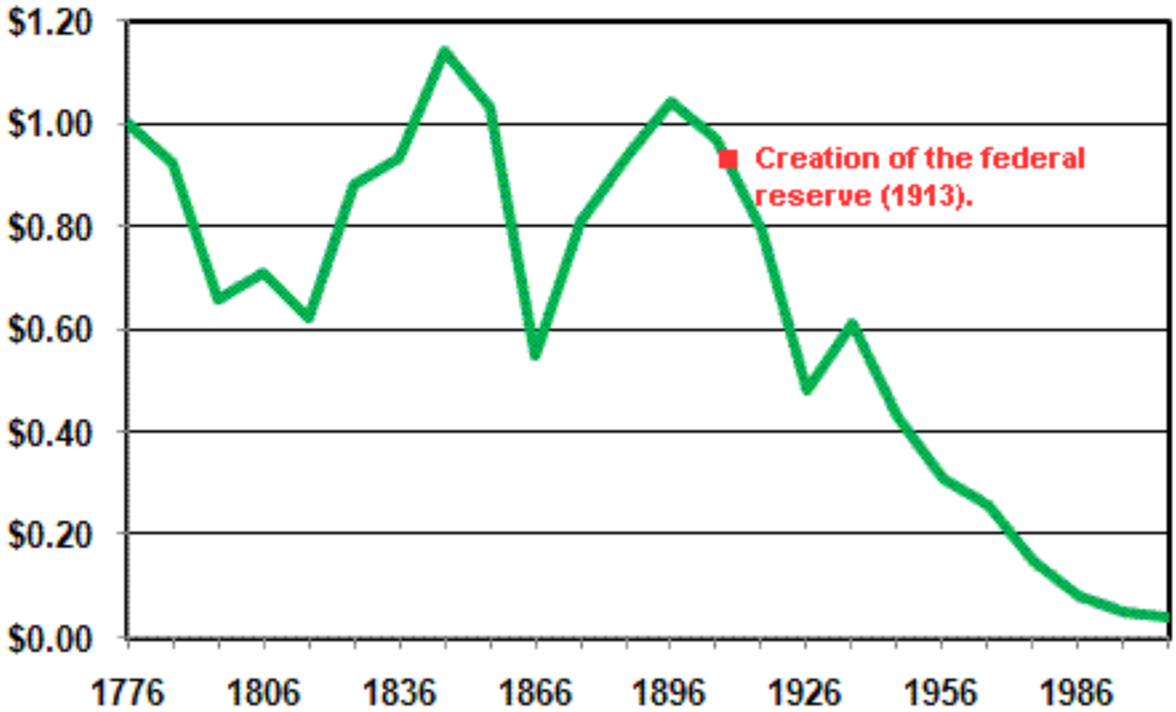
If China and or Russia (which also wants to increase the convertibility of its rubble and perhaps create a petro-ruble) were indeed to move to back their currencies with gold the U.S. and EU would have no option but to follow suit. They would first have to demonstrate that they have the physical gold in their possession, in order to avoid a breakdown of their own currency. Subsequently we would look at a new gold standard and most likely a new reserve currency. Who has the gold has the (purchasing) power!

From 1980 through 2008 the U.S. dollar lost an astounding 62% of its buying power

The correlation between the loss of the purchasing power of the US dollar and the increasing gold price is at the heart of the accumulation of gold by the Chinese. You would ask why do the Chinese have to hedge their US dollar denominated reserves, surely the US dollar is the reserve currency, the most important and "thus a safe and trustworthy currency", that governs most money transactions. The answer is: because of the continuous currency or purchasing power devaluation. Purchasing power (sometimes retroactively called adjusted for inflation) is the number of goods or services that can be purchased with a unit of currency (Wikipedia). As emphasized many times the currency can be seen as the real benchmark of your wealth, ask the Indians about their plunging Rupee. The US dollar has lost 62% of its purchasing value since 1980 (see below). And the unsuccessful QE measures are putting further downward pressure on the value of the US dollar and thus the Chinese don't have any option but to acquire physical gold if they don't want to lose most of the value of their US dollar dominated forex reserves.

To put the effect of the unsuccessful QE measures into context the Fed sits on a balance sheet in excess of $3.5 trillion, supported by theoretical capital of $50 billion. From the beginning of May 2013 the 30 year Treasury note fell by 12% from 148 to 130, the 10-year Treasury note fell by 7% from 133 to 124 whilst the 5-year note fell by 4% from 124 to 119 and the 2-year not fell by 0.4% from 110.3 to 109.9. Considering Treasuries moves to multi-year lows two weeks ago, Fed's losses on its portfolio since early May are estimated to be in the vicinity of $200 billion (6% of $3.5trn), effectively wiping out its entire capital base!! One has to wonder how the Government i.e. Treasury will redeem the bonds in possession of the Fed, even if the Fed keeps the bonds till expiration, when as a result of the higher interest rates, the world can't afford, the economy implodes and there are hardly any tax revenues to keep the Government's most important services going! Let alone pay for the much higher interest burden. In other words what is the US dollar worth or what is it that you can buy with the US dollar when the economy and its monetary authorities are bankrupt?

The Bureau of Labor Statistics Inflation Calculator has calculated that $1 in 1913 has the same buying power as $21.89 in 2010. In other words, the U.S. dollar lost about 95% of its value since the establishment of the Fed in 1913.



The following table shows the equivalent amount of goods that, in a particular year, could be purchased with $1. The table shows that from 1774 through 2008 the U.S. dollar lost about 97% (95% since 1913) of its buying power, though the majority was lost from 1980 through 2008 when the U.S. dollar lost an astounding 62% of its buying power.

Money is a medium of exchange and a store of value, and if the purchasing power of the currency is being diluted, as is the case with the QE measures, the currency holder can purchase fewer goods and gets less foreign currency for the US dollar and thus gets poorer along the way. In general the loss of purchasing power is a gradual process, which often accelerates at the end of its process when it is not reversed (Zimbabwe, Weimar).

Though often the loss in purchasing power is most palpable when we go abroad to a stronger currency country and experience how “poor” we are. **A currency is the ultimate benchmark of your wealth**, it shows how many goods you can buy with the same nominal value (amount printed on a banknote) and the matrix below clearly demonstrates that purchasing power has been continuously eroded since 1774 but especially since 1913 the year the Fed was created and as of 1980 when the credit ceiling was increased (money printing) to facilitate economic growth. And then people wonder with the US dollar losing so much in purchasing power why gold and silver have gained so much in value.

Buying power of one U.S. dollar since 1774

Year	Equivalent buying power	Year	Equivalent buying power	Year	Equivalent buying power
1774	$10.53	1860	$10.22	1950	$3.42
1780	$6.20	1870	$6.51	1960	$2.78
1790	$9.30	1880	$8.31	1970	$2.12
1800	$6.77	1890	$9.34	**1980**	**$1.00**
1810	$6.91	1900	$10.12	1990	$0.63
1820	$7.25	1910	$8.94	2000	$0.48
1830	$9.21	1920	$4.11	2007	$0.40
1840	$9.83	1930	$4.93	2008	$0.38
1850	$10.88	1940	$5.87		

Conclusion: The Chinese, and to a lesser extend the Indians, Russians and Indonesians, are hording gold, which is the main reason for the strong gold price increases.

Either the Western bullion banks have misjudged the perception that gold still retains its value and that it still is a key financial instrument a function it has had for thousand of years, or the Asian citizens, investors and central banks of the new world, which are continuing to accumulate gold at a high rate, have got it wrong.

According to reports in 2011 Indian households are holding at least 18,000 tons of gold while Chinese households account for only 6000 tons. In India, gold is acquired over generations. Except for the last few decades, gold was the only form of savings that was practical.

As we described gold purchases in India are entwined with religious and cultural beliefs. Indian customs demand buying gold for special occasions like weddings, births, birthdays, celebrate various festivals or offer gold to Indian deities. Gold is an integral historic and cultural part of the Indian society.

Whilst the Indian government is discouraging its citizens to buy gold in order to reduce further downward pressure on the Rupee at the same time the Chinese government is encouraging citizens to buy physical gold. Although Chinese citizens have only recently started to accumulate gold, since 2006, it is not unlikely that their middle class, who has been gaining wealth rapidly, could overtake the Indians in terms of holdings in the not too distant future.

We basically have 4 currencies in the world: the US dollar, the Yen, the Euro and gold and silver (I group the latter two as one). Of these currencies only gold and silver are not printed or diluted ad infinitum because you can’s print them, they have to be mined out of the ground at all-in costs of between $600-$1,300 and $7-$16 which gives it its real value.

The printing exercise of the central banks of the developed countries hasn't delivered and won't deliver the desired result of economic growth. How much more conviction do the authorities need? Apply the same current conditions for a country on a household and you will understand, how difficult it is to pay back with interest a household debt that is 100% or 150% or 200% of your income before tax whilst your income is being reduced!

Anyway we see the so desired growth currently failing in China, in Europe, the emerging markets and the US. Where is the growth going to come from to pull us out of the downward draft moreover all the catching up of major emerging economies has happened? We are at the end of the rope. I understand that governments try to stimulate economic growth by printing money but at one stage and we have passed that stage the money printing is becoming very counter productive leading to destruction of the currencies and thus their purchasing power. This is when gold and silver will take off, of which we are witnessing the initial stages. We are setting ourselves up for prices in gold and silver we have never seen before, even corrected for inflation. Moreover Societe Generale uber-bear Albert Edwards is repeating his call for 450 on the S&P 500 — a 73% drop — plus a six-fold rise in gold's price, to above $10,000. And sub-1% yield on U.S. Treasury bonds.

At present we see a lot of foreigners (Indians, Japanese, Brazilians, Chinese), in anticipation of higher interest rates, selling their US treasuries which puts downward pressure on the US dollar and thus adds to price rises for gold because of the inverse relationship with the US dollar. In other words fear for higher interest rates helps to push up gold prices next to its increasing demand for a safe haven (Syria, Egypt, oil). Adding to the downward pressure on the US dollar is the selling by foreign investors of Indian, Brazilian and any other emerging market securities. As we have witnessed in a lot of emerging markets foreign capital is being withdrawn following the taper uncertainty with as a result that a lot of central banks have to sell US dollars in order to defend their own currency.

Though in my point of view, next to the lower dollar, the overwhelming reason behind the rising gold price is: the hording of gold by the Chinese and other countries and the failure of the central banks to depress the gold price. Next to that what alternatives are there left to invest in and preserve your capital considering that we are looking inevitably at destructive higher interest rates.

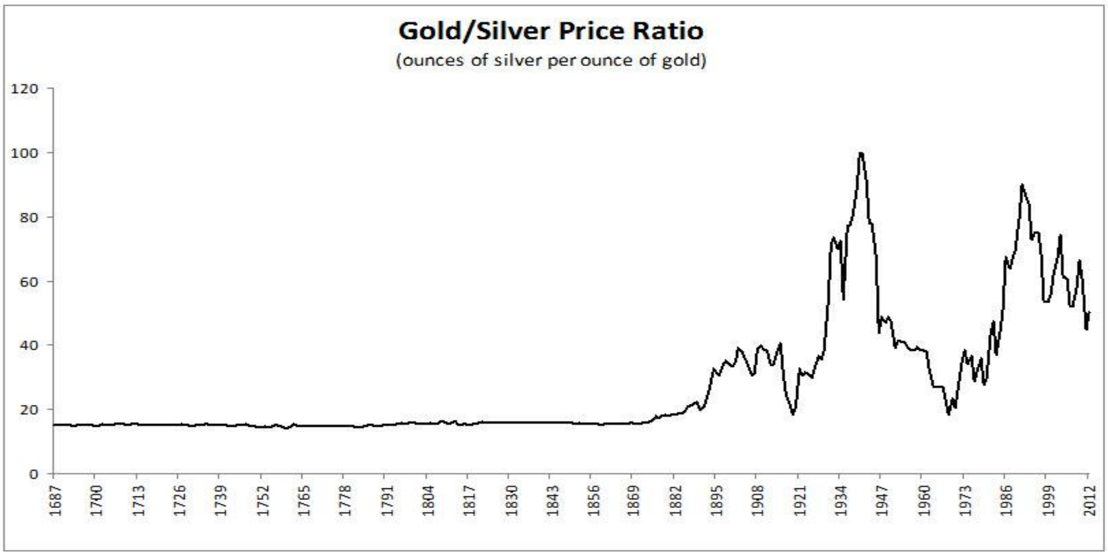
With the Fed technically bankrupt and the $3trn+ stimulus not sorting the desired economic growth the US dollar's purchasing power continues to be undermined (see table here above). Hence why the People's Bank of China is serious about phasing out the failing dollar as the reference currency or peg for the Yuan, and to start using gold as the benchmark. As mentioned Beijing's possible move to back the Yuan with gold would be a strategic move in order to, lessen the risk of inflation, increase the Yuan's attractiveness as an investment medium and create faith in the Yuan as a reserve currency. The change in value of the forex reserves, i.e. a lower US dollar, clearly could also have an impact on the country's currency especially when most of $3.5trn reserves are held in US dollars. The gold accumulation therefor also is a necessity for China in order to hedge its vast US dollar holdings against loss in value and prevent a Yuan devaluation.

Nonetheless it is paramount to keep a close eye on the CGA and Hong Kong gold import/export figures in order to determine the gold demand from China.

Last but not least it looks like the de-monetizing of gold by the central banks of the developed countries is not working hence the quick and strong rebound from the sell-off, which happened from April till the end of June of this year. The paper or future gold market was put in its place by the physical gold market. There was clearly a “mismatch” in pricing hence why physical demand took off; gold was far “too cheap”.

Again recapping there are a lot of arguments favoring the physical precious metals. Where will investors invest their money when treasuries are being sold and the economies are not showing any serious traction? And then I am even not talking about geopolitical problems that are clearly on the rise. For how much longer will we be able to control the Middle East before something goes seriously wrong?

As mentioned many times consider what will happen to your gold if governments will confiscate gold in order to back up a gold standard because they are forced to by China. You have won the battle but you lost the war. You want to consider silver because it is the proxy to gold (the historic gold/silver ratio during many centuries has been 12.5:1 whilst the average gold/silver price ratio during the 20th century was 47:1, at present it is 59:1), cheap and central banks barely have any silver in their central bank vaults. If the ratio were to return to the pre-1900 average of 16.13x the silver price would have to rise from approx. $24 to about $87/oz ($1,396:16.13).



According to Jefferson Lab, silver is almost 19 times more abundant than gold within the Earth's crust. While this doesn't necessarily mean the deposits are economically recoverable using modern technology though ultimately this is the most realistic yardstick.

A more relevant measure of physical availability is reserves and production. According to the US Geological Survey 'reserves' are defined as only economically recoverable materials. According to US Geological Survey's Mineral Commodity Summaries (January 2012), 2011 reserves and production for silver was respectively 10x and 9x more abundant than gold. To adjust to the 2011 reserves ratio between silver and gold, the silver price must rise to about $139/oz. To adjust to the 2011 production ratio, the silver price must rise to about $155/oz.

In addition it should be emphasized that aboveground silver inventories are constantly depleted because it is consumed for industrial purposes. In contrast, most gold that has ever been mined exists in a vault somewhere. Anyway I just want to emphasize be aware of “The silver lining”!

g.groenewegen@goldarrowpartners.com
www.groenewegenreport.com