MACLEODFINANCE SUBSTACK

Preparing for China's gold standard

Recent moves by the Chinese state indicate that she expects a full-on dollar crisis and is moving to protect her own currency by linking it to gold.

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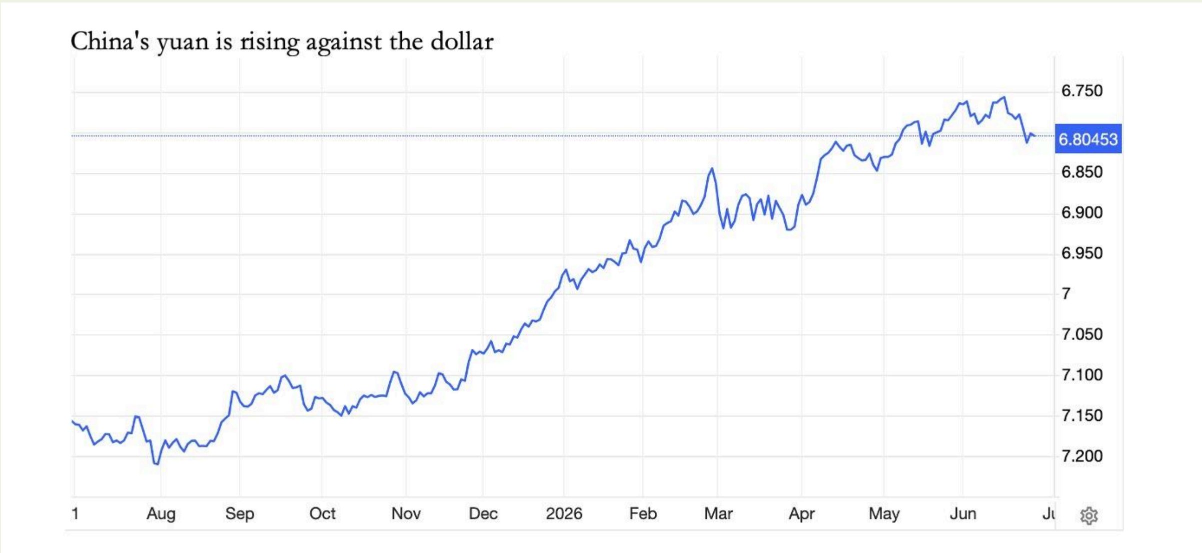


China's yuan has been rising against the US dollar. But it hardly begins to tell the real story. The Chinese state is bailing out of the dollar, buying almost anything just to get rid of them. And you don't have to be the Brain of Beijing to understand why — the US's disastrous campaign against Iran has badly backfired leading inevitably to an economic slump for all G7 nations, the bailouts of which will destroy the values of their currencies starting with the US dollar.

China sees this writing on the wall and is moving to save herself and her trade partners from the consequences.

Introduction

There is a timeline of events which strongly suggests that China expects that the global dollar-based fiat currency regime is coming to an end. These developments are all about the dollar's replacement, and securing the value of the as-yet fiat renminbi with a link to gold.

One concern of the Chinese authorities is that the transition should be smooth. **Speculation in gold and silver is being shut down** and hoarding physical gold through gold accumulation accounts is encouraged. These developments emerged only last week, and the major banks have been behind much of the buying. There has been some commentary in the western blogosphere, but it mostly misses the point. The purpose of this article is to explain that China has been working to a plan, commencing with the appointment of the Peoples Bank (PBOC) in 1983 with exclusive control of national gold and silver accumulation and trading, alongside its foreign exchange dealing monopoly.

The timing of this article is triggered by events last week, which strongly suggest preparations are being made by China for the beginning of the end for the dollar. They include accelerating the establishment of Hong Kong as the world's major gold and silver trading hub, replacing London and New York which being based on dollars will cease to function with the dollar's collapse.

These are major developments, and the rest of this article examines the reasoning behind China's actions, and the steps taken to ensure that China emerges safely from the end of the fiat currency era.

The original hypothesis

China was not exposed to the Keynesian-based macroeconomic theories which led to the end of conventional monetary systems in 1971, when the Bretton Woods Agreement was finally abandoned by the then-developed world. China emerged from the Mao era understanding that a metallic standard was required to guarantee a currency's purchasing power. This was one thing which China's Marxist universities could agree on, the other being that a fiat currency was always doomed to fail, unequivocally proven by history.

Nevertheless, they were going to play by the fiat currency rules by expanding their banking system to ensure there would be credit available for Chinese-based businesses to develop and expand. But the planners knew they would still have to insure for a post-fiat currency world, which meant accumulating gold and silver in large quantities, more or less from scratch. It would have to be done secretly so as to not threaten the US and her currency's standing because the dollar was almost the only global trade currency.

Accordingly, Regulations of the PRC on the control of Gold and Silver were promulgated on June 15, 1983, by the State Council. Article 1 sets the scene:

> These Regulations are formulated to strengthen control over gold and silver, to guarantee the State's gold and silver requirements for its economic development and to outlaw gold and silver smuggling and speculation and profiteering activities.

Article 3 appoints the PBOC as the state organ responsible for the control of gold and silver in the People's Republic. And,

> The total income and expenditure of gold and silver of State organs, the armed forces, organisations, schools, State enterprises, institutions and collective urban and rural economic organisations… shall be incorporated into the State plan for the receipt and expenditure of gold and silver.

The effect of the legislation was for the State to accumulate gold and silver using the PBOC. It was to be hidden by being widely distributed through diverse government entities. Initially, gold ownership was banned for citizens until 2002 when the PBOC established the Shanghai Gold Exchange (SGE). Until then, the PBOC had a clear run accumulating gold and silver for the State.

Other than the PBOC itself, no one knows how much gold it accumulated on behalf of the State between 1983—2002, or indeed subsequently. Bearing in mind that with equally strict exchange controls, the PBOC had the means to divert growing quantities of dollar inflows and outflows into gold purchases. Just 10% of them at contemporary gold prices was the equivalent approximately of 20,000 tonnes.
We can only guess at the true figure, but the 20,000-tonne number was certainly possible, and could be an underestimate for the following reasons:

- According to analyst Frank Veneroso, between the early 1980s and 2002, between 10,000—14,000 tonnes were leased by central banks and sold into the market. Much of the supply for China would have come as a result of these leasing activities.
- Gold suffered a significant bear market between 1981—2002, with even Swiss private banks selling customers' holdings, providing perhaps an extra 5,000 tonnes.

- Global mine supply accelerated, with above ground stocks increasing by 41,100 tonnes between those dates, which was fully absorbed despite the bear market. China also invested heavily in her own mine output, which out of the global total supply was about 2,000 tonnes.

After the SGE was established, the State even advertised the attractions of gold ownership and by today over 28,000 tonnes have been delivered from the SGE's vault network. This does not include scrap, for which figures are not available. Mostly, this was rendered into jewellery with some being fabricated into coin and small bars. But in addition, within the SGE's vaults there are significant gold reserves earmarked for investment vehicles and to back gold accumulation accounts at the commercial banks.

The State continues to accumulate gold, only some of which appears in the form of reserves on the PBOC's balance sheet. Global above ground stocks have increased to about 200,000 tonnes, 67,000 more than existed in 2002, about 10,000 of which is output from China's mines. Virtually no gold leaves China, yet she still imports it in quantity: in the five months to May this year, China imported about 700 tonnes and mined an extra 150 tonnes.

Given all these factors, we can put together a rough estimate of how much gold is now locked up in China:

Estimated gold ownership in China		*Tonnes*
China State 1983-2002		20,000
China State accumulation post 2002, say		15,000
PBOC reserves		2,332
Chinese citizens withdrawal from SGE		28,000
Chinese bank accumulation accounts and other investment vehicles, say		5,000
	TOTAL	**70,332**

Note: Scrap supplies, particularly from Chinese citizens are combined in the total but will represent shifts into other ownership categories.

This amounts to 35% of global above-ground stocks. Clearly, whatever the true figure the state has sufficient bullion for a credible gold standard to back its renminbi. This is the basis upon which the PBOC's future monetary policy will evolve, based on decisions taken over forty years ago.

More recent events

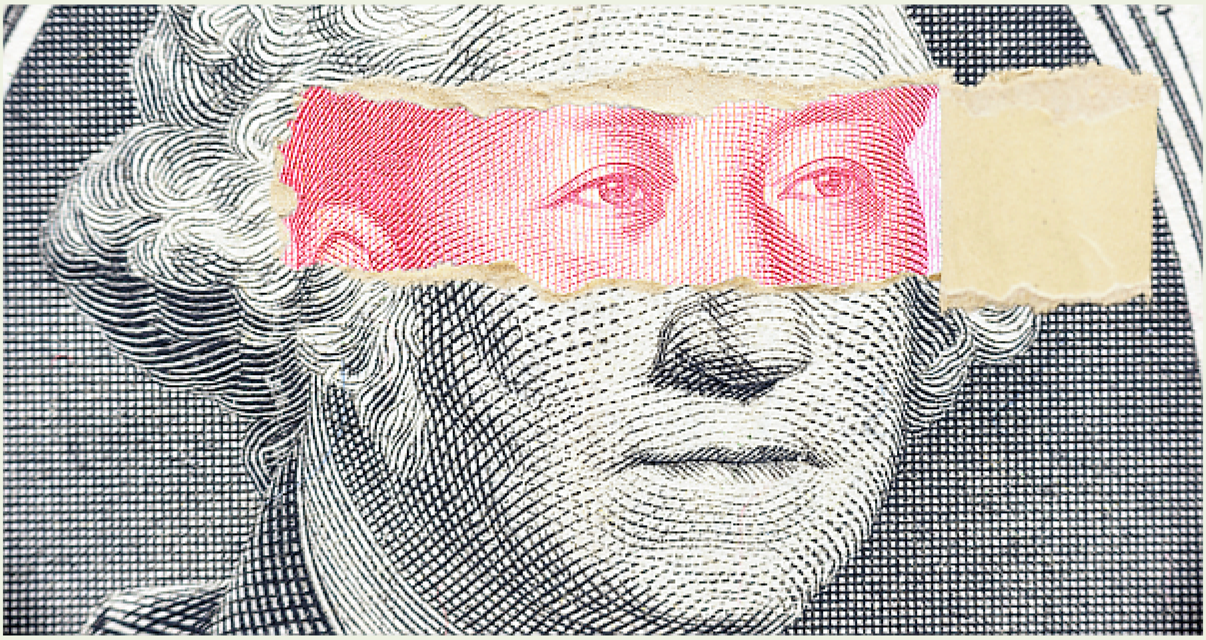
As China's trade-based influence has spread, she has been able to set up parallel settlement systems for cross-border trade. Originally developed in 2012, the growth of China's Cross-Border Interbank Payment System (CIPS) has accelerated more recently with users encouraged by America's weaponisation of the dollar. CIPS still accounts for only a modest proportion of global trade settlement and finance, but the point is that it has nearly 200 direct and 1,600 indirect participants in over 124 countries, and as a yuan-based settlement alternative to SWIFT it is instantly accessible.

The next move was to establish international gold-for-yuan exchange facilities, and it is to this end that SGE (International) vaults and delivery hubs have been established in Hong Kong and in Saudi Arabia. The Middle East is a major energy supplier for China, which means that exporters end up with renminbi. The facility allows them to exchange renminbi for gold, which with similar facilities in Hong Kong establishes a mechanism whereby the PBOC can at any time establish a fixed rate of exchange: in other words, put the renminbi onto a gold exchange standard.
Other gold-for-renminbi exchange vaulting facilities are reportedly planned in Singapore, Malaysia, Dubai, and even Zurich has been mentioned. But the US's attack on Iran and the closure of Hormuz will undoubtedly destabilise G7 economies and their currencies sooner than China will have planned for. She has had to up the pace for her plans.

Only weeks before the Iran war started, China's PBOC gave guidance to her banks and broader financial institutions to limit purchases of dollar-denominated bonds and to reduce their positions "if too high". This unusual message suggests that China's authorities were taking the view that the US would lose the war which was imminent and that the consequences for dollar bonds and the dollar itself would be disastrous. At the same time, gold prices had soared before correcting, indicating that market concerns about the dollar's future were mounting.

Despite the volatility in the dollar/gold exchange rate, China has been dumping dollars rapidly by buying gold, silver, and copper. Exports of rare earths, sulphuric acid, and fertilisers all of which would have earned dollars have ceased. And then we had some important developments last week.

Chinese banks are winding down or suspending leveraged gold and silver trading services for Chinese citizens with a cut-off date commonly 24th July. Gold accumulation plans, ETFs and options purchased for cash are unaffected. Banks reported to be taking these and similar actions include ICBC — the world's largest bank, Postal Savings Bank, Ping An, China Construction Bank, and Guangfa Bank to mention a few.



These actions suggest that the banks have been told to protect themselves against a dollar crisis.

Separately, China is beefing up gold and silver dealing facilities in Hong Kong. A cooperation agreement between SGE and Hong Kong was signed in January to establish a cross-border gold trade clearing system. The SGE has already opened its offshore vault and launched yuan-denominated gold contracts.

Hong Kong has also established Hong Kong Presious Metals Central Clearing Company, which is a copy of the London Precious Metals Clearing Limited central clearing operation. A massive expansion of gold storage capacity is planned, and incentives are being introduced to expand refining and processing facilities in Shenzhen to service the Hong Kong market.

If the dollar collapses as China expects, gold trading in London and New York will simply cease for lack of a credible settlement medium. Global gold trading will continue in Hong Kong. With China leading the way back to gold standards for currencies, gold trading will have gravitated eastwards along with most of the world's gold.