Will Chinese Monetary Authorities Acquire More Gold?

At a Meeting of the New York Society of Security Analysts entitled, "Gold: A Necessary Asset Class Not Just for the Doomsday Scenario"

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I wish to start our discussion tonight by assuming that we are turning the clock to a new Day Light Losing Standard by saying today's date is June 5, 1947 rather than 2010. I start June 5th by saying:

> ***"Tomorrow will be the 3rd anniversary of the Invasion of Normandy and I have just learned that Secretary of State, George Marshall, will speak in a few minutes at Harvard University. He will advocate a plan for economic recovery of Europe of Western Europe. This will prevent European governments from destabilizing.***
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> ***But I am afraid to tell you that international reserves are insufficient for an expansion of international trade. Gold production does not increase monetary reserves sufficiently. The only solution is for the United States to increase the number of dollars in circulation outside its borders so foreign central banks will have more reserves in order to expand international trade and subsequently their domestic economies. That means a deficit in America's balance of trade."***

Let's fast forward to 1960, when the term, "the Triffin Dilemma," described the conflict with the U.S. dollar as a reserve currency. More dollars in foreign hands were necessary for more foreign trade, but more dollars put at risk the purchasing power of this reserve asset and the stability of the Bretton Woods Agreement. Then on August 15, 1972, this glue failed.

Take a look at modern China. A large population and a low GINI coefficient with many people in rural areas prompt a significant policy decision. One solution is to favor large exports, which will employ large numbers of people and allow rural people to migrate to better paying jobs. You already know that a cheap currency is an incentive for foreign buyers to shop in your currency. With this view, I am going to make an assumption, which can sometimes be a chopping block for one's career. Nevertheless, this is mine:

> ***China needs mercantilism. As you recall, this means exports are to exceed imports, so that the exporting country will build up a surplus in its reserves. If you think that China is going to allow its pegged dollar exchange rates lead to a balance in its trade, I beg to differ. China needs surpluses in order to grow its economy, not only for favoring an export-driven economy but also for meeting its import needs. For example, much of the growth in oil consumption worldwide is coming from China. The Chinese currency is not convertible, so international reserves are needed.***
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> ***China needs mercantilism for another reason, namely to increase employment. Can you imagine how many jobs are needed each year in order to keep up with such a large population, even though there is a single child policy in effect?***

So let's take a deep breath after these panoramic sweeps. China pegs its currency to the dollar. By maintaining a peg, the Chinese government is forced to intervene in the yuan-dollar exchange market to supply yuan when the demand from dollars is greater than the supply. A combination of US importers, foreign direct investors, portfolio investors and hot money are buyers of yuan.

When the Chinese central bank supplies yuan, these monies end up in China's money supply. The central bank has a few options currently to deal with any overheating in the local money supply. It can tighten monetary policy by raising reserve requirements and/or raise interest rates in the local domestic capital markets. Or, it can operate a sterilization program buying up the excess money supply. These operations are boiler plate responses that satisfy the Chicago/Milton Friedman School of Economics theory that inflation is merely a monetary phenomenon.

While the above options are available, tools to deal with an overwhelming increase in Chinese money supply are not available, particularly when exports increase strongly. For example, February's exports increase 46% from year earlier data. Can these kinds of gains continue for a longer period of time and be consistent with stable inflationary pressures? No! Tightening monetary policies and sterilizations have limited effects under circumstances of robust exports. So it is reasonable to expect the Chinese to reach out for some method to moderate their large purchases of dollars and also seek to have a monetary asset which has the chance to gain in purchasing power. The Chinese fear a decline in the purchasing power of the US dollar, which is suffering from twin deficits in Washington and our balance of trade. Abolishing foreign exchange control could help. This would allow Chinese investors the ability to purchase foreign investments.

Will China change from having so much of its reserves in US dollars? Yes, I think so. Will China allow the exchange rate float freely per supply and demand and satisfy the complaints of western economists and political leaders? No, I do not think so. It will keep its currency cheap for mercantile reasons. Will China diversify its reserves? Just because we, as investment analysts and portfolio managers are taught the benefits of diversification, can't we honestly expect the Chinese monetary authorities to diversify? Remember the old saying ***"Don't keep all your eggs in one basket?"***

Yes, it is reasonable to expect the Chinese monetary authorities to diversify. Gold is the only asset in the international monetary system that is not someone else's liability, and it is a perfect option. Gold may be viewed as the world's second reserve asset next to dollars.

All of the above fits into what I would call a resurgence of Keynesianism. In his *"Notes on Mercantilism,"* in his General Theory, Lord Keynes ran a thread from greater money supply by monetary injection, to a lower interest rate and then to greater Big I- Investment, to greater employment and then greater Big C - Consumption. The mercantilists love this because it leads to their advocacy of export surpluses and the build up of reserves, which was gold under the Gold Standard, but is now dollars under the Dollar Standard. It also fits in with the mercantilist's advocacy of national advantages instead of international advantages.

I close with an advertisement for my committee, The Investment Strategy Committee of the New York Society of Security Analysts. We hope to put on a conference on October 21, 2010, a few days before the mid-term elections concerning something along the lines of, ***"Investment Implications of Adopting a Keynesian Perspective."*** I hope you will stay tuned in.

Thomas Hart Wilkins, CFA is Chief Executive Manager of Joseph Jekyll Advisers LLC, an investment advisory firm. The firm honors an unsung hero of American history, Sir Joseph Jekyll, who is described by Wilkins in the Georgia Historical Quarterly, Volume XCI, Summer, 2007, Number 2. Tom began his investment career in 1966 on the floor of the New York Stock Exchange, later promoted to investment research and then portfolio management. In later years, he went back to university and earned his M.A. (economics) from the University of Georgia in 2002, where he argued for, "An Economic Interpretation of the Founding of the Colony of Georgia." He is a Chartered Financial Analyst, a Georgia-registered Investment Adviser, and a member of the New York Society of Security Analysts (NYSSA where he was a Past Director, a Past Chairman of the Program Committee and the recipient of the Volunteer of the Year in 1983.

As a member of the CFA Institute, Tom authored an article on market-to-market accounting in the CFA Magazine (2009) during the apex of the 2008-2009 financial crisis. His review of Nobel prize winner George Akerlof's book appeared in The Investment Professional, where he was once a member of the magazine's Editorial Board. He also authored an article on,"Saturday Night Fever at the Federal Reserve Board," after attending the 1979 Annual Meeting of the International Monetary Fund held in Yugoslavia. He was an early advocate of gold as an alternative investment, and sponsored meetings in New York, California, and Johannesburg, South Africa. Mr. John C. van Eck of International Investors, Inc. was an early mentor. Tom is also a member of the CFA Society of Atlanta, and the CFA Society of North Carolina. He is an exam grader for the 2010 Investment Research Challenge at The New York Society of Security Analysts, and also a columnist for the Shanghai-based ChinaStakes.com.