Chinese CFOs Think China should Triple Gold Holdings

By Claude B. Erb and Campbell R. Harvey

China's official gold holdings are 1,054 metric tons which ranks sixth in the world. However, a single Exchange Traded Fund, the SPDR GLD, holds more gold than China. Furthermore, gold represents only 1.7% of China's foreign exchange reserves. This sharply contrasts with the U.S. (76.3% of reserves) and Germany (73.5% of reserves).[1]

Duke-CFO Survey Results

In the recent Duke-CFO Global Outlook Survey, we asked Chinese CFOs their view on China's official holdings. The respondents are mainly drawn from manufacturing firms. On average their sales revenue is about $440 million and the average number of employees is 1,650.

Of the 43 respondents, 62.8% thought that the gold holdings should increase. Only one respondent thought that the gold holdings should be decreased.

We also asked the CFOs what the target level of gold should be by 2015. Extraordinarily, the CFOs thought that the official holdings should more than triple to a level of 3,616 metric tons.

In our research paper "The Golden Dilemma", we do the following exercise. The U.S. gold (metric tons) to GDP (billions) ratio is 0.56. The current ratio for China is 0.18. How much gold would China need to hold to match the U.S. ratio? It is 3,279 metric tons – which is remarkably close to the survey results.

Is it possible to get to 3,000+ metric tons? Since the first quarter of 2000, China has accumulated more gold than any other country. Over this period, China has added 690 metric tons – or roughly 50 metric tons per year.[2] Indeed, the entire world gold production in 2011 was only 2,700 metric tons[3] and Jewelry and Industrial/Dental consumed 2,425 metric tons of it. To hit the 3,616 target, China would have to be accumulating 800 metric tons a year over the next three years which seems infeasible.

[1] See World Gold Council (2013) World Official Gold Holdings.
[2] In April 2009, China announced the purchase of 454 metric tons of gold. However, this purchase took place over the previous six years, amounting to an accumulation of 76 metric tons per year.
[3] See U.S. Geological Survey.

China's Gold Strategy

There are at least two reasons to consider owning gold. The first reason is that an individual might not trust their own government to maintain a stable currency. The second is a country might trust the currencies with which your trading partners buy your exports. Given the economic troubles in America and Europe, China has every reason to believe that the dollar and the euro are risky.[4]

Gold is just one of the ways that China can deal with its large dollar and Euro reserves. China has at least three choices: 1) continue to accumulate reserves in the risky currencies of trading partners, 2) convert some of its reserves into holdings of gold or other real assets, or 3) start conducting trade in yuan.

Benjamin Franklin, one of the Founding Fathers of the U.S., once noted that "distrust and caution are the parents of security". If China continues to accumulate dollars and Euros, it will have done nothing to alleviate the fact that it questions the intentions of its trading partners. The status quo is a 'kick the can down the road' scenario.

Is there reason to believe that the value of the dollar and the Euro will decline in the future? Yes. It is simply common sense to be prepared for negative outcomes. Is it a foregone conclusion that the value of the dollar and the Euro will plunge to zero? No. The search for economic security requires greater diversification of the tools of economic trade.

It is also worth considering that investing out of necessity rarely leads to a good bargain. To accumulate at a rate of 200 metric tons a year (let alone 800) would cause gold prices to soar. This is because all the gold in the world is already owned by someone and the only way to accumulate a large gold holding is to pay a high price.

The American investor Warren Buffett is fond of saying that "price is what you pay and value is what you get". The value of gold may not increase if China buys gold, but the price of gold will increase. Yet as we show in our research paper,[5] the inflation adjusted price of gold, the real price of gold, is already high. If China bought all of the newly mined gold over the next year, the price of gold might double. In a very approximate way the price of gold is already pricing in a 50% decline in the value of the dollar and the Euro. Also, sizable Chinese purchases of gold, by driving up the price of gold, will increase the wealth of those who already own the gold. Large scale Chinese purchases of gold will primarily benefit gold owners outside of China.

[4] Japan is the third largest trading partner. However, in contrast to the U.S. and Europe, China has a trade deficit with Japan and has not accumulated significant Yen reserves.

[5] Erb and Harvey (2013) show that if the price of gold reverts to its mean, the target price is $780.

In the end, one might consider gold to be a very expensive insurance policy against a collapse in the value of the dollar and the Euro.

A Sound Currency

In the post 1948 period, Deutsche Mark was viewed as a sound currency because German monetary policy was essentially the same thing as a "gold standard". The Mark was not viewed as a sound currency because the Germans had reserves of gold. It was viewed as a sound currency because the Germans followed sound economic policies. These policies favored economic growth through exports, low inflation and a culture that encouraged both citizens and the government, on average, to live within their means.

Buying gold might be a psychologically rewarding way for China to reduce its exposure to the dollar and the Euro. However, moving into gold, and away from the dollar and the Euro, is likely to be very expensive. Following "gold standard"-like economic policies (no currency conversion into gold but a currency in which the growth of the money supply is perceived to be low), would probably benefit China more than the purchase of gold.

What does this mean for China? Gold might be a barometer of failed economic policies. Investing in barometers is not the answer; responsible economic policies are the answer.

Economic Policies

As long as China follows prudent economic policies then it has enough gold for the orderly operation of its economy. In fact, a healthy economy that follows sound economic policies may not even need any gold reserves. Think about it this way: would China have grown more rapidly if it had more gold? Probably not. Going forward a question to ask is whether China will be better off asking that its exports be paid for in gold or in dollars and Euros.

The best insurance going forward lies in sound economic policies both from a government and individual perspective. First, debt should be used in moderation by governments, businesses, and households. Second, governments should strive to eliminate persistent deficits. Third, the economy should run a moderate trade surplus. Fourth, the government should ensure that social welfare programs such as pensions and health care are sustainable.

It is hard to find any connection between the size of a country's gold reserves and the health of that country's economy. What matters for the health of an economy is that a country follows prudent economic policies.

Conclusion

Holding a lot of gold does not ensure economic stability. Growth and stability come from prudent economic policies. That said, it is reasonable to question China's risk management when gold represents only 1.7% of foreign currency reserves. China should be debating different ways to manage the risk of their huge currency holdings. The role of gold should be part of that debate.

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Links

The above article is available in English:

- http://faculty.fuqua.duke.edu/~charvey/ChinagoldE.pdf

and in Chinese:

- http://faculty.fuqua.duke.edu/~charvey/ChinagoldC.pdf

The main research paper is available at:

- Erb, Claude B. and Campbell R. Harvey, 2013. The Golden Dilemma. SSRN: http://ssrn.com/abstract=2078535