

## Shocking Breakdown of China's Foreign Reserves is Bullish for Gold

July 1, 2016

I want to focus on the composition of China's foreign reserves, explain why the liquid portion of the reserves may be much smaller than widely believed, and how that situation is bearish for RMB and bullish for gold.

According to Wikipedia:

"The foreign-exchange reserves of China are the People's Republic of China holdings of cash, bank deposits, bonds, and other financial assets denominated in currencies other than China's national currency (renminbi). At the end of January 2016, the foreign-exchange reserves of China stood at US\$3.23 trillion. The management of foreign-exchange reserves is governed by the State Administration of Foreign Exchange and the People's Bank of China. The composition of foreign-exchange reserves is a state secret in China."<sup>1</sup>

We managed to retrieve the following financial data from the China State Administration of Foreign Exchange (SAFE) website ([www.safe.gov.cn](http://www.safe.gov.cn)):

### 官方储备资产 (2016.01 2016.05)

#### Official reserve assets

项目 Item	2016.01	2016.02	2016.03	2016.04	2016.05
	亿美元 100million USD	亿美元 100million USD	亿美元 100million USD	亿美元 100million USD	亿美元 100million USD
1. 外汇储备 Foreign currency reserves	32308.93	32023.21	32125.79	32196.68	31917.36
2. 基金组织储备头寸 IMF reserve position	37.60	107.25	107.24	106.51	104.22
3. 特别提款权 SDRs	102.73	102.80	104.85	105.48	104.41
4. 黄金 Gold	635.70	710.06	714.85	747.51	704.75
5. 其他储备资产 Other reserve assets	-2.05	-3.30	1.72	5.16	5.71
合计 Total	33082.92	32940.02	33054.45	33161.35	32836.43

## 国际储备与外币流动性数据模板

### Template on International Reserves and Foreign Currency Liquidity

<sup>1</sup> [https://en.wikipedia.org/wiki/Foreign\\_exchange\\_reserves\\_of\\_China](https://en.wikipedia.org/wiki/Foreign_exchange_reserves_of_China)

2016年4月30日  
As at Apr 30 2016

## 一、官方储备资产和其他外币资产（近似市场价值）

### I. Official reserve assets and other foreign currency assets (Approximate market value)

	(亿美元) 100million USD
A. 官方储备资产 Official reserve assets	33,161.35
(1) 外汇储备（可兑换外币） Foreign currency reserves (in convertible foreign currencies)	32,196.68
(a) 证券 Securities	32,028.18
其中：总部设在报告国但办事处位于国外的发 行人 <i>of which: issuer headquartered in reporting country but located abroad</i>	
(b) 货币和存款总额，存放于以下机构： Total currency and deposits with:	168.50
(i) 其他国家的中央银行、国际清算银行和基金组 织 other national central banks, BIS and IMF	25.66
(ii) 总部设在报告国的银行 banks headquartered in the reporting country	72.30
其中：办事处位于国外的银行 <i>of which: located abroad</i>	72.30
(iii) 总部设在报告国以外的银行 banks headquartered outside the reporting country	70.54
其中：办事处位于报告国的银行 <i>of which: located in the reporting country</i>	
(2) 基金组织储备头寸 IMF reserve position	106.51
(3) 特别提款权 SDRs	105.48
(4) 黄金（包括黄金存款和适用情况下的黄金掉期） Gold (including gold deposits and, if appropriate, gold swapped)	747.51
以盎司计算的纯金数量（百万盎司） volume in millions of fine troy ounces	58.14
(5) 其他储备资产（请列明） Other reserve assets (specify)	5.16

金融衍生产品 financial derivatives	5.16
对非银行非居民单位的贷款 loans to nonbank nonresidents	
其他 other	
<b>B. 其他外币资产 (请列明)</b> <b>Other foreign currency assets (specify)</b>	<b>2,042.43</b>
未列入官方储备资产的证券 securities not included in official reserve assets	1,967.70
未列入官方储备资产的存款 deposits not included in official reserve assets	
未列入官方储备资产的贷款 loans not included in official reserve assets	70.22
未列入官方储备资产的金融衍生工具 financial derivatives not included in official reserve assets	4.50
未列入官方储备资产的黄金 gold not included in official reserve assets	
其他 other	

As expected, this disclosure didn't say a whole lot, as 97% of the reserves assets fall into category A(1) -- "Foreign currency reserves (in convertible foreign currencies)". Furthermore, 99% of category A(1) falls into the A(1)(a) "Securities" category.

So what's in the "Securities" category?

The following article published September 2, 2015 in *Nikkei Asian Review* entitled "Does China really have \$3.6tn in foreign reserves?" reported:

"Funds available for foreign currency purchases declined because the authorities had to sell Treasurys to meet demand for dollars and other foreign currencies associated with capital flight. 'The PBOC has sold at least \$106 billion of reserve assets in the last two weeks, including Treasurys, according to an estimate from Societe Generale,' U.S. wire service Bloomberg reported Aug. 27.

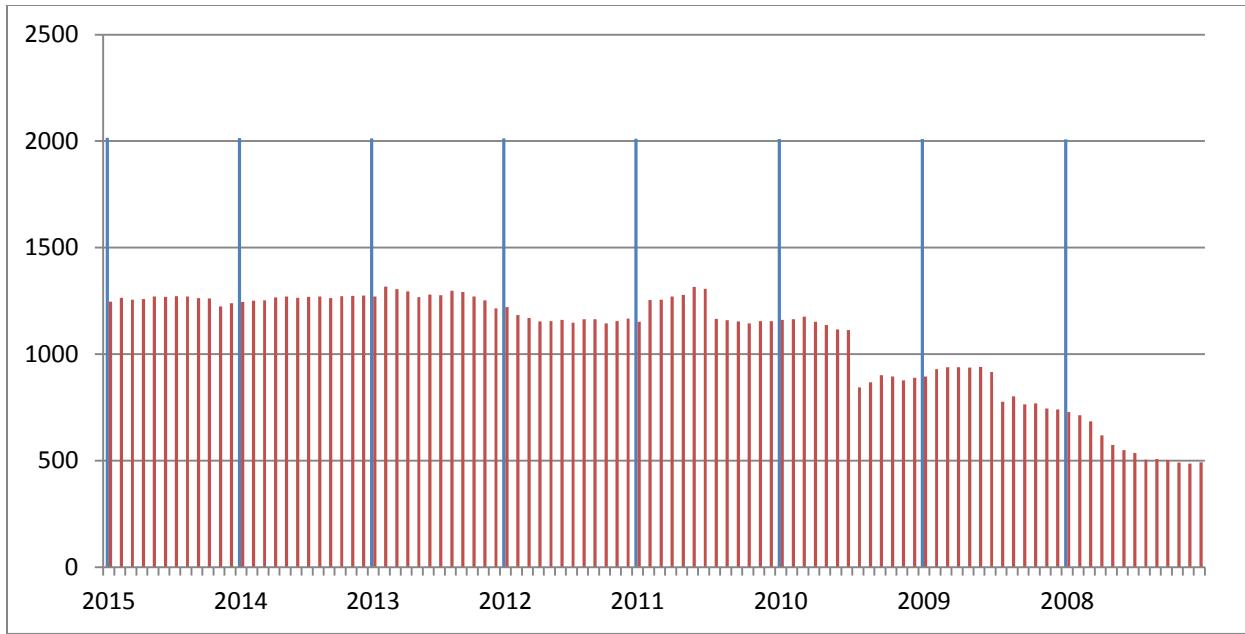
According to data from the U.S. Treasury Department, China's Treasury holdings -- \$1.82 trillion -- were only about 45% of its total foreign reserves...

China invests some of that money in Euro bonds, Japanese government bonds and Japanese, U.S. and European stocks, but 'it is unknown how China manages at least \$1 trillion of foreign reserves,' said a veteran market economist.<sup>2</sup>

Through the US Treasury Department's website (<https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/ticsec2.aspx>), I was able to plot the following:

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<sup>2</sup> Y.Takita, "Does China really have \$3.6tn in foreign reserves?" *Nikkei Asian Review* (2 September 2015).



China's US Treasury holdings (in US\$ Billions)

It's clear China's US Treasury holdings have held steady between US\$1.2 and \$1.4 trillion during 2010 to 2016, and likely comprise the single most significant portion of the category A(1)(a) "Securities".

And what about the other US\$2 trillion under "Securities"?

Based on publicly available information, the answer led us to China Investment Corporation (CIC), which is a sovereign wealth fund responsible for managing part of the People's Republic of China's foreign-exchange reserves. CIC was established in 2007 with approximately US\$200 billion worth of assets under management.<sup>3</sup> At the end of 2014, the CIC had over US\$740 billion in assets under management.<sup>4</sup> CIC's holdings increased from US\$200 billion in 2007 to over US\$740 billion by means of capital gains, income gains or additional cash/asset injections by the People's Bank of China/SAFE. If we assume CIC's assets stay at US\$740 billion today (although they are likely to have increased, as they have every year since 2007), they will make up over 23% of China's total foreign reserves holdings in 2016.

Adding up the numbers, this leaves us with roughly US\$1.2 trillion worth of unexplained assets remaining under "Securities".

To answer the question of what these "Securities" are, we have to first examine what's held in CIC, then we will come back to where we think the remainder of the "Securities" went, as I believe through my research, that those two issues are interlinked.

What makes up CIC's fund?

We retrieved the following financial information from CIC's latest annual report from its website (<http://www.china-inv.cn/>):

<sup>3</sup> [https://en.wikipedia.org/wiki/China\\_Investment\\_Corporation](https://en.wikipedia.org/wiki/China_Investment_Corporation).

<sup>4</sup> China Investment Corporation Profile. Sovereign Wealth Fund Institute. July 2, 2008. Retrieved August 27, 2013.

As of December 31, 2014

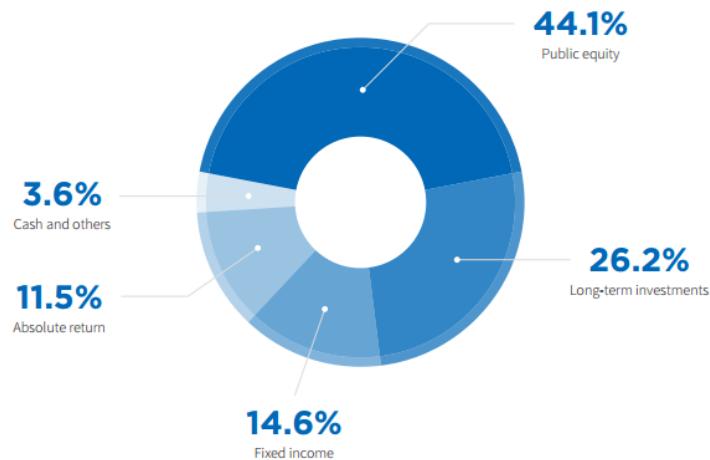
(Amount in millions of US dollars)

	2014	2013
<b>Assets</b>		
Cash and deposits	23,939	27,884
Financial assets at fair value through profit or loss	225,321	205,197
Receivables and prepayments	2,877	3,437
Available-for-sale investments	668	421
Loans	-	754
Long-term equity investments	489,147	412,416
Deferred tax assets	1,648	1,556
Other assets	3,130	1,498
<b>Total assets</b>	<b>746,730</b>	<b>653,163</b>
<b>Liabilities</b>		
Financial liabilities at fair value through profit or loss	1,744	2,189
Bonds payable	17,990	18,051
Deferred tax liabilities	7,023	5,828
Other liabilities	10,624	7,865
<b>Total liabilities</b>	<b>37,381</b>	<b>33,933</b>
<b>Owner's equity</b>		
Owner's capital	200,000	200,000
Capital reserves and others	509,349	419,230

For the year ended December 31, 2014

(Amount in millions of US dollars)

	2014	2013
<b>Investment income</b>		
Interest income	2,448	2,643
Dividend income	3,368	3,289
Net realized gains on investments	9,141	3,952
Unrealized gains (losses) from changes in fair value of investments	1,217	9,796
Investment income from long-term equity investments	79,383	73,259
Foreign exchange gains (losses)	(821)	(548)
Other income	133	109
<b>Total investment income</b>	<b>94,869</b>	<b>92,500</b>
<b>Expenses</b>		
Investment expense	(342)	(444)
General and administrative expense	(171)	(156)
Finance expense	(647)	(642)
<b>Total expense</b>	<b>(1,160)</b>	<b>(1,242)</b>



The composition of the above 2014 Global Investment Portfolio Distribution pie chart is, I assume, a breakdown of the "Financial assets" under the balance sheet (i.e. 2014: US\$225,321 million).

How about "Long-term equity investments" under the balance sheet (i.e. 2014: US\$489,147 million)? This investment grew from US\$171 billion to \$489 billion in 2014, consistently generated 15% to 20% annual investment income, and is what drove CIC's meteoric rise in asset base.

	2014	2013	2012	2011	2010	2009	2008
Long-term equity investments	489,147	412,416	356,097	304,880	253,340	201,409	171,156
Investment income	2,014	2013	2012	2011	2010	2009	2008
from long-term equity investments	94,869	92,500	63,358	53,383	40,761	31,706	26,253
							US \$billion

Source: <http://www.china-inv.cn/>

The 2014 Annual Report is vague about what CIC's "Long-term equity investments" are. I managed to find out under a footnote in the 2010 Annual Report:

#### Consolidated Balance Sheets

As of December 31  
(Amount in millions of US dollars)

	2010	2009
<b>Assets</b>		
Cash and deposits	14,480	18,622
Financial assets at fair value through profit or loss		
Cash management products	3,458	20,673
Equities	65,645	39,828
Fixed income securities	34,932	25,383
Alternative investments	29,274	7,430
<b>Total financial assets at fair value through profit or loss</b>	<b>133,309</b>	<b>93,314</b>
Receivables and prepayments	4,210	3,067
Available-for-sale investments	113	—
Held-to-maturity investments	2,000	14,424
Long-term equity investments*	253,340	201,409
Deferred tax assets	1,046	962
Other assets	1,081	596
<b>Total assets</b>	<b>409,579</b>	<b>332,394</b>

\* Principally comprised of investments by Central Huijin

CIC's Long-term equity investments are “\*Principally comprised of investments by Central Huijin”.

So, what is Central Huijin?

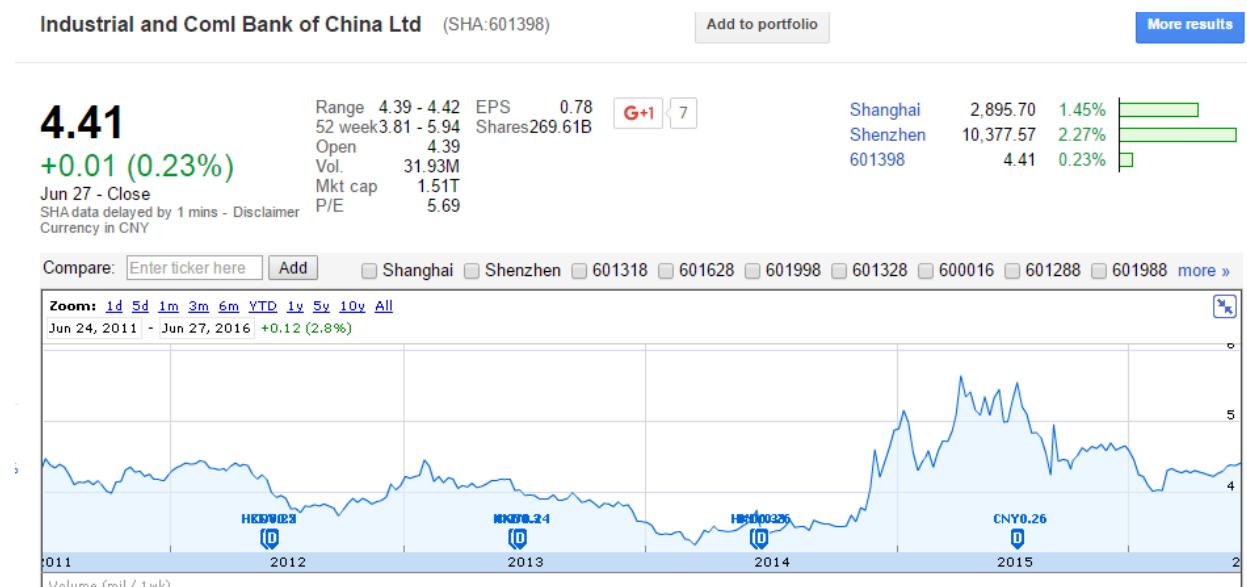
Central Huijin Investment Ltd. (Chinese: 中央汇金投资有限责任公司) is a Chinese investment company owned by the government of the People's Republic of China. It is a wholly-owned subsidiary of CIC, and an organization through which the Chinese government can act as a shareholder of the "big four" state-owned banks, thereby improving corporate governance and initiating reforms in the banking industry.<sup>5</sup>

Central Huijin was acquired from the State Administration of Foreign Exchange by the CIC for roughly US\$67 billion in 2007.<sup>6</sup>

According to CIC's 2014 Annual Report, Central Huijin held the following equity stakes in China's major banks:

Listing		% by Huijin	June.28.16 market cap*	Huijin stake	Huijin stake
n/a	China development bank	47.63%	n/a		
SHA:601398	ICBC	35.12%	1,510	530	\$80
SHA:601288	Agricultural bank of china	40.28%	1,010	407	\$62
SHA:601988	Bank of china	65.52%	921	603	\$91
SHA:601939	China constructin bank	57.26%	1,050	601	\$91
			Total	2,142	\$325
			RMB billion	RMB billion	US\$billion
					*Google Finance

If we assume all of CIC's assets are included in China's foreign reserves, then 15% of the foreign reserves are stakes in Chinese banks. The peak in Chinese banking equities coincided with the peak in China's foreign reserves which hit US\$4 trillion in 2014.



<sup>5</sup> [https://en.wikipedia.org/wiki/China\\_Central\\_Huijin](https://en.wikipedia.org/wiki/China_Central_Huijin).

<sup>6</sup> J. Anderlini, "China investment arm emerges from shadows" *Financial Times* (5 January 2008).

Only approximately US\$225 billion worth of CIC's assets (under "Financial assets" in the balance sheet) are foreign assets in the form of equities and bonds. This number was echoed in an article published in *The Wall Street Journal*, March 27, 2015: "Ding Xuedong, chairman of China Investment Corp., which has about \$220 billion in overseas assets, said in an interview with The Wall Street Journal on Friday that he sees diverging economic growth in coming years, with a resurgent U.S. leading the way."<sup>7</sup>

Now circle back to the question: what's the remaining US\$1.2 trillion worth of unexplained assets under China's foreign-exchange reserves category "Securities"?

Recall that CIC (which manages a portion of the China's foreign-exchange reserves) owns 47.63% of China Development Bank (CDB). CDB was the second-biggest bond issuer in China (after the Ministry of Finance) in 2009, accounting for about a quarter of the country's yuan bonds, and the biggest foreign-currency lender.<sup>8</sup> At the end of 2010, CDB had US\$687.8 billion in loans, more than twice as much as the World Bank.<sup>9</sup>

The question then becomes: where did the US\$687.8 billion in loans come from?

*Reuters* reported on April 20, 2015:

"The People's Bank of China will inject \$32 billion into China Development Bank (CDB) and inject \$30 billion into Export-Import Bank of China (EXIM), the magazine said in a report on its website, citing sources.

The capital injection will be conducted via converting entrusted loans into stakes, it said, adding that the central bank will become the second largest shareholder in the China Development Bank and the biggest shareholder of the Exim Bank.

The capital injections will provide long-term foreign currency for the banks to support Beijing's 'One belt, One road' initiative for boosting connectivity between Asia, Europe and Africa, it said....

China's cabinet said last week that it had approved the central bank's reform plans for CDB, Exim Bank and Agricultural Development Bank, in a bid to better finance projects during the current economic slowdown....

China had previously used part of its foreign currency reserves to recapitalise big state lenders to help them restructure and list their shares."<sup>10</sup>

EXIM does not publish figures for overseas loans. However, U.S. officials estimate that it finances more than the total export financing of the Group of Seven industrialized nations combined.<sup>11</sup>

It is entirely plausible that the remaining US\$1.2 trillion worth of foreign-exchange reserves have already been lent to CDB and Exim and the newly created Asian Infrastructure Investment Bank (AIIB).<sup>12</sup>

In summary, shocking as it may be, and contrary to popular belief, about two-thirds of China's foreign-exchange reserves are held in U.S. Dollars, approximately one-fifth in Euros, and almost all the rest in Japanese Yen and British pounds.<sup>12</sup>

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<sup>7</sup> L. Wei, "China's CIC Gearing Up Investment in Overseas Assets" *The Wall Street Journal* (27 March 2015).

<sup>8</sup> M. Forsythe and H. Sanderson, "Financing China Costs Poised to Rise With CDB Losing Sovereign-Debt Status" *Bloomberg Market Magazine* (June 2011).

<sup>9</sup> *Ibid.*

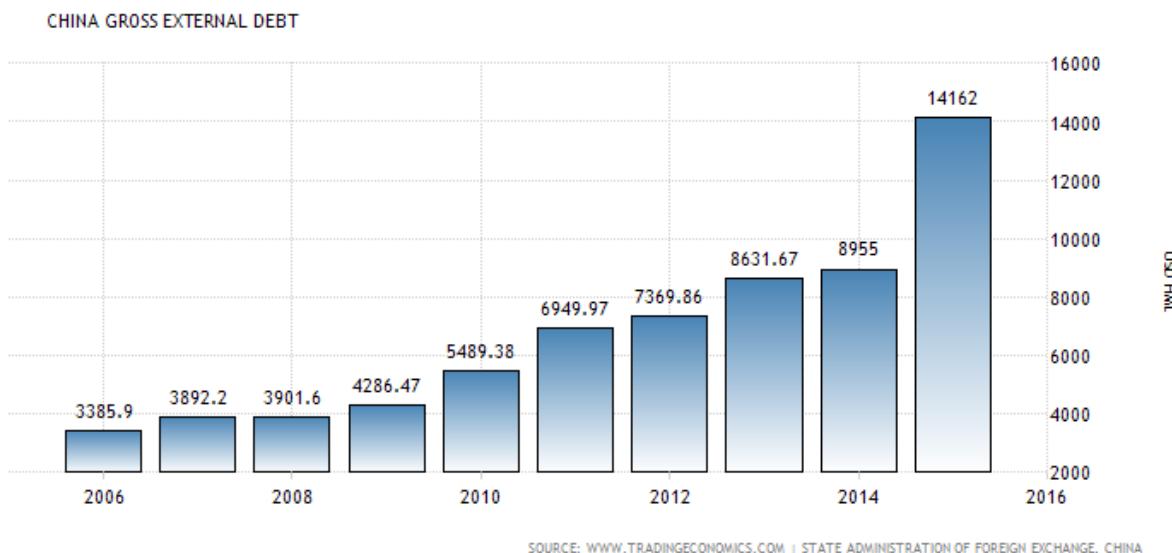
<sup>10</sup> K. Yao, "China to inject FX reserves into policy banks – Caixin" *Reuters* (20 April 2015).

<sup>11</sup> S. Reddy, "U.S. Export Financing Challenges China" *The Wall Street Journal* (12 January 2011).

Here is what I think the breakdown is of China's foreign reserves:

- US\$1.2 trillion in US Treasury holdings
- US\$80 billion in gold
- US\$740 billion in CIC (of which, approximately \$500 billion is in stakes in Chinese banks, and \$240 billion is in foreign equities and fixed income securities).
- US\$1.2 trillion in equity stakes in, and loans to: CDB, Exim and AIIB.

This would also mean that less than half of China's foreign-exchange reserves are liquid i.e. in the form of Treasury notes, cash, and gold. China reportedly spent over US\$50 billion in three days during August 2015<sup>13</sup> to support the RMB, and lost US\$500 billion in reserves in 2015.<sup>14</sup> The depleting of foreign-exchange reserves is particularly concerning given the country's current account surplus which exceeded \$300 billion in 2015<sup>15</sup>. This suggests a net capital flight in excess of \$800 billion in 2015, and I fear the numbers may be even worse when we account for the over US\$500 billion increase in gross external US dollar debt in 2015 over 2014.



Source: tradingeconomics.com

Amid full-scale capital flight, the cash/US Treasury reserves could be depleted sometime in 2017. Such an event could spell market uncertainty ahead with a magnitude bigger than that caused by Brexit. Watch for the pace of gold's bullish trend and the RMB's bearish trend to accelerate.

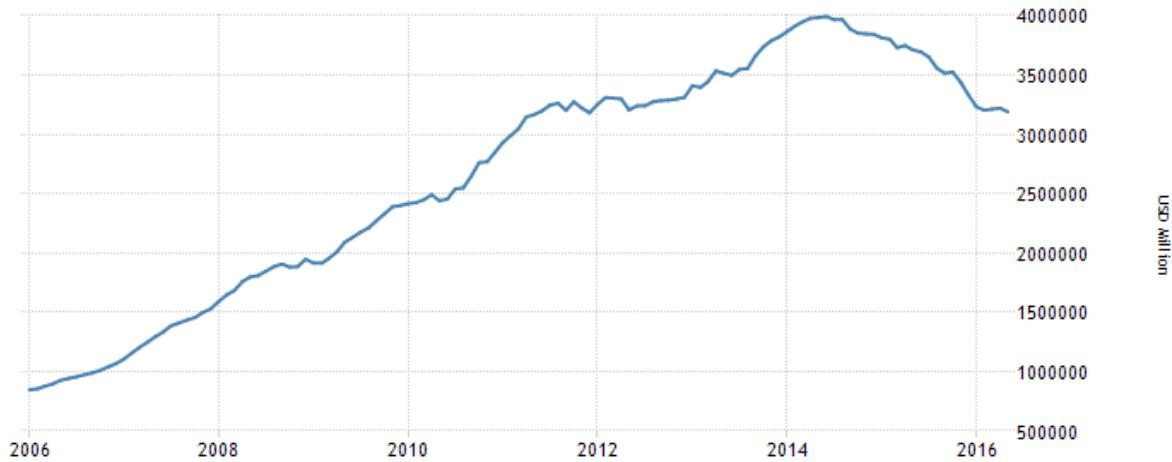
<sup>12</sup> G. Wildau, "China's large forex reserves constitute both a blessing and a curse" *Financial Times* (30 September 2014).

<sup>13</sup> L. Wei, "China's Forex Reserves Fall by Record \$93.9 Billion on Yuan Intervention" *The Wall Street Journal* (7, September 2015).

<sup>14</sup> C. Yap, "China's Forex Reserves Fall by Record \$107.9 Billion on Yuan Fears" *The Wall Street Journal* (7 January 2016).

<sup>15</sup> <http://www.tradingeconomics.com/china/current-account>

#### CHINA FOREIGN EXCHANGE RESERVES



SOURCE: WWW.TRADINGECONOMICS.COM | PEOPLES BANK OF CHINA

#### CHINESE YUAN



SOURCE: WWW.TRADINGECONOMICS.COM | OTC INTERBANK



I own physical silver and manage a company engaged in silver exploration.

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**John Lee, CFA** is an accredited investor with over 2 decades of investing experience in metals and mining equities. Mr. Lee joined Prophecy Development Corp ([www.prophecydev.com](http://www.prophecydev.com)) in 2009, as the Company's Chairman. Under John Lee's leadership, Prophecy raised over \$100 million through the Toronto Stock Exchange and acquired a portfolio of silver assets in Bolivia, coal assets in Mongolia, and a Titanium project in Canada. John Lee is a Rice University graduate with degrees in economics and engineering.