Give Full Play to the Gold Market's Investment and Hedging Function

By Zhou Xiaochuan, Governor, the People's Bank of China

The establishment and development of China's gold market marks the basic completion of the construction of a market for major financial products in China, which will provide better micro grounds for China's macroeconomic adjustment. For further development, China's gold market should gradually realise three transformations: from commodity trade to financial product trade, from spot transactions to futures transactions, and from a domestic market to integration with the international market.

The London gold market is the largest in the world; in addition it has the longest history. In 1804, London, taking the place of Amsterdam, became the center of the global gold trade; the London gold market was officially established in 1919; and the London gold futures market debuted in 1982. At present, the London gold market conducts US$2-3 billion of trade each week, accounting for 43 per cent of total global gold transactions. The London gold market is not only the largest gold sale market, but also the arena for most central banks' official gold transactions, and, more importantly, the major price-maker for gold markets in other countries and areas worldwide.

As the administrator of the London gold industry, the London Bullion Market Association (LBMA) enjoys a lofty status and has an outstanding reputation in the international gold circle. The LBMA convenes its annual meeting for precious metals in different cities around the world, which has become one of the most important international meetings for the gold market. The LBMA's choice of Shanghai for the 2004 annual meeting will facilitate communication and cooperation between China and the world gold industry, thus contributing to the further reform and the opening of China's gold market.

Compared to the long history of the London gold market, China's gold market is merely two years old, during which time, however, it has witnessed remarkable achievements. Market scale has expanded markedly; the proportion of investment has risen rapidly; a pricing mechanism is taking shape; investment varieties have diversified; and an increasing number of participants access the market. As of the end of 2003, the Shanghai Gold Exchange had 108 members. It traded 235.35 tonnes of gold worth 22.962 billion yuan in 2003, with the real delivery volume reaching 148.62 tonnes. In the same year, gold production in China stood at 200 tonnes, indicating a rosy future for the gold market.

Realising the full Potential of China's Gold Market

The international gold market and those participating in this annual meeting are concerned with the past and present of China's gold market. However, most of us are more concerned with the future reform and the opening of the gold market in China. I would like to avail myself of this opportunity to discuss the developing orientation of China's gold market. In my opinion, China's gold market should gradually realise three transformations: from commodity trade to financial trade, from spot transactions to futures transactions, and from a domestic market to integration with the international market.

First, China's gold market should move from commodity trade to financial product trade. Gold is a commodity that combines the attributes of a currency, financial commodity and general commodity. Despite the declining function of gold as currency in the world, the activeness and development of investment activities with gold as the target indicates that gold still has a strong financial nature and remains an indispensable investment tool. In major financial centers in the world, the gold market, together with the money market, securities market and FX market, constitutes the main part of the financial market.

Since China's reform and opening up to the outside world, gold has entered China's consumption domain as a general commodity, and in particular, as a consumable item. The establishment of China's gold market has satisfied the consumption demands of the public and enterprises producing and using gold. Nevertheless, the financial demand for gold investment and hedging is yet to be met, and the country still exercises control on trading of gold as a financial product. Thus the gold market's investment and financing function has not been fully explored.

How best to transform China's gold market from commodity trade into financial product trade? In light of current conditions, developing individual gold investment business is a practical option. At present, up to 12 trillion yuan stays in domestic residents' saving accounts. The launch of individual investment in gold, therefore, will allow residents to change currency assets into gold assets. At the macro level, it will expand channels for changing savings into investment, thus adjusting the money supply; in the micro aspect, allowing citizens to trade and keep gold can improve social welfare, benefiting both the country and the population. Moreover, with the dual attributes of common commodity and currency commodity, gold is a desirable instrument for hedging. Therefore, developing individual gold trade is practical.

Secondly, China's gold market must grow from spot transaction to that of gold derivatives. Currently global gold market trade can be classified into two types. The first is the traditional spot transaction, mostly found in the London, Zurich and Hong Kong gold markets. The other type is gold futures trading, including gold options, gold futures and swaps, mainly traded on the Chicago Mercantile Exchange, New York Mercantile Exchange, Mid-America Commodity Exchange and Tokyo Commodity Exchange for Industry. The development and improvement of the gold derivatives market can effectively improve the gold market's hedging, investment and financing function.

Currently, spot transactions are still the major transaction form at the Shanghai Gold Exchange, but as the market grows, the Exchange will eventually offer various kinds of gold derivatives, including forward transaction and futures. In February and August this year the SGE, based on spot transaction, introduced T+5 and deferred delivery businesses respectively, attempting to help, to some extent, enterprises to fix cost, hedge, and ward off uncertainties in production cost from price fluctuations. The pilot deferred delivery business is operated in the manner of initial payment, either by delivering and paying in advance according to two parties' negotiation, or by on-time or deferred delivery and payment with the spot matching price as the concluding price. The introduction of this business, on the one hand, provides enterprises producing or needing gold with the opportunity to hedge, and, on the other hand, offers investors diversified investment tools and enriches market trading varieties. Under the premises of effective prevention of financial risks, the central bank will launch gold futures and option products step by step.

Thirdly, China's gold market must integrate into the global market. As is known to all, China's gold market is still relatively closed. Trading participants are limited to domestic gold-producing/consuming enterprises and commercial banks; free import and export of gold is not allowed in China; and the domestic gold market is not capable of conducting 24-hour trading in line with the global market. Therefore, considering the above-mentioned problems, China will further open up the market and quicken its steps toward integrating into the international market. China should actively create conditions for its gold market to become an important component of the international gold market.

From the perspective of the central bank, the development and improvement of the gold market will facilitate the improvement of regulating instruments for monetary policy and macro adjustment system. On the one hand, gold still bears the marked nature of money under the modern financial system. Though gold currency has been less important as a value measurement since the Bretton Woods System collapsed, the fluctuation of gold prices remains a key reference for central banks to judge the level of inflation.

Furthermore, central banks still hold a considerable amount of gold as official reserves. Gold reserves, FX reserves, and special drawing rights in the IMF form the international reserves of a country, jointly assuming the function of warding off risks. The establishment and development of China's gold market marks the basic completion of constructing a market for major financial products in China, including markets for currency, securities, insurance and foreign exchange. A complete financial market system will provide more solid and efficient micro grounds for China's macro economic adjustment. Therefore, China's aim is, through the three transformations, to establish a safe and effective system for gold trading and to give full play to the gold market's functions of investment and risk warding, thus promoting the development of China's gold market. We will strive for this aim with members from the international financial industry, and in particular, the global gold fraternity. ■

(Source: Governor Zhou Xiaochuan's speech at the 2004 annual meeting of the London Bullion Market Association

Dr Zhou Xiaochuan *assumed the Governorship of the People's Bank of China in January 2003, at which time he also became Chairman of the Monetary Policy Committee of the People's Bank of China in January 2003.*

Dr Zhou has served as Deputy Governor of the People's Bank of China and Director of the State Administration of Foreign Exchange and been President of the China Construction Bank and Chairman of the China Securities Regulatory Commission.
His early career in finance includes positions as Assistant Minister of Foreign Trade, membership on the State Economic System Restructuring Committee and Vice President of the Bank of China and Director of the State Administration of Foreign Exchange. He graduated from Beijing Chemical Engineering Institute in 1975 and received his PhD from Tshinghu University in 1985.