

Zhou Xiaochuan: Gold market functions to hedge against risks

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the 2004 London Bullion Market Association Annual Precious Metals Conference, Shanghai, 6 September 2004.

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I would like to congratulate, on behalf of the People's Bank of China and in my own name, the convening of *2004 London Bullion Market Association Annual Conference on Precious Metals*. Relying on improved infrastructure and as a cohesive force in the national economy, Shanghai is developing various types of financial markets. Any of these markets, be it a foreign exchange market, a bond market, a futures market or a gold market, serves as an important center that connects and influences the rest of the country. This is why it is so encouraging and appropriate to hold this year's Precious Metals Conference in Shanghai.

London gold market is the biggest as well as the oldest gold market in the world. In 1804, London replaced Amsterdam to become the world's gold trading center; in 1919, London gold market was formally founded; and in 1982, London futures market for gold declared its foundation. Currently, the London gold market is trading at a per week volume of 2-3 billion U.S. Dollars, accounting for 43% of the world's total gold transactions, establishing itself into not only the world's largest gold sales market, but also a governmental gold trading market for most of the world's central banks. It is even a major force in influencing the gold prices in many other countries and regions.

As the administrator of London gold market, LBMA enjoys authority as well as fame in world's gold circle. And each year in different cities of the world, LBMA holds its global annual conference on precious metals - one of the world's most important international conferences of the gold industry. The Shanghai conference creates conditions for exchange and cooperation between market participants in China and the world and will promote the reform and opening up of China's gold market.

Compared with the time honored London gold market, Chinese gold market is only two years old. However considerable progress has been achieved with the market notably expanded, investment ratio rapidly improved, pricing mechanism gradually formed, investment instruments diversified and market participators increased. By the end of 2003, Shanghai Gold Exchange already had 108 members. The transaction volume in 2003 was 235.35 tons or 22.962 billion RMB, of which 148.62 tons were actually delivered. China's gold production of the same year was 200 tons. A sound prospect for Chinese gold market is unfolding.

International gold market and colleagues present at this conference have paid a lot of attention to the past and present of Chinese gold market, but the future of a reformed and open market is of even greater concern to all of us. So today, I would like to associate myself in the discussion of the future of the market where I see three transformations: first, transformation from a market majoring in commodity transactions to financial transactions; second, transformation from spot transactions to futures transactions; third, transformation from a domestic market to an international market.

1. To transform Chinese gold market from one for commodity transactions to one for financial product transactions. Gold as a commodity has the multi-characters of a currency, a financial product and an ordinary kind of good. Globally speaking, gold is phasing out as a currency, but the thriving investments in gold demonstrates its financial characters and its indispensability as an investment instrument. In all the major international financial centers, gold market is an integral part of the financial markets consisting of the money market, securities market and foreign exchange market.

As an ordinary commodity, gold has become a consumption product for the urban and rural residents after the reform and opening up. The gold market can meet the demand of the consumers, and the gold producing or consuming enterprises. But gold is yet to be cultivated as a financial instrument for investment and store of value. Transaction of gold as a financial product is still restricted in China, and it has not been brought into full play the financing function of the gold market.

How can we transform the gold market into a financial market from its present stage as a commodity market? The current situation presents individual investment in gold as a realistic answer to this question. Our total domestic household savings amount to as high as 12 trillion RMB, readily conditioned for investment in gold or rather turning the asset of the

ordinary people from currency into gold. From the macro-economic perspective, it creates an additional channel to convert savings into investment balancing the demand and supply. From the micro-economic perspective, allowing people to hold assets in gold can improve social welfare benefiting both the country and its people. Also, the dual characters of being an ordinary commodity and a currency allow gold to well hedge against risks. So it is practical to develop individual gold trading business.

2. Transform the gold market from spot transactions to gold derivatives transactions. There are two major types of transactions in the international gold market: the traditional spot transactions taken place basically in the gold markets of London, Zurich and Hong Kong; and the futures transactions including gold options, forwards and swaps basically on Chicago Board of Trade, New York Mercantile Exchange, the Mid-America Commodity Exchange and Tokyo Commodity Exchange. A fledged gold derivatives market can effectively function for market players to hedge against risks and carry out investment and financing.

The current major form of gold transaction at Shanghai Gold Exchange is firm order spot transaction. With the development of Chinese gold market, we will phase in a variety of gold derivatives including forwards and futures. In February and August this year, Shanghai Gold Exchange has put forward successively T+5 and deferred delivery products in addition to spot transactions. The attempts help the enterprises to fix costs, further preserve value, and avoid the uncertainties in production costs caused by price fluctuations. Currently, the deferred delivery is done on a trial basis by means of down payment. The transaction could be settled before, after or on the contracted date as negotiated by the buyer and seller. The price is decided on the day of transaction. This product avails gold producing and demanding enterprises to hedge against risks, diversifies tools for investment and enlarges the variety of transactions on the market. The PBC will conduct further research on gold forwards and futures provided that financial risks can be effectively contained.

3. To integrate Chinese gold market into the international market. We all know that the present Chinese gold market is a relatively closed one with membership accessible only to domestic gold producers, intermediate consumers and commercial banks; exports and imports have not been liberalized; and no round-the-clock synchronized transactions with the international market. Therefore, we plan to open the market further in an effort to solve the above problems, fuse the Chinese gold market into the global market and create conditions to forge our market into a global player.

We see as central bankers, that developed gold market can help to compliment the monetary policy instruments and improve macro-economic management. This is because gold still apparently demonstrates its character as a currency in the modern financial system. Even after the collapse of the Bretton Woods System, the price of gold is still an important index for central banks to evaluate inflation. Also, all central banks still hold considerable amount of gold as government reserves. Gold reserves, foreign exchange reserves and quota at the International Monetary Fund form a nation's international reserves that can be used to weather risks. The establishment and development of Chinese gold market symbolizes a preliminary completion of a financial market system consisting of the money market, securities market, insurance market and the foreign exchange market. An improved financial market system will serve as a firm and effective micro-economic basis for macro economic adjustment. So we aim at realizing these three transformations to establish a secure, and effective gold trading system where hedging instruments are widely available, and to foster the development of the gold market. This is to be achieved with the joint efforts of our colleagues from the world financial circle especially colleagues of the gold industry, and my colleagues in China.