

The Foundation and Development of the Chinese Gold Market

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Respected chairman of the conference, all distinguished guests, ladies and gentlemen: firstly, let me express great appreciation on behalf of the Shanghai Gold Exchange (SGE) China to all the guests attending this LBMA Precious Metals Conference. We feel honoured to have this Conference held in Shanghai, which shows support from the global gold market for the Chinese gold market as well as the Exchange. Now please allow me, on behalf of the SGE and in my own name, to extend our warmest welcome and sincerest greetings to all attendees and friends and wish this Conference great success.

The SGE officially opened on 30 October 2002, which represented a great achievement for the management system, revolutionising the Chinese gold market. It is also a symbol that we have started the gradual process towards standardised market principles. On this occasion, I am honoured to have the opportunity to give you a brief introduction to the SGE.

About the SGE

Approved by the State Council of the People's Republic of China and founded by the People's Bank of China (PBOC), the SGE is a non-profit and self-managed legal entity. It organises the trading of gold, silver and platinum according to the principles of openness, fairness, justness and honesty.

The SGE has adopted a membership system. Our membership consists of qualified financial institutions and corporations that produce, smelt, process, wholesale, import and export precious metals including gold, silver and platinum and precious metal products. These legal entities should have good credit and a strong reputation. Currently, we have 128 members, which account for 75% of China's total gold production, 80% of gold consumption and 90% of refining capabilities.

Overall Operating Conditions

Generally speaking, operating conditions have been steady with a smooth operating system and a continuous increase in trading volume. The Exchange launched platinum on 30 July 2003

followed by the AuT+5 (transaction day + 5 days) product on 18 February 2004 and began a trial contract of small-scale gold bars on 28 June. On 16 August, our new trading system officially came into operation, and deferred trading transactions were listed in the meantime. From our opening until 31 July 2004, accumulated trading volume reached 363.76 tonnes with a turnover of 36.861 billion yuan.

Following are the key market characteristics.

1) The continuous expansion of scales, the enhancement of investor ratios and the full display of allocation functions to market resources

From 1 January to 31 July this year, total trading volume was 170.043 tonnes, up 36.53% year-on-year, and turnover reached 18.247 billion yuan, up 57.04% year-on-year. On 25 June, daily trading volume broke through three tonnes, the highest level to date. The country's total gold production reached 89.733 tonnes from January to July this year. During this period, gold trading volume was 80.31 tonnes higher than domestic gold production, which showed the market's improved investment function. The transaction conditions of gold producers and users show that there are very good connections between supply and demand.

After the PBOC abolished the monopoly on gold allocation and management, SGE assumed the basic role of allocation and management of gold resources, stipulating the healthy and orderly

development for gold production, circulation and consumption.

From 1 January to 31 July this year, the amount delivered was 105 tonnes, with the delivery ratio reaching 61.76%, down 5.25% year-on-year. There is an evident increase in investment business, which has become the main force driving the growth in trading volumes.

2) With an improved price discovery function and the gradual formation of a fixed-price mechanism, the SGE's gold price has become the dominant price on the domestic gold market

International gold prices fluctuated widely during the first half of the year, and domestic gold prices generally kept close pace with them. Over the 123 trading days, our prices were higher than those on international markets on 86 days, with the average spread reaching 0.68yuan/g. During the remaining days, gold prices on SGE were lower, with a price differential of 0.32yuan/g. The transaction gold price on our exchange has now become the reference benchmark for gold producers, users and some investors, directing their operational activities and consumption.

3) Increase in trading products and market functions

During the first half of this year, our exchange launched two contracts, AuT+5 and Au50g, in February and June respectively. The Exchange not only carries out the allocation of gold resources but also improves investment functions, proven by the increase of market participants and the enrichment of profit-earned models.

These two years of our operation have proven that our project design is in accordance with the market requirements of continual development and a steady increase in basic market functions. On the whole, we have reached the expected objective of revolutionising the management system on the domestic gold market, realising a smooth transition for gold from a monopoly to market trading and have achieved consistent periodic successes.

Some Plans for the SGE's Development

We are only at the initial stages of development, and the PBOC, local counterparts and counterparts in the international gold market have great expectations for us. They have also offered strong support and created a good external environment for us. At the working conference of PBOC earlier this year, Governor Zhou Xiaochuan gave some requirements for the Chinese gold market for 2004. He noted that,

“...by further developing the gold market, creating safety and a highly efficient gold trading system and exploring new trading products with investment and hedging functions, the Chinese gold market should fulfil its transition from the present spot market to a comprehensive financial market.”

In addition, Governor Zhou gave important instructions on strengthening management, controlling risks and meeting the needs of the market during an inspection this April. Under the guidance of PBOC, we will conduct suggested methods gradually and designedly on the basis of the study and research on the successful experience of international markets and connecting the Chinese practical situations closely.

1) Setting up a safe and highly efficient gold trading system to ensure the development of SGE

Having a safe, efficient and high-capability trading system that can fully adapt to the evolution of trading is a key point in our steady operation and sustainable development. To meet further demands from the market, the SGE began to investigate the installation of a new trading system. During the period of development and design, we frequently consulted specialists in technology and business and listened to the suggestions of our members.

The objective of this research was that the new trading system should have advanced technology, high levels of information, steady capability, strong compatibility and a high loading ability. Thus this new trading system can meet the needs of sustainable development of business at maximum levels, with the characteristics of flexibility, the ability to retract and transferability. The peak level of the application system can now support 1,000 quotations per second and three million customers at the same time. In addition to maintaining current business, this new trading system can also support spot, forward, deferred and even futures trading methods.

After continuous development and testing lasting almost a year, the new trading system came into operation on 16 August this year. Now this system operates well with reliable host computers and a smooth trading net. Through simulated testing and practical operation, our members have had a good command of the business flows for the new trading system. There is no doubt that the installation of the new trading system will provide us with a broad business platform.

2) Developing new trading products with hedge functions on the gold market to meet the needs of various investors.

Since the official opening of the SGE, we have been able to meet the consumption needs of gold producers and consumers, but we should enhance the investment functions of the market as a whole. According to related files, the banking deposits of Chinese residents are as high as 12,000 billion yuan. If the Exchange lists individual gold investment, the monetary assets in the hands of residents may be turned into gold assets.

Keeping gold among the residents could relieve the country's heavy pressure on the currency market and take back some money in a favourable act that would benefit our country as well as its residents. Meanwhile, gold has the double attribute of being a general and monetary commodity. Research by a related department shows that 20% of respondents would like to invest in gold, with the preferred amount being 10% to 30% of their financial assets. Using 20% of respondents and 15% of financial assets as a reference base, we could expect about 300 billion yuan to flow into the gold market once the market is open to individuals – a huge potential.

On 28 June this year, the SGE began a trial listing of small-scale (50g) gold bars. These bars have lowered the threshold for investors to enter the market, widening the pool of trading participants and actively promoting the market's investment aspect. The trial is also helping us gather experience and prepare for the entrance of individual investors. Under the supervision of the PBOC and related government departments, we will further standardise the market. The introduction of individual investors into our market system will ensure the steady development of economic conditions.

3) To expand the extent of market functions and gradually achieve the transition from the current spot physical market to a financial market.

The SGE has continually strengthened its creation of products, seen in the recent launch of T+5, adding deferred trading to the base of spot trading to help meet the requirements of locking in costs and maintaining value to hedge uncertainty due to price fluctuations.

The current trial of deferred transactions is being conducted in instalments. Traders can choose to deliver before, on or after the contract day through negotiations between buyer and seller. The contract price is the matching price of the day.

We balance supply and demand in the market by adjusting the compensation charged to deferred traders. We also regulate the margin ratio to ensure smooth trading. Meanwhile, we protect from and control risks by adhering to strict regulatory rules.

As with the 50g bar contract, the launch of deferred trading helps us gain experience. After the basic framework of the financial product trading system with investment and hedging functions has come into being, we will take full advantage of advanced international experience by investigating the use of financial products as futures and options, thus achieving further diversity in trading products. Our products should not only have commodity characteristics, but should also build up a relatively complete financial product trading system, driving the creation of the domestic gold market and truly fulfilling the transition from a spot market to a financial market.

Everything must have its own beginning. Only by beginning can you have the chance to conquer difficulties. The emerging SGE will work hard and maintain a solid footing from the start. By consolidating the existing trading business, we will study and master the successful and mature operational experience of the international markets as quickly as possible. By staying in close touch with developments, the SGE will speed its progress and reach the pace of international markets, striving to become an important member of the whole financial system.

Finally, I wish this conference a complete success and prosperity to all distinguished guests in their businesses. You are also welcome to visit the SGE during your time here. ■

