The Liberalisation of the Gold Bullion Market in China: "Crouching Tiger and Hidden Dragon" or "Hero"?

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Ladies and gentlemen, distinguished guests: good morning! It is, indeed, a great pleasure for me to talk to you about the liberalisation of the gold bullion market in China. I remember visiting New Delhi in 1996 when India was about to open up its own domestic gold market. Five years of growth later, India has become the largest gold consumption market in the world.

At the World Gold Council's 2002 annual meeting in Melbourne last April, I made a presentation explaining the evolution of China's gold market liberalisation process and outlining the specific measures WGC had proposed in order to drive the market reform process. At the time of our meeting, the Shanghai Gold Exchange (SGE) had not yet officially opened, and I therefore characterised the stage of the gold market in China as "at the dawn of a new era" and the ascendancy potential of China's gold market as a "Crouching Tiger and Hidden Dragon".

Today, just three months after the SGE's official opening on October 30, 2002, I would like to share with you the progress of the bullion market liberalisation in China, and update you on current and future developments. Suffice it to say that we at the World Gold Council, expect that China's gold market will no longer be characterised as a "Hidden Dragon."

My presentation today will focus on the following four sections:

- Evolution of the bullion market liberalisation in China
- Current market situation
- Development plans and policy indications
- Prospect and potential for a modern day "gold rush".

Evolution of Bullion Market Liberalisation in China

My colleague, Albert Cheng, who will speak tomorrow, and I have been intimately involved in deregulatory efforts ever since we set up our offices in Beijing seven years ago. Over these years, the Council continually informed the local regulatory authorities about the latest developments in the international gold markets and sought to assist them in formulating and implementing market-oriented reform policies. At the same time, we also helped local gold enterprises to prepare for the transition to a market-oriented system.

With its strong annual GDP growth (of approximately 8% during 2002), large foreign currency reserves, (over US$268.6 billion at the end of 2002) and 20 years of industry development, China has emerged as one of the key potential gold consumption and production countries.

Major Breakthroughs Since 2001

We have been very excited to witness that, over the past two years, the Council's fundamental ideas of gold market liberalisation have already been incorporated in the "Outline of the 10th Five-Year Plan for National Economic and Social Development in China", which was approved in March 2001 by the People's Congress and listed as one of the Seven Strategic Priorities of the People's Bank of China for the next five years.

The main principles of the gold market reform are very similar to the "Three-Step Process" outlined in WGC's reform reports produced between 1999 and 2002. They are:

- **Step One:** End the gold monopoly system, remove price controls, and establish a membership-based Gold Exchange in Shanghai (the SGE).

- **Step Two:** The licensing system for gold manufacturing, wholesaling, and retailing, is to be gradually abolished, starting off first with the retail sector. The gold bullion market will then be open to individuals.

- **Step Three:** Concurrent with the progress of foreign exchange reforms, the import/export controls on gold will be gradually lifted.

Since 2001, a series of new gold-related policies have been announced:

- On April 27, 2001 the governor of the PBOC, Mr. Dai Xianglong, for the first time, publicly announced the plan to remove the antiquated "Monopoly Purchase and Allocation" policy as well as the launch of Shanghai Gold Exchange.

- On June 11, 2001 the PBOC instituted a weekly quotation system for domestic gold purchases and allocation prices, and thereby a gradual process to synchronise domestic gold prices to the prevailing international prices got underway. This represents a first, but quite positive step towards establishing a market-oriented gold price system through the gold exchange.

- On August 1, 2001 the State Price Bureau-imposed domestic gold jewellery retail price control was abolished. Retailers are now free to set their gold jewellery prices according to the exchange price and product quality, and not determine price solely by the gold content, as in the past. This will undoubtedly encourage new and innovative jewellery designs, increase retailer profit margins, expand jewellery product lines, and help establish gold jewellery brand names in the long term.

- Effective November 1, 2001 the licensing system for local retail, wholesale, and manufacturing of gold products was abolished. However, wholly-owned foreign retail jewellery business is not allowed for the time being.

- On November 28, 2001, the Shanghai Gold Exchange began its simulated operations.

- On October 30, 2002 the SGE officially opened. Initially, 108 members started trading gold bullion through the exchange. The PBOC ceased its 50 year-old allocation system, but will retain its purchasing channel for low-purity gold (gold that could not meet the trading standard on the exchange) for the time being, as new purchasing channels through exchange members have not yet been well established.

The Current Market Situation

The official opening of the Shanghai Gold Exchange (SGE) on October 30, 2002 marked a new era for China's gold circulation system. It marked the successful transition from the monopoly gold purchase and allocation system (through China's central bank) to the market-oriented gold purchase and selling system, via the SGE. Local gold traders are now free to buy and sell gold bullion at the SGE (through the SGE members) without any limits or quotas, as previously.

However, according to the current *Gold Management Regulation* issued in 1983, individuals are still prohibited from trading gold bullion, and no local commercial banks or other financial institutions are yet allowed to handle gold trading for individuals as a savings or investment vehicle.

The trading volume on the SGE has reached over 20 tonnes by the end of 2002, after the exchange had been open for just two months! The detailed information and trading rules of the SGE can be obtained from the SGE's own website, www.sge.com. At present, the SGE only trades physical gold bullion and has not integrated its trading with the international gold market. This situation has limited the initial trading volumes and price matching activities. However, the SGE has recently extended the trading hours until 15:30 daily and it also plans to develop new products such as "Deferred" services and trading for smaller bars.

Development Plan and Policy Indications

First of all, allow me to make this clear again – the gold investment market is not yet open in China, officially.

However, such trading and products are clearly stated in the reform plan, to come about as the "third stage", after the SGE's opening.

Some policies and technical issues are currently being reviewed:

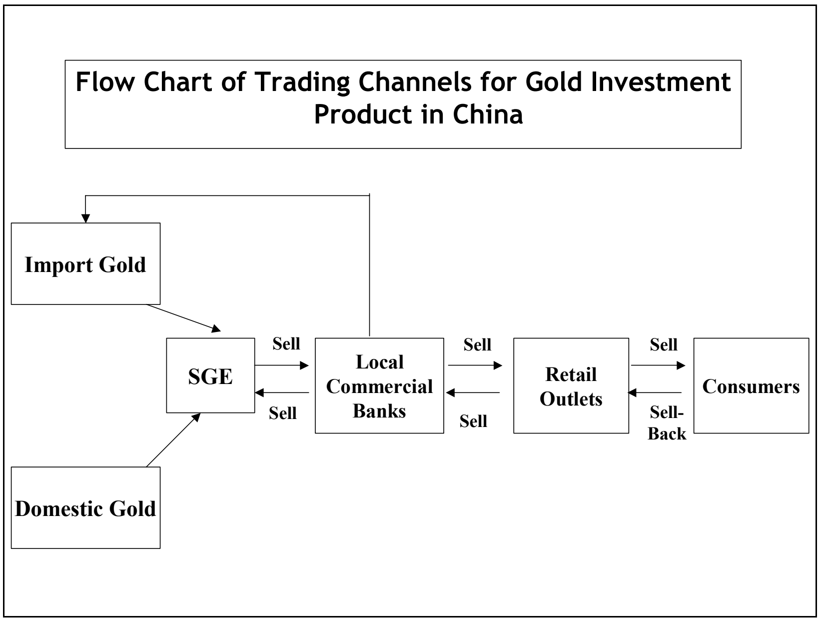
1. Revise the current *Gold Management Regulation* to open the gold bullion investment market.

2. A new set of policies to clarify the new gold investment including:

    a. Allowing selected domestic commercial banks to provide retail gold products to individuals, with two-way trading (sell/buy-back) during market hours, and based on the SGE price.

    b. Establish an efficient channel to connect and integrate the SGE with the international gold markets, in order to bring the local gold prices in line with international prices, provide sufficient liquidity and supply, and allow local commercial banks/trading houses to hedge their price risks. (Currently, gold import/export is still controlled by the PBOC).

The new policies are on their way to become reality, soon. What will be the possible processes and trading channels for gold investment products? Based on various sources of information, we are able to draw a pretty clear picture, indicated by this flow chart:



1. Some SGE members (not all, but the majority, possibly starting with the four largest state-owned domestic commercial banks, namely: Industrial and Commercial Bank of China (ICBC), Agriculture Bank of China, Bank of China (BOC) and China Construction Bank buy gold from the exchange or import through consignment plan. SGE starts to trade various sizes of gold bars.

2. Commercial banks offer both physical gold and gold accounts through their retail outlets nationwide. For gold account trading, no physical gold is required for delivery. Prices will be in local currency per gram, and based on SGE prices.

3. Those same approved banks can import/export gold and hedge their price risk and positions through SGE, or international gold markets.

The aforementioned commercial banks have prepared and established the necessary systems and products to start gold retail business since 2002. Although some of them may focus on physical and others on gold account business, they all plan to start their activities right after the PBOC issues the new policy to open the gold bullion investment market.

The Prospect and Potential for Untapped Gold Investment Market in China

You may be wondering just how large this new gold market could be. Let me try to give you some idea of it, predicated on our joint efforts to develop it successfully:

- China's annual GDP growth is over 8% (as seen in 2002) with over US$268 billion of foreign reserves. Per capita GDP reached $1000 per year recently.

- It has been reported that private financial assets stood at about RMB10 trillion (US$1.208 trillion), however, most of this pool has been sitting idle (earning little, or no interest) in banks. Of these funds, individual bank deposits totalled RMB8.47 trillion at the end of 2002 (about US$1 trillion) and foreign currency bank savings deposits (mainly in US dollar) reached over US$81.1 billion, plus about RMB1 trillion (US$120.8 billion) cash in residents' hands. Hence, in China, the pool of individual bank savings is called "Crouching Tiger" (since you don't know when and where it might jump out). How to lure this "tiger" to come out and "consume" is one of the major challenges faced by the Chinese government as well as the gold bullion trade.

What does this mean to gold as a retail investment product?

It might mean a huge market potential – or, a "Hidden Dragon". Why?

- The bank deposit interest rate in China was cut several times since this year, down to only less than 2% on average. These rates plus a 20% tax rate on interest income, are a big disincentive to saving. Nevertheless, bank deposits funds are still growing. About 31% of this money is parked in short-term or flexible accounts, and "ready" to spend. It shows that consumers could not find better investment products (especially given the poor stock and bond market performance over the past two years, during which more than 80% of private investors in China lost money in them)!

- Another interesting phenomenon in China was the "Hot Sales" for gold bars since mid-December last year. As I mentioned earlier, although the official channel for gold investment products is not yet open, some local trade (refiners, jewellery manufacturers and retailers) already took their initiatives to start selling so-called "investment" gold bars since about December 18, 2002. The weight of these bars varies from 10 gr. to 1 kilo, and their selling price fluctuates as well, based on the SGE spot price. However, even these trailblazing retailers could not promise the buy-back of bars under current policy controls. Selling price rose from RMB92/g to 96/g within one week in concert with the soaring international gold price (now rose to RMB99/g), a “gold rush” for the “little yellow fish” (a term for small gold bars 50 years ago) still occurred in major cities like Beijing and Shanghai (pictures showing crowds of buyers lined up at gold bar counters appeared on local media). More than 1.2 tonnes was sold within a one-month period (up to mid-January.).

- If only 0.1% of the current total private bank savings pool might turn toward investing and saving in gold bullion, it would mean US$942 million – at least 100 tonnes of gold – would be consumed!

Conclusion – the “Hidden Dragon” Will Become the “Hero”.

I believe I have given you an optimistic picture of the future prospects for China’s gold investment market. But we, the Council – and all of us here – still have a lot of work left to do, such as properly educating the Chinese gold trade and the Chinese consumer about the role of gold as an investment product. We also need to conduct effective promotion and channel expansion, in order to make gold investment products easier to trade, along with lowering their premiums. Consumers appear to be quite eager for such developments. Let us not disappoint them.

I would now like to give you a quote from the speech by Mr. Dai Xianglong, former governor of the PBOC, at SGE’s opening ceremony last October: “The set-up of the Shanghai Gold Exchange completes the establishment of financial product markets in China, encompassing currency, securities, foreign exchange, insurance and gold. This will help Shanghai to become an international financial centre in the future… The Shanghai Gold Exchange would not only provide physical trading, but also speed up the introduction of other investment-related products”.

A new Hollywood-financed Chinese film, “Hero” was just launched worldwide. We expect that the Chinese bullion market will become the new “Hero” to replace the “Hidden Dragon” from this year forward! ■