Precious Metals Trading in Japan

Bob H Takai, Deputy General Manager

Commodity Business Dept., Sumitomo Corporation

Thank you Martin, ladies and gentlemen. It is my great honour and pleasure to speak at the first LBMA gold seminar in Asia.

I would like to discuss how and why the Japanese precious metals market has grown since it was deregulated about 25 years ago with the hope that our footsteps will be a good reference for your market evolution here in India.

The History of the Japanese Precious Metals Market

Gold trading was under government control for just over 100 years, from 1867, when Tokugawa Shogun returned the reins of power to the Meiji Emperor, until the outset of modern Japan. Until the import ban was lifted, the price of gold was set by the central bank at around 600 yen/gram for a long time.

In February of 1973, the government abandoned the fixed rate of 360 yen to the dollar to float the currency in the free market. Then two months later in April, the import restriction on gold was lifted to kick-start the private trading of gold. In 1978, the gold export ban was lifted to make the yellow metal a completely free commodity for anyone to trade.

There have not been any restrictions at all on other precious metals like silver and platinum. Therefore, for instance in PGMs, international trade with the Russians and the South Africans has a much longer history than gold. This is one of the reasons why platinum jewellery was favoured over gold by the Japanese.

The trade liberalisation of 1978 gave birth to the gold consignment business in Japan. Swiss banks and English bullion houses shipped tonnes of 99.99 gold kilo bars as consignment stock into the vaults of their Japanese customers. Consignment business served the Japanese well, freeing us from price exposure as well as enabling immediate access to the metal whenever demand arose. This period coincided with the opening of Hong Kong offices by many Western banks and traders, in order to capture Japanese business.

1982 was an epoch-making year for the gold business in Japan. The Government of Japan gave permission to commercial banks and security companies to sell gold bars and coins to retail customers through their nationwide network of shops and branches.

The marketing of gold bars by banks to their clients has certainly raised the profile of gold investment, which had long been regarded as a professional investment item for expert investors only.

In the same year, the first official gold futures exchange was born in Japan. The Tokyo Gold Futures Exchange, the forerunner of Tocom, started to trade 1 kilo gold futures contracts in February 1982.

In 1983 three Japanese bullion traders and the Hong Kong office of a British bank formed a professional wholesale market called 'Loco Tokyo gold market'. The 3 Japanese houses included Tanaka, Mitsubishi Metals, and Sumitomo Corporation, with the overseas bullion dealer being NM Rothschild (Hong Kong). Traders started to make markets with each other for 50 kilos per price to transform the domestic physical gold market from a one-way to a two-way market.

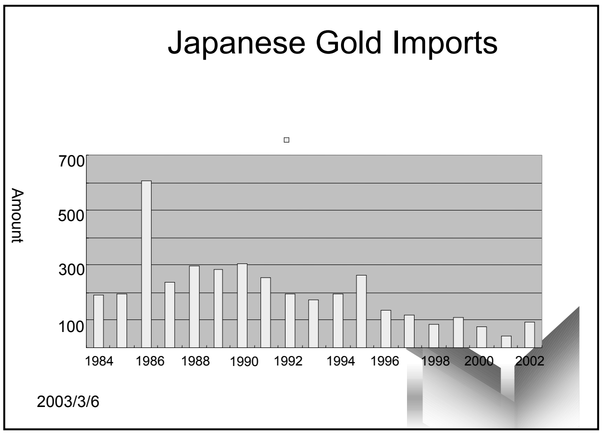
In 1984 Sumitomo Corporation became the first Japanese market maker in loco London gold and silver. Other trading houses followed shortly afterwards, helping to contribute to market liquidity in the Asian time zone. What enabled us to participate in international bullion trading was the growing liquidity in the futures exchange.

In November of that year, Tokyo Commodity Exchange for Industry (Tocom) was born through the merger of 3 existing exchanges, the Tokyo Textile Exchange, Tokyo Rubber Exchange and Tokyo Gold Futures Exchange. Tocom provided enough liquidity for trading houses to hedge their exposure arising from loco London dealing activities. Silver and platinum futures contracts were also listed in Tocom in 1984.

1986 was the year that Japan bought more than 600 mt of physical gold from overseas. More than a third of that gold was used to mint commemorative bullion coins to celebrate the 60th anniversary of Emperor Hirohito's reign. Japan was experiencing the so-called Gold Boom fuelled by the rising Nikkei index, which hit the all-time high of 38,915 yen in December 1989.

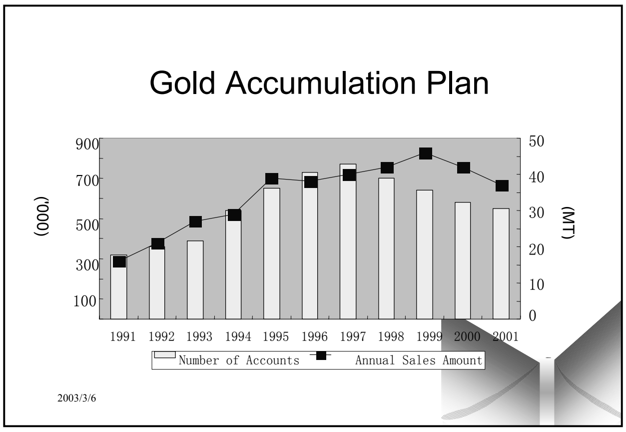
1990s – Falling Physical Gold Demand and Prospering Futures Exchange

The 1990s are often called the "lost decade" in Japan. The burst of the so-called " Bubble Economy" has depressed the physical demand in gold, on the contrary, the futures trading on Tocom has prospered throughout the decade. I will come back to the futures market later on.



Gold demand has fallen sharply in the late 90s to a record low of only 43 metric tonnes in 2001, a mere one-fifteenth of the peak recorded 15 years earlier. The gold jewellery industry was hit hard too, with its total size shrinking from a peak of 24 billion dollars to only six billion dollars.

However, there is some good news too in the '90s. The new style of gold investment has become very popular among the Japanese public.



The Gold Accumulation Plan has captured the minds of many potential gold investors. The system enables you to accumulate your gold savings on an average basis whereby you buy more gold when the price is low and less when the price is high. When your savings reach a certain level, you can either sell to take your profits, or you can convert your balance into either gold jewellery or coins. The nation-wide gold balance today is believed to be around 250 to 300 mt. An interest-bearing gold savings product was also introduced in the late '90s, where investors can receive a gold lease rate of about 1% p.a. for their deposit.

Tokyo Commodity Exchange

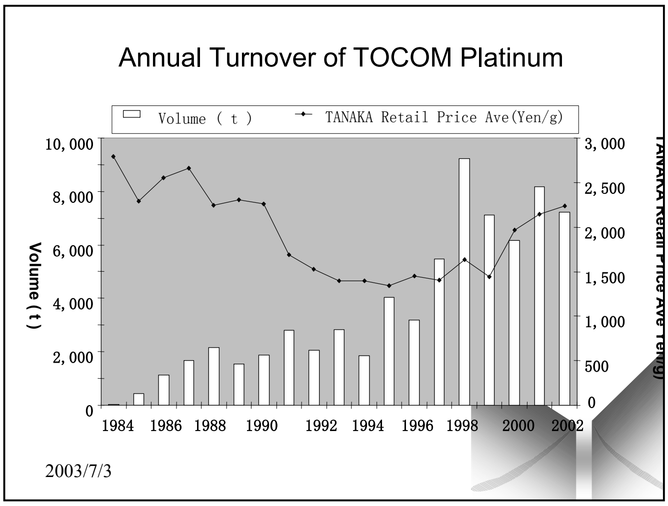
In stark contrast to the shrinking physical market, the futures trading on Tocom has experienced significant growth during the 1990s. Before showing you the bar charts, let me go through the general outline of the Tokyo Commodity Exchange.

The Tocom is a non-profit membership organisation given the statutory powers by the Commodity Exchange Law of 1950, regulated by the Ministry of Economy, Trade and Industry. The Exchange lists precious metals, energy products, and industrial materials like aluminium and rubber. The Tocom has 120 General Members, 44 Associate Members and 68 Broker Members.

In precious metals, gold, silver, platinum and palladium futures contracts are traded in Japanese yen for up to 11 months forward. Weight units are 1 kilo in 99.99 gold, 60 kilos in 99.99 silver, half a kilo in 99.9 platinum and 999.5 palladium. Trading is all screen based. The morning session lasts from 9 until 11am Tokyo time, and the afternoon session is from 12:30 till 3:30 pm. It is possible for you to follow the Tocom afternoon session from your office in Delhi or Mumbai.

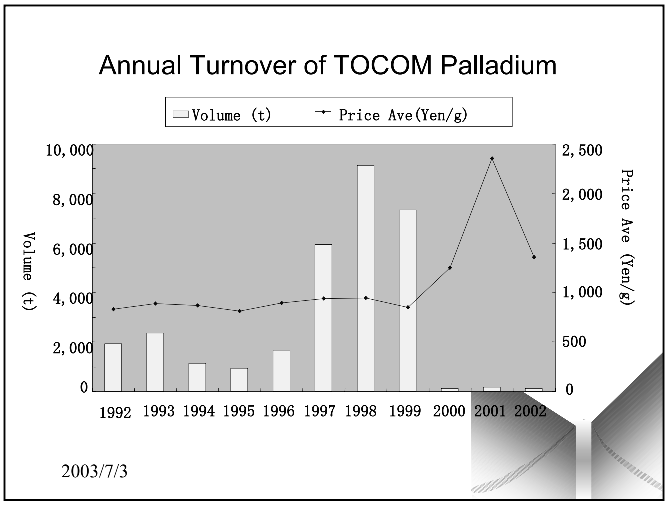
There has been a tremendous growth in trade volume on Tocom over the last 19 years. Last year, Tocom traded just over 20,000 mt of gold, which is about 85 mt per day, equivalent to Japanese annual imports in recent years.

On silver, the picture is more sporadic than gold, as they traded about 56,000 mt last year, which is about 230 mt per day. Annual Japanese imports are about 800 mt, so you can see that the Tocom silver contract is not as active as gold and platinum.



Next, let’s look at the platinum market which is the most successful contract in the history of Japanese futures industry. In 1985 when the contract was launched, the annual trade volume was a mere 430 mt, which had skyrocketed to 9,240 mt, more than 20-fold, by 1998. Last year it was slightly down to about 7,200 mt. This, I believe, was a consequence of the jump in the popularity of the TOCOM gold contract. Daily trade volume was 30 mt, which compares with an annual import figure of 50 mt.

Lastly palladium, which had a notorious hiccup about three years ago. As you can see in the graph on the following page, the contract was successful until around four or five years ago, when it recorded the highest trade volume of 9,140 mt. This is about 38 mt daily, compared with 78 mt of physical imports in the same year. The contract tumbled in February 2000, when the price experienced an explosive rise from US$ 440/oz to US$ 815/oz triggered by suspension of Russian exports. Having faced possible default by several broker-members who were caught short very badly and its negative impact on the international market, the Tocom Board decided to freeze the price until the end of that year at 2,363 yen/gram, which was approx. US$ 700/oz. The market reopened in the following year, but liquidity hasn’t recovered so far in spite of the fact that Russian shipments normalised in 2002.



Conclusion: Japanese Experience in Market Development

I have just covered, very quickly, how the market has developed in Japan from the 70s to the 90s. From my experience, I believe the following 3 phases are important to the successful market creation in precious metals.

Phase 1 – Lifting of import/export restriction: Physical market grows

In the first phase, you need to lift the import/export restrictions to create a healthy physical market domestically.

Phase 2 – Opening of an official futures exchange: Hedging market develops

In the second phase, well regulated futures exchange need to be established by government initiatives. This creates domestic hedging market for physical traders, investors and end-users.

Phase 3 – **Emergence of an Interbank OTC market: Liquidity increases**

In the third phase, professional trading community need to take initiative to quote bid and offer two-way prices among themselves to generate liquidity in professional market.

Last phase – Synergy among:

Industrial/Investment physical demand

Liquid OTC market (loco London)

Active futures exchange (Tocom)

In the last phase, inter-action among industrial and investment physical customers market, loco London professional market and active futures market will work together to form a very liquid market place.

I hope that the Japanese example will be useful in your context, and my speech succeeds in forming a bridge between the two very important markets here in India and in Japan. ■