A Shining Future—and a New Guise—for Tokyo Gold Exchange

By Hideji Shirae

When trading on the Tokyo Gold Exchange started on March 23, 1982, exchange president Yoshihide Watanabe declared, "This is a small baby, but we will raise it into a big adult." In a little more than two years, this 19th and youngest exchange in Japan has grown so rapidly that its trading now outpaces that of most of its older competitors. In the process, the gold exchange has introduced new forms of transaction which make it possible even for amateur investors to participate in futures trading. Now, ironically, success is pointing the way to the exchange's absorption into a new and larger entity.

Tokyo Gold Exchange is now trading in silver futures.

Silver trading a big success

Trading in silver futures, introduced by the exchange on January 26 this year, has proved a resounding success. As of mid-May, silver trading in terms of open interest totalled 63,000 contracts (one contract = 10 kilograms). This put silver third among exchange commodities in Japan, following the 74,000 crude sugar contracts (one contract = 10 tons) on the Tokyo Sugar Exchange and the 63,500 Chinese soybean contracts (one contract = 15 tons) on the Tokyo Grain Exchange. The open interest figure represents outstanding contracts for which payments remain to be settled. The greater the open interest, the greater the money invested.

It is unprecedented for a newly listed commodity to become the third most popular investment item in a little more than three months. Yet indications are that silver's open interest will continue to increase. And with signs of decreasing open interests for crude sugar and Chinese soybeans, there is even a possibility that silver may soon become No. 1. The open interests for gold and platinum are also rising steadily, though nowhere near the high pitch of silver. When the open interests for gold, silver and platinum are combined, it is no exaggeration to say that the Tokyo Gold Exchange has grown into one of Japan's three largest exchanges.

The exchange was established primarily to sweep unscrupulous gold dealers out of the market. Transactions in gold were completely liberalized in Japan in 1978 and ordinary people began to buy and sell the metal.

But unscrupulous dealers also proliferated. They duped retirees and housewives into thinking it would be a cinch to make big money on the gold market, and fleeced them out of their savings. In order to end the blight, legislation was passed to limit trading in gold futures to the government-authorized Tokyo Gold Exchange. The screening of dealers for registration with the exchange is much stricter than for the other exchanges, and gold dealers were required to observe rigid restrictions when soliciting customers. These constraints put a damper on trading until the end of 1983.

Admittedly, unprincipled brokers have not been eliminated completely. Shut out of the domestic gold futures market, they now operate clandestinely by telling their victims they use gold futures markets in New York, Chicago and other places overseas. But the establishment of the Tokyo Gold Exchange has had the desired effect of cleaning up the domestic market. As a result, at the start of this year, the Tokyo Gold Exchange began to shift its emphasis to enlivening and expanding trading in precious metals.

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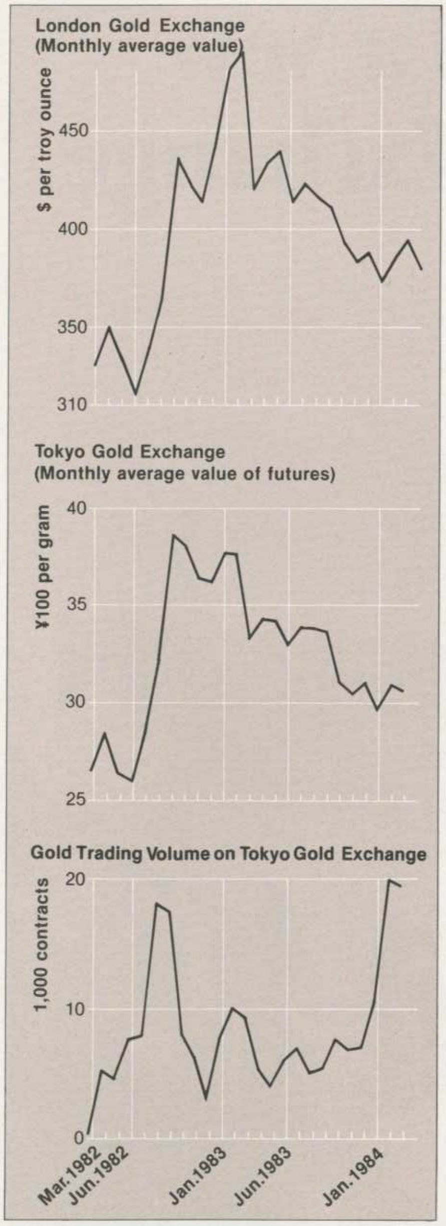


Three aces for expansion

The Tokyo Gold Exchange has three ace cards in its hand for a big leap forward. These are the recent addition of silver and platinum as trading items; the introduction of new forms of transactions; and the relaxation of restraints.

"The Tokyo Gold Exchange is the only exchange in the world where gold, silver and platinum are all traded," says an officer of the exchange proudly. On the New York Comex (Commodity Exchange), the most active trading is in gold futures. Comex also deals in silver, but not in platinum, which is traded on the New York Mercantile Exchange. In London, the traditional world trading center for precious metals, the London Gold Futures Market deals in gold, while the London Metal Exchange deals in silver. There is no exchange in London for platinum.

One Tokyo dealer says it has become much easier to solicit business since the exchange began trading in the three precious metals.

The sterling success of silver trading on the Tokyo exchange reflects a decision to keep the margin money necessary for participating in the market small. In May, the margin money per silver contract was only ¥42,000 ($175), compared with ¥135,000 ($563) for gold and ¥60,000 ($250) for platinum. Margin money per contract in the case of rubber and imported soybeans was ¥70,000 ($292) each, and for crude sugar ¥60,000 ($250). The investor was able to buy three silver contracts with the margin money required to buy one gold contract. And even if the investor should misjudge the market and forfeit his margin, his loss is smaller in the case of silver than with other commodities.

The second reason for silver's popularity is the fact that the price of silver fluctuates more violently than that of other commodities. Of course, this increases the possibility of losing, but it also offers better opportunities for big profits. The speedy outcome also appeals to speculators.

The brisk trading in silver futures is affecting spot silver transactions. Precious metal ingot dealers are beginning to trade in silver as a means of investment. In the past, they showed little interest in investing in silver ingot because unlike gold, it is bulky and takes up storage space. Moreover, there was not much general demand for the metal for investment purposes. Seeing the brisk trading in silver futures, though, precious metal ingot dealers are taking a second look at silver's potential demand as an investment commodity.

This growing demand has also stimulated silver ingot transactions among professionals such as Japan's sogo shosha (general trading companies) and metal ingot dealers. Because much of the demand for silver in the past was for industrial materials, such as sensitizer for photographic film, the conventional distribution route went from the mine to a trading company/ingot dealer and on to a film manufacturer. Now, instead of being just a link in the distribution chain, trading companies and ingot dealers are actively selling and buying silver among themselves.

Reducing risk with new forms of transaction

The Tokyo Gold Exchange introduced its new forms of transaction to counter the public's impression that futures trading is dangerous. The impression most people have is that while the profits can be big the losses can also be staggering. Laymen think it wiser to stay away from futures, leaving them to professional speculators. However, the new transaction forms introduced by the Tokyo Gold Exchange make it possible for ordinary people to invest in futures without losing their shirts.

The Tokyo Gold Exchange now offers investors a choice of "spread transactions," "stop loss transactions" and "straddle transactions." Spread transactions were developed to take advantage of a characteristic of the gold market: the more distant the delivery month, the higher the price. If the investor buys relatively cheaper gold with early delivery at the same time that he buys higher-priced gold with distant delivery, the difference in the two prices becomes his profit. Assuming that gold for delivery in May 1984 is quoted at ¥2,700 ($11.3) per gram while that in March 1985 is quoted at ¥2,900 ($12) per gram, a profit of ¥200 per gram is assured by buying the May 1984 gold and selling the March 1985 gold. Because there is no fear of losing, this "spread transaction" is tailor-made for beginners.

In a stop loss transaction, the deal is automatically cancelled when the investor's loss reaches a predetermined level but remains in force while he continues to profit. Because the loss limit is fixed in advance, there is no possibility of the investor getting his fingers burned. Needless to say, the possibility of making a killing remains.

The straddle transaction was developed to take advantage of the difference in price levels between two commodities, such as between gold and silver or gold and platinum. Past experience shows that the appropriate gold-silver price ratio is 35:1 and that the price of platinum is usually higher than that of gold. The idea is to use this proven standard to buy the metal whose prevailing price is relatively cheap and to sell the one whose prevailing price is relatively high. Profit can be realized when the normal balance is restored.

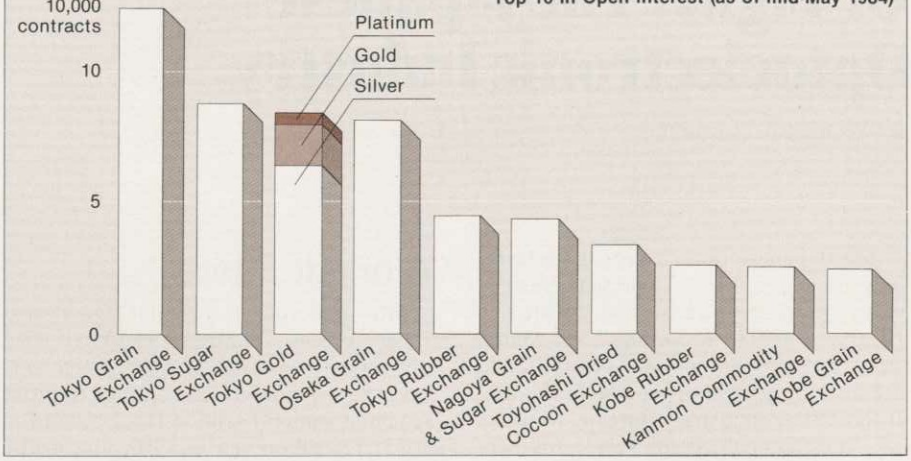
The new forms of transaction introduced by the Tokyo Gold Exchange have inspired innovations on other exchanges. In April this year the Tokyo Grain Exchange introduced its new "set transactions." This is a combination of the Tokyo Gold Exchange's three types explained above—spread transactions in imported soybeans and straddle transactions in Chinese soybeans and American soybeans, with stop loss transactions tacked on to the straddle transactions.

Relaxing restraints

On the face of it, relaxation of restraints may not be as eye-catching as the other measures taken by the Tokyo Gold Exchange. Yet relaxation actually has a direct impact on transactions. Take margin money, for example. The boom in silver futures was due largely to the fact that the margin money was pegged so low. When margin money for gold trading was halved, the open interest for gold trading surged past the 10,000 level, and early this year reached 17,000 contracts. Margin money for gold transactions is now only a quarter of the level set when the exchange opened.

Tokyo Grain Exchange	122,827
Tokyo Sugar Exchange	87,904
Tokyo Gold Exchange	83,861
(Silver 63,104) (Gold 17,210) (Platinum 3,547)	
Osaka Grain Exchange	81,458
Tokyo Rubber Exchange	44,752
Nagoya Grain & Sugar Exchange	44,537
Toyohashi Dried Cocoon Exchange	34,502
Kobe Rubber Exchange	26,801
Kanmon Commodity Exchange	26,525
Kobe Grain Exchange	25,051

Top 10 in Open Interest (as of mid-May 1984)



Toward an international exchange

The Tokyo Gold Exchange has grown rapidly since the start of 1984 as the steps taken by exchange authorities have produced results. But while the gold exchange's open interest is among the highest in Japan, it is still small compared with the New York exchange. For example, New York Comex's gold trading open interest is 137,000 contracts (one contract = 100 troy ounces = about 3.1 kilograms) and that of silver 64,000 contracts (one contract = 5,000 troy ounces = about 155 kilograms). The Tokyo Gold Exchange's gold trading open interest is roughly one-24th and silver trading open interest one-16th of New York's.

Now the Tokyo Gold Exchange is considering additional, far-reaching steps to ensure its further development. Watanabe remarked recently, "I will be the first and the last president of the Exchange." He was referring to the disorganization of his exchange scheduled for October. This is to open the way for a merger with the Tokyo Textile Exchange and the Tokyo Rubber Exchange tentatively scheduled for November 1. The new institution emerging from the merger, to be called the Tokyo Commodity Exchange, will certainly be Japan's largest futures commodity exchange. The enlarged exchange will have greater credibility and a much more stabilized management, encouraging more speculators to do business there. It will become easier to get more new commodities traded at the exchange.

An expansion of its business scale will also serve the gold exchange's ultimate purpose: internationalization. To this end, the rubber exchange has introduced what it calls an associate membership system ahead of the gold exchange. This system enables foreign firms to do business by paying as much margin as a full member. Nine foreign firms have been accepted as associate members of the rubber exchange. The gold exchange plans to adopt the same system.

These new moves by the commodity exchanges have obviously been prompted by the Ministry of International Trade and Industry (MITI), which is eager to see futures commodity transactions grow further in the future. The Japanese economy heavily depends on imports for its energy and other resources. This means Japan needs to minimize risks that may be incurred from fluctuations in primary goods prices and abrupt changes in exchange rates and interest rates. MITI advocates the development of a futures commodity market where such risks can be well managed.

Many problems must be solved before such a futures commodity exchange can fulfil its desired functions. First, it must be able to attract speculative funds in addition to money put in by regular commodity dealers. Otherwise the exchange won't be able to secure enough liquidity. Surplus money held by individuals has been growing in volume and there is increasing interest in varied forms of investment instruments. A futures commodity exchange would attract such individual investors. It is for this purpose that the Tokyo Gold Exchange has introduced new forms of transactions.

Second, the scale and organization of the commodity exchange must be enlarged. The planned merger of the gold, rubber and textile exchanges is a step in this direction. But the merger alone will not quite serve the purpose. The enlarged exchange must have greater credibility, including greater ability to offer necessary guarantee. It also needs modernization, including mechanization of its facilities.

Third, member dealers of the exchange, whose social reputation has not necessarily been high, must have their credibility improved. They must be credible enough to be entrusted with massive speculative funds by their clients. They also need to have greater ability to gather relevant information. Unfit dealers will be weeded out while others may have to seek a merger for survival. ●