PREFACE

In this fast evolving era, China, being the largest developing country in the world, is faced with an awkward conundrum - identify opportunities within the context of immense market challenges: The opportunities are presented by its impending membership to the World Trade Organization, reform of the State enterprises and modernization of its legal and financial framework and these are intertwined with the challenges posed by global economic integration and the dawning of the internet era. All these are critical issues that demand immediate attention.

Likewise, the gold market of China, following its gradual evolution through 20 years of economic reform, finds itself struggling at the crossroads with an antiquated market system that can no longer be adapted to meet the needs of the new market situation.

This unsatisfactory state of affairs was duly highlighted by the World Gold Council in 1999 when it commissioned a renowned Chinese economist, Professor Fan Gang, to lead a team of economists to conduct comprehensive research into the gold market and come up with appropriate reform recommendations.

A research report entitled *"China's Gold Market: Reform and Opening Up - Some Basic Thoughts and Directions"* was subsequently released. This report provided theoretical underpinnings necessary for further progress of the gold market re-structuring and outlined a three-phase development blueprint for the reform.

Since then, the gold industry in China and the relevant government departments reached basic consensus on the subject and undertook major efforts over the past year to work towards the reform goal. Still, there are unresolved questions and difference in opinions regarding how and when reforms are to be carried out and what the reform directions should be.

Building on the reform momentum garnered by the first blueprint report, World Gold Council again commissioned the Industrial Economics Research Department, Development & Research Centre of the State Council to chart the reform progress through an in-depth research into the gold production and circulation systems in China and to present a lucid account of the rationale, methodology and plans that will lead to successful market liberalization.

Dr. Liu Shi-Jin leads this research team. With the ardent support and assistance of both local and overseas gold market experts and after months of in-depth interviews and thorough analyses, the team has finally completed this study. Its findings are summarized in a research report entitled *"China's Gold Market Reform in a New Era: Related Policy Research and Suggestions"*.

Through these research findings and recommendations, the Council would like to propose feasible action plans to provide a fillip to the reform process and ensure that the development of China's gold market come about in an efficient, logical and orderly manner with the minimum of fuss and hassle at both micro and macro fronts. We also hope that our research efforts will offer assistance and guidance to the policy-making bodies, and provide the gold industry, both local and international levels, with reference points for their strategic developments.

This research report will be released in the 2000 Gold Economic Forum to be held in Beijing this first 'golden' autumn of the new century for what is the largest closed gold market in the world. With the addition of invaluable opinions and policy discussions provided by local and overseas experts during the Forum, World Gold Council strongly believes that the road to eventual opening up of this hitherto closed market in China will be orderly, well-organized with the emergence of a golden era for China sooner in sight.

World Gold Council

Opening China's Gold Market in a New Era: Related Policy Research and Suggestions

Part 1 Introduction

We submitted a special report last year concerning the reform of China's gold production and circulation system and market opening up. Our current report is the continuation and deepening of the previous report. It will therefore be helpful to recap some of the important views contained in that report:

- The deepening of China's economic reform, further opening up marked by entry into the WTO, severe difficulties with the existing regime of "centralized purchase and planned allocations" by PBC on gold raw materials, the continued growth of gold supply and demand, all call for market-oriented thorough reform of China's gold production and circulation system. And the conditions for such reform are maturing;

- The reform in the production sector should emphasize the separation of enterprises from government, diversification of forms of ownership, the establishment of modern enterprise systems, and promotion of merger and cooperation. At the same time, attention should be paid to special difficulties of the enterprises during the transitional period;

- The reform of the circulation system could be carried out in three stages, with clear objectives and sure-footed progress;

- During the reform of the gold production and circulation system, government bodies, especially the central bank, will have to adjust their internal management structures in order to strengthen supervision of the emerging new market circulation system.

Developments over the past year have proved that the above views and judgements are basically correct. Various parties concerned tend to agree on the direction and steps of reform and have gained a deeper understanding thereof. Now the question is not "whether to reform or not". Rather, "it is how to reform" to achieve the desired objectives. The success of the gold production and circulation system reform and the market opening up, to a large extent, depends on the correctness of approaches to such reform and market opening. This report will further analyze and discuss such issues.

Part 2 Main Problems for Opening up the Market

1. Restore and Extend Gold Functions after Market Opens up

Gold is a multi-featured commodity that functions as a currency, financial product and general commodity. Despite the fact that the currency function of gold is not the same as it was during the time of the gold standard, governments of various countries still keep a considerable proportion of gold in their reserve assets. At the same time, the thriving development of investment in gold products demonstrates gold's important place as a financial asset, side by side with other tools of financial investment such as stocks and bonds. This proves that gold is also an important risk-avoiding tool for ordinary people. Along with the speeding up of globalization of the world economy, uncertainties and risks are increasing. Gold is an irreplaceable last resort in face of grave emergencies. Another note-worthy tendency is the diversification of the uses of gold. As revealed by literature, at present, gold is mainly used in areas such as jewellery, electronic instruments (including aeronautics and space, sophisticated instruments, electronic instruments and meters for modernizing traditional industries), dental care, industrial decoration, medals and souvenirs. The jewellery industry is the biggest consumer of gold, accounting for 70-75% of total gold demand, and is steadily increasing. Another 8-15% of gold market demand goes to electronic instruments, dental care, industrial decoration, medals and souvenirs and other sectors. Then, gold lending and borrowing, gold reserve and investment demand take up 10-15% of total market demand. The diversification of gold use has stimulated gold transactions all over the world, and laid the foundation for the development of the gold market.

Since the beginning of China's economic reform, gold as a general commodity has been received well by China's urban and rural consumers, but its price and variety are still subject to certain restrictions. As a financial product, gold is still being strictly controlled by the government, not open yet for the domestic market. But the domestic demand for gold as a financial investment and value-keeping medium still manifests itself in some ways. Enthusiastic response to the first public sales of gold bars in certain cities in December 1999 and high volumes of pure gold sales in the retail market reflect the potential domestic market demand for financial gold products.

In a sense, opening the gold market is a process to restore and extend gold's functions both as a general as well as a financial commodity. Those designing market opening must consider gold transaction requirements not only as a general commodity, but also as a financial commodity, while paying attention to the coordination between various modes of transactions.

2. Main Problems in Opening up the Market

Under the traditional centralized gold purchase and planned allocations, gold circulation was realized through the intermediary of the central bank. The central bank was responsible not only for the balancing of supply and demand, but also for the price setting, credit backing and risk absorption. When the central bank gradually withdraws from gold circulation, the newly emerging market circulation system has to face and resolve the following problems:

First, balancing supply and demand. As the central bank gradually reduces the quantities subject to centralized purchase and planned allocation and closes its purchase stations, balancing gold supply and demand is to be left to market transactions. In an efficient gold market, there should be various forms of transaction to meet the demand of both suppliers and consumers. After the central bank stops purchasing and selling operations, the first severe challenge the new system confronts is whether the new gold market can maintain smooth and steady circulation channels, so that gold producers, processors and consumers will not be affected.

Second, price discovery. After the opening of the gold market, it will arrive at prices through the direct and equal trading between market participants, instead of prices set by the central bank. For bulk goods and raw materials, any highly institutionalized exchange market has a significant price-discovery function. It should be pointed out, gold (especially standard pure gold bullion) is a highly homogeneous international commodity. Prices at major international gold markets as in London are decisive for price setting for all global gold markets. Even if China's gold market is opened up and the market itself is somewhat insulated from the international market, it remains a regional market within the global gold market system. Gold prices at China's domestic market will follow fluctuations of international market prices.

Third, reducing transactions costs. In any market, no matter what forms of transactions are adopted, the parties involved always seek to reduce transactions costs. Competition between the forms of transaction is, in essence, the competition for a lower transaction cost. Only those transaction forms with lower cost will survive and develop. Under the centralized gold purchase and planned allocation system controlled by the central bank, gold producers, processors and other parties have no right to choose the forms of transaction, and have no other transaction forms to choose from anyway. So there is no pressure for reducing transactions costs. In a sense, one reason for reforming the traditional gold production and circulation system is the excessively high transactions costs over the whole system. With the opening of the domestic gold market, the suppliers and consumers of gold begin to acquire the right to choose transaction forms, and various forms of transaction have already emerged or are emerging.

For example, some cities have been vying for the hosting of a gold exchange in recent years. Some regions have already set up or are preparing for the setup of some form of local gold exchange. Commercial banks are becoming more interested in gold transactions. Among various forms of trading, which is more reasonable and competitive? In a nutshell, which form of trading has the lowest cost?

Fourth, diffusing and avoiding risks. Under the central-bank-controlled and planned gold circulation system, gold producers and consumers sell to and buy from the central bank gold at fixed prices and procedures. They are not exposed to market risks, price risks and credit risks. When international gold market prices fluctuate by big margins, the price risk is borne and absorbed by the central bank. Such a burden has weighed the central bank down in recent years. Under open market conditions, as the central bank reduces the proportion of its gold purchase and relinquishes its control on gold allocation and sales, gold enterprises will have to face a series of market risks in the short as well as the long term. Most important risks are credit risk and price risk. Due to the lack of a time-honored and highly credit-leveraged market institution and transaction norms, credit risk will be most pronounced at the initial opening of the market. This may, to a certain extent, affect the vitality of market transactions and the interaction between production and sales. Therefore, it is highly necessary for the beginning of a newly open gold market to formulate and implement reliable transaction norms, and introduce highly credit-based transaction mechanism, and foster highly credit-worthy market players. Another note-worthy risk is price uncertainty, which is to accompany gold enterprises for a long time. As a special international commodity, the gold price in the international market is determined not only by supply and demand, but also by multifarious political and economic factors. Sometimes large price fluctuations in international gold markets once again point to the need for avoiding and diverting price risks. The adoption of hedging mechanisms with futures and forward transactions and through cooperation between domestic and international commercial banks to diffuse and reduce price risks will be an unavoidable option in a sound gold market system. In addition, the promotion of innovative financial gold products will also conduce to the reduction of gold price risks.

Part 3 The Architecture of an Open Gold Market

1. Relevant International Experience

In the international perspective, a gold market circulation system would include inter-bank (over-the-counter) gold market, physical exchange market for spot gold transactions, market for gold futures trading and gold retail market, etc.

The OTC market is the main channel for gold circulation. Usually commercial banks are the main participants in OTC gold market. With respect to gold markets in major countries of the world, e.g. gold markets in London, Zurich, New York, Tokyo, Hong Kong and Singapore, the core of membership consists of banks or companies affiliated to banks. Among 62 members of the London Gold Market, half are banks or companies affiliated to banks. At the Zurich Gold Market, all the core members are commercial banks. Relying on their great financial strength, strict and standard operational procedures and wide-spread business networks, the commercial banks have established an outstanding reputation in gold markets, and have become the most influential players in gold markets across the world. Commercial banks are not only market makers, they also play an important role in the whole spectrum of the gold circulation process, from physical gold circulation, smelting, custodian and transportation, to risk management, provision of financial gold products and gold retail business.

A physical gold spot market or gold exchange market is an important means for gold circulation, and an important form of gold market. Typical examples are the Hong Kong Chinese Gold and Silver Exchange Society and the Istanbul Gold Exchange Market in Turkey. One common characteristic of the two markets is the large volume of gold consumption demand and the heavy reliance on imports from international markets for gold supply, therefore the need for a concentrated trading market for effective gold distribution. It should be pointed out that a gold spot market is an important form during the development of a gold market circulation system. The Hong Kong gold market gained its prominence in the world not long ago. Turkey's gold market represents an important effort taken by the government to open a gold market in order to replace illegal gold smuggling channels. Even at the London Gold Market, there used to be concentrated physical gold trading at its inception. The initial method of price setting by its core members is still followed today. So, a physical market for spot gold trading is particularly pertinent at the beginning of market opening and nurturing.

A futures exchange market with fixed contract amount and trading period meets other needs - the need for gold as investment and store-of-value and even for speculative purposes, it is also one of the main channels for gold market participants to avoid and reduce price risks. It is believed that a gold futures exchange market is an important component of the gold market circulation system, and an important supplement and support to the gold spot market. In the world perspective, gold futures trade is concentrated at the New York Mercantile Exchange and Chicago Commodity Exchange of the USA. There are also futures exchanges of considerable scale in countries such as Japan.

A gold retail market mainly refers to the gold jewellery market and retail transactions such as sales of investment gold products, gold savings account and gold coins. A gold retail market is mainly to meet the needs of citizens for gold jewellery consumption, investment in gold products, and also to meet some industrial gold consumption and investment needs. Gold retail markets are composed of retail enterprises, gold jewellery manufacturers, and gold retail outlets under commercial banks.

To sum up, the international gold market circulation system is actually a multi-level institution with diverse market forms. Each market form has its "reason-to-be", shaped by the specific environment in which it first emerged. The inter-bank market is based on a highly developed market environment, while a simple and even primitive spot market is suited to the matching of supply and demand among private and small enterprises. Some markets have reached their maturity through a long period of growth and "running in", while others represent the best effort in view of the conditions at their initiation. Market forms may be regarded as progressive or backward, but they cannot be generalized as "good" or “bad”. A “good” market form should be able to suit specific conditions at specific time. A “good” market system should be an organic combination of various good market forms.

2. Constraints and Architecture of an Open Gold Market in China

China’s gold market will confront the following basic constraints at its inception:

- China’s gold production is widely scattered. Gold consuming enterprises and other consumers are also scattered;
- At present and in the foreseeable future, China’s domestic gold demand is much larger than domestic supply, the gap has to be filled by imports;
- The prospective market participants, including gold producers, gold-consuming enterprises and banks, are not sufficiently prepared in terms of institutional arrangements and operating mechanisms, experience and material equipment. It will take some time for them to get used to a new market ;
- Low credit rating of enterprises is a prominent issue in the current commercial environment in China. This weakness will also be felt at the newly emerging gold market;
- Before the issue of currency convertibility under the capital account is resolved, in order to avoid any possible impact on exchange rate stability, foreign trade in gold should be strictly controlled through proper insulation between domestic and international markets.

In view of the above constraints, the newly opened gold market in China cannot be a monolithic market form; rather, it should consist of various market forms. While the objective is set to align with mature international market practices, at the early stage, the market has to adopt a transitional form to accommodate the current situation in China. At the same time, it is possible to envisage the basic architecture of China’s gold market:

- Whether to establish a nation-wide gold exchange is still open to debate. One opinion is that it is superfluous to set up an exchange, once gold suppliers and buyers can trade freely in an open market. Another view holds that the over-the-counter gold market is the main stream of the international gold market, and that is where China should be heading, and there is no need for China to set up a physical exchange for gold. Such views should not be ignored, but they are not adequate to dismiss the need for a nation-wide gold exchange. Firstly, the great imbalance between supply and demand calls for a concentrated market for spot trading; Secondly, at the beginning of market opening and if it is necessary, it would be easier for the central bank to adjust price differentials between domestic and international markets through a concentrated trading market; Thirdly, and the most important, low credit support and uncertainties in the trading environment will be salient problems when the market is first initiated. The exchange can create a high level of credit support and a more certain market environment. Members of the exchange will be screened for their qualifications, and their credit worthiness will be guaranteed. Trading regulations of the exchange are formulated, executed and supervised by the members. Such regulations are transparent, and make it easy to pin down offenders. The exchange can also effectively reduce the cost of identifying business counterparts and transactions. That is very important for gold producing and consuming enterprises who are used to a planned economic environment for a long time and are not familiar with market operations. Nonetheless, the exchange will have to meet challenges from other trading mechanisms. For example, various forms of ex-pit transactions will reduce the market share of the exchange. If at a particular time when the exchange has to be closed due to shrinking trade volume, it can be regarded as a transitional market form on the road of China's gold market development.

- Commercial banks and the inter-bank (OTC) gold market are playing an important role in gold circulation. They may become the main actors. Among the prospective participants in gold operations, commercial banks have remarkable advantages in terms of funding, credit, trading infrastructure, qualified personnel, etc. The inter-bank (OTC) gold market has the conditions and potential to prosper. With proper policy guidance, this form of market is not in conflict with the gold exchange, rather, they can be mutually supplementing and reinforcing at the early days of market opening. Commercial banks as members of the gold exchange will facilitate communication with other exchange members, including other banks, in the "running in" stage. Within the exchange, commercial banks may trade among themselves, fostering the basic form of the inter-bank (OTC) market. Trading within the exchange among commercial banks does not exclude their transactions outside the exchange. It is not impossible for the inter-bank market to develop independently outside the exchange for an extended period of time, and even grow into the most important market form, once it reaches maturity.

- Some regional gold spot markets are very likely to appear. Due to the fact that China's gold producing and consuming enterprises are widely scattered in space, it is not possible, nor is it necessary, to concentrate all gold trading in one single place. On the contrary, it is reasonable for some regional gold spot markets to exist. As a matter of fact, several regional gold markets have always existed overtly or under cover, and some have grown in scale. If such markets can survive even under the system of centralized purchase and planned allocation, we have less reason to eliminate them under open market conditions. Healthy development of regional gold markets can supplement a national central market such as the gold exchange and they can enter into cooperative relationships. For example, some "big traders" at the regional markets may become members of the national gold exchange.

- Gold retail markets will develop further. On the one hand, restrictions on entry into the retail market will be eased. The reform of the planned gold management system will reshape not only the purchase links but also the sales aspect. The government should change the practice of granting special trading rights to certain particular enterprises under the traditional system. All enterprises interested in and qualified for such business should be allowed to enter the retail market. On the other hand, in the retail market, gold should be available to citizens not only in the form of jewellery, but also in the form of investment products. This may help to enrich the content of the retail market and attract more gold consumers and investors, and hence promote the prosperity of this market.

As mentioned above, in order to avoid any possible impact on the foreign exchange market before full convertibility of the capital account is realized, it may be desirable for a period of time after the opening of the market for it to be insulated from international markets. This insulation would be effected by strict control over gold imports and exports. However, large price differentials between domestic and international markets would encourage smuggling. Moreover, excessive price differentials are not consistent with the objective of rational allocation of resources. It would be the responsibility mainly for the central bank to adjust price differences. One option is that the central bank sets up a special fund, and entrusts a commercial bank to balance price differentials between domestic and international markets through sales and purchases of gold at gold exchange. One opinion holds that some commercial banks can be granted special privileges to sell and buy gold at both domestic and international markets to narrow price gaps. Despite some merits of that practice, its drawbacks are also quite obvious. If only one or two commercial banks are permitted to carry out such business, they may take advantage of such privileges to cash in on the price differences to reap a monopolistic profit, which would be very difficult to justify. Corporate interest will be in conflict with national interest. If too many commercial banks are granted special rights to conduct such business, then it is the opening up the international market entirely. Moreover, if commercial banks were granted such special rights subject to an approval procedure, it would be very difficult to stop rent-seeking activities in return for such privileges.

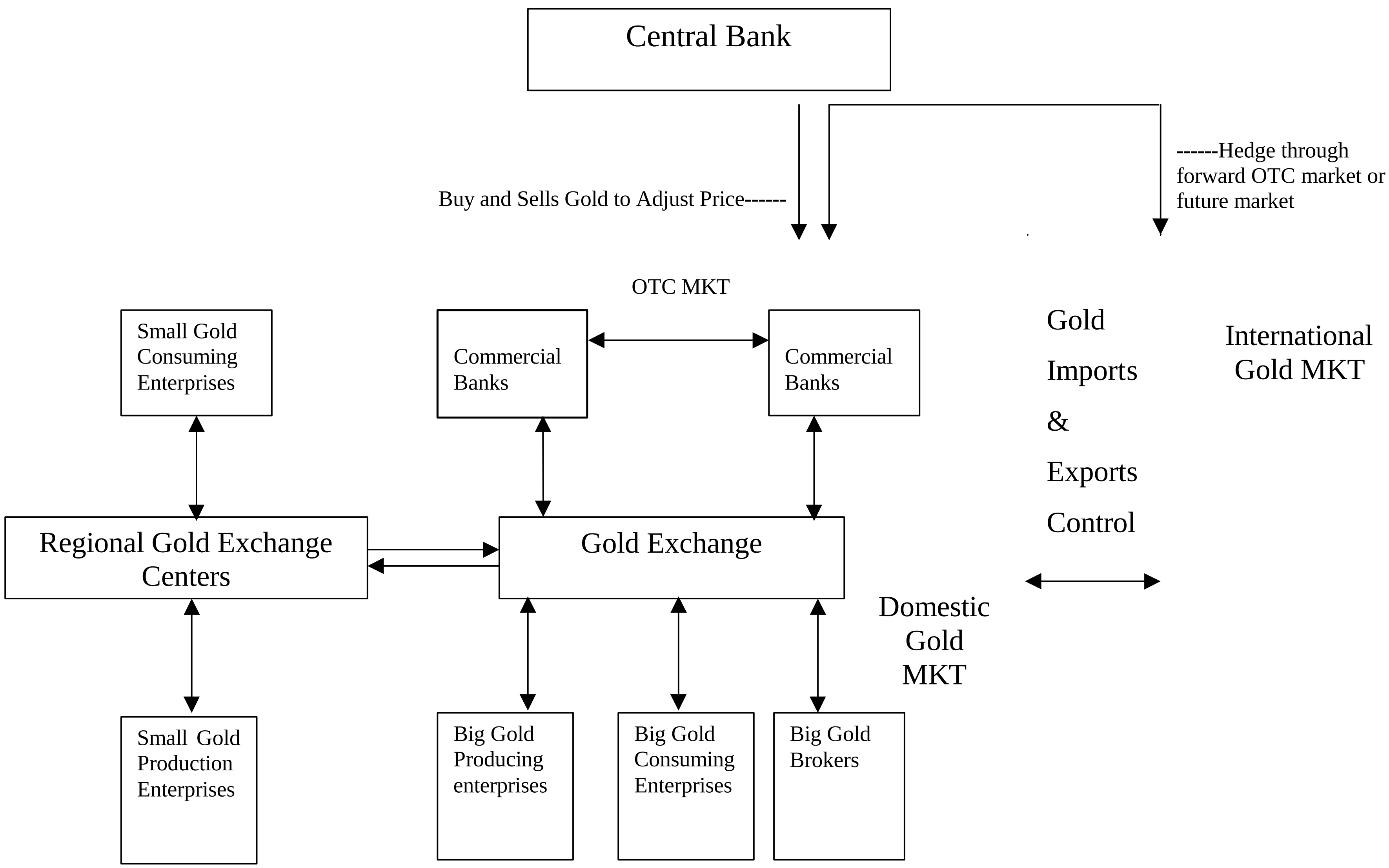
The risk of price fluctuations can be reduced through trading in gold futures contracts and through forward trading with international bullion banks. In the medium to long run, China's gold exchange may find it difficult to resist futures trading. In the early days of the gold exchange, if it is not possible to conduct futures trading due to various reasons, commercial banks with high credit-rating can be granted special permission to participate in futures transactions and forward trading in international gold markets, in order to help gold producing and consuming enterprises to reduce price risks. Such arrangements, if done properly, will not break the insulation between domestic and international markets. This arrangement will appear more significant in that the commercial banks will continue to play a leading role in futures and forward trading in the international gold market after the full linkage between domestic and international gold markets is established in future as they have already gained the necessary experience in the domestic market in its early days.

How foreign business entities will enter China's domestic gold market operations is a matter for further study. Generally speaking, opening up is the trend, but needs to be coordinated with the opening of the national circulation system and the financial system. The sequence of opening can be as follows: retail market to be opened first, allowing foreign-Chinese joint-ventures or exclusive foreign-owned enterprises to do retail business; wholesale and other related businesses will be opened up afterwards. Since the latter will mainly be conducted by overseas commercial banks, when and how to open up will depend on national policies for opening up the financial sector. For the near future, we should encourage technical cooperation and exchanges between domestic and overseas commercial banks, so as to learn from overseas banks their experience and practice in gold transactions.

From the above, we can envisage the basic framework of China's gold market system as it is opened up.

(Chart 1)

(Chart 1)


Central Bank
Buy and Sells Gold to Adjust Price------
------Hedge through forward OTC market or future market
OTC MKT
Small Gold Consuming Enterprises
Commercial Banks
Commercial Banks
Gold Imports & Exports Control
International Gold MKT
Regional Gold Exchange Centers
Gold Exchange
Domestic Gold MKT
Small Gold Production Enterprises
Big Gold Producing enterprises
Big Gold Consuming Enterprises
Big Gold Brokers

This market system embodies the following important principles: the coexistence of various market forms to cater to the diverse and complicated situation at this stage in China; encouragement of reasonable competition between various market forms so as to promote the most efficient market forms; at the initial stage of the new gold market, it is important to maintain a stable and credible transaction environment so as to avoid upheavals during the transitional period.

The following section presents a further elaboration on some important issues concerning the market architecture.

Part 4 Startup, Structure and Operation of the Gold Exchange

1. Main Conditions for the Location of the Gold Exchange

In recent years, many cities in China have indicated their willingness to host the gold exchange. Viewed from technical and economic perspectives, any location for a gold exchange should satisfy the following conditions:

- Large gold trading volume, which is the foundation for establishing a national gold exchange.
- Concentration of commercial banks. A location that offers convenience for commercial banks to play their important and even main role in gold circulation.
- Advanced communication infrastructure. The gold exchange is not only the "hub" of the domestic gold market, it is also the main link with international markets. Its daily operations need to be supported with advanced and fast communication facilities.
- Well-established refinery facilities. When the gold market is first opened, it would be difficult to handle scattered smelting and forging. So, the location where gold trading is concentrated is better to have some good refinery ability.
- Mature market operation and management experience. A gold exchange is not a simple wholesale market of industrial goods. It involves the other aspects of gold as a financial investment and even speculation tool, thus it is important to set a high standard in operational management. Priority should be given to cities, which have experience in establishing and managing other exchanges.

2. The Corporation is a Suitable Organization Structure

Traditional exchanges are membership-based organizations spontaneously formed by traders and brokers. Members formulate trading rules and are self-restraining and self-managing, with their trading capacity directly linked with membership qualifications. Against the background of accelerated globalization of the world economy, fierce competition has forced more and more exchanges to give up traditional membership systems, and turn to a corporate ownership and management structure so as to extend trading time, reduce cost, expand trading scope, to promote cross-product and cross-function integration and mergers and strategic alliance. On June 27, 2000, the Stock Exchange of Hong Kong Limited, the Hong Kong Futures Exchange Limited and the Hong Kong Securities Clearing Co. Ltd. merged to form the Hong Kong Exchanges and Clearing Company Limited, which was then listed on the stock exchange. It became the third listed exchange after the Australia Exchange and Stockholm Exchange. It shows that this kind of reform is gathering momentum.

In establishing a gold exchange in the form of a corporation, sponsors will be mainly gold traders and brokers. At the same time, all the enterprises and individuals related to gold transactions should be given the right to participate. In the establishment of the exchange, the main sponsors should give written notice to other gold producers, jewellery processors, manufacturers who use gold as a raw material, and other traders and intermediary bodies, informing them of their right to participate in the process. In order to avoid a small number of enterprises controlling the exchange, its equity structure should be sufficiently dispersed. Regulatory authorities should define the upper limit of shares held by any single legal or natural person. Wide representation and dispersed share holding will be conducive to the coordination and balance of interest between various parties sponsoring the exchange. This may also help to some extent mitigate the rivalry for hosting the exchange.

The exchange should set up its management structure according to the same principles as for corporations. The annual meeting of shareholders is the supreme authority of the exchange. The board of directors elected by the shareholders has the final say in the operation management of the exchange. The management team is entrusted with the daily operations. Trading rules and management regulations of the exchange are examined and approved by the board of directors and enter into force after appraisal by regulatory authorities. Unlike exchanges based on membership club, the operation management of the gold exchange is overseen by investors instead of self-ruled by members. This kind of structure is more conducive to clarifying exchange ownership, forming internal restraining and controlling mechanisms over management in handling business and outlay, so as to ensure good governance.

A gold exchange is similar to a public utility stock company. Its operations should not be at variance with "Company Law". And at the same time, it is subject to stricter supervision by the government (including the appraisal of trading rules and management regulations, monitoring daily operations and setting the upper limit for the shares held by major shareholders). What is more, the exchange is also subject to scrutiny by exchange members and the general public.

3. Transaction Management and Physical Gold Refining, Storage and Delivery

The exchange should first analyze the possible future scale of transaction in the light of its conditions, determine the number of trading seats, and then, sell an appropriate number of seats to each different category of trading members. After purchasing trading seats, trading members may lease the right to use the seats to others, or transfer the ownership of such seats. With the marketization of domestic gold circulation, the proportion of settlement by physical gold in the concentrated trading market will decline. Even settlement by physical gold will give way more and more to the settlement by warehouse warrants. Therefore, the exchange should follow international practice and select 99.99% pure gold and one currency type, i.e. using RMB as its settlement unit. As regards the price-matching, open-outcry on floor is suggested. Where conditions permit, market-maker system may be introduced to allow some big traders to keep the market viable.

The refining of physical gold should be concentrated as it is for the initial phase of the market opening. Gold to be traded at the exchange should be refined at designated refineries. In the long term, with the steady development and perfection of the domestic gold market, some qualified traders may be granted the right to refine gold on their own under certain conditions. When necessary, foreign refineries can be introduced to provide advanced technology and service support. Physical gold ready for market transaction is deposited at the clearing warehouse designated by the exchange. The exchange is responsible for storage and movement of gold within the clearing warehouse. Traders are responsible for transporting gold outside the clearing warehouse. The exchange follows the system of concentrated bargaining and unified settlement. Unlike futures market, the gold exchange will settle for the whole contract amount and not just for margins. After each deal, the exchange will freeze the buyer's contract amount and the seller's gold according to the contract amount and price, as is the case in international practice. At the end of each session, the settlement function of the exchange will, after deduction of tax and fees, enter the money and gold involved in the transaction respectively in the seller and buyer's account.

In order to enable those traders who need some time to arrange funds or physical gold to fix deals, a settlement system called "deferred clearing" can be introduced. The right to do "deferred clearing" is to be granted by the settlement department which takes into account the transaction volume and credit-worthiness of the exchange members. During settlement after the market is closed for the day, exchange members eligible for deferred clearing (referred to as "eligible members" hereinafter) will only have certain percentage of the total transaction volume frozen, be it money or gold, and they will be unfrozen when it comes to actual settlement. If an exchange member buying from or selling to an eligible member does not have this right, then its money or gold needs to be frozen for the full transaction amount. But the two parties can agree at the time when the transaction is fixed that the eligible member shall compensate the opposite party for deferred clearing, specifying the subsidy standard, or "the warehouse fee" or "interest subsidy". The time limit for deferred clearing is set by the exchange. Eligible members must complete clearing within such time limit, either by physical gold or by cash. If a gold price shift causes loss to an eligible member, and if such loss plus subsidies due to non-eligible member have reached the point equal to the frozen sum of money or gold, the settlement function of the exchange has the right to resort to forced delivery of the frozen portion and conduct clearing by cash.

Part 5 The Ever More Important Role of Commercial Banks

1. The Status and Role of Commercial Banks in the International Gold Market

The experience of international gold market development indicates that the participation of financial institutions headed by commercial banks in the early stage of gold market development can help in many ways. On the one hand, the operational experience and marketing channels of commercial banks may help expand gold transactions. On the other hand, the business scope of commercial banks may also be expanded in return. They can mobilize their financial strength to provide necessary funds for the gold market and maintain market liquidity.

Generally speaking, commercial banks may enter the following aspects of gold market operations:

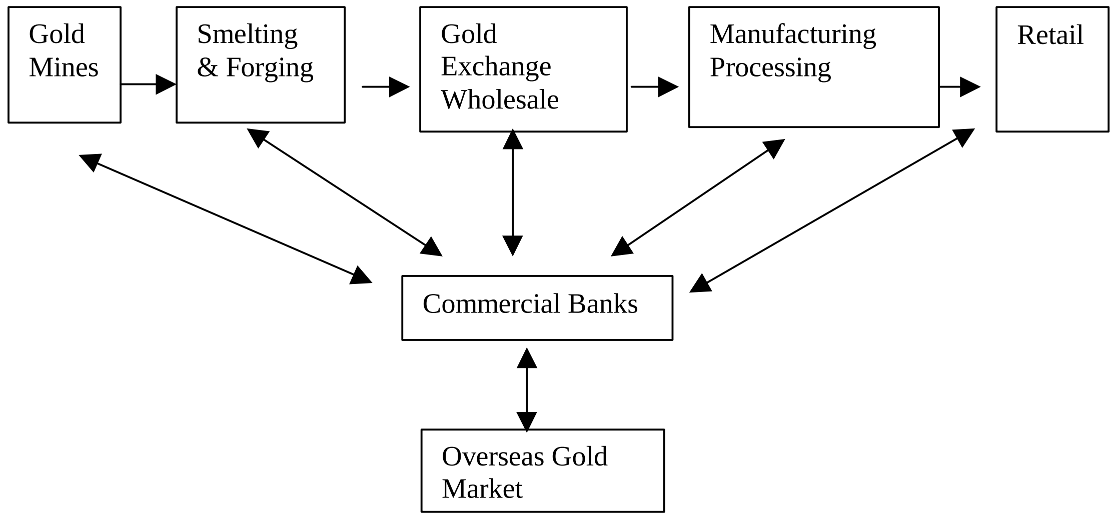
- Gold clearing and delivery service. In general, big commercial (bullion) banks participate in international gold market clearing. Relying on their financial strength and gold storage facilities at various locations, they are in a position to provide clearing, storage and physical gold delivery services for the gold market at any time and place.
- Gold leasing operations. They can provide gold loans to enterprises. The banks lend out gold. The customers repay interest on the borrowed gold at regular terms (the interest rate is lower than that on borrowing money), and return gold as the loan matures. In this way, the customer can get the much-needed gold raw material. The customers also save on interest payment and, if well manipulated, reduce losses resulting from price fluctuations.
- Gold trading and brokerage. As members of the gold market, commercial banks can purchase gold in the market for their own accounts, they can also enter gold transactions on behalf of their clients. The gold markets in London, Zurich, New York, Tokyo, Hong Kong, and Singapore have developed into an invisible OTC trading network. As members of those markets, commercial banks can provide gold transaction services to their clients at any time. Whenever a client indicates his or her willingness to sell or buy gold by telephone, commercial banks can immediately quote a buying or selling price of gold.
- Gold retail service and others. This mainly consists of over-the-counter (OTC) service to the general public and private investors, including selling and purchase of gold, gold safekeeping and gold savings or investment accounts.

2. Process Flow and Basic Functions of Commercial Banks in the Gold Trade

For commercial banks, engaging in gold business can effectively expand their business scope. They can also use their network systems, ample funding, personnel and information resources to provide quality service to both gold suppliers and consumers. The chart below shows business opportunities for commercial banks at each link of the value chain of gold circulation.

(Chart 2)

(Chart 2)


Gold
Mines
Smelting
& Forging
Gold
Exchange
Wholesale
Manufacturing
Processing
Retail
Commercial Banks
Overseas Gold
Market

More specifically, commercial banks can (1) provide gold mines, refining plants with regular loans for them to renovate their equipment, increase their investment and provide financial derivatives such as forward sales to help them to avoid price risk; (2) as members of the gold exchange, buy and sell gold for their own accounts, or on behalf of non-member enterprises to earn commissions; (3) provide services to gold jewellery manufacturing and wholesale enterprises, such as souring raw materials, gold consignment sales, gold lending or gold leasing; (4) provide such services to general consumers as trading in gold bars, gold coins, gold bullion and other investment gold products, gold deposits, average price gold purchase scheme, and gold safe-keeping; (5)serve as a bridge between domestic and international gold markets, act as an agent for domestic enterprises to conduct arbitrage, and organize export/ import of physical gold.

3. Advantages, Problems and Policy Support for Commercial Banks Involved in the Opening of China's Gold Market

In the process of opening China's gold market, commercial banks enjoy certain obvious advantages as compared with other market entrants, e.g. the powerful financial strength, the ability to mobilize large sums of money through the inter-bank borrowing market, a low cost of funding that is very important for the capital-intensive gold business, a wide-spread network of outlets, comprehensive client base, almost perfect sales channels for gold, well-established internal management and regulatory mechanisms, professional management and trading specialists to raise operational efficiency, sophisticated computer systems to provide clients with fast quotation information and efficient transaction services, a solid and perfect vault to facilitate storage of physical gold and reduce its handling cost, comprehensive relations with other banks to easily conduct offsetting transactions and balance their positions, high credit-worthiness, strict government supervision and a good market reputation. Besides, most of the domestic major commercial banks conduct foreign exchange transactions. They buy and sell foreign exchange for their clients, in a similar way as the gold exchange shall operate. The foreign exchange business departments and networks of commercial banks can carry out gold transactions simultaneously with a trivial increase in cost, etc.

On the other hand, domestic commercial banks also confront some problems in participating in gold market circulation. Firstly, the "Commercial Bank Law" restricts commercial banks from entering into gold business. Secondly, except for the Bank of China, other domestic commercial banks lack experience in gold business operations. Some of them lack a clear understanding of such business. In order to encourage commercial banks to enter gold market circulation, the People's Bank of China should amend the "Commercial Bank Law" so as to allow commercial banks to engage in gold business, including "borrow gold and repay gold" lending for domestic clients, gold arbitrage at international gold market, gold deposit, brokerage for gold sales and purchase, gold safe-keeping, as well as gold investment. On the part of commercial banks, they should understand the importance of participating in gold market circulation, and realize this is an important business opportunity for them, and a new area of competition among them. They should be prepared to enter this area in terms of qualified personnel, institutional structure and material inputs.

Part 6 Tax Policy Options after Market Opening

1. Current Status of Tax Collection for China's Gold Production, Circulation and Jewellery Business

Since tax reform in 1994, the government has issued some preferential tax policies vis-a-vis the gold business. When the international gold price was close to the price of domestic gold that was centrally controlled for its purchase and sales, such policies guaranteed that gold enterprises got some profit.

As far as gold mining, refining and circulation are concerned: Beginning from July 1 1996, the resource tax on original gold ore products has been reduced by 30%; beginning from the tax reform of 1994, VAT has been exempted for gold produced and sold by gold mines and smelting enterprises. Since 1994, the People's Bank of China started the policy to refund the VAT as soon as it is collected on the allocated sales of gold. Since April 1 1994, a mineral resource compensation fee has been levied on gold mines. It is estimated that this compensation fee accounts for about 2.9%-3% of an enterprise's sales income.

As far as the gold jewellery business is concerned: wholesale and retail enterprises both pay 17% VAT on the value added part. Since 1995, consumption tax has been reduced from 10% to 5% for gold jewellery on the total value (including gold, silver and gold-based and silver-based alloys and in-bedded ornaments). The point of levy has changed from wholesale to retail.

As regards import/export of gold and related products: Since January 1 1996, government-approved imports of gold and concentrates can be exempted of VAT; gold raw material and gold-containing industrial goods or for laboratory use enjoy 0-11% preferential tax rate; export of gold jewellery enjoys 17% VAT refund, but not consumption tax refund. But since June 20, 2000, export of gold products made out of imported gold raw material will no longer enjoy refund; import of gold jewellery has to pay custom tariff of 40%, and on top of that, the customs office levies 17% VAT but not consumption tax.

2. International Comparison of Gold and Gold Jewellery Taxes

Gold can be divided on the basis of its nature and uses into raw material gold, investment gold and jewellery gold. Raw material gold is a primary product, with low value-added. Investment gold is a financial product, highly liquid and valuable for investment. It exists in the form of pure gold bullion, gold bars and coins. Jewellery gold is a consumption good just like other consumer good. Various countries adopt different tax policies in the light of the 3 kinds of characteristics of gold.

Raw material gold usually enjoys favorable tax treatment. In Europe, according to “European Special Tax Scheme”, raw material gold enjoys special tax treatment from mining to processing stages: from mining to refinery, only processing fees are subject to VAT; from production enterprises, exchange market to processing links, VAT is refunded as soon as it is collected; producers exporting gold enjoy zero tax rate; refineries, and the gold exchange market pay VAT for the raw material gold they import and may have their tax refunded upon showing invoices evidencing sales of such gold.

Most countries have preferential tax policies regarding VAT (sales tax) on investment gold. Some countries do not levy on investment gold products and other refund tax after collecting it. Such countries and regions include the 15 EU member countries, Malaysia, Thailand, Indonesia, Hong Kong and Taiwan.

Countries refunding tax under certain conditions include Japan. Countries levying VAT include Korea, the Czech Republic and Russia. There are many reasons for granting tax preferences to investment gold. For example, gold is a financial product. Just as stocks, bonds, and savings are not subject to VAT, there is no reason to levy VAT on investment gold products. Investment gold is quite liquid, and easy to cash in. The gold price is very sensitive to taxation, so it is very easy for tax-evading and smuggling to occur. The social cost for stopping such smuggling may be higher than the benefit of any incremental tax revenue.

There are two main systems practised in the international market with regard to consumption tax on jewellery gold products. Some European countries, in order to avoid double taxation, do not levy consumption tax on jewellery gold products while already having the VAT on circulation links. But some countries regard jewellery gold as a general commodity or luxury good and levy about 10% consumption tax or similar taxes.

With regard to import and export of gold, most countries follow zero tax rate on gold exports (usually fully refund VAT already paid previously), and collect no tax or low tax on import of raw material gold (bullion). But most of them charge rather high tariff rate (5-30%) on imported gold jewellery.

In order to encourage gold market transactions, some European countries implement “black box tax policy”. Namely, implementing a preferential VAT policy for the gold exchange. For example: gold transactions within the exchange (floor transactions where physical gold does not actually leave the market ring) are exempted from tax; varying rates of VAT are levied on gold physically delivered and moved out of the market; members entering into transactions with non-members will benefit from tax refund scheme according to VAT invoices issued to the buying party. They enjoy tax exemption when dealing with private traders and zero tax rate when dealing with export enterprises.

3. Factors for Tax Policy Considerations and Alternatives

Along with the deepening of China’s gold production and circulation system reform and market opening, the adjustment of taxation has become a growing concern to various parties. The formulation of tax policy under changed circumstances should mainly consider the following:

- The objective of reform is to form a gold production and circulation system compatible with the market economy. The formulation of tax policy should conform to the same objective.
- In view of the problems resulting from the “delayed” tax adjustment after the opening of the silver market, tax policy adjustments related to

the gold market should be advanced in priority;

- At the early stage of gold market opening, enterprises involved in gold production and circulation are in the process of readjustment. Some are newly founded. They are fragile under a heavy burden. So, tax policy should be one of encouragement and support;
- The domestic gold market is highly interactive with the international market, dealing with smuggling is expensive. Therefore, the main rates at home must not differ too much from corresponding tax rates of international markets, especially those of neighboring countries. In other words, they should be aligned with international practice;
- Attention should be paid to the consistency and stability of tax policies. Some adjustment policies may be implemented step by step.

Proceeding from the above understanding, and looking at international experience, we can briefly evaluate China's current tax system on gold as follows: On the whole, gold production, refining and procurement enjoy encouragement policies similar to international practice; VAT and consumption tax rates on jewellery gold are much higher than world standard; raw material gold import and jewellery export enjoy tax favors, but custom tariffs on jewellery imports are higher than most countries. Against such a background, the following tax scheme can be considered for the initial stage of gold market opening:

- The current tax scheme on gold production and refining can be maintained. Can VAT exemption be terminated for gold producing and refining enterprises after the reform of gold circulation system, as is the case for silver-producing enterprises? We think it inappropriate to terminate VAT exemption, in consideration of the burden on domestic gold producing and refining enterprises, and increasing their competitiveness at home and overseas markets and compatibility with international practice.

- Preferential VAT will be levied on raw material gold entering various legal markets. The "legal markets" refer to the gold exchange, government-approved OTC gold markets and regional gold exchange centers. There are two alternatives: One is to continue with VAT exemption for gold-producing enterprises. Gold transactions concluded in the markets (referring to transfer of gold ownership, without physical gold departure from the markets) are exempted from VAT. If physical gold delivery takes place in the markets and gold is physically shipped out, the markets will issue VAT invoices to the buyers, and VAT will be refunded as soon as it is collected. The other alternative is to practise VAT Immediate Refund for gold producing enterprises; the seller issues the VAT invoice to the gold markets if the gold is sold into the market (VAT could be refunded as soon as it is collected for the gold producing enterprises). Then gold transactions concluded in the markets (referring to transfer of gold ownership, without physical gold departure from the markets) are exempted from VAT. If physical gold delivery takes place in the markets and gold is physically shipped out, the markets will issue VAT invoices to the buyers, and VAT will be refunded as soon as it is collected.

- There are merits and defects to the above alternatives. The first alternative is better for the initial period of market development. Preferential tax policy on raw material gold in legal markets is conducive to policy consistency and promotes the growth of government-approved legal markets.

- Consumption tax of 5% on gold jewellery should be waived to encourage the development of domestic gold jewellery enterprises. And 17% VAT should only be charged on the value added part, not on the total value of jewellery. This will help to bring out the advantages of China's labor-intensive industry and suppress smuggling.

- Along with the opening up of investment gold products to society, international practice should be adopted to give tax preferences to investment gold products.

- Tax policy on import and export of gold should be basically the same. But tariffs on gold jewellery imports can be lowered as appropriate, e.g. to 20%-30% level. This may help to undercut smuggling and stimulate market competition between domestic gold jewellery processing enterprises.

Part 7 Issues of Gold Market Regulation/Supervision

1. The Multiple Roles of Gold Call for Intensified Market Regulation and Supervision

Gold is a special commodity with multiple roles. Apart from the above-mentioned roles as a general commodity and a financial product, its monetary character should also be emphasized. Viewed from the history of monetary development, the collapse of the Bretton Woods System in

1973 meant that there was no longer a formal gold-dollar linking. Nevertheless, the attempt to write gold out of international monetary arrangements was unsuccessful.

The special characteristics of gold determine that its monetary role will be with us for a long time to come. Although in recent years, gold reserves in various countries have been falling in proportion to total reserves, the demand for gold in jewellery and industrial uses have been rising in proportion to total gold demand. It remains the case as demonstrated by the Bank for International Settlements (BIS) that gold is one of the acceptable tools for international settlement. Among the general public, gold is taken as an important medium for value keeping and risk-avoidance, actually recognizing its monetary function in terms of value and payment reliability. Therefore, gold today remains a special commodity with general, financial and monetary traits. In the process of opening a gold market, each of the three traits belongs to a different market category. But in practice, it is impossible for one market to accommodate all the three different categories. As a general commodity, a market for production raw materials is more appropriate. As a financial product, it needs a financial market. As a sort of a currency, it will affect the foreign exchange market. For the latter two markets, requirements for regulation are very compelling. Imports and exports of gold represent not only transnational flows of commodities, namely international trade, but also transnational flows of capital. If gold circulation is not well regulated, it may exert an impact on national foreign exchange policy and the foreign exchange rate. China has not achieved free capital account convertibility, which is all the more reason to exercise strict control over gold imports and exports. The reform of the gold production and circulation system requires the government to reduce its intervention. But that does not mean forsaking market regulation. Government supervision and regulation under the new system is fundamentally different from government control over gold production and circulation under the traditional system. The crux of the systemic transition is not to get rid of government management; rather, it is to change the way government manages. Viewed in the international context, regulation of gold markets has always been emphasized. Take the London Gold Market, the world's major gold market, for example. Although it is the world's biggest, free-trading gold market, it is still subject to strict supervision and control by the Financial Services Authority (FSA) - the superior body to the Bank of England and to oversight by London Bullion Market Association for self-discipline.

2. Choice of Regulatory Body

In the selection of a regulatory body for the gold market, the People's Bank of China in the position of the Central Bank has obvious advantages in terms of management experience, historic continuity, ease of coordination between gold and money markets and the foreign exchange market. Firstly, the PBC has been for many years responsible for managing national gold reserves, and for the purchase and allocation of gold. It has accumulated rich experience in gold circulation management. Secondly, during the period of time when government has exercised foreign exchange control under the capital account, imports and exports of gold have also been subject to strict control. This has resulted in insulation between domestic and international markets, causing price differentials between those two markets. As is pointed out in the preceding paragraphs, in order to avoid such problems as gold smuggling stimulated by large price differentials, it is necessary for the PBC to balance prices between domestic and international markets through buying or selling gold. This function can be better performed by the authority, which at the same time is vested with the regulatory function.

In addition, as is evidenced by the development of gold markets in most countries in the world, "gold management system should be coordinated with national foreign exchange management system". Since the PBC is responsible for the national foreign exchange management, supervision over the gold market by the PBC will be conducive to achieving harmony between the gold market management system and the foreign exchange management system. Finally, the PBC may buy and sell gold in the domestic market as an adjustment tool for its monetary policy, in furtherance of its monetary policy objectives as the central bank.

The gold market involves many sectors, and presents various problems at its initial opening stage. Therefore, gold market regulation calls for the participation and support of other government bodies. The management of a gold spot market, gold futures market and retail market as well as imports and exports requires the participation of national commodity market regulatory bodies, futures market regulatory bodies as well as foreign trade management bodies. Their participation may facilitate an exchange of experience among those bodies and what is more important, coordinate their relations, avoid and reduce inter-departmental conflict of interest and policy incoherence.

In terms of organizational structure, one possibility is for the PBC to organize a committee with representatives from the PBC and other relevant regulatory bodies as well as related experts. If necessary, the committee may be headed by a government leader at vice-premier level. The functions of the committee would include the formulation of a strategic plan, principles and policies for China's gold market development, and advice on relevant legislation. The day-to-day regulatory work would be executed by a special subsidiary of the PBC.

3. Objectives, Content and Main Duties of Regulation

Under the new system, the regulatory authority must not follow the old administrative way. It should explore and establish a regulatory mode suited to a market economy and compatible with international practice. That is quite a challenge to the newly established regulatory authority.

As for the objectives for gold market supervision and control, they should be the promotion of a steady and healthy development of the gold market, in accordance with the general development strategy for China's gold market, and in coordination with national monetary policy and foreign exchange control system, and in anticipation of their evolution. The content of regulation will include: (1) entry standards for market participants and products, trading norms and rules, advice to relevant legislative bodies; (2) market monitoring and supervision, including monitoring gold market operations, supervising market players' behavior, investigating and penalizing violators of market discipline; (3) gold market adjustment and control; utilizing gold market buffer fund and other means to maintain equilibrium between supply and demand, price stability and gold storage security; (4) to formulate, coordinate and implement other policies relevant to gold market development.

It should be emphasized that legislation is of fundamental importance to the growth of China's gold market. When conditions permit, swift action should to be taken to update the necessary legislative procedures, amend out-dated laws and regulations and form a complete legal framework for gold market operations and regulation. Through the effort of all parties concerned, market participants and regulators will then have a robust set of laws to go by.

Part 8 Summary: Abstracts of Comments and Suggestions

The analysis and views of this report can be summed up as follows:

- With the pressing urgency for reform of China's gold production and circulation system, the need for market opening and the basic orientation of reform and market opening has become clear. Conditions in other related areas have developed favorably. Reform and opening up process should therefore be accelerated and not delayed.

- The opening of the gold market, in a sense, is a process to restore and extend gold's functions both as a general commodity and also as a financial commodity. The design for opening the market has to consider the transaction requirements of gold as a general commodity as well as a financial product. The main issues to be resolved for the opening of the gold market include: equilibrating supply and demand, price setting, lowering transactions costs, avoiding and diverting price risks.

- China's gold market, after opening, cannot be of one monolithic form. It should accommodate such market forms as a national gold exchange, an inter-bank (OTC) gold market, regional gold exchange centers and a retail gold market. While the ultimate aim is to align with mature international markets, in the early days more attention should be directed to the special transitional market forms suited to China's current realities. Rational competition between different market forms is to be allowed and encouraged. The most effective market forms are to be promoted. At the inception of market operations, it is important to achieve a stable and credit-worthy trading environment, and to avoid big upheavals during the transition period.

- It is still necessary to establish a nation-wide gold exchange. Its biggest advantage is to create a highly credit-backed and predictable market environment, which is especially important at the inception of market opening. The gold exchange should assume a corporate organization structure, in conformity with international practice.

- Commercial banks have a wealth of funds, network of operations, personnel, management know-how and credibility, and can provide services for gold production, circulation and other links. They can play an ever more important role and even a main role in the newly established gold circulation system. In order to encourage domestic commercial banks to take part in gold market circulation, the current "Commercial Bank Law" should be amended, and commercial banks should be permitted to conduct gold operations. Commercial banks should understand better the importance of participating in gold market circulation, and get prepared in terms of necessary personnel, institutional and other infrastructure set-up. Domestic commercial banks should be encouraged to cooperate with and learn from overseas commercial banks their practices and experience in gold exchange operations.

• How foreign business entities will enter China's domestic gold market operations is a matter for further study. The sequence of opening can be as follows: retail market to be opened first, allowing foreign-Chinese joint-ventures or exclusive foreign-owned enterprises to do retail business; wholesale and other related businesses will be opened up afterwards. Since the latter will mainly be conducted by overseas commercial banks, when and how to open up will depend on national policies for opening up the financial sector. For the near future, overseas commercial banks could start the technical cooperation and exchanges with domestic commercial banks to share their experience and practice in gold transactions.

• In view of the numerous problems resulting from delayed tax adjustment following the opening of the silver market, tax policy adjustment in support of gold market opening should be given a high priority. Given the current realities of domestic gold producing and circulating enterprises and the necessity to bring themselves up to re-align with international practice, tax policy should be one of encouragement and support. The main points are: maintain existing tax policy for gold production and refining stages; apply preferential VAT policy to raw material gold traded in legal markets; abolish 5% consumption tax on gold jewellery and the 17% VAT only for value-added part; with the opening of investment gold products to the general public, grant tax preferences to investment gold transactions; basically maintain the existing tax policy on gold import and export, but lower tariff rates on gold jewellery imports as appropriate.

• Reform of the gold production and circulation system calls for reduced government intervention, but it does not mean forsaking market supervision and regulation. The crux of the matter lies in the transformation of government management methods. With respect to institutional arrangements, one option is to form a committee comprising of representatives from the PBC and other relevant departments as well as related experts. The committee's main functions would be formulating development strategy and principles and policies for China's gold market, and putting forward suggestions for relevant legislation. A special body under the PBC would execute day-to-day supervision. Under the new system, regulatory bodies would not stick to the old ways of rule by administrative orders. Rather, they should explore regulatory methods suited to a market economy and compatible with international practices and attach importance to the rule of law.

Project team:

Entitled “Opening China’s Gold Market in a New Era: Related Policy Research and Suggestions”, by the Development Research Center under the State Council of P.R.C.

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During the research work, experts and scholars from domestic and international gold field have offered valuable information, comments and suggestions, to whom we hereby extend our gratitude.

October, 2000

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