Creating the momentum for stable and healthy development

Shang Fulin, chairman of the China Securities Regulatory Commission, explains to Euromoney the efforts the CSRC has made to build a futures market – and how the launch of index futures will affect China’s capital markets.

As the regulator of China’s futures market, what important policies have been implemented by the China Securities Regulatory Commission (CSRC) regarding legislation, institution and market development? What are the achievements? What are the plans for the further enhancement of regulation and the growth of the futures market?

China’s futures market has a 20-year history. In the new century, the Chinese government put forward the strategy of “steadily develop the futures market”, which pointed out the direction for the development of China’s futures market. Especially, after the State Council released Opinions of the State Council on Promoting Reform, Opening and Steady Growth of Capital Markets, CSRC upheld the strategy of combining international experiences with the realities in China, and comprehensively reformed the futures market. China’s market shows a good momentum of stable and healthy development.

First, market regulations and market infrastructure have been steadily improved. Currently, a system of laws and regulations suited to the realities in China has been basically established. The Regulations on the Administration of Futures Trading promulgated by The State Council is the core of the system. The Commission department regulations and regulatory documents are the main and the business rules of the Futures Exchanges, Futures Margin Monitoring Center and the China Futures Association are for the supplement. Meanwhile, the institutional infrastructures of the futures market are improving. The China Futures Margin

“China’s commodity futures market has become one of the biggest in the world in terms of trading volume”
The China's financial futures market is gradually assuming its economic functionality. The futures market is ever-increasingly integrated with the cash market and real economy, and its ability to serve the related companies in the industry chain is continuously improving. Currently, futures prices are becoming the pricing basis of the spot trade negotiations in some industries. Prices of some of the relatively mature futures contracts like non-ferrous metals are increasingly seen as an influential factor in commodity pricing. The development of the China's futures market provides some related agricultural and industrial companies with a platform to hedge and manage their risks. More and more enterprises start using futures market to smooth their operation.

In the future, CSRC is going to adhere to the guideline of “steadily develop the futures market”; solidly improve the market infrastructures and promote the coordinated development of China's commodity and financial futures markets. The regulatory policies of CSRC will focus on cracking down on market manipulation, preventing and resolving risks, promoting market functioning and protecting the legitimate rights and interests of investors.

The stock index futures were launched in the China's Financial Futures Exchange on 16 April this year. How is it going to affect China's capital market? What are plans of the stock index futures' development?

After nine-year research, four-month thorough planning and three-month detailed preparation, the stock index futures, a mature futures product in the global market, was successfully and smoothly launched. The launch of stock index futures under the background of global financial crisis shows the determination of the Chinese government to promote the capital market reform and development. This indicates that China has taken a key step in building its financial futures market. China's development of the stock index futures will help change the situation that China's stock market has long been a one-directional market. This is going to improve the market mechanism, increase market flexibility and prevent market volatility. The development of the stock index futures is also conducive to the capital market price formation mechanism, the optimal allocation of resources and the industrial restructuring. It will help to improve the futures market system, to expand the scope of futures companies' business, to enrich the instruments of risk management of financial institutions. It is helpful to foster sophisticated institutional investors and safeguard the legitimate rights and interests of investors.

From the current market situation, the stock index futures market achieved a smooth start overall. The trading is fairly active. Investors are relatively rational. The co-movement of futures prices and spot prices are relatively high. The trading systems, intermediary institutions and regulatory system have withstood the market test. Next, the CSRC will continue to explore in depth the operation law of stock index futures, innovate the ways and means of regulation, strengthen the ability of research and risk judgment. Efforts should be put on promoting the smooth operation and the gradual improvement of the function of the stock index futures market to give China's financial futures market a good starting point.

How does CSRC encourage investors to participate in the futures market rationally, to carry out hedging through futures but not excessive speculation?

Futures market is a specialized risk management market, with high-lev-
erage and high-risk characteristics. It is not suitable for retail investors to participate. To strengthen the risk education of investors from the source, the Commission introduced the Regulatory Rule of Qualified Investors in the stock index futures market, drawing on the concept of the appropriate product sold to the appropriate investor from the international market. By monitoring the account opening activities of the futures companies and the security companies conducting introducing broker business, the Commission requires intermediaries to "fully understand their customers"; combine hard and flexible indicators to comprehensively assess investors' awareness of the stock index futures, their acceptability and risk tolerance level, and guide rational investors to participate in stock index futures market. As the strict implementation of the Regulatory Rule of Qualified Investors, the phenomena of irrational speculation on new instruments didn't appear after the listing of stock index futures. Most investors participated in the trading rationally. Next, CSRC is considering implementing the Regulatory Rule of Qualified

Efforts should be put into ensuring the smooth operation and the gradual improvement of the functions of the stock index futures market, to give China's financial futures market a good starting point.

The stock index futures were launched in the China's Financial Futures Exchange on 16 April this year. How is it going to affect China's capital market? What are plans of the stock index futures' development?
Investors in China’s commodity futures market.

To guide and encourage enterprises to actively participate in and make use of the futures markets is one of the basic policy orientations of the futures market regulation and development. The Commission will guide and supervise the Futures Exchanges to revise and improve the contract specification and the trading rules to be favourable for the enterprises to hedge their cash positions. The Commission will encourage the industrial enterprises to hedge and manage their risks in the futures market through market nurture and investor education. The Commission will lead the futures companies to become professional futures brokers, to strengthen their intermediary functions and their capacity to service the enterprises to hedge their risks. At the same time, the commission will lead the effort to actively cultivate professional institutional investors in the futures market.

**China’s commodity futures market currently has 23 products, and stock index futures are also available now. What are the plans on the new product development in the future?**

In recent years, innovation sped up in China’s futures market. Many new commodity futures were launched in a relatively fast speed. Currently, except crude oil, all the main varieties of commodity futures available in the international market are listed in the exchanges in China. In particular, the first financial futures -- stock index futures, was successfully launched this year. The Commission actively and steadily promotes the innovation of commodity futures according to the principle that risks are measurable, controllable and acceptable. First, the new product must be necessary for national economic growth and the listing will help improve the economic functions of futures markets; second, the conditions on the spot market must be mature. Specifically, the Commission conducts a comprehensive evaluation on the size of the spot market of the underlining commodity, the difficulty of standardization, the convenience of physical delivery and other related factors. Third, the design of the contract, and the trading, clearing, settlement and other related institutional arrangements should facilitate price discovery and corporate hedging.

Next, the Commission will continue to actively support the Futures Exchanges to steadily develop new varieties of commodity futures, which meet the needs of the national economic development and whose market conditions are mature. Meanwhile, the Commission will summarize the experiences of the stock index futures development and study the introduction of other financial futures and options products that are helpful to China’s financial market reform and development.

**Currently, what is the status of foreign investment in China’s futures market and what is their performance? Are there any initiatives to open up China’s futures market in the future?**

The Commission is actively and steadily pushing forward the opening up of the futures market based on the overall framework of the capital market opening policy. Many international production and distribution companies participate in China’s futures market through its joint ventures or wholly owned enterprises established in China. Six futures companies have set up subsidiaries in Hong Kong, and three entities with Hong Kong background have invested in futures companies based in mainland. Thirty-three qualified SOEs are granted licence to hedge in offshore futures market. The feasibility of offshore brokerage pilot programme is being studied. The Commission will conduct analysis and assessment of the effectiveness of the opening up policy on the futures market. The Commission will adhere to the overall strategy of opening up and promote the opening of China’s futures market in an orderly fashion according to its own development needs.

**How do the China’s futures market regulatory bodies, exchanges and intermediaries cooperate with their international counterparts?**

The financial crisis last year spread and transmit rapidly worldwide. This further reinforced the necessity and importance of the international cooperation of regulation. The Commission is actively and steadily pushing forward the opening of capital markets according to the overall strategic plan of national economic reform and opening-up. High priority has been given to the exchanges and cooperation with the oversea securities and futures regulators. Up to 12 May 2010, the Commission has signed 47 memorandums of cooperation with related foreign exchanges and futures associations. The Futures Exchanges and the China Futures Association have also signed a number of memorandums of cooperation with related foreign exchanges and futures associations. The capital market innovation is also going to across national boundaries with the economic globalization. To prevent and control systemic risk, the Commission hopes to cooperate with other national financial regulators to jointly cope with various crises and challenges.
<table>
<thead>
<tr>
<th>Exchange</th>
<th>Chinese Futures and Commodities Exchanges</th>
<th>Zhengzhou Commodity Exchange</th>
<th>Dalian Commodity Exchange</th>
<th>China Financial Futures Exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>City</strong></td>
<td>Shanghai Futures Exchange</td>
<td>Zhengzhou</td>
<td>Dalian</td>
<td>Shanghai</td>
</tr>
<tr>
<td><strong>Founded</strong></td>
<td>Its current form dates from the 1999 merger of three Shanghai exchanges</td>
<td>October 1990</td>
<td>1/2/1993</td>
<td>1/9/2006</td>
</tr>
<tr>
<td><strong>Trading began</strong></td>
<td>1993</td>
<td>May 1993</td>
<td>1993</td>
<td>April 2010</td>
</tr>
<tr>
<td><strong>Contracts offered</strong></td>
<td>Copper, aluminium, zinc, gold, steel rebar, steel wire rod, natural rubber, fuel oil</td>
<td>Wheat (including strong gluten wheat and hard white winter wheat), cotton, white sugar, pure terephthalic acid (PTA), asphalted oil, early rice</td>
<td>Soybeans (No. 1 and No. 2), corn, soybean meal, soybean oil, RBD palm oil, LLDPE (low density polyethylene) and PVC</td>
<td>CSI 300 index futures</td>
</tr>
<tr>
<td><strong>Selected volume statistics</strong></td>
<td>Copper: 82.11 million lots in 2009 - greater than the London Metals Exchange. Natural rubber futures: world leader. Fuel oil contract ranks third behind NYMEX WTI and ICE Brent Crude among energy futures worldwide.</td>
<td>Cotton: 17.07 million contracts worth RMB1.3 trillion traded in 2009; more than 19 million contracts worth RMB1.59 trillion in the first four months of 2010. White sugar: 29.21 million contracts worth RMB1.28 trillion in 2009; 260 million contracts worth RMB1.38 trillion in the first four months of 2010. PTA: 105.5 million contracts worth RMB1.3 trillion in 2009; 31.9 million contracts worth RMB1.3 trillion in the first four months of 2010.</td>
<td>Total exchange: 83.4 million bilateral contracts, worth RMB36.94 trillion, in 2009 - the world’s largest agricultural futures market and the world’s largest plastics futures market. Soybean meal: 310.8 million contracts in 2009. Soybean oil: trading volume (bilateral) of 189.67 million contracts worth RMB 13.78 trillion in 2009. Plastics: LLDPE and CVC combined trading volume was 126 million contacts totaling RMB5.74 trillion in turnover in 2009.</td>
<td>In the first three weeks of trading up to May 5, the average daily volume has been 130,000 contracts. Single-day high to date has been 190,000. Open interest was 13,000 contracts on May 5. However at this early stage institutions are generally not involved; volumes are expected to increase significantly when they are</td>
</tr>
<tr>
<td><strong>Technology platform</strong></td>
<td>Launched a New Generation Exchange System in November 2006.</td>
<td>Oracle database; system operation platforms are HP-UX, Linux and Windows; trading system is made up of core trading subsystem, settlement subsystem, warehouse warrants management and delivery subsystem and member service subsystem.</td>
<td>Sixth generation system capable of 6,000 transactions per second and three million per day. Consists of 30 small machines, 50 PC servers, over 100 pieces of network and security equipment, and has passed ISO9000 certification.</td>
<td>New Generation Exchange IT, a Chinese-designed IT system. Can currently handle 10 million orders a day. Maximum capacity is up to 9,000 transactions per second with constant capacity of 6,000 transactions per second</td>
</tr>
<tr>
<td><strong>Regulatory/supervisory notes</strong></td>
<td>Risk management requirements include margin requirements, daily price limits, speculative position limits, large position reporting system, forced liquidation system and risk warning system. In addition a real-time risk monitoring system is used.</td>
<td>Members must hold a license for futures brokerage business from the CSRCC and have registered capital of RMB5 million of more to apply for non-brokerage membership. Membership Qualification Examination Committee vets members.</td>
<td>Non-for-profit member-based self-regulatory organization. Guided by the exchange’s rules and regulations, DCE supervises the business conduct of member firms, overlooks the qualification of warehouses, interacts with banks and other organizations, and so fulfills a self-regulatory role.</td>
<td>For &quot;natural person customers&quot; - individuals - they must have a minimum of RMB500,000 in a margin account, pass a test to show knowledge of index futures, have conducted at least 20 transactions in mock trading or 10 in a commodity market within a set period, and have no restrictions, bans or history of discredit. For institutions, they must have a minimum RMB1 million in net assets and show evidence of strong decision systems and trading processes. Staff must pass a knowledge test</td>
</tr>
<tr>
<td><strong>Membership</strong></td>
<td>210 members of which 167 are futures brokerage firms</td>
<td>215 member firms of which 173 are futures companies</td>
<td>188 member firms: 173 brokerage firms, 15 proprietary firms</td>
<td>128 brokers</td>
</tr>
<tr>
<td><strong>International links</strong></td>
<td>Has MoUs with numerous international exchanges including CME, CBOE, NYMEX, MCX and TFX</td>
<td>Kansai Commodity Exchange, CBOE, NYBOT, BM&amp;F Bovespa, CME, CBOT, Tokyo Grain Exchange, Monetral Exchange, National Multi-Commodity Exchange, Abuja Securities and Commodities Exchange, NYSE-Euronext</td>
<td>Numerous. Member of several industry associations and has signed memorandum of understanding on cooperation with 15 overseas exchanges for cooperation on information sharing, training, product development and technology enhancement. Also has close relationships with regulatory commissions and government bodies.</td>
<td>Not yet</td>
</tr>
</tbody>
</table>

Source: Euromoney and the four exchanges
Bringing financial futures to China

16 April 2010 was a landmark day. After four years of work and development, futures based on the CSI 300 index, China’s leading stock market benchmark, began trading on the China Financial Futures Exchange in Shanghai.

The reception has been remarkable. Up to May 21, the first contract expiration day, there are totally 25 trading days. The average daily volume is 198,207 contracts, with the lowest of 58,457 contracts, and the highest of 362,039 contracts, and most of the trading is concentrated on near month contract. Open interest grows steadily as it reached 16,527 contracts on May 21. The number of opening accounts is up to 26,000. The market runs smoothly and normally.

It is no surprise that the new contracts have received such a healthy reception, because they have long been hoped for by local market participants. “Stock index futures are relatively mature in the global market, but still in their infancy in mainland China,” says the CFFEX. “The launch of index futures is intended to enhance the mechanisms of the stock market, and improve the market’s operation.”

Improving the market

It seeks to do so in several ways. Firstly, index futures help to form what the exchange calls an “internal stabilizer mechanism” for the stock market. Secondly, index futures help to build price-forming mechanisms. It is easier for markets and their participants to assess prices, and where they should be going, when an index futures market is in place.

Thirdly, they provide a vital tool for investors to hedge systematic risks. For some, this is the most important advantage: risk management has never been more important than it is in today’s volatile global and local environment, and the presence of futures provides a vital mechanism to protect against sudden market movements. Finally, an index futures market should help to build a mature group of institutional investors.

“We hope that China’s stock index futures market is dominated by institutional investors or sophisticated investors,” an exchange spokesperson says. “We adhere to the view that the main purpose of the product is to help them hedge market risk, this giving full play to its function of risk management.”

To ensure that futures are used properly, the exchange has set restrictions designed to protect market integrity. It imposes an “Investor Suitability Regime” requiring that individual customers meet four criteria before being permitted to trade:

- Have no record of serious discredit, and have no restrictions or bans on trading index futures.

Similarly strict requirements apply to non-financial investors, which must also have at least RMB1 million in net assets. The professional institutional investors (most are financial firms) should directly apply to the regulators and CFFEX.

The exchange has other, broader methods of supervision and compliance, with risk control measures including margin setting, price and position limits, large position reports, forced liquidation or position cutting, joint clearing guarantees, risk alarms and joint regulation among regulators, exchanges and organizations.

The exchange has also prepared itself for growth by adopting some of the most sophisticated technology available in the industry. CFFEX chose the New Generation Exchange IT system: its maximum capacity is 9,000 transactions per second, or a constant capacity of 6,000 per second.

For the future, the CFFEX is well positioned for any changes in regulation that might allow international participants to trade. It is expected that at some point qualified foreign institutional investors (QFIIs) will be permitted. “In the future, the regulators will formulate rules about how QFIIs can trade index futures, with the purpose of providing hedging instruments for them,” the exchange says. CFFEX expects that QFIIs can help enhance the function of index futures as a risk management instrument in China.

For further information, please contact

Mr. Zhang Peng
R&D Department, China Financial Futures Exchange
6th Floor, Lujiazui Plaza, No.1600, Century Avenue, Pudong, Shanghai 200122, PR China
Tel: +86-21-50160683
Stepping into the future

The launch of China’s first financial futures contract in April was a turning point. Not only is the new index futures contract likely to become a world leader, it will also open up a new world of opportunities for investors and asset managers.

On 16 April, the development of China’s futures exchanges took a significant step forward. On that day, the first index futures contracts in the country began trading on the China Financial Futures Exchange (CFFEX) in Shanghai. They became the first financial futures ever to trade in China, and mark the start of what is likely to be a major new market – one that, if China’s other futures markets are any guide, will one day become a world leader in volumes.

Commodity futures have been around in China for many years and are discussed in more detail in the next article. Although relatively young – the oldest established contracts date from 1993 and some are barely a year old – they have in many cases become world leaders. The Dalian Commodity Exchange leads the world in a number of soybean and plastics contracts; the sugar contract on the Zhengzhou Commodity Exchange is the most widely traded agricultural future or option in the world; and the Shanghai Futures Exchange last year overtook the London Metals Exchange to become the world leader in copper trading volume, an extraordinary achievement for an entirely domestic exchange.

What’s more, all are growing at a staggering rate, with a great many contracts on track to double their 2009 volumes in 2010.

But the significance of the new index futures is that they are financial products rather than commodities. “For the past 16 years there have only been commodity futures,” says Kathy Xu, who covers international business at Shenyin & Wanguo Securities in Shanghai. “Index futures will be a very important start for financial futures products in China.”

They matter because of the opportunity they give traders to take a view on the Chinese market. “In the securities market China does not have any short selling system,” she says. “Now we have index futures. That means investors can sell, so they have a shorting mechanism. In the past investors could only make money by buying stocks, and if the market fell, they lost money. Now it’s different, and that is very important for investors – retail and institutional.”

Janet Kong, managing director and head of commodities research at CICC, agrees. “I used to work on the buy side, and we used to talk about how the information ratio of an investment manager cannot be improved without relaxing the shorting constraints,” she recalls. “A manager needs to be able to buy a stock to express a positive view, but also to short a stock to express a negative view. These constraints eliminate half the universe for managers to improve their information ratio.” Being able to do so now, she says, “helps them to add alpha for investors.”

Getting it right

The new index futures, based on the CSI 300 stock market index, follow four years of effort that demonstrate how China takes its time to ensure it gets things right. The CFFEX itself was formed in Pudong, Shanghai, in September 2006, as a joint venture between China’s three other futures exchanges – in Shanghai, Zhengzhou and Dalian – and the Shanghai and Shenzhen stock exchanges. Mock trading of CSI 300 index futures dates back to October of that year, but the State Council waited more than three years, to January 2010, before granting formal approval for the introduction of stock index futures in principle. In that time, a host of brokers were vetted and eventually approved to be clearing and trading members – today there are 128.

The State Council’s approval of index futures was part of a broader advancement of market tools. On the same day it approved index futures – 8 January – it also announced approval for a new margin trading pilot programme. “The margin trading and index futures programmes will open up the attractive hedging option for all kinds of investors in the market,” says Ivan Shi at Z-Ben Advisors, a leading Shanghai-based research group focusing on the Chinese asset management and financial markets industries. He counsels against reading too much into them: “The pilot stages are designed to contain potential risks and uncertainties to..."
A milestone in capital markets development

The introduction of index futures in China makes the domestic capital market more complete, in the view of CICC, allowing investors much greater scope. The opportunities are huge.

The Chinese futures market, which has already enjoyed several years of outstanding growth, is primed for even greater progress with the launch of index futures, according to experts at China International Capital Corporation (CICC), China's first joint venture investment bank.

“The launch of index futures on the China Financial Futures Exchange is a major milestone for capital markets development, in my view,” says Dr. Huang Haizhou, managing director and head of the Sales and Trading Department at CICC. “Up until now, for equities, one could only go long. But with index futures, investors can hedge and diversify risk, and can trade on different views. Without the possibility of shorting, the market is incomplete: the introduction of index futures into China adds an important dimension and creates a more complete market.”

Janet Kong, managing director and head of commodities research, agrees. “Managers need to be able to buy a stock to express a positive view, but also short a stock to express a negative view,” she says. “Restrictions on shorting eliminate half the universe for managers to improve their information ratio. Index futures will help them to add alpha for investors.”

Global powerhouse

CICC, the leading mainland Chinese investment bank, has helped clients in futures in China for many years. Many commodity futures contracts have been active since as long ago as 1993, although the boom in these futures is more recent. “It’s not until the last five years that the strong economic growth in China has propelled it into a global powerhouse,” notes Kong. “That has made it very important in commodities in particular: China consumes almost 40% of copper and 35% of aluminium worldwide. That has been reflected in the commodities futures markets becoming more important.”

Kong notes that the Dalian Commodity Exchange is now the second largest agricultural futures market in the world by trading volume.

Kong has seen a significant evolution in the maturity of China’s futures markets over that time. “Back in the 1990s, some traders were perceived as being more speculative rather than having any real needs,” she says. “But in recent years, the regulators, the government and the futures exchanges themselves have put a lot of effort into investor education. That awareness has helped more and more people to manage risk.”

The development of futures in the capital markets has the potential to create several knock-on effects. “I think there will be many more products developed,” says Huang; Kong suggests early steps will be access to more institutional investors, contracts over more equity indices, and then futures or options over individual stocks. On the commodity side, she suggests lead, nickel and crude oil as potential new contracts. In time there could be even bigger innovations: “I think China can develop its own derivative and futures market as well as a hedge fund industry,” says Huang.

Foreign involvement

Additionally, Qualified Foreign Institutional Investors (QFIIs) are expected to be given approval to participate in index futures before long, which will also have a significant impact both on the market and brokers who serve it. “China will welcome foreigners to participate in the investment market,” Huang says, “and from our own perspective at CICC we have been providing services to that group of clients for many years.” In fact, CICC has roughly a one third market share of servicing QFIIs, who between them have over $17 billion in allocations to invest in China. “QFII investors will hopefully be very active in the index futures market and we look forward to servicing them.”

Futures will also present other opportunities to groups like CICC. If Huang is correct about the emergence of a hedge fund industry, it will need services such as stock lending. Clients generally will need support as they become familiar with index futures and build volumes in them, and as products develop, a major research need will grow too.

“We want to provide our services to our whole range of investors,” says Huang. “In China, the hedge fund industry is an infant, but it will grow into a teenager and then an adult in the next decade. And for all investors, we look forward to some very important opportunities to grow with our clients,” says Huang.

Index futures represent a huge opportunity for market development, to continue the outstanding growth achieved in commodity futures in China. CICC looks forward to helping market participants make the best possible use of these opportunities.

For further information, please contact

CICC - A milestone in capital market’s development
April inception, CSI 300 futures have become one of the most active, with an average daily volume of 130,000 contracts and open interest of 13,000 contracts. “Since their inception, they have started strongly, with an average daily volume of RMB117 billion, less than 5% of average daily volume. The exchange says that in the first three weeks of trading, open interest contracts were 13,000, just 10% of total daily volume by contract numbers.” Open interest is a useful measure for the growth of futures contracts because it reflects the level of long-term investor exposure in the market, Lui says.

But that’s just the start. These volumes come purely from retail investors, as precise guidelines for institutional use are still under development. On 23 April the CSRC finalized trading regulations for domestic brokers and mutual funds; once they are implemented and those institutions can trade, volumes will go up significantly, particularly since qualification standards appear to favour institutions over retail. Retail investors must have at least RMB500,000 in usable capital in margin accounts, and must show trading experience, either in mock trading of index futures or for real in commodity futures markets. That’s reasonably restrictive. Institutions, on the other hand, have a minimum net asset requirement of RMB1 million — hardly a hurdle at all for an institution – alongside other practical stipulations such as a proven internal governance system. “It is apparent to notice, in this design, a bias towards institutional participation from the regulators,” Shih says.

The exchange itself confirms this. “We hope that China’s stock index futures market is dominated by institutional investors or sophisticated investors,” an exchange spokesperson says. “We adhere to the view that the main purpose of the product is to help them hedge market risk, this giving full play to its function of risk management.”

The CSI 300 index has already shown some interesting characteristics. The exchange says that in its first three weeks average daily volume was 130,000 contracts, and open interest 13,000; brokers say that early average trading volumes in value terms were around RMB117 billion notional, which is one of the leading contracts worldwide and represents 57% of the average daily turnover of the overall A-share market.

After 10 days of trading, Goldman Sachs opted to look more deeply into trading patterns, and noted several traits:

- Index futures trading volume often reaches 50% of the cash market within the first six to 12 months of trading. The CSI 300 contract managed it within the first 10 days.

- More than 90% of CSI 300 futures trading so far has been in the front-month contract – that is, at launch, the May 10 contract. In the first 10 days of trading, 93% of volumes went into this contract, 5% into June 10, and 1% each into September 10 and December 10. This, says Goldman’s Jason Lui, is “similar to global patterns.”

- Open interest is dramatically lower than trading volume. When Goldman looked, in notional terms, open interest had reached only RMB7 billion, less than 5% of average daily volume. The exchange says that in the first three weeks of trading, open interest contracts were 13,000, just 10% of total daily volume by contract numbers.” Open interest is a useful measure for the growth of futures contracts because it reflects the level of long-term investor exposure in the market, Lui says.

- Trading distribution shows volume picks up in the afternoon, which perhaps reflects the presence of retail investors. “We suspect this is partly caused by retail investors starting to close their intra-day positions,” Lui says.

- Goldman says all four CSI 300 futures contracts (May 10, June 10, September 10 and December 10) have been trading at premiums to fair value.

- CSI 300 futures have the largest mispricing of regional peers. Lui says this is “understandable due to its short trading history and the current conservative operational environment. Over time, the magnitude of CSI 300 futures mispricing should decrease as trading volume becomes more balanced (retail speculation versus institutional flow) and the operational environment becomes more flexible.”

The minimum. For financial institutions, watching, trying and learning and (are?) the feasible choices at present.” But that is the local way, and still hints at a major new market. “It is paramount at this stage for CSRC to ensure a successful start for these tools,” he says. “Any experience and lessons learnt now will contribute to the perfection and further expansion of margin trading and index futures platforms in the future.”

**How is it doing so far?**

The CSI 300 index has already shown some interesting characteristics. The exchange says that in its first three weeks average daily volume was 130,000 contracts, and open interest 13,000; brokers say that early average trading volumes in value terms were around RMB117 billion notional, which is one of the leading contracts worldwide and represents 57% of the average daily turnover of the overall A-share market.

After 10 days of trading, Goldman Sachs opted to look more deeply into trading patterns, and noted several traits:

- Index futures trading volume often reaches 50% of the cash market within the first six to 12 months of trading. The CSI 300 contract managed it within the first 10 days.

- More than 90% of CSI 300 futures trading so far has been in the front-month contract – that is, at launch, the May 10 contract. In the first 10 days of trading, 93% of volumes went into this contract, 5% into June 10, and 1% each into September 10 and December 10. This, says Goldman’s Jason Lui, is “similar to global patterns.”

- Open interest is dramatically lower than trading volume. When Goldman looked, in notional terms, open interest had reached only RMB7 billion, less than 5% of average daily volume. The exchange says that in the first three weeks of trading, open interest contracts were 13,000, just 10% of total daily volume by contract numbers.” Open interest is a useful measure for the growth of futures contracts because it reflects the level of long-term investor exposure in the market, Lui says.

- Trading distribution shows volume picks up in the afternoon, which perhaps reflects the presence of retail investors. “We suspect this is partly caused by retail investors starting to close their intra-day positions,” Lui says.

- Goldman says all four CSI 300 futures contracts (May 10, June 10, September 10 and December 10) have been trading at premiums to fair value.

- CSI 300 futures have the largest mispricing of regional peers. Lui says this is “understandable due to its short trading history and the current conservative operational environment. Over time, the magnitude of CSI 300 futures mispricing should decrease as trading volume becomes more balanced (retail speculation versus institutional flow) and the operational environment becomes more flexible.”
The exchange hopes that index futures will "enhance the mechanisms of the stock market, and improve the market's operation." It isn't launching futures to help speculation: instead it has very specific hopes for what they will achieve.

**Stabilizer mechanism**

Firstly, the exchange views index futures as an "internal stabilizer mechanism" for the stock market. By this, the exchange means that the presence of these futures should dampen volatility. It also hopes futures will help build price-forming mechanisms, and allow hedging of risks, which has previously been exceptionally difficult in the stock market in China. Finally, the exchange hopes that the existence of index futures will help to build a mature group of institutional investors for the stock market – something that usually helps the market itself behave in a more steady, balanced and predictable fashion.

"Giving institutional investors access to the futures market will help promote growth in the open interest and diversify the market away from retail day traders," says Lui at Goldman Sachs.

Speculators, by contrast, are discouraged, as they have been in China’s commodity exchanges. "For speculative investors, there are strict limits on the number of positions they can hold," Shi says. "The maximum number of a contract is 100 on a single direction, which is far lower than the market expectation of 600. Investors with hedging purposes, such as from retail day traders," says Lui at Goldman Sachs.

While the guidelines that would allow mutual funds, securities firms and other institutions to invest are eagerly awaited, there is a still more significant set of guidelines to follow: those governing qualified foreign institutional investors (QFIIs). QFIIs have been allocated quotas to invest in China’s stock markets under certain conditions (such as not repatriating their capital outside of China), and by the end of 2009 $17.07 billion of quota had been granted to these foreign institutions. But they have never been permitted to invest in futures.

There seems little doubt, though, that QFIIs will soon be permitted to trade index futures domestically; the regulator, the CSRC, is understood to have compiled draft measures already. "It is a very significant step for foreign investors to be able to participate in the futures market in China," says Xu.

The CFFEX confirms this is under way. "Currently QFIIs can invest in the stock market of Mainland China," the exchange says. "In the future, the regulators will formulate rules about how QFIIs can trade index futures, with the purpose of providing hedging instruments for them."

When foreigners are allowed in, given the level of interest in Chinese securities from overseas, volumes on CFFEX are expected to show even more impressive growth, although opinions do vary on what the impact will be. "In Taiwan, for example, QFII investors are more active in terms of their participation in the futures market than domestic players," says Dr Huang [full name?], managing director and head of sales and trading at CICC. "I hope this is the case in mainland China: QFII investors will hopefully be very active investors in the market." Institutions like CICC will certainly hope so – CICC has about a one third market share in serving the needs of QFII investors and stands to benefit from a lucrative new business line as they engage in index futures too. "We are talking with them, and like us, they are looking forward to participating in a new market," Huang says of QFIIs already in China.

Janet Kong, though, argues that foreigners won’t necessarily bring bigger volumes with them. "If you look at cash equities, turnover is about half and half retail versus institutional, and of the half belonging to institutional trading, it’s dominated by domestic mutual fund managers, not QFII," she says. "The QFII turnover rate is much less than at domestic managers. And if you’re just using index futures for risk hedging, then the pattern will probably be the same: the lower turnover will carry through to futures trading as well."

Whether foreigners will one day be permitted to invest in commodity futures is a different story, and divides opinion. In almost 17 years, they haven’t been allowed yet. "This time, with index futures, the regulators have decided to change the situation because QFIIs have cash market trading in the securities market, and need to be able to hedge their positions," Xu says. "For QFIIs to be able to trade commodity futures, the regulators would need to modify the law – and I don’t think it will happen in the next few years."
Up to the future. Together.

Committed to the wide-ranging needs of economy and businesses, Shanghai Futures Exchange is building an instrumental futures trading venue for metals, energy and chemicals. We are well positioned to serve you in your growth into the future.
The development of index futures doesn’t necessarily create a new business stream for foreign banks though, and they have tended to be hesitant about commenting. “HSBC currently does not have the right to do China index futures – it would require a JV with a Chinese financial institution,” says a spokesperson there, adding that comments would therefore be hypothetical and inappropriate. It may, though, represent an opportunity for those foreigners who have managed to negotiate brokerage as part of their securities joint ventures in China: Goldman Sachs, UBS and CLSA.

Both UBS and CLSA declined comment, but Goldman is already putting out quite detailed research on the futures contract and making positive noises. “We would expect this to be not only a dominant index futures contract in China but, in time, it has the potential to become one of the region’s most liquid contracts,” said Christopher Eoyang, a Tokyo-based Goldman Sachs analyst, in a report timed for the first day of trading on 15 April. “We are encouraged by the prospect of a well-designed equity derivatives contract in the Chinese domestic market. Although we anticipate the ramp-up period to be conservative and gradual, we expect the CSI 300 index futures contract to contribute to the deepening and maturity of the Chinese domestic equity markets, and look forward to the time when QFII investors are also permitted access to the contract.”

Reflected opportunity

Foreign banks do, though, see a certain reflected opportunity. Deutsche Bank, for example, launched 11 UCTIS (UCITS)-compliant China A-share exchange-traded funds (ETFs) on 25 March in Hong Kong, all of them based around the CSI 300 or its various sector indices. While index futures don’t technically impact these ETFs, their launch is still good news for Deutsche as it raises awareness of the indices themselves. “We are not directly impacted by the turnover in futures, because the Chinese market is not connected to the Hong Kong one, but the fact that we launched our ETF on 25 March and futures were launched on 16 April has of course helped us to market,” says Marco Montanari, Asia head of Deutsche’s ETF platform, db x-trackers. “The fact CSI 300 has been chosen for the first index futures in China is very important to us.”

He sees the launch of futures as momentous. “It’s a positive development for the market, and any instrument that can be used to hedge exposures for investors is a good thing,” he says. “If we are one day able to use it as a hedging instrument, it will help to offer even better market-making conditions to foreign investors.” For an ETF provider this would make quite a difference. “Instead of buying the standard stocks, you could just buy the future as a hedge. This would of course make our life easier and improve the conditions of final investors in our ETF.”

The CFFEX has started out with the CSI 300 index, probably the most closely watched index in China, but there are several others that would lend themselves to index futures too. The CBN 600, for example, is the one quoted in the Wall Street Journal every day; others that are closely followed domestically are the Shanghai Composite Index and SSE 50. “After the CSI 300 Index futures are launched, we will provide more financial futures or options products according to demand – and, of course, with the approval of the regulators,” the exchange says.

Kong at CICC expects a steady evolution “when the regulators become more comfortable with the operations of index futures. The first step may be access to more institutional investors; the next step may be to offer futures or options on individual stocks, to give investors more flexibility to express their views.”

Kong’s colleague at CICC, Dr Huang, looks still further ahead. “I think there will be many more products to be developed, and another innovation would allow lending and borrowing in stock. Then I think China can develop its own hedge fund industry. This would be a major step: while there are funds in China which express an absolute return philosophy, the inability to short means that hedge funds in any western sense – where the term is most commonly applied to long/short funds – do not really exist.” This is where I think index futures substantially change the landscape of the money management industry in China,” he says. “China is still a largely incomplete market, where many products are not fully developed. So this is a milestone for China’s capital markets development.”
Building the future for China’s futures

Zhengzhou Commodity Exchange has exploited its central location and pioneering status to become a mainstay of China’s growing futures industry.

The Zhengzhou Commodity Exchange was the first futures market to be approved by the State Council: it was established in October 1990 and began futures trading in May 1993. Today it is a vital mainstay of China’s growing futures industry.

The ZCE trades several commodities crucial to Chinese agriculture and industry. “The listed commodities are widely recognized for their functions and roles in industrial economy development,” the exchange says. Cotton, white sugar and PTA are the most actively traded products on the exchange, and each plays an important economic role for China.

World leader
China is a world leader in cotton production and consumption, and trading in its futures contracts has soared since they were first listed in 2004. They hit a trading value of RMB1.29 trillion in 2009, up 82.7% from the previous year, with contract volume up 58% to more than 17 million. And 2010 is on track to more than double both numbers: in the first four months of the year alone more than 19 million contracts worth RMB1.59 trillion were traded.

Their use became important in 2008 when cotton future prices hit both a record high and a record low in the course of the same year: a level of volatility that increased the need for hedging. “ZCE cotton futures play a significant role in leading production, consumption, and providing a reference for domestic macroeconomic policy,” the exchange says.

Sugar futures are even more popular. According to the Futures Industry Association (FIA), the top agricultural future or option anywhere in the world in 2008. In 2009, 292.13 million contracts with a total trading value of RMB12.82 trillion changed hands. Again, 2010 had already achieved a record in just the first four months of the year, with 259.6 million contracts with a trading value up 281% year on year to RMB13.78 trillion. These volumes help China’s sugar industry “keep sustained, stable and healthy development,” says the exchange.

PTA futures are also exceptionally active, with 105.5 million contracts traded in 2009 worth RMB3.814 billion. Trades worth RMB1.33 trillion were made between January and April 2010, representing 91.98% year on year growth.

Strategic position
There are several reasons ZCE has been able to achieve such remarkable growth and success. One is the advantage of having been the first futures market in the country. Another is location. Zhengzhou City in Henan Province is located in central China, putting it at the hub of cross-traffic for the country. “In China’s economic development pattern, Zhengzhou is in a central strategic position whether it flows between east and west or north and south,” the exchange says.

“Relying on Zhengzhou’s unique advantages in location, transportation, information, logistics, agriculture and natural resources, ZCE can set a more scientific and reasonable layout of delivery warehouses, conduct more convenient and efficient management of delivery warehouses, and reduce delivery costs and fees,” the exchange says. “This benefits the development of the commodity futures market.”

Additionally, ZCE has developed a comprehensive and sophisticated membership system with leading use of technology. Membership of the exchange – the 215 members hail from 27 different provinces, municipalities and autonomous regions – follows a rigorous set of regulatory and licensing requirements, covering capital, organization, reputation and qualified staff.

Overseas links
On the technology side, ZCE has gone through four phases of system development, the most recent of them starting in 2005. Since then Oracle has been used as the core database, with the system divided into subsystems for core trading, settlement, warehouse warrants management and delivery, trading management and risk control, remote trading and member service. A sign of ZCE’s best practices is the memorandum of understanding it holds with eight overseas exchanges, including some of the best regarded in the world: NYSE-Euronext, CME, CBOE and the Tokyo Grain Exchange.

For the future, ZCE plans to emphasize proper operations, risk control, enhanced market service quality and international cooperation. “ZCE will endeavor to establish an exchange with an important position and great influence on domestic and world markets,” the exchange says. “We will insist on our principle of openness, impartiality and justice - meaning we will be fair, innovative, safe and efficient.”
Commodity exchanges build world leaders

While index futures have grabbed the headlines, many of China's most successful commodity futures contracts have been running since the early 1990s. Increasingly, they lead the world themselves, there has been a lot of investor education around the country telling people that futures can be an important thing to manage risk. That awareness helps."

Exchanges themselves are delighted with their new environment. "After decades of development, the futures market has entered a period of sustained and healthy development," says Liu Xingqiang, president of the Dalian Commodity Exchange. "The futures regulatory environment has greatly improved."

Building the infrastructure

Liu says this improvement is embodied in three ways: legal environment, regulatory environment and supervision by public opinion.

"China's futures market has gradually improved and perfected its legal and regulatory system," he says. This is underpinned by the Futures Trading Regulations, a foundation upon which other key rules such as the Futures Exchange Regulations and Futures Company Regulations have been developed. "These documents included the regulation and normalization of the relevant futures exchanges, futures companies and futures executives," he says. "At the same time, it also established the futures margin deposit system, investor protection fund system and a series of other basic systems."

On the regulatory side, Liu speaks of the building of a "five-in-one" regulatory model. In 2000, China established a self-regulating futures organization called the China Futures Association, to strengthen management and self-regulation of the growing futures industry. By 2006, the China Futures Margin Monitoring Centre was established to improve margin deposit management, and from this evolved the five-in-one model Liu refers to: the China Securities Regulatory Commission (CSRC), the CSRC Agency, the futures exchanges, the China Futures Association and the margin monitoring centre. "This model has helped to achieve control over the entire process of futures regulation."

"Finally, in terms of supervision by public opinion, the media has begun to play a significant role in the regulatory system," says Liu. "With the continuous development of the futures market and the growing awareness of finance in society, the reporting of futures-related content in both financial and comprehensive media outlets has increased and become more standardized. "The media, he says, has been responsible for delivering and disclosing futures market information, "and in this way it has directly supervised the market through public opinion."

And while it can seem curious from a distance to have three different
Plastic fantastic

Despite its purely domestic scope, Dalian Commodity Exchange is the biggest plastics futures exchange in the world and the second biggest in agricultural futures. Its success is widening awareness among Chinese manufacturers of the value in hedging against price fluctuations.

The Dalian Commodity Exchange is the busiest futures exchange in China accounting for almost half of domestic market share. In 2009, its 834 million bilateral contracts amounted to RMB36.94 trillion in turnover, making it the second largest agricultural futures market in the world, and the largest plastic futures market worldwide.

Founded in 1993, the DCE trades a wide range of products: two soybean contracts (known as number one and two), as well as soybean meal and soybean oil; corn and RBD palm oil; and two plastics, LLPDE and PVC. It has 188 members, 173 of them brokerage members (futures companies).

Hedging focus
Its contracts have become domestic market pricing centres, and the focus of hedging for corporates with activities in those markets. What’s more, they’re growing fast.

Take soybeans, for example. China produces 15 million tons a year, but consumes 50 million, and accounts for 22% of global soybean meal consumption; its heavy import needs create a strong demand for hedging in the industry. In 2009 its soybean meal contract enjoyed 1.55 billion tonnes of turnover, calculated unilaterally, and 948.37 million tonnes of soybean oil – in both cases considerably bigger than their equivalents on the Chicago Board of Trade. The trading volume for soybean meal contracts in 2009 was 310.8 million contracts – more than 35 times the volume in its first listed year and almost double the 2008 volume.

And while soybean-related contracts are where the exchange has made its name, plastics show how quickly it can build a dominant position in a newer market. In 2009, 126 million contracts worth RMB5.74 trillion in LLPDE and PVC changed hands, despite the fact that PVC futures were only launched that year and LLDPE in 2007. “Although China’s plastics futures market is still relatively young, the scale of its market has far exceeded that of other international exchanges,” says Liu Xingqiang, president of the DCE.

In coming years, DCE will continue to develop its agricultural futures market, and will also expand elsewhere, emboldened by the success in plastics. “In the future, the DCE will move into the field of energy futures with new products, and research has already been under way on coke futures,” Liu says.

World scale
DCE, despite operating in a purely domestic market, is acknowledged as a major force on a world scale. Already deeply involved in collaboration with industry associations, futures exchanges and government bodies at home and overseas, the DCE has signed MoUs on cooperation with 15 overseas exchanges, cooperating in information sharing, training, product development, technology enhancement and other areas. “It is a great way to short-cut the learning process and provides a valuable opportunity in promoting joint growth,” Liu says.

The length of time the DCE has been operational has helped it to develop best practice. For example, its information technology system is now in its sixth generation, and today can handle 6,000 transactions a second, or 3 million a day. It has passed the rigorous ISO9000 certification.

It has also been set up with a successful model, as a non-for-profit, member-based, self-regulatory organization. The DCE itself supervises the business conduct of member firms, the qualifications of warehouses, interaction with banks and other organizations, and so fulfils its self-regulatory function.

Deeper understanding
As DCE has evolved, so too has the market itself. “In the first few years of development in the futures market, most Chinese people did not understand the concept of futures,” says Liu. “But in recent years, futures market participants have gained a deeper understanding of the market. Usage of the futures market has greatly raised awareness of risk management. 'With that, the market has played a more active role in helping industrial development, improving price formation mechanisms, integrating industry resources and hedging corporate risks. Today, corporate client open interest accounts for about half of total open interest on the exchange, as companies use the market to hedge against price volatility risks. As awareness rises, so does demand for hedging, which is to the benefit both of DCE and Chinese industry and agriculture generally.”

For Liu, it is natural that China should host such a strong commodity exchange. “China is a leading global commodity production and consumption nation,” he says, pointing out that the World Bank ranks China in the top three of production and consumption for 12 of the 16 bulk commodities it covers. “At the same time, China’s economy continues to develop at a rapid pace, and it has already become the world’s third largest economy... With the support of the huge spot market and China's vigorously growing economy, China’s futures market, including the DCE, will gain the power of sustainable development and be faced with the potential for huge development.”

For further information, please contact

Dalian Commodity Exchange
18 Huizhan Road
Dalian, China 116023

Media Relations Information Department:
Joshua Johnston, liyong@dce.com.cn +86 0411 8480 8626
Xuefen Song songxf@dce.com.cn +86 0411 8480 8517

President’s Office:
Jiashu Li lijs@dce.com.cn +86 0411 8480 8622
commodity exchanges in operation (in fact there are now four futures exchanges, with the launch of the China Financial Futures Exchange, which is part-owned by the three commodity exchanges), those who have followed the industry over the long term consider it a sharp rationalization. “I don’t think China will continue to reduce the number of commodity exchanges, because China is such a big market,” says Kathy Xu, who covers international business at Shenyin & Wanguo Securities in Shanghai. “And among the three commodity exchanges, they trade different products. We haven’t seen a single product listed at three exchanges.”

Indeed, a look at the three exchanges shows how they have all evolved with different characters and strengths. The Shanghai Futures Exchange, whose legacy institutions include the Shanghai Metals Exchange, is still best-known for its metals, plus rubber and fuel oil. Dalian Commodity Exchange is centred on agricultural products, particularly soybean and its derivatives; and has more recently built a highly successful specialism in plastics. And Zhengzhou Commodity Exchange with its greatest success in sugar, cotton and pure terephthalic acid (PTA).

**Extraordinary growth**

All three have enjoyed tremendous recent growth across the board, and what’s really noticeable is the pace at which that success seems to be increasing.

Take Zhengzhou. Its sugar contract was, according to the Futures Industry Association, the top agricultural future or option anywhere in the world in 2008, and by 2009 logged 292.13 million contracts worth RMB12.82 trillion in the course of the year. But look at 2010: in the first four months alone it had already shattered the 2009 full-year value, with RMB13.78 trillion – which, if continued through the year, would equate to 281% growth. Some 259.6 million contracts changed hands during that time; at this rate it won’t be long before China sees a billion contracts change hands in a single commodity futures contract in the space of a calendar year.

Zhengzhou is enjoying similar growth in its other key commodities. Turnover in cotton was up 82.7% in 2009 over 2008, at RMB1.29 trillion, with contract volume up 58% to more than 17 million; yet in the first four months of 2010 both the volume and contract figures for 2009 had already been comfortably eclipsed. Similarly in PTA futures, the first four months, in which RMB1.33 trillion of trades were made, represented 91.98% year-on-year growth.

Similarly on the Dalian Commodity Exchange – now the second largest agricultural futures market in the world by volume – volumes on its soybean meal contract (1.55 billion tonnes of turnover in 2009) and soybean oil (948.37 million tonnes) were both cases well ahead of their equivalents in Chicago, traditionally considered the global leader for agricultural futures, although its contracts in soybean itself still lag Chicago. The soybean meal turnover gives an illustration of just how dramatically Chinese contracts can grow: its 310.8 million contracts in 2009 were double the figure for 2008 and 35 times the total in the contract’s first year of trading.

Another aspect of the Dalian Commodity Exchange is even more revealing. The exchange launched its first-ever plastics future – for LLDPE (linear low-density polyethylene) – in 2007, following it up with a PVC contract in 2009. Yet in that exceptionally brief period of time, Dalian has become the world’s leading plastics futures market, with 126 million contracts worth RMB5.74 trillion traded in 2009. “Although China’s plastics futures market is still relatively young, the scale of its market has far exceeded that of other international exchanges,” Liu says.

In Shanghai, it’s the copper contract that has been grabbing global attention, because it has taken on one of the true heavyweights of the world’s futures markets. The London Metals Exchange is traditionally seen as the world focus for copper: clients from all over the world use that exchange either to hedge their exposures or to speculate, and have been doing so for more than 130 years. Yet in 2009, the world’s largest trading volume was not in London, or New York, but in Shanghai: 81.22 million lots. It is clearly one of the major price determination markets in the world, but extraordinarily has become so based entirely on domestic trading.

Shanghai is also the world leader for natural rubber futures, and its fuel oil contract is the next largest energy future or option in the world after the Nymex West Texas Intermediate and Brent crude contracts. Its steel rebar and wire rod contracts are world leaders too – even though both were launched in only March 2009.

**The economic driver**

It becomes easier to understand why such huge contracts volumes have been achieved in a domestic market when one considers just how active China is in the underlying commodities, both as a producer and a consumer. “China is a leading global commodity production and consumption nation,” says President Liu at the DCE. He cites World Bank statistics showing that among 16 selected bulk commodities, China is in the top three worldwide for production and consumption in 12 of them. “At the same time, China’s economy continues to develop at a rapid pace, and it has already become the world’s third largest economy.”

Some examples: China produces 15 million tons of soybeans each year – but consumes 50 million. The difference has to be imported. Another: Macquarie Bank analyst Bonnie Liu forecasts 6.6 million tons of real copper consumption took place in 2009, and expects net imports of 2.5 million to 2.6 million tons of refined copper in 2010. She also says China has already become the world’s largest importer of aluminium in 2009, that iron ore imports will hit 650 million tons in 2010, and adds: “Chinese zinc demand has been growing strongly since mid-2009, especially from the construction, appliance, machinery and automotive industries.”

In all industries where there is an interplay between domestic production and imports, there is a need to hedge against price movements, and more than anything is what has driven the extraordinary growth in futures volumes. It is, in some sense, a play on the Chinese economy itself: the economic engine grows and grows, the volumes of raw materials in play grow too, and with them a need to hedge. “The increase in volume we have seen in the commodity markets in recent years is due to the increasing importance of the Chinese market, especially the increasing demand for commodity products,” says Xu.

Janet Kwong at CICC adds: “It’s not until the last five years that strong economic growth has propelled China into being a global economic powerhouse. That has made China very important in commodities in particular: it consumes almost 40% of world copper and 35% of aluminium. That’s reflected in the futures commodities markets becoming more important.”

In many cases, volatility in commodity markets has been extreme in recent years, underlining the need for hedging: in 2008, for example, cotton futures prices on the Zhengzhou exchange hit both a record high and a
record low in the course of the same year. In others, volatility is combined with increasing interaction between local and international markets. Soybeans are an example. “Due to the severe volatility in the agricultural products market, the growing linkage between the domestic and international soybean markets, exchange rates, shipping fees and other volatility risks have created a strong demand for hedging in the soybean crushing industry,” says Liu at the DCE. He says China’s dependence on the international economy has now passed 60%, which also feeds a need for hedging.

China’s changing agriculture

A close look at how agriculture has developed in China is useful to understand why hedging is growing and will continue to do so. “In recent years, the extent of marketization in China’s agriculture has steadily increased,” says Liu in Dalian. “This has not only created demand for specialization in production and operations of agriculture, but also created demand for farmers to obtain a sense of certainty in cultivation and sales,” he says. Agricultural futures help to create that sense of certainty for farmers, “a sense of market security,” as he puts it. For its part, the Dalian exchange launched the Village and Household Market Service Project in 2005 to provide free training to northeast Chinese grain farmers and rural civil servants; in more developed areas, it ran trials on futures styles that would fit farmers. “The purpose of these programmes is to help the parties better understand the futures market, and to use the relevant prices and information from the futures market to better serve the cultivation and sale of agricultural products.”

As China’s agricultural market develops and becomes more industrialized, these themes will continue. “Rural and farmer cooperative organizations have developed together, and these organizations will help to bring together and unite the operations of many scattered farming households,” Liu says. “Thus there is an urgent demand for greater market information and for futures hedging.” Rural co-op leaders are now being trained on futures markets.

Unlike Chicago or London, where much trading simply follows a pattern of where traders believe they can make money, the futures available in China so far are vital to the stability of the industries around those commodities. “Our listed commodities [wheat, cotton, white sugar, PTA, rapeseed oil and early rice] are widely recognized for their functions and roles in industrial economy development,” says President Zhang at Zhengzhou Commodity Exchange. “ZCE cotton futures play a significant role in guiding production, consumption, and providing a reference for domestic macroeconomic policy.” Similarly, an official at Shanghai Futures Contracts says: “All our contracts are responding to the call of China’s economic development and the needs of risk management at corresponding industries and enterprises. They have all been well tested by the market and have shown stability, functionality and received sound feedback from the real economy.”

Location, location, location

All three exchanges believe they are in a favoured location for further growth. Zhengzhou, for example, makes much of its central location: the crossroads between north and south, east and west, on the Beijing-Guangzhou and Longhai railways, the Beijing-Zhuhai and Lian Huo expressway, and two national highways. “In China’s economic development pattern, Zhengzhou is in a central strategic position whether it flows from east to west or north to south,” says Zhang. It has China’s largest railway marshalling yard and a container transfer station supporting the shipping routes from Shanghai, Kowloon, Lianyungang, Tianjin and Qingdao. It’s also in Henan Province, whose wheat planting area and output ranks first in China, besides being a main producing and sales area for cotton.

Dalian benefits from the Northeast Asia Revitalization plan and other state-driven programmes to revamp its surrounding region. “According to the national government’s plan, Dalian is to be positioned as a regional financial centre and as northeast Asia’s international shipping centre,” Liu at DCE says. “These two centres will promote each other’s development.” On both counts, it should help the DCE achieve its mandate from the state, to develop “into Asia’s leading futures trading centre” and “to promote the Northeast Area’s inherent advantages and match them up with the DCE’s futures products.” Liu says that, with this backing, “our goal is by 2020 to be Asia’s largest fully-functional derivatives exchange with standardized operations, a rich product offering, advanced technology and significant influence in the global marketplace.”

As for Shanghai, the advantages of that city are clear – the key financial and markets centre of the world’s most exciting and vibrant nation.

What’s next? “Now that commodity futures have been operating in a relatively smooth mode for 10 years, a lot of consumers and producers are expressing a desire to have more futures contracts specific to their needs,” says Kong at CICC. “So far you can only trade three metals: copper, aluminium and zinc. That leaves out lead and nickel, which are important to operations. If you look at their price volatility, they are no less than the other three: there is a growing industry need for more contracts to be introduced for commodity futures.”

There’s also oil. A fuel oil futures contract trades on the Shanghai exchange, but there’s no crude oil. “That potentially may be another area the exchange looks into. If you look at Chinese production, they have become an increasing importer of crude, and a major producer of refined products.” If the inputs are imported from the overseas markets, then those with approval to do so can hedge the risk in overseas markets too. But as futures contracts have developed locally, “there should be a way to hedge risk on a total basis,” says Kong. “Over time, there should be more leeway, to hedge risk both overseas and in the domestic market.”

For their parts, the exchanges are certainly keen to do more. Liu says Dalian will continue to develop agricultural futures, and expand in plastics, and into energy futures. “Research has already been under way on coke futures,” he says. Shanghai Futures Exchange has a five-year strategic plan for 2008 to 2012 which talks about developing contracts in sequence from base metals to precious metals, energy products and chemicals. T.Kong names steel, lead, silver, oil, petroleum, diesel, liquid gas, electricity, asphalt, glycol and methanol as possible underlyings, as well as “actively developing other derivatives such as options, index futures and emission rights.” In 2010, he says Shanghai will “push forward the launch of lead or silver futures, intensively focus on research and efforts to launch oil futures and options, and deepen R&D on metal index and carbon emission rights.”

Whatever contracts they decide to launch, expect them to be challenging for world-leading volumes within a year.