

All the right moves – A snapshot of the China derivatives markets

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The 12th Five-Year Plan

The 12th Five-Year Plan (2011-2015) marks a turning point in the development story for China. Focus has shifted from rapid and almost unrestrained growth to a more sustainable and healthy growth model that addresses the growing disparities between rich and poor. Key targets for the plan include maintaining GDP growth of around 7 to 8%, increasing domestic consumption, and maintaining stability of prices.

In effect, the biggest threat to China's rise to prominence comes from within. Ensuring social stability has never been higher on the agenda. In a sign that the government is listening to the voices of the proletariat, Premier Wen Jiabao became the first leader in 60 years to visit petitioners earlier this year.

In November of 2010, China's highest governing body, the State Council, announced a slew of measures to rein in rising commodity prices. Many of the measures mandated in the cabinet announcement involved the improvement in efficiency of agricultural production, reduction of delivery costs, clamp downs on hoarding, and further subsidies and price controls.

Other more indirect measures have since been implemented, including quantitative tightening measures such as increasing banks reserve requirement ratio nine times since late last year, and increasing interest rates. One can understand recent rumors of imminent cuts in the reserve ratio. October CPI came in at 5.5%, still an uncomfortable level, however an indication that tightening measures are working. It may be premature to expect a shift to an easing cycle, however the authorities will continue to monitor the situation closely. The Chinese authorities have the flexibility and the tools to consistently fine tune policy as and when they see fit. Although not an easy task, thus far the authorities have used the tools at their disposal to navigate to complex balance between inflation and growth extremely well.

China derivatives markets

Despite not being specifically mentioned in the Plan, it is widely known that the Chinese futures exchanges have also been guided to rein in speculation and ensure stable prices. The domestic capital markets have a major part to play and have been "recruited" so to speak, to ensure stability of prices.

Although the China futures market has experienced unprecedented growth since the late 90s, focus has shifted firmly toward ensuring the markets are used as a

tool for managing price risk as opposed to a venue for wealthy punters to gamble away their savings.

Since November of 2010, all four Chinese futures exchanges have introduced a number of measures designed to deter the high proportion of retail participation, estimated at over 90%. Margin requirements and exchange fees have been increased, and order placement restrictions have been imposed. Earlier this year, the Shanghai Futures Exchange recently increased contract specifications of its fuel oil contract and other exchanges were said to be mulling similar steps with their contracts. We had witnessed a consistent year on year growth trend in China futures volumes for a decade up to 2010 where the four futures exchanges traded a whopping 1.57bn lots. This year the industry has witnessed sharp declines in volume. According to the Futures Industry Association, the Dalian Commodity Exchange traded nearly 145 million lots in the first six months of 2010, but during the first six months of 2011, the exchange had only posted around 123.9 million, a drop of 14.6%. The Shanghai Futures Exchange witnessed an even bigger 57.2% drop in volume, from 300.4 million to 128.5 million. The third commodity futures exchange, the Zhengzhou Commodity Exchange, saw a more moderate drop of 4% during the same period. Despite this, all three commodity exchanges remain in the top 15 global futures and options exchanges based on transacted volume. **Gone too far?** Although there are numerous factors contributing to the volume drop, the drop has caused little concern amongst the exchanges. Unlike in the West where most major exchanges are listed companies and thus place increasing trading volumes high on their list of priorities, the Chinese exchanges are government managed and do not have obligations to shareholders for higher returns. The exchanges, which are strictly monitored and controlled by the China Securities Regulatory Commission, need not be too concerned about volumes so much as fulfilling an important role in providing a tool for companies to manage price risk. **Fine tuning** Just a few months ago, in almost an about turn, the Shanghai Futures Exchange announced it would lower exchange fees on copper and steel rebar futures effective 1st August. In addition, reversing an earlier rule change, for gold and copper, the exchange would only charge one side fees if contracts are bought and sold on the same day. Margin requirements for lead futures have also been reduced. The exchange's official line is that these adjustments are aimed at enhancing price discovery, hedging, and market efficiency. According to sources, the China Financial Futures Exchange is also mulling measures to increase volumes by reducing transaction costs. Unfortunately, although these are promising developments, it seems that there will be no near term reversal of the "abnormal trading rules" implemented last November. One of these rules restricts the number of order cancellation messages that traders can send to the exchange. Although this rule limits investors ability to execute market making or high frequency trading strategies, we believe that the regulators will continue to fine tune rules to both protect investors whilst developing listed derivatives markets that compete with those in the West. The exchanges and regulators understand the need for a more diversified client pool and have been studying

proposals to increase institutional participation in the futures markets. CFFEX recently approved QFII to initiate account opening procedures with domestic futures companies to trade the CSI 300 index futures. This is the first time that foreign investors have been allowed to directly trade futures in China. Impact is expected to be limited since trading is restricted to hedging only and within an approved quota system. Despite the anticipated limited impact, the move is an important first step to opening the capital markets for foreign investors.

Thus far, the exchanges have succeeded in curbing volumes, however it is hard to attribute the recent drop in the headline CPI numbers to measures implemented by the exchanges. Although there are many factors at play, one must surely note that inflation is moderating due to the “engineered” slowdown in growth that is part of the 12th Five-Year Plan.

Baby steps

China has the benefit of hindsight. They can use observations of Western and regional systems to build a better, and unique China model. However spectators will be misguided if they expect things to develop in one big bang. The authorities have demonstrated caution through the extensive use of pilot projects. Last year, the CSRC introduced a pilot project to allow a select number of domestic securities brokerage houses to offer short selling on a select number of mainland stocks. Indeed, Newedge was able to participate in a pilot project as one of only three joint venture futures brokerages to offer agency brokerage in the domestic futures markets. Both the outbound QDII program and the inbound QFII program are designed to gradually expand the amount of onshore/offshore investment in order to ensure no dramatic shocks to the system.

China has mapped out a road map for Shanghai to become a major international financial center by 2020. In terms of sheer size, I have no doubt that this is indeed possible. At the beginning of 2011, the Shanghai Securities News reported that China’s stock market capitalisation had overtaken Japan as the world’s second biggest. Already back in 2009, the then Chairman of the China Securities Regulatory Commission, Shang Fulin, reported that China’s two decade old futures industry had become the second largest in the world after the US. We are almost certainly going to see more and more steps to full convertibility of the Renminbi which is likely to happen in the latter half of the decade.

Socialist market economy – Socialism with Chinese characteristics

Spectators in the West are often easily prone to criticise the Chinese government. As with any rapidly developing nation, the government has the right to enact policies that are in the interests of their people. Although one cannot dismiss democracy as a great ideal, a strong central government is able to enact quick and effective policies. Most would agree that it is unlikely China could have

achieved so much in the past decades under democracy. A strong central government works better than democracy so long as it is the right government. Both Singapore and China have clearly demonstrated the system works. The Chinese policy makers are an intellectual collective of officials that actually care about their people and nation. Many policies that may raise eyebrows in the West are actually born of good intention, and that is to benefit as many people as possible. The West would do well to embrace China as a friend, and trust that as China takes her place as an economic powerhouse, China will fulfil her duties as a responsible global leader.

Newedge is a leader in global brokerage and operates in China through a 42% stake in a joint venture with CITIC Futures.

In addition to my role as Chief China Representative, I also act as a Senior Advisor for CITIC Newedge Futures Co., Ltd. a joint venture between CITIC East China, CITIC Shanghai Import & Export, and Newedge.

CITIC Newedge is a member of all 3 commodities futures exchanges as well as the China Financial Futures Exchange (CFFEX) and is a leading pure agency brokerage company providing tailor made solutions to qualified investors on listed derivatives in China.

With a branch office in Dalian, the joint venture currently employs over 90 staff dedicated to providing qualified investors with access to the fast growing domestic futures markets. By combining Newedge best practices and knowledge with

CITIC's deep local expertise, CITIC Newedge aims to be a leading force in futures brokerage amongst the 160 strong FCMs operating in China.