

Achieving Robust Derivatives Markets in China

Craig S. Donohue, CME chief executive officer, describes the challenges of developing derivatives markets in light of China's economic expansion.

China is in ascendancy. Since 1980, Chinese gross domestic product has grown nearly eight percent annually, outperforming the record of sustained growth in any other country at any time in history. Foreign investment, exceeding \$53 billion in 2003, signals China's importance in the world's economy.

The promise of China's continued economic expansion offers valuable opportunities to develop its derivatives markets for hedging and risk management of financial exposures. Such derivatives markets are essential adjuncts to fuel China's further economic growth. Access to global interest rate, stock index and foreign currency futures and options contracts will provide Chinese banks, corporations and financial institutions with valuable hedging and risk-management tools necessary to preserve the economic benefits of China's increasingly free and growing market economy.

China faces fundamental challenges

That said, the question remains: "What challenges are associated with achieving robust derivatives markets?" China faces fundamental challenges relating to credit and monetary policies, property rights, resolution of financial failures and defaults, the free flow of accurate market and financial information, and the adequacy of corporate disclosure and accounting standards. These issues are well understood within China and are being addressed.

Other unique challenges relate to the establishment of successful derivatives markets, such as those trading futures and options on futures. First, Chinese exchanges must ensure that all participants have equal and immediate access to accurate and fully transparent market information. Second, they must ensure standardized practices and rules for market participants and have the ability to detect, deter and punish individuals or entities that engage in practices that can lead to market manipulation or unsound business prac-

tices. Third, Chinese exchanges must guarantee the financial performance of all transactions in their markets, as well as the safety and soundness of the related banking, settlement and custodial functions necessary to support market transactions.

These three fundamental requirements are best accomplished by close cooperation between the government and private sector entrepreneurs. Government should strive to create an environment that requires exchange directors and managers to take full responsibility for all business decisions, subject to strong incentives to operate efficiently and honestly.

China must gain entrée to global capital and financial markets

Another challenge facing China is how best to gain entrée to the global capital and financial markets. I believe the best way is for China's exchanges to open up to investment, joint ventures and commercial business arrangements with other global exchanges and intermediaries. This approach will be most advantageous as the global derivatives markets, such as those trading futures and options on futures, increasingly standardize and consolidate in order to meet users' and intermediaries' demands for lower operational costs and greater capital efficiencies.

China can successfully develop its derivatives market infrastructure by concentrating on product development, economic analysis and the development of sound market regulation standards, and by engaging in education and training efforts to ensure the prudent use of Chinese financial and agricultural derivative contracts. These efforts can and should be undertaken from within.

Forthcoming changes will create new opportunities

However, China's exchanges can accelerate their growth by collaborating with global exchanges to utilize their extensive infrastructures, trading and clearing platforms,

and industry standardized business practices. Mutually beneficial partnerships will help broaden the distribution and reach of China's derivatives markets, just as the advantages created by leveraging established non-Chinese equity capital markets with global reach are clearly complementary to China's sovereign interests in further developing, over time, its own global equity capital markets.

Although China's markets may face periods of uncertainty in terms of global investment and expansion, this uncertainty should be embraced as an unavoidable and even positive feature of dynamic market economies. Changes forthcoming in Chinese derivatives markets will create new opportunities to extend the rapid pace of economic growth unleashed by the country's historic move toward a market economy.



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