A STUDY ON COMMODITY TRADING IN ASIA: A REVIEW

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ABSTRACT

The paper is an attempt to find out commodity trading in Asia which is one of the great puzzles of the modern trading world. Asia, with 3 billion people, has become the world’s engine of commodity demand. In spite of this, the region has failed to establish a strong commodity exchange. The lacuna has allowed London, New York and Chicago to thrive as commodity trading hubs. Consequently, today we have a scenario where Asian-based analysts look at macroeconomic trends in the region to forecast demand for commodities but have to turn to places like Chicago and London to check prices. What makes the whole situation even more ironic is the world’s first commodity exchange — the Dojima Rice Exchange — was introduced by Japan way back in 1697.

Introduction:

While Asia in general and China in particular, may be the biggest force in commodity demand, it has not become a center for commodity trading. That may be changing.

Commodity trading in Asia, or rather the lack of it, has been one of the great puzzles of the modern trading world. Asia, with 3 billion people, has become the world's engine of commodity demand. In spite of this, the region has failed to establish a strong commodity exchange. The vacuum has allowed London, New York and Chicago to thrive as commodity trading hubs. Consequently, today we have a scenario where Asian based analysts look at macroeconomic trends in the region to forecast demand for commodities but have to turn to places like Chicago and London to check prices. What makes the whole situation even more ironic is the world's first commodity exchange - the Dojima Rice Exchange - was introduced by Japan back in 1697.
Reasons for this mismatch between the growth of commodity trading and commodity exchanges in Asia

1. Lack of liquidity because of regulatory barriers:

The commodity exchanges of the two tiger economies in Asia - India and China, which now lead the region's commodity derivatives trading by volume - are under stringent regulatory constraints. Consequently foreign market participants can't trade on them. This has the dual effect of cutting off liquidity on these exchanges and encouraging trading at rival bourses in Chicago, New York and London. The fact that domestic bourses have a monopoly in the country as domestic firms have a regulatory obligation to use them didn't make up for loss of liquidity for the better part of the last decade and stunted their growth.

2. Narrow view by regulators:

As bizarre as this may sound, the regulatory authorities in Asia (read India & China) take different views on stock exchanges and commodity exchange. The former are considered a barometer of the country's growth and can be opened to foreigners, mainly institutional investors. However, the sole purpose of the latter's existence in the policymakers' eyes is to hedge commodity exposure for domestic firms. Consequently the growth and development of commodity exchanges in Asia never has been a matter of concern for regulators as long as they were fulfilling "their role" of hedging.

But all of this is changing fast. There have been significant developments in commodity trading infrastructure (both physically and regulatory) in Asia over the last few years. It is apparent that the pace of growth would have been faster had the global financial crisis not hit us in 2008. Asian countries became weary of derivatives and began trading slowly. India in particular feared inflation in commodities and, like some politicians in the United States, blamed markets and speculators and successfully restricted them. The effect on the stock markets of foreign speculative inflows (known as "hot money") taking "flight to safety" made Asian regulators more jittery.

The key players in commodity trading in Asia over the next decade:

**China**

China has a relatively short history of commodity trading. However, the country has made giant strides in this field. In 2010, Shanghai Futures Exchange (SHFE) became the world's largest commodity exchange by number of contracts traded. "Building a sector" (right) shows the growth in trading volumes at the three major commodity exchanges in China: SHFE, Zhengzhou Commodity Exchange (ZCE) and Dalian Commodity Exchange (DCE).

As you can see, there has been steady growth over the last decade, though volume dipped in 2011. What is remarkable is that this growth is driven completely by domestic firms.

China plans to make the renminbi fully convertible by 2015. This is a major change in its currency policy and shall be accompanied by the opening up of its stock market, bond market and commodity trading. Already we are witnessing the exponential growth of the offshore renminbi-denominated bond market (known as the dimsum bonds market) over the last year since its inception. Liberalization of the country's
stock market and commodity trading shall be paramount if the country is to realize the ambitions for its currency. This shall be nothing but music to the ears of foreign participants who are desperate to enter this space.

Singapore & Hong Kong

Singapore is the largest OTC energy trading market in the world. The island nation opened a second commodity stock exchange a few months ago. The same is in collaboration with Indian exchange operator Financial Technologies. Hong Kong also launched Hong Kong Mercantile Exchange (HKMEx) recently.

BUILDING A SECTOR

The good news about both Singapore and Hong Kong is that the operators of these exchanges realize that being in Asia and in the Asian time zone doesn't guarantee trading volumes. They would have to differentiate themselves by offering niche products and intricate specifications that are not available on exchanges in the United States and Europe.

Similarly, providing unique services can be a great advantage. For example, HKMEx offers physical delivery of the underlying gold and silver at a purpose built Precious Metals Depository at Hong Kong airport. This is something commodity exchanges in Chicago or London can't match.

OPENING NEW MARKETS

India

Commodity trading in India commenced much before it started in many Asian countries. But years of colonial rule and lack of focus by the government caused it to diminish in the country. However, commodity trading was revived recently. Today, apart from numerous regional exchanges, India has four national commodity exchanges, namely, Multi Commodity Exchange (MCX), National Commodity and Derivatives Exchange (NCDEX), National Multi-Commodity Exchange (NMCE) and Indian Commodity Exchange (ICEX). MCX and NCDEX have seen strong year-over-year volume growth, but they still pale in comparison to financial exchanges MCX Stock Exchange and the National Stock Exchange of India (NSE), both of which continue to grow their currency markets (see "Arrow pointing up," page 57).

The regulatory body governing commodity trading in India is the Forward Markets Commission (FMC), which was set up in 1953. FMC announced its intention to develop the country's commodity exchanges a few months ago but has run into many roadblocks. The biggest challenge it currently faces is the lack of uniformity (in transaction charges, KYC norms, etc.) among the various exchanges. The fact that regional exchanges feel marginalized by national ones isn't making the regulators' job any easier. Another issue that requires immediate attention is monitoring trade uniformity because unlike SEBI (Securities Exchange Board of India - the stock market regulator in the country) that monitors the entire trade on a centralized server at the regulator's office, FMC lacks the technological infrastructure to do so.

All of these are significant issues that the regulators in India need to address to develop commodity trading in the country. However, just like China, trading volumes in India are soaring (turnover of 23 commodity
exchanges, accounted together, saw a giant leap of 63.5% year-over-year in mar-2014) and sweeping regulatory changes in the next two years or so would not be a surprise.

Japan

Home to the world's first commodity exchange, two decades ago Japan accounted for nearly a fifth of global futures and options trading, with particular success in commodities. However, since then, it has been a downward slide for the country.

Like India, Japan was grappling with the trading split between the Tokyo Commodity Exchange, Tokyo Grain Exchange, Kansai Commodities Exchange and the Central Japan Commodity Exchange. An amendment to the Commodity Exchange Law in 2005 that made it much harder for Japanese commodity exchanges to market to retail investors was another blow to the gut of the industry and saw a colossal fall in trading volumes.

However, recently some solutions have begun to emerge. Most notable of these is the consolidation of the exchanges. Apart from talks of mergers, the government is believed to have drawn up a plan to unify, derivative markets. The main trigger for this sense of urgency by the regulators is the rise of competition from commodity exchanges in Singapore. Rapid consolidation and providing accessibility to foreign participants are seen as the only ways to make Japanese commodity exchanges competitive.

Another issue that the commodity trading fraternity in the country wants the government to address is its tax system. At present, firms that have any trading infrastructure in Japan are taxable at higher levels than in other countries. However, given the seriousness with which Japanese regulators have been trying to bring about the "renaissance" of commodity trading in the country, it is only a matter of time before these minor glitches are removed.

It is obvious to anyone who looks at commodity markets that with or without foreign involvement, Chinese exchanges are headed for the top in commodity trading. The regulators in India have been far less proactive but expect them to get their act together over the next 12 to 18 months. Both these nations are slowly but surely looking to deregulate commodity exchanges. Add to this the rapid strides being made by Singapore and Hong Kong (especially the former), and Asia is set to be the commodity trading mecca of the world (see "Opening new markets," above). It won't happen overnight, but if somebody is asked to name the top two commodity trading hubs in 2020, there is a good chance the answer will be Singapore and Shanghai.

Conclusion:

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