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INTERVIEW- Chicago Mercantile Exchange sees China moving ahead on derivatives

---- by Chris Myrick ----

SHANGHAI (XFN-ASIA) - The Chicago Mercantile Exchange (CME) expects China's financial derivatives markets to develop quickly in the next few years, in spite of weak underlying equity markets and tough crackdowns on derivatives trading in the past, CME director and chairman emeritus Leo Melamed said.

The CME is partnered with both the Shanghai Stock Exchange and the Shanghai Futures Exchange, working mostly to develop skills at the two China exchanges, with a long-term eye to expanding its own business into China as regulators allow.

Melamed told XFN-Asia in an interview that he expects China's derivatives markets to expand rapidly, though he added a note of caution.

"There's a lot of hope involved in my answer, one can't be certain. These are decisions that we must respect of a government, and we can't suggest when or if they should do what they do.

"My hope is that sometime before the end of next year they will have authorized some kind of financial derivative products to be used - and by their own community, I'm not talking about us," Melamed said.

Melamed is regarded as the father of financial futures. In 1972, the CME, with Melamed as chairman, launched currency futures and created the International Monetary Market, the first futures market for financial instruments.

The Chinese derivatives market is now highly restricted but it is again starting to expand after crackdowns in 1993 and 1998.

As a result of the trading problems that led to those crackdowns, regulators cut the number of tradable contracts to 12 from 55, slashed the number of exchanges to three from more than 40 and limited trading on foreign exchanges to a handful of global firms.

Melamed said he sees a new desire by regulators to re-open and encourage derivatives trading, and this eagerness has continued in spite of the setback from the 550 mln usd in derivatives losses suffered last year by China Aviation Oil. The Singapore affiliate of China's state-owned aviation oil monopoly suffered from losses related to selling over-the-counter crude oil calls.

"One of the heartening things that I saw was that the Chinese government officials understood that what happened with China Aviation Oil was a human violation and had nothing to do with the instruments of trade. In effect it was someone violating the rules," he said.

"The Chinese officials have really advanced their understanding of these things and I saw no attitudinal change whatsoever (after the incident)."

This has helped convince him that the development of the derivatives market will be relatively rapid in China.

"I'm always of the opinion that (derivatives development) will be sooner rather than later. If you look at the direction that has occurred in the last five years even, it's almost impossible to conceive that it could move in its development as quickly as it did," he said.

"That is a lesson for the future and I think that it will speed up from here. So, I'm very very optimistic on the growth of these markets here."

Still, Melamed acknowledged that technical concerns and weak underlying financial markets will limit the speed at which China can develop its markets.

"Index (based derivative) products would be the most likely products to go (first) because it will help establish and solidify their stock exchange markets and their securities market," he said.

"I would think it's in their interest to move in that direction first and then secondarily move into interest rates, and probably foreign exchange is the final stage in this process."

He added that it would be necessary for regulators to fix structural problems that are hampering the stock markets before a strong market for index derivatives is created.

"I really think they have to make provisions for a stronger cash market. You can't really have futures markets without a fairly liquid and resilient cash market," he said.

China's stock markets have been burdened with a huge overhang of non-tradable state-held shares.

The government controls as much as two-thirds of the shares of listed companies through non-tradable stock held off the market. While Beijing wants to list these shares, public investors are worried this will send the value of their stock tumbling.

There is also concern that the majority state-held firms are not as attractive as more publicly held firms in terms of transparency and corporate governance.

"You have to be transparent, you have to be open and that will help provide the integrity for the stock market and I think that that is something that they should work on," Melamed said.

The CME's activities in China are currently as advisers to the exchanges on market development, and Melamed described the CME as "evangelists seeking to spread the Gospel of derivatives".

"Here we are for an educational effort that we have done in many different geographical centres, what we are are sort of evangelists ... and we provide information for the financial community on what derivatives are about, how to use them, how to advance their derivative markets on there own."

"Over time, we then get to be really helpful and they get to know us and the ultimate result is an expansion of our business into wherever we are proselytizing," he said.

While the CME has confirmed that it is considering expanding through acquisitions, Melamed would not comment on any possible purchases. He stressed, however, that the exchange's plans for China are at present limited to educational partnerships.

"If you look at our history, we began advancing this model into Europe in the 80s, the early 80s, them we moved in a similar model through education and eventually partnering and advancing our trade into Singapore and Japan and it's worked marvelously well."

The CME's partnerships in China are with both the Shanghai Stock Exchange and the Shanghai Futures Exchange, two exchanges that are known to be competing for the eventual listing of financial derivative instruments.

Melamed said the competition between the two was good for the market and that the CME's cooperation with both exchanges was solid and unaffected by the rivalry. Beyond China, he said the CME is looking at India and, to a lesser degree, South Korea as areas for future market development.

"We see some very, very promising Indian markets developing. I would tell you that I'm as high on Indian market development as I am on Chinese market development," he said.

Melamed said that he was hopeful that India would start to develop interest-rate futures, although it is unlikely that they would develop currency-based instruments due to convertibility issues.

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