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The growth of financial futures

by
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LESS than ten years ago, the International Monetary Market in Chicago pioneered the concept of financial futures trading. In their short lifetime, financial futures — that is, futures contracts based on currencies and interest-bearing instruments (with precious metals usually included) — have surged to the forefront as prime instruments of financial management.

It is no coincidence that financial futures emerged as a mechanism for protecting risk during the 1970's. No other decade of the century — not even the 1930's — has had so great an impact on the national economies of the world. Inflation, energy costs, changing relationships between currencies and volatile movements in interest rates have had great effect on the private and public sectors of all nations.

In this perspective, financial futures markets already offer credible and convincing evidence that they are fulfilling a very important role. Last year, financial futures — traded on six exchanges in the United States — represented more than 34 per cent of the total volume of 76 million contracts on all exchanges. From zero volume in 1970 to a volume of 25.9 million in 1979 represents impressive growth by any standard and this year is shaping up as an even better year — on the International Monetary Market alone, volume for the ten months ending in October reached 8.1 million, more than 24 per cent higher than the same period last year.

Still another reflection of the increasing importance of financial futures is the spawning of exchanges outside the United States. Interest rate futures in Treasury Bills and Treasury Bonds are already being traded in Canada, while currency futures and gold futures markets have opened in Australia. Hongkong's gold futures market is expected to be followed by one in London, linking the Far East and Europe to the active gold futures markets in Chicago and New York. London, too, is expected to launch a financial futures exchange in 1982 with markets in interest rates and currencies.

Meanwhile, in the United States itself, expansion of financial futures markets has continued in 1980 with the formation of the New York Futures Exchange. NYFE, as it is called, began trading in August with five currency contracts and two interest rate contracts. In Chicago, the birthplace of financial futures, the International Monetary Market and the Chicago Board of Trade have applied for new markets in Eurodollars and domestic certificate of deposits. The IMM already has active markets in 90-day Treasury Bills, five currencies and gold — while the Board of Trade has successful markets in 20-year Treasury Bonds, government-backed mortgages (GNMA's) and silver.

Why are financial futures so useful? How do they work? Long before financial futures came into being, the functions of futures markets in the United States were identified and characterised as follows:

First, the central function of a futures market is to permit the transfer of risk.

Second, a futures market also functions importantly as a price discovery mechanism, showing what prices are expected to be up to two years ahead.

Third, a futures market also functions as a price dissemination mechanism, allowing fast access to actual transactions taking place on exchange trading floors.

These three functions are served by futures markets irrespective of whether the contracts are based on agricultural commodities or on financial instruments. They had their origins more than 100 years ago in Chicago, primarily because of the city's location at the confluence of East and West in the United States. Chicago was — as it remains today — a hub of the transportation network bringing produce from the rich agricultural belt of the Midwest to the markets of the processors providing food for the populous Eastern seaboard.

Where producers and processors met, there was, on both sides, a strong common interest to protect against risks on future deliveries. This resulted in the formation of exchanges where participants, knowing their own future needs, were able to enter a market to establish positions which served to hedge their future commitments. While it was not possible to eliminate risk altogether, informed hedging strategies functioned to minimise or cushion risk.

Without question, today's new financial futures markets fit ideally to the needs of the present period of economic uncertainty. Just as America's agricultural industry required a risk-protection mechanism in the last century — and continues to do so today — so American business and financial institutions have found the same mechanism to be of immense use 100 years later.