Chapter 2 : History and Internationalisation of Futures Markets

2.1 The Futures Contract

Futures trading has been a part of the world economic scene for a long time. Its basic concept goes back to the beginning of commercial trade when merchants tried to protect themselves from variety of adverse conditions, including declining and advancing prices. **The standard definition of futures contract is a legally binding agreement requiring to take or make delivery of a given quantity and quality of a commodity at an agreed price on a specific date of dates in the future.** However, there is a simpler way to define the essence of a futures contract. "A futures contract fixes the price and conditions now for a transaction that will take place in the future".

When signing a futures (forward delivery) contract the parties involved agree to make or take delivery of a specified quantity and quality of a commodity (anything from cattle to corn to currency) at a specified future time and price. The price is often subject to supply and demand factors and a certain element of risk is involved.

Before the advent of financial futures, the commodities that used futures contracts included agricultural products, such as sugar, soybeans, and live cattle, and physical commodities, such as crude oil, aluminium, and gold. A financial future is just like any other futures contract, except that the "commodity" is a financial instrument. In some cases the instrument is tangible, like a treasury bond or foreign currency. In other cases, the instrument is intangible, like a stock index or an interest rate.

2.2 Origin

The existence of risk is precisely what prompted the first use of a futures contract. Take farming for example. When an independent farmer plants crops for his own use, no outside party depends on him to produce. However, when a farmer plants to derive a profit form selling the crop, that's a different story. In the spring when the farmer plants his corn, he faces many risks between the planting and the harvesting of his crop. Some of the risks include blight, drought, vermin, and bad weather. There are even risks involved in having a good crop. If an abundance of corn at harvest time drives prices below the break-even point, the farmer risks losing his profit because his and his competitors' supply outweighs demand.

Clearly, the risks are there. With the advent of futures trading a third party steps in to assume some of those risks. Often, a speculator who has money pays the farmer for the right to assume the risk as well as some of the future profit. The speculator arranges a contract to sell the commodity (corn in this case) to an interested buyer such as a grain miller.

The speculator feels secure in his commitment because he has analysed the prospect of price changes in corn and feels the changes will be in his favour. While providing a service to those involved by assuming some of the risk, he also hopes to make a profit on his deal based on some market forecasting he has done. The primary reason for the establishment of the futures contract is to alleviate some of the inherent price risks of producing, storing, and marketing the corn.

2.3 History

Futures contracts and futures exchanges have been in operation since middle of the 19^{th} century, when the Chicago Board of Trade first started to offer "to arrive" and "time" contracts on agricultural products. Surprisingly, more than 100 years was to pass before financial futures contracts were conceived in the early 1970s. Since then, financial futures have become a vital mainstay for the other financial markets.

The term future itself connotes how a trade is handled and the reasoning behind it. Around the time of the Civil War, the farmer usually took the brunt of market fluctuations. If he was ready to sell soon after the harvest, so was everyone else. Consequently, at that time supplies were usually well in excess of immediate requirements - a situation that resulted in depressed price levels. Farmers had several alternatives : accept whatever price they could get for their crops in an already oversupplied market, put their crops in storage (incurring additional costs) and hope prices would improve, or haul their crops back home. Often, finding anyone who would even make a bid for their hard-earned crop was difficult.

However, the situation reversed itself toward the end of the crop year. As the season's crop was consumed, the supply of available unsold grain became smaller and smaller, and this scarcity resulted in higher prices. This meant grain merchants were forced to buy the bulk of their year's supply (more than they could sell at the time of purchase) during the harvest period. Or they had to pay high prices late in the marketing year, before the next season's crops were available. In order to keep their mills running, manufacturers competed with each other for the dwindling supply. On the other hand, during the years of oversupply, producers had to dispose of their goods at fire-sale prices. Similar situations occurred with other commodities as well.

In order to protect themselves against seasonal price fluctuations, producers and consumers of agricultural commodities began to buy and sell for forward delivery. These transactions, which became known as to-arrive contracts, involved a binding sale by a farmer to a buyer for a designated amount of grain (or other crop) to arrive 10, 20, 30, or 60 days later.

Contracting for deferred delivery did not, of course, eliminate the risk, nor did it solve the problem of the market risk. The risk, when you think about it, was not completely off the shoulders of the seller. Of course, the producer/seller had estimated sufficient return for a crop before it was even harvested and need only be concerned with the production of the crop and its delivery to the buyer. But the seller could still lose potential profit. He had to deal with the possibility that the price of the commodity would rise before delivery. If the price of corn advanced , he stood to lose out on additional profit. The buyer, on the other hand, still had to fear a price decrease. Should the price of corn drop by the time of delivery, the buyer would suffer a loss if his competitors bought the cheaper merchandise.

Contracting for deferred delivery, however, did at least enable a merchant, manufacturer, or processor to schedule raw material shipments for arrival at designated intervals and to know their costs. Insuring the availability of raw materials for operating needs at all times tended to stabilize the market to a degree, because product prices could be projected from known costs.

Eventually, these forward contracts were bought and sold without waiting for delivery. Many other people who were not in the grain trade were willing to assume the risks but were not willing to take the actual delivery. These speculators were interested in a possible gain on any change in value, not in profits on the sale of the physical commodities themselves, The merchant with a contract, who did not want to absorb the risk at all, could transfer ownership of the contract to a third party (dealer or speculator) who was willing to take a chance solely in the hope of making a profit.

Once speculators became interested in the futures contract as such -that is, as a negotiable item on its own - the futures contract market became a viable adjunct to the actual commodities market, or cash market as it is sometimes called.

2.4 The Commodities Exchange

A commodity exchange is merely a central meeting place where buyers and sellers (or their orders) meet to transact business. Facilities are provided where transactions can easily take place between members, the only persons permitted to trade on the floor of the exchange. Exchanges do not buy or sell commodities of contracts or establish prices. They enforce rules and regulations in order to promote uniform practices among buyers and sellers in the market and provide for an orderly market. They also act to quickly adjust business disputes and to distribute price and market information valuable to members and their customers.

2.5 The Fundamentals

For many years the definition of commodities was confined to agricultural products, and understanding commodities was fairly easy : A grower sold the crop for the best price as soon as it was harvested - or stored it until either imminent spoilage forced a sale or the price was right.

Now, not only does the term "commodities" include a long list of products, but it also involves two separate yet parallel markets : the cash market and the futures market. Though commodity futures trading can no longer be considered simple, it is still no harder than any other product subject to the law of supply and demand.

A commodity is any product, service, financial instrument, or foreign currency that is bought and sold on a recognised exchange. Commodity futures, on the other hand, are predetermined contracts whose terms are defined by an exchange. There are approximately 80 different commodities traded on 12 different exchanges in the United States.

Trading commodity contracts is very similar to trading securities inasmuch as both are influenced by the forces of supply and demand. However, unlike securities, where a company may offer a set number of stocks for sale, a commodity contract exists whenever there is a buyer and a seller. Contracts exits when both the buyer and seller mutually agree to transact business at a given price. Thus, there is no limit to the number of futures contracts that can be created.

This brings up an interesting situation: The number of contracts for any particular time frame may exceed the actual supply of the commodity. However, as the delivery month draws near, the number of contracts tends to decrease naturally.

A futures contract trades in months, ranging from one year to almost three years before the contract expires. Unlike the stock market, for which corporations decide how many shares of stocks will be available for sale, in the commodities futures industry no contracts exist when the trading begins. And no contracts would exist if no one was interested in trading. But, as soon as the buyer finds a seller, a contract is created. All the buyer and seller recognise is that a commodity will be available and they want to speculate on price action.

The process of contract creation can theoretically go on as long as buyers find sellers and vice versa. This is an interesting facet of the commodities market that also makes establishing positions easier. As you are probably aware, going long in the stock market simply means buying stock; going long in commodities means buying a futures contract that involves the possibility of accepting delivery. In stocks, selling short means selling stocks the investor does not own; stocks must be borrowed somewhere to deliver against the sale. In commodities, however, since contracts can be created indefinitely, selling may involve two situations: selling short for the purpose of making delivery or selling to liquidate a position.

So how are trades made to eventually balance the number of contracts with the commodity supply? The vast majority of futures trades are settled by offset(liquidation). In fact, less than 2% of all futures contracts that are traded actually result in delivery. Ninety-eight percent of the contracts are settled long before delivery is even an issue. The speculators, and most hedgers, are offsetting, leaving the actual commodity dealers to deal. Contracts that remain at the time trading ends must be honoured through delivery. If the deliverable supply of a commodity is greater than the amount totalled up in all the open contracts, then prices tend to drop because supply exceeds demand. The surplus of a commodity brings the buyers of contracts (the longs) under pressure to sell off (to liquidate) as many and as fast as possible. Needless to say, the selling behaviour of the speculative longs becomes increasingly aggressive as the delivery month approaches because they have to liquidate (offset) or risk taking a delivery.

On the other hand, if the commodity is in scarce supply, then the sellers (or the shorts) would come under pressure to meet their obligations. In simple terms, the shorts would not have enough commodity to fill all the futures contracts. In the cash market, the price would go up because of the scarce supply. But in the futures market, whatever contracts go unfilled have to be bought back from the longs. Buying a contact back from a long is called covering . In such a case, the longs could hold out for a favourable price - one probably a lot higher than that anticipated by the shorts.

The ability to profit from both bullish and bearish market conditions is an integral part of futures trading. For example, a wheat farmer in anticipation of a drop in the price of wheat due to the abundant supply during harvest time will need to lock in the selling price now by selling futures; whereas, a manufacturer of bread may need to lock in the purchase price of wheat now by buying futures instead of waiting for harvest time when the price may rise.