

Development Status and Policy Recommendation for China's Futures Market

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Abstract. The reform process within China's financial markets has led to rapid expansion and structural changes in China's futures markets. As globalization and market volatility have developed, futures markets have garnered heightened attention concerning their ability to manage risk and discover prices. The purpose of this paper is to evaluate the structural and institutional challenges to the development of China's futures markets. In China's futures markets, I will consider the market structure, the structure of participation, and the performance of the market, to evaluate conjunctively the market structure, information asymmetry, and the shortcomings of regulations. The principal conclusion is the substantial development China's futures markets have made in both their volume and overall market performance, and the chief deficits emerging market participation, the diversity of available products, and the institutional deficits of China's futures market regulations. The reform of regulations should be the principal focus for the improvement of efficiency and the stability of China's futures markets. This paper is a step toward a qualitative and sustainable growth of the futures markets in China, in a market system that demands a more functional performance relative to the volume of the markets.

Keywords: China's futures market, Financial derivatives, Market structure, Risk management, Regulation

1. Introduction

The role of financial markets has been increasing in importance in the last few decades. Markets help in the development of the economy and the allocation of resources. A specific example of the importance of financial markets can be seen in the case of futures markets. Futures markets facilitate the development of tools needed for price management and risk management. Financial system development is important for all economies, China being one of the largest emerging economies, has shown rapid development of their financial system. Since the early 1990's China's futures market has shown rapid development in trading volume, the diversity of available products and development of institutions. In the last few years, China's futures market has seen strong growth driven from the development of the industry, financial innovation and the gradual relaxing of market policies. The Chinese futures market also has many challenges. China's futures market has a lot of challenges; therefore, it is very important to study these challenges to understand the limitations it has for the future development of the market.

A lot of literature is available for study concerning the function and performance of futures markets. The first studies focus more on the importance of futures markets in price management and risk transfer. For example, Black analyzes the pricing mechanisms of commodity contracts [1]. Garbade and Silber demonstrate that futures markets contribute significantly to the price discovery process [2]. In addition, Bessembinder and Seguin show that futures trading activity may influence market volatility [3]. These studies provide a theoretical and empirical foundation for understanding the role of futures markets.

Recent literature analyzes the dynamics of futures markets and the overall economy, as well as developing economies. Fang notes that China's futures markets are increasingly helping the industrial economy by enhancing price signals and the allocation of economic resources [4]. Gao and Gao explain that the correlation of futures markets with macroeconomic variables is growing, and therefore, they have a higher contribution to economic theory [5]. On the other hand, research on particular commodity markets shows that the efficiency of futures markets is heterogeneous across markets and situations [6]. Furthermore, studies that compare China with developed economies point out the structural differences, especially concerning the investor profile and the variety of products [7]. Notwithstanding the contributions of these authors, literature on the market still remains isolated to a particular perspective, therefore, a greater synthesis of structural aspects, market efficiency, and the policy impact is warranted.

This paper will try to provide an integrated analysis by looking at the development status and key challenges of China's futures market. Specifically, this paper will try to look at the market structure, patterns of participation, and functional performance, and will try to highlight the issues of structural imbalance, information asymmetry, and regulatory issues. From these findings, this paper will try to provide structured policy recommendations to alleviate the regulatory issues and information asymmetry. The study holds both theoretical and practical importance. Theoretically, it contributes to the literature on the emerging financial markets by providing a structure analysis framework, and it presents analytical literature to the policy makers and market players for the purpose of improving the quality and sustainability of the supply chain of China's futures market. In addition to this, the classical theories such as the storage theory provide better understanding of the mechanisms of futures price formation [8].

2. Current development of China's futures market

In the last few decades, China's futures market has experienced rapid development and has undergone institutional transformation, and has become a vital part of the financial system of the country. The market has changed a lot from the early 1990s when it was re-established to date. Recent years has seen China become one of the leading futures markets in the world by trading volume. The developments in the futures market have in a greater capacity supported the industrial sectors in risk management and optimum utilization of resources, as well as in determining prices [4].

In regards to market structure, China's futures market is still largely focused on commodity futures. In 2023, the commodity futures market constitutes 75% of total trading activities, while financial futures comprise only 25% (see Figure 1). Trading activities in crude oil, metals, and agricultural commodities result in a large volume of total trading activities. Compared with financial derivatives, commodity futures were introduced earlier and have relatively more developed trading systems. Developed economies have futures markets that are integrated with real economic activities, and this is particularly in the agricultural and manufacturing sectors, where real economic activities are directly inter-related with the prices of the underlying agricultural commodities [9].

That close relationship increases the significance of futures markets in stabilizing production expectations and enhancing the allocation of resources. The structure of China's futures market as depicted in Figure 1 shows underdevelopment of financial futures and dominance by commodity futures.

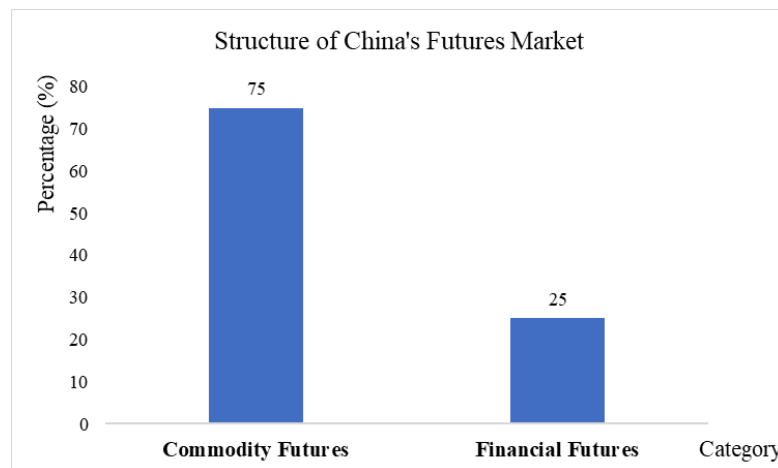


Figure 1. Structure of China's futures market

Source: Compiled by the author based on market structure analysis.

The financial futures market is as well developing, but more slowly than, and therefore the same as, the commodity derivatives marketing the futures markets. Financial risk management has led to the introduction of stock index futures and treasury bond futures in China. Usage of these instruments by institutional investors for risk mitigation is on the rise, and is attributed to heightened levels of market uncertainty in the economy [6]. Despite the introduction of these instruments, China's financial derivatives, as compared to developed countries, still have a limited variety and depth.

Another notable trend is the continuous improvement of the market's functions. The price discovery function of the Chinese futures market, as documented by research, has become effective over time, as evidenced by the increased co-movements between futures and spot markets. This means that futures prices tend to reflect market expectations to a greater extent [2]. Simultaneously, the function of managing risk has also been bolstered, as more businesses utilize futures instruments to hedge.

Moreover, China's futures market is starting to globalize. The launching of the first open futures product (i.e. crude oil futures) is a significant milestone in China's market openness. Over the years, the literature has been silent on the fact that the structural and institutional barriers remain. The progress in the market is significant, but it still remains in the transitional phases.

3. Problem analysis

The rapid expansion of the Chinese futures market is not an indicator of the structural and institutional challenges it continues to face, which will most likely limit its efficiency and development over time.

3.1. Development of market structure

For a considerable time, there has been a persistent imbalance in market participation. Most of the trading activities are executed by individual (retail) investors, whereas the position of institutional

investors is considerable smaller. The presence of institutional investors in a market increases its overall stability and efficiency, while a high presence of retail investors is associated with a higher level of speculative activities, thereby increasing price volatility as well [7].

The financial futures sector is another area that needs more development. Even though many instruments have been introduced, like stock index futures, financial futures only account for 25% of market activity. Compared to more developed markets, the range of financial instruments is still lacking. This limits the investors to create diverse hedging strategies. Some studies show that, even if some commodity futures markets have effective price discovery, the balance of the market with different types of derivatives is lacking. Therefore, the market still does not have the capacity to support financial risk management to the fullest.

Analyzing the empirical literature is important for the understanding of structural imbalances. Research shows that the presence of retail investors in the Chinese futures market is associated with short-term trading and increased market volatility. As a developing market, Wang notes, the low presence of institutional investors destabilizes price formation [7]. This indicates that the current structure of participation is an important factor influencing the efficiency of the market. The structural imbalances are likely to cause large fluctuations in prices, and also limit the market's ability to give clear signals to aid the efficient allocation of resources and industrial development.

Additionally, the analysis of particular commodity futures markets also shows the existence of structural imbalance. Peng observes that some agricultural futures markets in China, despite having some level of efficiency in price discovery, present highly disparate performances in different market situations [6]. This disparity shows that the efficiency of the market is not uniform, but rather that it varies according to the type of product and the level of development. Consequently, the uneven development of commodity and financial futures also restricts the market's total functionality even more. This imbalance of products may also limit the capacity of the emerging high-tech manufacturing sector to financially hedge, thus preventing the futures market from being integrated more closely with the real economy.

3.2. Market volatility due to information asymmetry and other reasons

Market volatility is another primary problem. China's futures market is sensitive to macroeconomic variables like global commodity prices, exchange rates, and monetary policy, and thus it is affected by both domestic and external variables for price changes. Increasing these variables increases uncertainty and makes effective risk management more difficult [10]. In some cases, excessive short-term trading increases volatility, thus decreasing the efficiency of the market.

Insufficient market transparency also diminishes market performance due to the disparity in information asymmetry. Having timely and accurate information is an advantage that some market participants have, and in less developed market segments, the lack of transparency and information disclosure makes this problem worse. This phenomenon tends to prevail in less developed market segments. The asymmetry of information diminishes the efficiency of the price signals which also decreases the confidence of the investors.

The intricacies of the motivating factors concerning price fluctuations are addressed by the studies on the subject. Macroeconomic factors are illustrated by Wang as principal determinants in the global economy and policy changes. Wang reiterates that the changes in policy and the economy are principal determinants of the changes in the price of futures contracts [10]. This assurance states that factors other than macroeconomic conditions are determinants of volatility in the price of the market. Therefore, it helps to look at the problem in regulation from this aspect. Additionally, the market shocks coupled with the information disparity aggravating the market instability is more

puzzling to the global and domestic market players in relation to their expectations and risk management.

3.3. Regulatory challenges

The other notable problem is with the market regulation. The Chinese market has one of the most advanced supervisory structures, but the speed of evolution is more than the complexity of the market, and the complexity is where the traditional structures of regulation fail. Increasing complexity in financial instruments and trading methods requires regulation that is more adaptive, flexible, and anticipatory concerning ongoing financial innovation. Most studies show that emerging risk is poorly managed by traditional approaches. These difficulties reflect the fact that the futures market in China is still undergoing changes and adjustments structurally and that optimally addressing these challenges is necessary for the market's efficiency, stability, and sustainable development.

The challenges China's futures market confronts are systemic and in the given context, are mutually reinforcing and interdependent, not only the structurally unbalanced composition of the investor base and the structurally unbalanced and underdeveloped product category of the market but also the externally imposed macroeconomic conditions. These factors together characterize the conditions within the market in question. As such, formulating effective responses requires balancing systemic and structured approaches, not ad hoc responses.

4. Suggestions

4.1. Addressing structural participation imbalance

To mitigate participation imbalance within the market, the development of institutional market participants is necessary. A greater presence of institutional investors will promote a more rational market and reduce speculative extremes. This is because institutional investors are more likely to adopt a long-term perspective and rational approach, positively influencing the market's price discovery mechanisms [7]. Therefore, improving market participant entry mechanisms and stimulating the participation of professional investors is a necessary condition for improving the structure of the market.

To improve the structure of the market, it is also necessary to advance the development of financial futures, i.e. the derivatives market. A greater range of financial instruments allows market participants to adopt more effective strategies for the control and management of financial risks. The development of appropriate instruments advanced the integration of the financial market and the real economy [4]. In light of this, the primary focus of developing financial instruments should be the promotion of product development and innovation.

4.2. Refining market supervision

Strengthening the regulators' framework is an imperative. The more complex a market becomes; the regulatory bodies have to become more flexible and adaptable. Numerous studies show the volatility and uncertainty of futures markets. It makes a strong case for an adaptable and flexible framework for regulators [10]. Better information collection and dissemination, more flexible and mobile real-time supervision, and early fixed risk monitoring systems may help mitigate systemic risks.

4.3. Reduce market information asymmetry

Reducing asymmetry of the information market is another significant policy target. Better transparency and equitable information distribution can increase market efficiency, and strengthen the confidence of the investors. This can be emphasized in the improved information distribution and digital utilization. This can be emphasized in the improved information distribution and digital utilization.

4.4. Control of risks

In an international context, the liberalization of China's futures market must be encouraged. The involvement of foreign investors and the marketing of foreign competitive products is important for the establishment of a competitive global market. The degree of openness must be balanced with the control of risks and the stability of the market in case of international market shocks.

To conclude, the financial technologies applicable in the market can also be utilized for supervision and for the market to increase its efficiency. Monitoring the use of Artificial Intelligence and big data in trading will help in the identification of risks and will create an efficient and flexible operation for the market.

China's futures markets can have long-term development by maintaining balanced and sustainable development by utilizing institutional participation, product innovation, regulation, and international integration.

5. Conclusion

The paper analyzes China's futures market development status, challenges, and policy implications comprehensively. The Market structure, participation, and functions demonstrate that despite considerable growth in trading scale, and the role in the market's price discovery and risk management, to the extent that the market has become of increasing importance, the market remains in a transitional stage. Greater institutional improvements are required. The analysis also uncovers issues that are the most prominent to the long-term development of the market, e.g. imbalance between commodities and financial futures, predominance of retail investors, asymmetric information, and inflexible regulation.

The growing importance of the market necessitates a focus on the institutional improvements outlined in the recommendations. These include the market's growing importance and the need for an improved, efficient, and competitive international futures market. The study has limitations, because of the reliance on existing literature and evaluations that do not include empirical testing, the analysis is qualitative. Recommendations for future study include the use of international markets to extend the analysis of China's futures market development and empirical methods to validate, define and deepen the understanding of the development of China's futures markets.

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