M R Pridiyathorn Devakula: Challenges and opportunities facing the Thai futures market

Remarks by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the gala dinner hosted by The Agricultural Futures Exchange of Thailand, Bangkok, 23 February 2006.

*   *   *

Distinguished Guests,

Ladies and Gentlemen,

It is a privilege for me to be here today amongst distinguished personalities from the banking and finance industry. First of all, I would like to thank the Agricultural Futures Exchange of Thailand for inviting me to address this distinguished audience. I have been asked to share some thoughts with you on the challenges and opportunities that I see facing Thai futures market going forward.

Thailand has been one of the world's leading producers of agricultural products. Thailand has always been top-ranked in rice, tapioca starch, sugar and natural rubber production. In fact, Thailand has been the world's largest rice exporter for more than a decade. Our rice export accounts for no less than one quarter of total world's rice exports. Likewise, we supply more than one-third of the world's total natural rubber production. With roughly half of our labour force being employed in the agricultural industry and with rice alone earning almost 2 billion U.S. dollars last year, the importance of the sector towards Thai economy cannot be overstressed.

However, unique characteristics of agricultural products are that of long supply adjustment lags and inelastic demand. Prices therefore tend to exhibit inherently high volatility. Thus, the establishment of the Agricultural Futures Exchange of Thailand (AFET) by the Ministry of Commerce was a major step in the right direction. The futures market aims to provide an efficient and effective mechanism for the management of price risks. By buying or selling futures contracts - contracts that establish a price level now for items to be delivered later - individuals and businesses have access to insurance against future adverse price changes. Futures market is a continuous auction market whereby prices should reflect the latest information about supply and demand conditions. This price discovery mechanism allows producers to be better informed when making their production plans. Even for small producers who may not actively participate in the futures market, the transparency and the availability of the futures prices in the public domain should enable them to negotiate and obtain fair prices for their produce.

Since AFET opened for trading in May 2004, the daily average turnover for a rubber sheet in the AFET rose almost 8-fold in 2 years to 400 contracts. This increase may look impressive, but if we look across to the futures exchanges in the neighboring countries, we find that the Tokyo Commodity Exchange (TOCOM) registers daily turnover for rubber sheets at 20,000 contracts while the Singapore Commodity Exchange (SICOM) sees around 8,000 contracts being traded daily. Given our prominence as the world's leading producer, it came as a surprise to me that Thailand remains a mere price-taker in the world's agricultural produce markets. I feel strongly that we should leverage our competitive advantage as the key producer to ensure the success of our futures market. Our main producers should be able to play an active role in the determination of the world prices – that is; AFET prices should be used as the world's benchmark. I believe we are well-placed to achieve that goal.

Ladies and Gentlemen,

Now it is time to channel our energy and effort into making AFET a successful futures market for agricultural products, especially in the international arena. The next key question then is "How"? This task is indeed a challenge and if we all agree on this part, I think the best approach is for us to focus on one product at a time. I propose that AFET conduct an in-depth study into each of the products currently listed on the exchange and evaluate their chances of success. AFET can then prioritise whether they should first concentrate on smoked rubber sheet, block rubber, tapioca starch or white rice. Commodity Trading normally involves reference prices based on a certain futures exchange. For instance, market participants prefer to use futures prices from the London International Financial Futures and Options Exchange as a reference for white sugar while benchmark prices for rubber products are currently determined in the Tokyo Commodity Exchange and Singapore Commodity

Exchange. It is worth noting that there are no well-established reference prices for white rice just yet. I see this as a great opportunity for AFET to prosper and fill in this void. At the same time opportunity does exist for us to steal the show on some rubber products as well.

To increase the role of AFET we should start by asking why is it then that players have not expressed interests in trading on the AFET? I will provide a few hypotheses of my own as to why market liquidity still remains unsatisfactory. **First**, it is said that liquidity begets liquidity. The Singapore Commodity Exchange (SICOM) has been in operations for 11 years while the Tokyo Commodity Exchange (TOCOM) will be celebrating its 22nd anniversary this year. So, the big players have already grown accustomed to trading on these two exchanges and enjoyed the liquidity, depth and variety that they offer. Even some large Thai market participants of these products have established an offshore entity in Singapore to trade the futures contracts on SICOM. For AFET to overcome their first-mover advantage, we need to channel all efforts into removing key impediments in order to convince these major players to make a switch.

Second, transaction costs in the AFET be it fees charged or margin requirements are comparatively higher than that in SICOM, and thus discouraging players from coming into the AFET market. The existing high level of fees may have contributed to the lower trading volume while in turn, inadequate trading volume means that AFET is not able to reduce the fees while hoping to become self-financed. Given this catch-22 situation and the fact that other exchanges have had a head start, I do not think we can afford to wait for a pick-up in volume before planning for a fee reduction. On the contrary, I advocate that AFET's fees should be adjusted to a competitive level as soon as possible. Admittedly, in the initial phase, operating losses may mount up as liquidity takes time to migrate. Therefore, it is imperative for the Ministry of Commerce to express its full support for this initiative and earmark a special budget for subsidising AFET's operating costs

Third, as mentioned previously, one primary objective of a futures market is that of providing hedging instruments. However, the use of futures or derivatives per se does not add or subtract to the risks inherent in the economy, but they allow risks to be borne more efficiently by transferring risk from those with low risk tolerance to those with higher risk tolerance. Therefore, a futures market cannot be complete with only those players with genuine hedging demand. In order to enhance efficiency in the economy, we need international arbitrageurs or traders with relatively higher risk tolerance to bear the risks. In addition to providing liquidity, this group of players will also ensure that prices reflect all currently available information in the market. Prices will be aligned with fundamentals through their arbitrage activities.

How then do we convince these arbitrageurs that they should become active in the AFET? One possible solution I think is that of making all contracts on AFET U.S. dollar denominated. This way, the arbitrageurs are not exposed to any foreign exchange risk and they can manage their positions across markets with ease. Of all the commodities listed on SICOM, only one contract namely ribbed smoked rubber sheet no. 1 is Singapore dollar-denominated and coincidentally, it is also the least liquid contract on the SICOM. All other contracts are denominated in U.S. dollar. Moreover, commodity prices in the world are generally quoted in U.S. dollar, therefore, corporate buyers and sellers are already aware of their costs and revenues in terms of U.S. dollar. If we aim to establish futures price of, for instance, white rice on the AFET as a benchmark, it is logical for this reference price to be denominated in an international currency such as the U.S. dollar. That way, the price quotations would purely reflect all relevant information relating to demand and supply conditions of the products and are not influenced by exchange rate fluctuations.

Some may express concern, however, that by eliminating foreign exchange risk for foreign arbitrageurs, we in turn, expose our local producers and end-users to the very same risk. I feel, on the contrary, that local buyers and sellers are already accustomed to commodity prices being quoted in U.S. dollar in the world market and manage the risk in a proficient manner. Given the increasing availability of innovative financial products and much improved risk management techniques by commercial banks in Thailand, the Bank of Thailand has gradually relaxed our regulations in this area. At the moment, importers and exporters who wish to hedge this foreign exchange risk for a trade-related transaction can choose from forward contracts, plain-vanilla options or even certain structured products to suit their needs and preferred level of sophistication.

My final point concerns the role of the futures market as an insurance mechanism. As mentioned previously, agricultural products tend to exhibit highly volatile prices causing farmers to suffer from this risk of violent price fluctuation. The government has stepped in to provide relief in the form of government price support scheme. At present, the government is running commodity price stabilisation schemes in four products namely paddy rice, corn feed and tapioca. These price support schemes provide an insurance for farmers against adverse price movement- in the form of selling put options to the farmers. The schemes have grown to become a substitute for the futures market- eliminating the very incentive for farmers, traders and producers to participate in the futures market. This is particularly the case when the guaranteed buying prices from the government are set at relatively high level compared to market-determined prices.

I mentioned before that the average daily turnover in the AFET now is around 400 contracts. However, the majority of the trading is heavily concentrated in the ribbed smoked rubber sheet no. 3 while the contracts for white rice are rarely traded. I cannot help but feel that the existence of the price support scheme may have contributed to this apparent lack of interests in rice futures trading. As of last Friday, only 3 contracts for white rice were traded and the open interests were only for 60 contracts - equivalent to 300 metric tonnes. For a country that exported 7.6 million tonnes of rice last year-the highest volume in its history, I believe our rice futures market has high potential to grow, if conditions are right.

The government guaranteed prices are set once a year and thus, do not incorporate new information into the price. On the contrary, futures contracts are traded on a daily basis and these prices are said to be the best predictor of prices in the future – pricing in all currently available information. Players should be encouraged to hedge their produce through the futures market rather than through a static price-support scheme. In the medium term, the price-support scheme should be eventually phased out so that our producers would be freed to stand on their own feet. It is crucial that we implement the change gradually to enable those involved to adjust. I feel that we should strive in this direction - it is only then would our producers be able to respond to competition in the global market place.

These days, many agricultural-related products in Thailand are subject to price ceilings. These price control schemes coupled with the price support projects outlined above mean that the market mechanism is not well-functioning. Distorted prices in the spot market may have also discouraged foreign players from participating actively in our futures markets. A freely traded spot market is a necessary condition for a successful futures market.

Ladies and Gentlemen,

I would urge the board of directors of AFET and AFTC, the Ministry of Commerce, the government, all members of AFET and key players in our main agricultural products to be totally committed to making AFET a highly successful futures market - an exemplar to our neighbours and one where global trading is benchmarked. We need to be strategic, prioritising our products and evaluating needs of different participating groups. I pledge my full support to this cause.

I have spent a great deal of time talking about the AFET, I would now like to briefly touch on its sibling-TFEX. TFEX is launching its very first product SET50 futures in the next few months and from the road shows to date, I hear that it has been very well-received. As the next step, the Stock Exchange Commissioner and the Bank of Thailand are currently working on launching the much-anticipated bond futures or interest rate futures. I hope that once Thai financial market has been complemented by these interest rate futures, our players will be able to make much progress in the area of risk management, financial product innovation and trading.

I personally feel that it is imperative for a country to have a well-developed futures market. They enable growers, traders and end-users to benefit from improved riskmanagement practices. For the price discovery mechanism to be well-functioning, the futures market needs to command respectable volume and liquidity - the achievement of which is a goal that I feel we should set for ourselves. To sum up, the future of futures promises to be exciting and challenging. For TFEX, I hope that it gets off to a very successful start. For AFET, I am seeing a lot of potentials for it to be a futures market with sustainable growth and efficacy, enhancing the efficiency in the agricultural market. To realise its vision statements is only possible with full and complete cooperation from all of us. Again, I would urge the board of directors of AFET to take a lead and push for the much-needed change.

Thank you.