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China's Futures-Market Boom Creates Headaches in Beijing

CHINA'S GROWTH

• China's Growing Appetite Puts Strain on Commodity Suppliers[1]
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BEIJING -- The Chinese government has been trying for months to prop up its markets. Now, the wrong one is soaring.

China's three futures exchanges -- in Shanghai, Dalian and Zhengzhou -- are hosting the country's hottest but least heralded trading. Benchmark contracts for food and metal products have rocketed, a worrying prospect for a government eager to control rising consumer prices and keep foreign and Chinese speculators at bay.

Indeed, Beijing's attempt to subdue the soaring futures market illustrates the balance it's trying to maintain between market forces and political imperatives -- whether that means controlling the exchange rate or directing investment to particular markets.

"The government is worried, but it is also committed to an open market," says Wang Jian, a futures expert and government adviser at Beijing's University of International Business and Economics.

In the past two months, for example, the copper contract deliverable in April 2004 has climbed 31%; other key contracts have posted sharp gains. Trading volumes so far this year are more than double the total for all of 2002. After cutting margins -- the minimum required investment -- to spur trading, regulators announced Friday that they are raising margins two percentage points to 7% to cool things down. Copper and aluminum margins were the exceptions.

The market rally is sensitive not simply because speculators are finding ways to swamp China's futures exchanges, which are officially off-limits to foreign investors. The bets also disclose something that Beijing isn't eager to highlight: It has become quietly content with modest inflation as a way to relieve upward pressure on its currency, the yuan. Inflation would increase the cost of key materials, lifting the price of its exports and possibly muting accusations by the U.S. and others that China uses the weak yuan as an unfair trade advantage.

Beijing's balancing act is a delicate one. If it allows prices for staples such as cooking oil to rise sharply, public anger could spread. China's leaders recently prohibited news reports of rising grain prices for fear they would spark hoarding, say officials at the Beijing Youth Daily and the national Workers' Daily. At the same time, authorities have ordered local governments to increase grain reserves to deal with potential shortages.

The sizzling futures trade is complicating other government initiatives. Beijing is trying to pump up its stock and bond markets so it can list cash-strapped state companies and the government can borrow more money. But China's stocks are plumbing nine-month lows, despite Beijing's decision to allow foreign institutional investors to trade Class A shares, once reserved for Chinese.

And China's credit markets haven't made it easy for the government to finance its budget deficit this year. Some doubt that Beijing can meet its $77 billion domestic fund-raising target: Investors have shunned treasury-bond offerings, apparently because they don't pay sufficiently high coupon rates.

Like few other pockets of the economy, China's futures markets can offer an instructive view of consumer psychology. Though contracts traded on overseas markets can drive Chinese prices for metals and grains, domestic markets can assume a life of their own during uncertain times. Wild price swings can become self-fulfilling prophecies in spite of tight controls.

Beijing has worked to minimize such risks. In the early 1990s, about 60 futures exchanges dotted the country, and investors bid up everything from metals to mung beans. By 1998, China's regulators had pared the number of exchanges to three and rolled out trading measures, such as high margin requirements, to damp speculation.

These days, China's futures trade has settled into a more appropriate reflection of market realities. China's economic growth has pushed up demand and prices for raw materials, as the building and auto sectors boom. Because China represents an increasingly larger slice of global commodity sales, that demand is helping to price futures contracts overseas as well as domestically.

But speculators also have returned to the fray. In contrast with past rallies, many overseas investors are piling in as well, say market participants. Some foreigners are setting up domestic trading companies that exist only in name to help funnel funds to the futures markets, and later move profits overseas or into other parts of the Chinese economy, such as property.

"It's very common," said one Shanghai analyst, who has advised a Japanese client on the shell-company practice. "Many [foreign investors] are in the market already and many more are ready to come."

So-called hot money poses another danger. For every dollar, yen or euro that arrives in China, the central bank sells yuan to keep the exchange rate steady. Those short-term note sales to Chinese banks result in more money flowing into the economy, feeding industries that some fear may be overheating. Though the number of foreigners in China's restricted futures markets is supposed to be relatively small, they are adding punch to prices, which some think will drop as suddenly as they rose.

*Says Huang Chongyan of Shenzhen Gold Bull Futures: "Once these investors make money, they are getting out of the market."

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