

# **Research on Necessity of the Establishment of Financial Derivative Market in China**

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**Abstract:** With the development of China's market economy, the objective laws require the establishment of the country's financial derivative market more and more. Establishing derivative market will improve the capital structure and profit-making ability of our commercial banks, strengthen the effect of our monetary policies and absorb more international capital into our country, thus accelerating Chinese economy's future growth. [The Journal of American Science. 2005;1(1): 87-90].

**Key Words:** financial derivative market; underlying instruments; derivative instruments; functions of financial market

## **Introduction**

Speaking generally, what we call "the financial derivative market" is an assemblage of relations between supply and demand of derivative instruments and its mechanism. We also define the derivative instruments as newly emerged instruments, which are created by the underlying instruments' displacement of its elements or elements groups with those of other matters.

With the invention of derivative instruments and the founding of derivative market, the market system in many countries and regions, mostly in the advanced countries and regions, has been promoted much so far especially in providing the instruments and mechanism of risk-shifting because of the characteristics and unique advantages of derivative market. The successful experience of these advanced countries and regions has proved the importance and necessity of the derivative market, stimulating many other nations to consider the establishment of derivative market, which probably will accelerate their economic growth.

After more than twenty years of opening and economy reforms, China has achieved a great achievement in its economy and has begun establishing market economy system. Yet, our development is still in a primary stage and it's hard for us to make it maturely without some necessary elements introduced to our market. By now, perhaps the most important element we need is derivative market.

## **1. Establishing Financial Derivative Market is the Objective Requirement of Our Financial Market Deepening Development**

### **1.1 Establishing Financial Derivative Market is the Requirement of Strengthening the Financial Market Functions**

Modern economy is essentially running with the deepening of financial market, which is considered by some economists as the nucleus of the macro-economy system. Now, China is in the time period of continuous economy growth, objectively requiring the deepening development of the financial market. In this process, the establishment and development of derivative market is absolutely necessary.

As far as the present situations of China's financial market, an important step of the deepening is to improve its effect of functions. As we see, the reflecting function of China's financial market plays the worst among the big 4 functions (gathering function, distributing function, adjusting function and reflecting function), mostly because the lack of scientific pricing mechanism, which can improve the market efficiency in the financial market.

With the establishment of derivative market, such problems can be solved by participators' repeated-trades of derivative instruments with their expectations formed after the sufficient utility of market information. Meanwhile, the scientific pricing mechanism will be formed by the adjustments of prices in trades. In this way, the information assemble in the market will also be ample with the market

prices' rationally changing, thus the market efficiency will reach a high level.

In addition, the distributing function of our financial market plays worse as well, mainly in the lack of risk distributing function, which needs risk-shifting mechanism innately owned by the derivative instruments.

### **1.2 Establishing Financial Derivative Market is the Objective Requirements of Participators' Eluding Risk and Risk Venture**

Because of the increasing financial risk, hedge is now becoming more and more market participators' choice when they make investments or trades. However, no speculations, no hedges. They are the two-side of one matter. We need hedgers, who want to shift their risks to the others. The market needs speculators, and it wants to make profit by taking the risks.

Still, in our country many people take the hedge seriously except the speculations. They claim that hedge is a rational action while speculation is not. According to the conclusions of many economists, proper speculations can generally decrease the risk of whole market instead of increasing. So in this sense, hedgers and speculators are both good for the sound development of our financial market.

As we mentioned above, derivatives innately own the characteristic of risk-shifting, such as financial forward contracts, financial future contracts, options and swaps. Yet, we haven't any market of such instruments that would provide the participators with proper mechanism of eluding risks and venture. According to the realistic requirements of market and its participators, China should set up financial derivative market as soon as possible to meet the objective rules of market development.

### **1.3 Establishing Financial Derivative Market is the Objective Requirements of the Development of Financial Market**

With the deepening development of financial market, the participators' demand for kinds of instruments is becoming larger than before. Since the 1970s, theory of financial liberalization and innovation has become the impetus of the financial market development. In the past thirty years, such theory stimulated the emergence of many new financial products and services. In this process, people have found that traditional instruments have little

room for expanding, and that some new elements or elements groups must be introduced to the traditional factors, thus derivatives are created.

By now some of the derivatives such as financial forward contracts, financial future contracts, options and financial swaps have entered a mature period of their development and have played a more and more important role in the market. Even in some advanced countries more non-economy elements have been introduced to the traditional underlying instruments to create even more "avant-garde" products.

Although China's financial market is still in a very primary stage, the demand for the variety and structure innovations of instruments will rapidly increase with our links with international usual practice, further opening level of our market, especially with the further reforms in our rate and exchange rate system.

In this situation, establishing our own derivative market filled with innovation mechanism will meet the natural rule of financial market development.

### **1.4 Establishing Financial Derivative Market will Promote the Development of Basic Financial Market**

We might identify the basic financial market as the market backed by the underlying financial instruments, which are regarded now as the elements of new financial products and services. Underlying instruments is a comparative concept. Some new instruments today maybe the underlying ones in the future, and what we mention in this paper is the original ones.

At present, China's basic financial market is still not perfect enough, mainly in the poor safety and poor liquidity and irrational prices of underlying instruments. The deepening reforms of the basic market depend on the establishment and development of derivative market because derivative market itself is a kind of risk-shift mechanism and a kind of profit-distributing system. Derivatives, based on underlying instruments, can provide underlying instruments with factors needed by speculations and hedge.

On the other hand the prices of derivatives depend on the current price of underlying instruments and the expectations of participators on them, so the scientific pricing mechanism of derivatives is good for the stabilization and rationalization of underlying instruments.

## **2. The Deepening Reforms of China's Financial Business Require the Support of Financial Derivative Market**

### **2.1 Establishing Financial Derivative Market will Promote the Optimization of Commercial Banks' Capital Structure and Improve Commercial Banks' Profit-making Ability**

Firstly, one of the projecting problems in the operations in China's commercial banks (especially in the state-owned commercial banks) is irrational capital structure, particularly in the proportion between the bad-loan and total capital and the capital liquidity. If the derivative market had been founded, more bounds instruments and trade-patterns would have been promoted through the effects of derivative means in securitizations, thus the goal of capital structure optimization would have been achieved.

With the deepening reform of market economy, many economists believe that China should grasp the opportunity of its linking with the international normal practice, forming derivative mechanism to promote the healthy development of its commercial banks.

Secondly, the derivative's characters of its virtual and levering action will help commercial banks make high profit through great deal of trades with a little venture, and gain commissions and fees with their superiorities in the information, technologies and services. That will be an important way of improving commercial banks' profit-making ability, which is now considered as one of the biggest problems faced by China's commercial banks in the future competitions with foreign banks.

### **2.2 Establishing Financial Derivative Market will Strengthen the Effect of Monetary Policies and the Adjustment of the Macro-economy**

Since 1980s, China has made great progress in the economy, China also undergone some inflations or deflations especially in the last ten years, when the problems have not been resolved effectively. These situations, in some extent, reflect the fact that the central bank's monetary policies are not effective enough, so China will have to face this difficulty for a while.

However, establishing derivative market will strengthen the monetary policies effect by providing the central bank with ample and effective information through its scientific pricing mechanism, enough

operation instruments and rational expectations about markets. On the other hand, the abundance of derivative variety can effectively improve the conductive accuracy of monetary policies, just like some theory say, the more abundant the financial instruments are, the more effective the monetary policies play. Derivative's large room of expanding provides the effect with possibilities of such a strengthening.

## **3. The Globalization of Economy Requires the Establishment of Financial Derivative Market**

### **3.1 Establishing the Financial Derivative Market will Help Us Rationally and Effectively Absorb Foreign Capital**

Since the opening and reforming of the economy, China has made a great accomplishment in absorbing the foreign capital, although there are still some problems in this business no matter in the quality or in the rationality, mostly in the lack of necessary market mechanisms and varieties of instruments for shifting risk. Some foreign investors do not think it is O.K. to enter the China's market, considering the issues of safety and capital liquidity. Because of the lack of necessary trade-means being as the guarantee, our work is irrational in the structure of currencies, time-period, rate and market in absorbing capital thus it will decrease the efficiency and effect of absorbing the foreign capital. Yet, establishing derivative market will be good for improving this work.

First, the risk-shift mechanism in the derivative market will make foreign capital entering China's market in the state of low-risk after some skilful dispositions to meet its safety requirements. And meanwhile, the abundant varieties of derivative instruments will provide foreign investors with more choice of ways of entering and withdrawal to improve the liquidity and profit. That will help much foreign capital float into China.

Second, the abundance of perfect trade-means, especially of the forward means, will help China improve the utilizing effect of foreign capital and overcome the problems of irrational structure.

Third, the financial globalization requires ample financial market. However, the present situation in China cannot meet such a requirement, and the key to

this issue is that we do not have a derivative market with abundant instruments. So, establishing derivative market will not only make China possess the basic conditions of financial globalization, but also help China promote the economy development in the wave of international capital.

### **3.2 Establishing Financial Derivative Market will strengthen the Promotion Effect of International Trade on China's Economy**

China has become one of the chief members in the international trade, which is an important pattern of the economy globalization. China's total import and export quantity is now in the top ones in the world, and has become a major promotion power of our economy. Yet, at the same time, China also faces the exchange rate risk during the trade. Although, we implement fixed rate system, we will gradually realize the marketization of exchange rate in China, which permit exchange rate's floating, to meet the requirements of the objective rules of market economy and the requirements of revaluations of Chinese dollar (RMB) from western countries.

The direct impact of exchange rate marketization on China's economy is its affection on the stability of profit gained from international trades, being caused by the fluctuation of exchange. Dramatically fluctuation of exchange will cause instability in the regular item of the Balance of Payments, and magnificent changes of standard currency value of expired debts in the capital item of the Balance of Payments, which can block the economy growth. If we establish the derivative market we will have more methods to relief the impact discussed above, thus we will make our economy growth steadier.

### **4. Conclusion**

After the research on China's present situations of macro-economy and financial market and some comparative jobs between China and some other countries in this field, it is definitely sure that China should establish its financial derivative market, not only to meet the requirements of international normal practice, but also accord with the need of rules of China's economic development. Setting up this market will be a very important step in China's strategy of its future development.

Although the conditions now in China is not perfect enough for establishing the derivative market, the tendency of derivative market itself cannot be changed. On one hand we should prepare positively for it as much as we can. On the other hand we also ought to gradually start some derivative trades as the overture of the main acts. The overture perhaps is not successful, even is lost, but the useful experience is necessary as well. And before that, I think the most important thing is our realization of the necessity of establishing the financial derivative market.

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