PROSPECTS FOR THE KOREAN FINANCIAL FUTURES INDUSTRY

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The International Markets for Derivative Instruments

Nowadays, we hear a lot about speculation, hedging and gambling. Has there ever been so much interest in the futures market? The most common questions being asked as of late are: What types of instruments are there and how much money is being traded in foreign futures markets?

A global overview of outstanding notional amounts by risk category is presented in Table 1, which shows that the interest rate derivatives markets are by far the largest category, both in over-the-counter (OTC) markets and on exchanges. Foreign exchange derivatives markets are the next largest category, particularly in the OTC markets. The equity derivatives markets are far smaller, while the commodity derivatives markets seem to be the smallest, though the amount of business being transacted in both cases may be somewhat larger than reported because the survey was not completed by many of the participants in these markets[1].

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〈Table 1〉 Outstanding Notional Amounts

(As of March 31, 1995; in billions of US$)

Instruments	Outstanding notional amounts
FX derivatives	
OTC	13,095
Exchange-traded	120
Interest rate derivatives	
OTC	26,645
Exchange-traded	15,669
Equity derivatives	
OTC	579
Exchange-traded	442
Commodity derivatives	
OTC	318
Exchange-traded	142

Source: *Annex 1: Overview of Survey Results* Proposal for improving global derivatives market statistics, BIS, July 1996

Volatile financial market conditions provided strong incentives to undertake transactions in organized derivatives markets in 1994. Most of the expansion in the number of financial contracts was in interest rate and stock index instruments, whereas currency-related business remained generally subdued. Activity continued to be supported by the globalization of investment flows, the opening of new exchanges, the introduction of new products and the broadening of the user base. The OTC markets' well-publicized losses and the collapse of Baring Brothers in early 1995 gave further impetus to the debate in official and private circles about the risks posed by derivatives markets.

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The Korean Financial Futures Industry

The prospects for the Korean financial futures industry can perhaps best be determined by the increase in Korean companies' foreign futures' trading. Table 2 shows that the number of financial futures contracts traded by Korean companies increased by 91.7% in 1996. Much of the expansion was triggered by the increasing foreign investment and bond issuance, which increased Korean companies' and financial institutions' need to hedge the financial risks.

At least 35 Korean futures trading companies will be active in the futures trading industry within the next two years. The top five companies among the current futures trading

〈Table-2〉 Korean Companies' Foreign Futures Trading

(billions of US $)

Instruments	1994	1995	1996
Currency-related instruments	5.3	11.7	28.4
Currency options	4.1	4.4	18.8
Currency swaps	1.1	6.5	9.5
Interest-related instruments	47.9	35.9	63.3
Interest rate futures	38.6	26.9	40.0
Interest rate swaps	3.7	4.7	15.7
Stock index-related instruments	0.7	0.7	0.9
Commodity-related instruments	7.0	9.5	31.6
Total	60.9	57.8	124.2

Source: The Bank of Korea

1) The Central Bank Survey of Derivatives Market Activity was carried out in conjunction with the triennial Central Bank Survey of Foreign Exchange Market Activity in April 1995. It was intended to provide an initial overview of the size and structure of these markets. More than 2,400 institutions in 26 countries took part.

companies account for as much as 88% of the Korean futures trading market. However, the financial futures market itself has not exactly been profitable. Most of the futures trading companies have run deficits, and only three or four futures trading companies recorded surpluses recently.

The stock index option market will be opened in Korea on July 7, 1997, while the Korean financial futures market as well as the Korean futures exchange are planned to be introduced in 1998. The opening of a new exchange, the introduction of new products, a widening of the user base and the decreased barriers to entry in financial futures industry make it easy to think that the financial futures trading business looks lucrative. However, even though the Korean financial futures market has grown rapidly, this has not translated into profits for the trading companies due to the high level of competition among trading companies caused by the easing of entry barriers. The revision of the current futures trading law enforcement order which was designed by the Financial Reform Council lowered the licensing criteria for futures brokerage business from a capital requirement of 10 billion won to 2 billion won (and also for futures investment fund business from 30 billion won to 5 billion won).

The futures business is a very dynamic worldwide business. The Korean financial futures market will be used by Europeans, by the Japanese, by Americans, and by Asians. The Korean futures market will become so large that futures trading will exceed the volume of the cash market fairly soon. According to several reports, the dollar volume of the Eurodollar futures trading alone is over 50 times larger than the average daily volume of the New York Stock Exchange.

If Won/dollar, CD, corporate bond, and gold futures are introduced on the Korean Futures Exchanges in 1998, the CD futures will probably be the most actively traded among them. The notional outstanding amounts of CD futures is forecast to be at least 1,456 trillion won in 2001, and up to 7,011 trillion won in the biggest case scenario.

Without a doubt, large volume and liquidity are expected in the Korean financial futures market.

Conclusion

Korea needs a futures market that can be used by the rest of the world. Both domestic and foreign users need to be given the opportunity to hedge their currencies or their business risks through this market. It seems only natural that the financial futures industry in Korea will grow very rapidly. Table 3 shows the notional amounts of financial derivative instruments trade on organized exchanges throughout the world. One point which is noticeable from Table 3 is the high possibility of growth for the Asian option market.

Anybody can make trades, but not everybody can make money in the futures trading industry. Analysts note that probably 80% of the people in this business lose money. Even though the Korean futures trading market would appear to be lucrative, only six trading companies at most will probably be winners. What, then, separates the winners from the losers? Discipline. This is probably the single most important tool that Korean futures trading industry need. VIP

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〈Table-3〉 Financial Derivative Instruments Traded on Organized Exchanges

(Notional principal in billions of US $)

Instruments/Location	Amounts outstanding			
	Dec. 1994	Dec. 1995	Sept. 1996	Dec. 1996
FUTURES				
All markets	**5,945**	**6,073.8**	**6,586.2**	**6,180.1**
Interest rate	5,777.6	5,863.4	6,341.6	5,931.1
Currency	40.1	38.3	46.2	50.3
Stock index	127.3	172.2	198.3	198.6
North America	**2,854**	**2,887**	**2,852.1**	**2,563.6**
Interest rate	2,768.4	2,787.4	2,738.1	2,439.1
Currency	31.8	31.2	41.9	44.7
Stock index	53.7	68.3	72.1	79.8
Europe	**1,155.3**	**1,372**	**1,630.1**	**1,699**
Interest rate	1,133.1	1,338.2	1,519.4	1,656.4
Currency	-	0.3	0.7	0.7
Stock index	22.2	33.4	38	41.9
Asia[1]	**1,906.4**	**1,782.5**	**2,058.0**	**1,873.2**
Interest rate	1,855.4	1,712.4	1,971.3	1,797.7
Currency	1.5	1.1	0.2	0.3
Stock index	49.5	69	86.5	75.3
Other Markets	**29.3**	**32.4**	**45.9**	**44.3**
OPTIONS				
All markets	**2,917.5**	**3,114.3**	**3,849.9**	**3,704.5**
Interest rate	2,623.6	2,741.8	3,417.7	3,277.8
Currency	55.6	43.2	47.8	46.5
Stock index	238.5	329.3	384.4	380.2
North America	**1,965.5**	**1,962.6**	**2,419.9**	**2,276.0**
Interest rate	1,773.5	1,705.2	2,192.2	2,013.4
Currency	53.2	39.6	44.4	44
Stock index	138.8	217.9	246.3	218.6
Europe	**676.4**	**869.6**	**1,136.2**	**1,132.7**
Interest rate	631.1	800.4	1,033.7	1,010.6
Currency	1.3	1.5	1.6	1.0
Stock index	43.9	67.7	100.9	121.1
Asia[1]	**265.4**	**207.2**	**279.2**	**280.8**
Interest rate	218.1	174.9	251.3	250.3
Currency	-	-	-	-
Stock index	47.2	32.8	27.9	30.5
Other Markets	**10.2**	**74.4**	**14.5**	**15**

[1] including Australia and New Zealand

Source: BIS Statistical Report June 1997