

Hedging Rollovers:

RISKS AND RETURNS IN CHINESE COMMODITY MARKETS

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In 2006, the Chinese economy experienced unprecedented growth. China's gross domestic product (GDP) comprised 30 percent of the global increase in GDP. The purchasing-power of China's currency exceeded that of the United States by more than 15 percent and in 2007, economic indicators estimated a three percent increase in GDP.¹ While the U.S. economy is still the world's largest, accounting for 20 percent of the global GDP, China's growth, at a rate of 11% in 2007 far surpassed a U.S. growth of two percent and a nine percent growth rate for India.²

Many experts say that the remarkable growth of markets in emerging countries, such as China, India and Russia, is largely attributed to high commodity prices. While high commodity prices are helpful to producers and exporters, they hurt consumers. In the long-term, these prices are not sustainable, unless they are supported by sufficient increase in demand.³

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Trade surpluses surpassing \$1 trillion have sustained China's growth and provided a strong buffer against credit disruptions.⁴ However, projections show that emerging markets will begin to suffer from the effects of rollover risks as the settlement dates for their long-term debts approach. With respect to China, investors

fear the following risks: loss of liquidity, in both foreign exchange and commodity markets; decrease in returns on investment in commodities; and decrease in commodity prices.

A rollover (often called "rollover hedging" when done speculatively) is a technique through which investors can extend a contract for the sale of a commodity by continually extending a futures contract, thereby tendering a new contract for the same commodity, with a later settlement date.⁵ Stated differently, the investor (also known as the hedger) enters into a contract which he later closes, while simultaneously opening the same position on a contract for the same good, where payment is due at a deferred time.⁶ This procedure allows investors to take advantage of fluctuating prices, giving them the opportunity to extend a contract for a specified commodity until the market for that commodity renders a lower price. Unfortunately, this procedure also reduces the liquidity of commodity markets by limiting the cash transactions and presenting risks for sellers, especially those of agricultural commodities.

Despite the use of rollovers in securing profitable investments in China, the country's government has yet to develop legislation to deal with the use and misuse of rollovers in capital markets. Similarly, their laws regulating foreign exchange markets are fairly new and are continuously expanding to address new issues as they arise. Given the vitality of China's foreign exchange markets, regulations on the use of rollovers would ensure settlement of large transactions, lending itself to the economy's growth. While the country is continually expanding the laws and



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procedures which govern foreign exchange transactions, these provisions remain silent as to the use of rollovers for an extended period of time in international and domestic currency exchanges. The country has three preeminent bodies of law that regulate foreign exchange transactions: *Rules of the People of China on Foreign Exchange Control*, *Rules for Implementation of Foreign Exchange Controls*, and *Administrative Regulations on Foreign Exchange Settlements and Payments*.⁷ While these laws cover issues ranging from procedures for registering foreign exchange transactions and their dealers to actions against default of settlement, they loosely regulate the ability of financial institutions to provide rollover loans on capital debts in foreign exchange markets.

Economists projected that by the beginning of 2008, Chinese foreign exchange reserves would reach \$1.53 trillion, a 43.3 percent increase from 2006.⁸ This has done wonders for the country's central bank by creating a surplus of liquidity. This soar in foreign exchange reserves is largely attributed to the increase in demand for Chinese goods and the country's flourishing international trade.⁹ This has, in turn, decreased the value of China's Renminbi (RMB) and created the central bank's dependence on U.S. currency to sustain its own.¹⁰ However, recent speculation that the U.S. dollar is depreciating may lead China to diversify its foreign exchange reserves, which may be done through the use of rollover hedging to secure lower prices for various currencies. If this happens, Chinese reserves would be greatly inaccessible, tying up large amounts of capital, limiting investments and curbing the liquidity of the country's banks.

Traditionally, the ability of rollovers to extend an investor's position until the markets present more favorable conditions has led people to associate their use with higher expected returns, since they lock in the long-run equilibrium value and reduce the risk of increased commodity prices.¹¹ Many investors are taking advantage of this technique, especially in regions like China

where there are emerging markets, and such investors are hedging their positions in an effort to reduce the risks created by increased interest rates, increased inflation, decreased currency reserves, and the diminishing strength of the U.S. dollar.¹² However, in order for rollovers to absorb the risk of unfavorable market conditions and render high returns, the market must be an efficient one in which futures traders foresee the mean reversion of cash prices. If inefficiencies exist, they must be too small or too short-lived for hedgers to take advantage of them.¹³ Experts have consistently supported the contention that emerging markets suffer more from temporary shocks as their values increase.¹⁴ With four years of stability, investors have become complacent about protecting themselves from the risks inherent in investing in emerging markets.¹⁵

While China is in the midst of booming capital markets, the utility of rollovers in foreign exchange markets has not yet been fully realized, which explains the lack of substantive law dealing with their regulation of improper use. However, a recent circular issued by China's State Administration of Foreign Exchange (SAFE) suggests that financial institutions and investors must greatly reduce their use of rollovers in foreign exchange capital markets.¹⁶ The Circular targeted the short-term debt of financial institutions, calling for quotas to be issued for outstanding external debts that exceed 90 days, are valued at over \$500,000, or are



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housed with overseas banks.¹⁷ The Circular calls for a 30 percent reduction in the debt quotas of Chinese-funded banks; non-bank financial institutions and foreign-funded banks are to reduce their quotas by 60 percent of their 2006 amounts.¹⁸ These provisions, coupled with SAFE's Circular on Administering Individual Foreign Exchange imply that by paying of short-term external debts, the use of rollovers is prohibited or at least discouraged.¹⁹ To date, one of the only provisions that authenticates the accepted use of rollovers can be summarized as follows: "In case of default or rollover of the forward contract at

maturity, the reporting institution shall record the default value and rollover value [in the ‘Statistics of Banks Forward Sale and Purchase Consolidated Statement’ form].”²⁰ These Chinese provisions, set forth by various administrative agencies, suggest that the government is discouraging the use of rollovers by requiring that all debts, foreign and domestic, be settled and by insisting on mandatory reporting for the use of rollovers where payment of debts is not proffered.

With the fastest growing major economy in the world, Chinese markets have remained strong as a result of the coun-

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try’s spending on investments and its expansion of exported goods. Their dependence on the United States will be problematic as demand for Chinese goods tapers off, leaving a trade surplus which will be too large to sustain.²¹ As China attempts to achieve market and economic equilibrium, many investors are growing increasingly nervous that the United States may be in the midst of an eminent recession. If so, this would completely upset China’s economy, undercutting the demand for Chinese exports and turning the Chinese economy on its head.²² Empirical evidence suggests that a comprehensive look at dynamic factors affecting these two economies and the balance between their currencies, along with others factors such as season-adjusted inventories, timer-to-maturity, and seasonality, is necessary to determine whether the use of rollovers is necessary to allow for more effective hedging in these contemporary economies.²³

Despite the absence of abusive use of rollovers, the Chinese government need not conduct more research into the nature of hedge models and the different effects that rollover hedging can have on commodities markets. China can simply look to the United States’ infrastructure for regulating rollovers and use it as a model and indicator of problems that will arise within commodities markets. Nonetheless, the U.S. system is not without its flaws.

While prosecution for abuse of rollovers in the United States would generally fall within the jurisdiction of the Securities and Exchange Commission, other organizations have been



also implementing various provisions for regulating and adjudicating certain violations in futures transactions. The National Futures Association (NFA) is a non-profit organization that regulates the trading of commodities of all of its members. It serves as a self-regulatory body and is codified under Section

17 of the Commodity Exchange Act. NFA establishes rules and procedures for its members, conducts audits of transactions, arbitrates disputes relating to the transaction of futures, and enforces compliance with its established financial requirements. In addition to its self-imposed duties, the NFA also created the International Regulator’s Alert System, in conjunction with the Commodity Futures Trading Commission (CFTC), in an effort to provide regulatory information for international exchanges, foreign exchange dealers, futures trading pools, and commodities exchange merchants.

Despite these implementations made by the NFA, CFTC and their affiliates, the excessive use of rollovers continuously poses a threat to the stability of many of the members of these organizations. Where rollovers have been used to extend a contract far beyond its settlement date, courts have consistently held that the use of infinite rollovers in this way is not a disputed issue of fact.²⁴ Moreover, the rollover feature does not transform a contract in a spot market into a futures contract, despite its use to extend a contract beyond the two-day period within which a transaction must be settled.²⁵ This has been reaffirmed in the

