Future markets
Futures Markets: Their Economic Role
Future markets
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Foreword

Futures markets, like most markets, usually perform their essential economic roles without drawing much public attention. Major new developments in patterns of usage or in prices, however, sometimes attract the attention of the public and of government.

Pronounced changes in futures market trading have occurred in recent years. In the more volatile and inflationary economic climate of the 1970s, the number of contracts traded in agricultural commodities and metals increased dramatically. Even more significant, however, was the introduction of trading in financial futures contracts and their phenomenal growth. Between 1970 and 1984 futures trading volume increased more than tenfold, and by the end of 1984 financial futures accounted for 50 percent of total trading.

The framework for futures market regulation also changed, first with the establishment of the Commodity Futures Trading Commission in 1974 and subsequently with the Futures Trading Acts of 1978 and 1982. The four-year sunset provision in the 1974 legislation, together with the government studies mandated by the 1982 act, ensured that several important issues would be on the national policy agenda for the next round of reauthorization.

The remarkable expansion of trading in financial futures has meant a more important and pervasive economy-wide role for futures markets. This expanded role has raised new issues, issues that deserve careful analysis by recognized scholars in the private sector as well as by experts in government. The studies in this volume are intended to contribute to a better understanding of the economic role of futures markets and of the role of regulation.

In view of the new opportunities and the new issues that emerged with the growth of futures market activities and AEI's continuing program of research and dissemination of regulatory policy analyses, we received encouragement from several sources in industry and government to examine futures markets and their regulation. Futures markets, the context in which they developed, and relations with other markets were analyzed in an earlier AEI publication, *A Treatise on Markets: Spot, Futures, and Options*, by Joseph M. Burns.
The studies in this volume were commissioned as part of AEI's project on the Economics and Regulation of Futures Markets. A companion volume, *Futures Markets: Regulatory Issues*, also edited by Anne E. Peck who served as project director, contains a series of related studies. In a third publication, *Futures Markets: An Overview*, Philip McBride Johnson draws upon these studies and upon his experience as a legal practitioner and former chairman of the Commodity Futures Trading Commission to highlight the major implications for policy.

These studies make a new and timely contribution to public policy formation for these important markets. The entire project of which these published studies are a part was carried out under the auspices of AEI's Center for the Study of Government Regulation directed by Marvin H. Kosters. The government regulation studies program at AEI has addressed a wide range of issues concerning the appropriate role of government. These studies by leading scholars and practitioners in their fields analyze the contribution that efficiently functioning futures markets make to achieving broader economic goals. They are particularly relevant in the current climate of public concern about meeting capital investment needs and about appropriate regulatory structures for financial services markets as a whole.

William J. Baroody, Jr.
President
American Enterprise Institute
These studies analyze the economic role of futures markets by carefully examining markets for different commodities and futures instruments. The implications for policy making are discussed in the context of how futures markets function and how they contribute to economic performance. The primary purpose of the studies is to foster better understanding of these markets and their economic contribution to promote more informed policy choices.

The project on the economics and regulation of futures markets under which these studies were carried out was stimulated by the remarkable expansion of financial futures trading and the issues that arose in connection with developments such as the emergence of trading in stock index futures and options on futures contracts. Questions were raised in the congressional hearings prior to reauthorization of the Commodity Futures Trading Commission (CFTC) about the growing array of derivative financial instruments trading on futures markets, the economic purposes they served, the extent to which they might be competitive with the well-established securities markets, and possible conflicts or overlap in the regulatory systems administered by different federal government agencies. Congressional concerns about these issues led to requests in the Futures Trading Act of 1982 for studies to be conducted by federal government agencies.

The Federal Reserve Board (FRB), the Securities and Exchange Commission (SEC), and the CFTC were directed by the act to carry out a joint study of the economic purposes of futures and options markets, to consider their effects on capital formation, and to evaluate the adequacy of their regulation. The CFTC was directed to examine the implications of trading on futures markets by individuals possessing material, nonpublic information. Finally, the FRB announced a study to review federal margin regulation policy. These three federal studies were underway by the spring of 1983.

In view of this concentration of government interest, the American Enterprise Institute proposed a project that would contribute additional research by leading scholars outside government to develop
better understanding in the Washington policy community of futures markets, their economic roles, and the related regulatory issues. The studies developed in this research effort are published in two volumes: *Futures Markets: Their Economic Role* and *Futures Markets: Regulatory Issues*. A list of the studies in the companion volume and a list of all the contributors are at the end of the book.

The studies in this volume assess the economic contributions of futures and options markets by drawing upon evidence from the long history of futures trading in largely agricultural products, by examining the contributions of newer financial futures and options markets, and by analyzing the specific implications for capital formation. The studies analyze how trading in financial futures instruments facilitates the management of interest rate and security price risks, thereby reducing the cost of capital and increasing incentives to invest in productive assets. Finally, the studies discuss the key underlying economic differences between futures and securities markets that provide the basis for the different forms and methods of regulation that have been developed in these markets and their adequacy for ensuring efficient market performance.

Studies in the companion volume, *Futures Markets: Regulatory Issues*, address specific market practices, institutions, or participants and associated regulatory concerns. Each of the current congressional concerns has a historical context. Some concerns, like the regulation of futures margins, have long histories of congressional debate. Other issues, like trading floor practices, arise in a new context because different, but related, financial instruments are traded under separate regulatory systems. The specific issue areas discussed in the companion volume are trading floor practices, the role of margins, characteristics of small public traders, cash settlements, and livestock futures.

Taken together, the AEI studies show that careful analysis of various futures markets and instruments and of industry practices is essential for understanding their economic contribution. They indicate that a complex set of institutional arrangements, commercial and financial practices, privately administered rules, and federal regulations have evolved in a highly competitive market environment to foster efficient and financially secure trading. As a final theme, the studies demonstrate that sound public policy toward futures markets must be based on a thorough understanding of how they function, and not on superficial similarities to features of other related markets.

In developing this project on the Economics and Regulation of Futures Markets, the Center for the Study of Government Regulation at AEI consulted extensively with government officials, private sector representatives, and academic scholars. These consultations contrib-
uted importantly to shaping the character of the studies and reviewing them as they were written. To provide for systematic advice and review while the project was underway, an advisory committee, chaired by Gary L. Seevers, was established. Representatives from the major futures exchanges, users of futures services, and research professionals from universities and business firms made up the committee. A research advisory committee was also established to identify issues for examination and to survey research under way by leading scholars. This committee was cochaired by Philip McBride Johnson and William L. Silber. The members of these advisory committees are listed in the back of the book.

The general advisory committee met in Washington at the outset of the project to assist in identifying the policy issues that should receive priority, and members or their representatives met jointly with the authors when their studies were planned and drafted. Subsequent meetings were held in New York and Chicago. These committees made invaluable contributions to the research, both for the advice and criticism that they provided and for the access to knowledgeable people in the industry that they made possible.

Although these studies were carried out entirely separately from the government studies, the project benefited from frequent consultation with government agency officials and staff. In particular, Susan M. Phillips, chairperson of the CFTC; members of the CFTC's economics staff; Frederick Struble, associate director of the FRB; and members of the FRB staff provided information to authors and helpful suggestions in response to draft papers.

Authors of the individual essays acknowledge the assistance they received in preparing their papers. Here I want to acknowledge the several additional people who provided formal review of some or all of the studies. They include: Robert M. Bear, Robert M. Bor, Galen Burghardt, Thomas Coleman, Read P. Dunn, Jr., Kenneth R. French, Marvin L. Hayenga, Marvin H. Kosters, Raymond M. Leuthold, Terrence F. Martell, Gary Perlin, Todd E. Petzel, Mark J. Powers, Donald J. Puglisi, Gordon C. Rausser, Charles E. Robinson, Gary L. Seevers, Sarahelen Thompson, and Terrance J. Wear. I want to acknowledge their assistance, as well as that of the advisory committees and members of their staff, and thank them for their contributions.

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Project Director
Futures Markets: Their Economic Role