CHAPTER ONE

The Birth and Development of the Commodity Futures Market

What is a Commodity?

A Commodity is simply defined as an article of commerce. A more germane definition to Dubai Gold Commodity Exchange [DGCX], is a merchandise or wares that are traded on legally-recognized and Government-empowered commodity exchanges. Examples include petroleum, foreign currencies, metals, agricultural products and financial instruments.

History of Commodity Trading

Organized trading in commodities started in the mid-nineteenth century in Chicago, United States. Its evolution can be traced to the solution to the associated problems of spot trading [exchange of good for physical cash immediately] in wheat, the available commodity at this time. Some of the problems faced included, lack of coordinated storage facilities and absence of a uniform quality & quantity assessment devices.

The two challenges listed above were the initial problems faced by buyers and sellers [farmers]. The solution to these problems led to an increase in the number of market players, hence increasing the number of stakeholders in the price determination of wheat.

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As expected, price fluctuations affect market players either positively or negatively. So those whose businesses were being threatened as a result of this risk began to seek for ways of alleviating the effect of these price fluctuations. Their discovery marked the evolution of **forward contracts**. It was discovered that both parties involved could agree to exchange produce for cash (transacting business) at a future date. **Forward contract** was a huge relief to both parties as it afforded them the opportunity of transacting business at a foreknown agreed price on the agreed date.

Since farmers and producers couldn't be too sure of the pre-determined agreed prices beforehand, some parties began to default the forward contracts. To fix this, it was agreed that, in case of counterparty default, the forward contract can be transferred to another interested party, at the current market price of wheat, which was subject to the powers of demand and supply.

Forward contracts kept gaining popularity as the investor's security tool against different adverse factors.

Then, a new category of market players called the risk takers joined the existing players. As their name implies, they were out to make money from the existing price fluctuations in the market based on their ability to predict the direction of future price movements accurately. They were neither consumers or producers or solution providers; they were making money without intending to physically handle the commodity associated with the forward contracts.

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Afterwards, standardization of the contract terms and market practices became the order of the day. Then, more commodities began to emerge on the futures market leading to the formation of a supervisory body – The Chicago Board of Trade [CBOT] in 1848.

The increasing success of the forward contracts and their associated profit potential led to the listing of the maiden "exchange-traded" derivatives contract in the US in 1865, after which they became known as **futures contracts**. Following its success, other local markets in charge of specific commodities established bodies too to ease trading in futures contracts, and in 1925, the first futures **Clearing House** was established.

Commodity trading

Two types of markets which differ in techniques and contingencies are associated with the commodity trading, they include: the physical markets and the forward market.

Physical Market: The physical market is also known as the spot or cash market. Here, there is a physical exchange of a commodity for a price. The commodity buyer pays cash to the seller of the commodity and collects the goods physically.

Futures Market: The futures market involves performance from the contracting parties at a later date though price, quality and quantity of the associated commodity has already been fixed at the time of agreement. The futures market can either be in form of **over the counter market** or **future exchanges**.

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- **Over the counter market** – It provides alternative trading platforms usually linked to a network of dealers who simply communicate via phones and computers. The terms of contracts need not necessarily be standardized as obtained in exchanges although investors are free to customize their contracts/undertakes. There are various types.

- **Futures exchange** – This is a cardinal market place for investors who use a trading platform to facilitate trading in standardized contracts known as **derivatives** (a financial document whose value is based on another security). Futures contracts and options on futures contracts relating to several commodities are traded on these platforms.

  Futures contracts constitutes an agreement between the parties involved to purchase or sell a commodity with standardized specifications; these specifications usually cover details relating quality, quantity, place of delivery e.t.c. Although the price of the commodity is fixed at the time of agreement, the delivery of the contract will be consummated at a specific time in future, as agreed by both parties.

  These contracts are referred to as derivatives since their value [contract value] is derived from the value of a fundamental asset [commodity, in this case]. For example, the underlying asset for a gold futures contract will be physical gold bearing in mind, the standard specifications laid down in the contract.

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This futures market is also known as a derivative market. The responsibility of the exchange is to ensure a fair, orderly and secure market; which they do with their established rules and regulations.

Transactions executed on an exchange are cleared and their execution guaranteed by a **Clearing House** (A financial institution which is a central collection place with participants maintaining an account against which their credits and debits are posted); the Clearing House bears the counterparty risks. A well-known advantage of Exchange Markets is their cost and information efficiency.

Physical Markets VS Futures Markets

Physical performance of the contract is not mandatory – In futures markets, the delivery of the fundamental commodity as required by the contract is a function of choice for the buyer or the seller – they ensure this by offsetting their position before the expiry of the obtained futures contract.

Leverage – Trading in the futures market affords a typical advantage when compared to physical trading in terms of leverage which implies using a small amount of capital to control a large value of commodity.

Security and better price determination mechanisms– The futures markets provide a better price determination mechanism through a continuous

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