

**A Position Paper on World Rice Futures
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***“Success comes in cans, failure comes in can’ts.”
-Author unknown.***

There is a widespread belief that rice futures are not necessary for the Asian rice markets because these markets are not “broken.” In any case, it is not clear to many why a rice farmer would benefit from such a risk management tool. Some believe that futures encourage price volatility and speculation. All these concerns are valid and need to be addressed in addition to concerns about type of rice traded, financial integrity of an exchange and delivery mechanisms.

Not to discourage enthusiasm for the idea, but it took the United States rice industry over 30 years to develop a workable rice futures contract and such an effort in Asia may take years to bring to fruition. Nevertheless, now is not too soon to start the process for many reasons.

We believe that credible and liquid rice futures can improve the potential for a rice farmer to make a profitable margin. If a rice farmer cannot make a profit, everyone will suffer as urbanization, water and food safety issues gain traction with the growing prosperity of Asian rice consumers.

We would argue that rice farming must move from subsistence farming to a business basis in the decades ahead. Rice futures are no cure-all for all the problems that lie ahead. Nevertheless, a transparent, risk management and price discovery tool for rice should contribute somewhat to the painful process of inevitable change in Asian rice markets in the next decade.

This short position paper is an attempt to analyze and recount the history of the rough rice futures contract in the US and explore its relevance to the current project of building a global rice futures contract. Presumably the futures would be based on a milled rice futures with perhaps optional pricing and/or delivery origins. The suggestion is made that Singapore be the location of such a futures contract for several compelling reasons.

Such a milled rice futures contract might be more similar to the cocoa, coffee or sugar futures contracts keyed off of global delivery points than the current domestically traded contracts in Japan, China or in the US. Delivery could be in the commodity or

a cash settlement based on a daily index of prices. There are inevitable issues such as rice export bans as occurred in 2008; but we see all pricing issues as hurdles, not barriers to the idea of rice futures trading.

If money is to be made, someone will sell and price cash rice in the world market.

This paper does not address the much larger questions implied in the following concept note:

“The authorship, an international task force on rice-based food security, suggested that such an exchange would stabilize rice prices and contribute to national, regional and global rice trade.”

The History and Character of the CMEGroup Rough Rice Futures Contract

Other than Japanese rice futures, mentioned below, most grain futures began in the US city of Chicago over a century and a half ago and trade a domestically produced crop. The rough rice futures contract at the CMEGroup exchange is no exception to this rule. However, the rough rice futures contract is just a teenager compared to its sister grains. It is a youthful 30-years old. Domestic agricultural futures markets have proven useful to hedging and trading crops grown in other regions of the world, a good example of this is the Chicago soft red winter wheat contract that has global participation far in excess of the acreage base in the US.

Frankly speaking, the US rice futures is a story of unexpected and unanticipated success through a series of errors and omissions that were corrected over a 30-year period in the evolution of the rice futures contract. It did not hurt to have rough rice futures find its home eventually at the Chicago Board of Trade, the most sophisticated and developed of all grain markets. When the contract migrated from New Orleans to Chicago, it demanded a lot of changes in its terms and the economic staff of the Exchange was up to the task.

Comparisons can kill and they are often inappropriate but hopefully some errors can be avoided in this Singapore project and omissions duly noted and corrected before the launch date.

Begin with the end in mind and success is a more likely outcome. In any new endeavor, some people will expend a good deal of intellectual energy and believe the idea just simply cannot happen. Such was the case with the rough rice futures contract that had to wade through many academic studies showing why it could not be successful. “Success comes in cans and failure comes in can’t’s,” is all we can say.

All of the academic critics were correct over the short-term, rice futures struggled for many years in an undernourished state. But as in many business ventures, persistence is often more important than forethought and intelligence in bringing about final success.

This position paper is not a manual on the mechanics of futures trading or hedging. It is simply a review of failure and success in starting up a rice futures contract.

The key to a successful futures market depends on a number of factors to include the commercial need to manage risk and the level of speculative interest in trading the market as a terminal or futures market. In the case of Asia, I would suspect that there is more speculative than commercial hedging interest in rice. Aside from gold, rice is a commodity with which almost everyone has some connection as a consumer or as a descendant of a rice farmer.

Such a condition of strong speculative interest can result in an unhealthy imbalance between cash market activity and the price level of futures. Then confidence in a contract is shaken. When distrust settles in, it is hard to reverse a bad experience; but it can be done. We are in the process of doing that in the US right now with the lack of convergence there between cash and futures rough rice prices since 2008. Convergence is not everything in a workable market but it helps. The correlation of cash and futures are essential and by this measure US rice futures are a qualified success already.

The most important element after contract design is the commitment of a few good companies to providing trades and open interest on a daily basis. It takes a level of visceral and monetary commitment to make a success of a new raw material futures contract. A futures market needs some commercial champions to succeed when it is still in its infancy.

Aside from speculative market makers, an agricultural contract may also benefit greatly from an active merchandiser class that plays the seasonality of basis (local cash minus futures) and spreads between delivery months. Grain futures markets are not meant to be just a casino, but rather a business tool to market what has been grown.

Every contract starts with small volume and in certain cases as a derivative product; the energy futures complex for example began actually with heating oil, not crude oil, and a small domestic market located around New York City and marketed by independent oil jobbers. It was not the big players, the "seven sisters", which launch heating oil futures. The same comment can be made about the origin of US rough rice futures, which in the beginning was traded by smaller, independent merchants in Arkansas and nearby states.

Here is my main point. The contract, heating oil, proved to the world that a crude oil futures market could happen. So, in that particular case, the market began not with the raw product but a distillate of that product. Normally, commodity markets begin with the most undifferentiated form of a commodity such as soybeans, not meal or oil for example or wheat, not wheat flour. But in futures some rules were meant to be broken, from time to time.

There may be a lesson for rice to learn from energy trading. Perhaps the project of launching a global milled rice contract could be similar to the development of the heating oil contract before the launch of crude oil futures both in the US and eventually London. The analogy here would be heating oil is to crude oil what milled rice is localized paddy or rough rice futures.

Are there other hurdles to be overcome? The thinness of trade may be an overstated hindrance to building a successful rice futures market. For example, the rough rice cash market in the US represents a very thin slice of world rice demand and supply. Rough rice exports drive Chicago futures and that is only about 5% of world trade, which is only about 7% of all rice bought and sold in the world. That means the cash market that backs up futures trading in the US is only about 0.35% of the world rice market. My point is that it does not take much price or quantity to get the attention of the world media and world speculative community.

The Press calls Chicago rice futures a world rice contract, which is somewhat misleading. It is at best an Americas' futures contract where pricing comes from cash trading in South and North America over time.

There are three somewhat actively traded rice futures contracts today: Japanese rice futures, Zhengzhou paddy rice futures and Chicago rough rice futures. All three are largely domestically focused markets. None are a world rice futures contract. The Zhengzhou contract basically replicated across the two rivers what is traded in Chicago. The US contract trades largely off the Arkansas cash and Mississippi River export activity. The Japanese contract is a brown rice contract, which trades at prices several multiples above world rice prices at the current time.

The fertile soil for raw material futures requires at least a modest level of price volatility and a limited amount of government intervention in that pricing. Both cash and futures need enough regulation to keep the market honest but not so much that it kills off volatility altogether. A good futures contract should feed off of good cash price discovery; however in the case of the US rice futures contract, cash price discovery was quite limited and still is. Some conditions need not be met to trade a successful rice futures contract.

Perhaps the key and often-overlooked ingredient is education. The heating oil contract was the result of a very intensive educational effort for small size heating oil merchants by the NY Mercantile Exchange. Education is the fertilizer of change. In the case of rough rice, White Commercial, a brokerage with an excellent training arm, had a great deal to do with enticing Delta merchants of cotton and grains to trade cash and futures differentials, known as the "rough rice basis."

The other decisive ingredient besides education and key players is a tradition of successful grain merchandising. For example, in the US the first contract developed was a milled rice contract and the rough rice contract was only an afterthought due

to lobbying by farmer interests. The milled rice contract failed at that time because rice millers then simply did not understand the merchandising function or consider it a legitimate part of their rice business. Rough rice took off because the mechanics of hedging rice is very similar to cotton, the grains and soybeans in the Delta.

Two other factors are almost essential to a healthy rice futures contract: a wise regulatory environment and a financially sound clearing mechanism. Without these last two ingredients, a new rice futures contract is almost certain to fail. There are no exceptions to this rule. The first effort at a rice futures contract in New Orleans from 1981-1983 failed not for a lack of regulation, but for a lack of an adequately financed clearing house. Futures run on money, money that is safe and is guaranteed by some kind of financial institution.

Start with the end in mind: paddy or milled rice futures?

Unlike the soy complex or the energy complex, rice is relatively simple, either you trade milled or rough/paddy rice futures. Take your pick. In that selection comes a host of different challenges for a successful startup. It will certainly be a challenge to trade a world rather than domestic rice futures, as is the case in China, Japan or the US currently.

There have been many attempts to trade milled rice futures but to my knowledge there has been only one success: Japanese rice futures. That contract was shut down before World War II. By the way, rice futures in Japan, which was recently revived, was in existence long before Chicago existed. Trading began in 1603. In this sense, agricultural and rice futures actually have their roots in Japan, not Chicago, Illinois. It pains me as an American to admit to this fact; but it should encourage those who wish to start up milled rice futures in Asia.

Other attempts have not yet succeeded in recent decades. Rice trading in India was shut down because the government thought the problem with their rice market was speculation. Thailand rice futures became dormant because of a buildup in rice stocks. Thailand is now experiencing the same phenomenon as the US rice futures back during the 1983-1986 period, when large US government-owned stocks clogged the market and killed off cash price volatility. Milled rice futures were tried twice in the US, once in the 1960's at the NY Mercantile Exchange and again in New Orleans from 1981-1983 without success. The Fox Exchange in London briefly tried a world milled rice futures but the effort was not successful there either.

Each of the previous efforts at rice futures came at a time when world trade was much smaller and price discovery and rice advisory services were nearly non-existent. That is currently not the case and since 2008, more rice services have come on line with the explosion of information vended or reported through the Internet even on a daily basis. Milled rice prices from a number of exporter origins are easily accessible from numerous reporting services. A good story and lots of easily

discoverable prices should make the current initiative much easier to start up. A good liquid futures market needs a continuous feed of market moving stories.

Another healthy development together with the Internet is the transforming of Chicago grain trading to the electronic platform. Prior to 2006, electronic trading was nearly zero. Now all futures and some options trading transpire nearly 24 hours a day through the electronic platform. The cost of electronic trading is a fraction of managing a future pit with traders and screens and the other fixed expenses.

In summary, the explosion in pricing and news services on rice, the search and news retrieval function of the Internet and the electronic grain trading platforms at the CME Group all are fertile grounds for launching a rice futures contract in Singapore. Much has changed since the previous milled rice futures attempts listed above were launched.

Some final suggestions for consideration in conjunction with the RSIS Centre for Non-Traditional Security Studies Asian Rice Futures Market - Expert Working Group Meeting:

1. Because Singapore is not a rice production center, settlement could be made in US dollars off a blended Index of rice prices or optional origin delivery at the ports of major exporters or accumulated in warehouses inside Singapore.
2. A small but successfully traded world milled rice contract may never grow to the size of crude oil futures or soybeans or coffee but still could encourage the formation of local paddy rice futures markets and create arbitrage for commercial and market-maker speculators as well.
3. Launch an educational program to dispel some prejudices about futures, for example, that they are "just a casino" with no legitimate function for commercial rice activity or that the rice price should be "tranquil, not volatile."
4. Consider encouraging major Asian rice players to start up their own domestically driven rough or paddy rice futures of a kind similar to the US and China that would allow farmers in local markets to hedge their rice through local merchants. Farmers historically do not trade futures but lean on the pricing services of local merchants and bankers that manage the money side of futures pricing for them.
5. Make an Asian commitment to reduce government intervention in rice market pricing and promote transparency of transactions for the benefit of the rice farms of Asia.
6. It is estimated that there are about 300,000,000 rice farms, mostly in Asia that will be benefiting from the technological trickle down effect of smart phones and inexpensive networks over the next five years. With the Internet and inexpensive delivery mechanisms, each farm can become a market force to the benefit and profit of farmers of rice.