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Development of commodity exchange in Croatia

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Introduction

Purpose of this thesis work is to show relevance and necessity for existing of commodity exchange and its influence to the economy of Croatia. Because eastern part of Croatia, region called Slavonia is mostly agricultural oriented, it is of essential relevance to establish and make operate of first commodity exchange in Croatia.

Widely in the past, while Croatia was part of Austrian – Hungarian kingdom, first commodity exchange in Europe that was established in 1853. in Budapest, practically was domestic commodity exchange for Croatian business subjects, and they were able to use benefits it brought. Me personally, and a lot of other business people and business society in Croatia believe that time to reestablish commodity exchange has come.

In this thesis, I will give a deeper look in to commodity exchange, describe actual situation in Croatia, show possibilities that commodity exchange brings, how it works and what has to be done to implement commodity exchange and benefits it will bring to Croatian economy.

As it is known, existing and doing business on commodity exchange, together with combine use of different financial derivatives (futures, options, hedging, etc...) and warehouse receipt brings benefits to all participants on market – producers, traders, buyers, financial institutions (like banks) and speculators. It largely reduces price risk, increases liquidity of market and opens a lot of space to increase and secure profit.

First commodity exchange in the world was established in 1848 in Chicago, and it was called Chicago Board of Trade (CBOT®)¹. It is still leading futures and futures –options exchange. As globalization and mergers are becoming leading trends, and CBOT has merged² together with Chicago Mercantile Exchange (CME) in this year, creating strongest commodity exchange in the world.

Commodities exchanges

A commodities exchange is an exchange where various commodities and derivatives products are traded. Most commodity markets across the world trade in agricultural products and other raw materials (like wheat, barley, sugar, maize, cotton, cocoa, coffee, milk products, pork bellies, oil, metals, etc.) and contracts based on them. Specificity is that no physical commodity is traded, but contracts are, and these

contracts are strictly standardized. These contracts can include spot prices, forwards, futures and options on futures. Other sophisticated products may include interest rates, environmental instruments, swaps, or ocean freight contracts. In most cases, commodity exchanges are formed as public companies, which main purpose isn't to make profit from operating, but to give possibility to establishers to operate on them, and they make profit from provisions for executing orders on exchange. In some way, establishers have monopoly in trading on exchange because only establishers / brokers are allowed to trade on exchange.

Since first commodity exchange – Chicago Board of Trade – was established in 1848. Their business and ways of doing it, their technical level and legal regulation, developed constantly. Two institutions have special role in existing and business transactions on commodity exchanges – Clearing house and trading commission. Functions of both of them are guarantee to participants that realization of trading will be done according to Law and competent regulations. Clearing house does it by taking offset position in all transactions stepping between sellers and buyers. Trading commission has function of permanent control of business activities, and if irregularity is noted, they have to intervene immediately.

Main participants of commodity exchange

Clearing house: An agency or separate corporation of a futures exchange responsible for settling trading accounts, clearing trades, collecting and maintaining margin monies, regulating delivery and reporting trading data. Clearing houses act as third parties to all futures and options contracts – as a buyer to every clearing member seller and a seller to every clearing member buyer. By doing this, they sit as buyer for the seller, taking long position, and for the buyer they become seller, taking short position.

Each futures exchange has its own clearing house. All members of an exchange are required to clear their trades through the clearing house at the end of each trading session and to deposit with the clearing house a sum of money (based on clearinghouse margin requirements) sufficient to cover the member's debit balance. For example, if a member broker reports to the clearing house at the end of the day total purchase of 100,000 bushels of May wheat and total sales of 50,000 bushels of May wheat, he would be net long 50,000 bushels of May wheat. Assuming that this is the broker's only position in futures and that the clearing house margin is six

cents per bushel, this would mean the broker would be required to have \$3,000 on deposit with the clearing house. Because all members are required to clear their trades through the clearing house and must maintain sufficient funds to cover their debit balances, the clearing house is responsible to all members for the fulfilment of the contracts.

Trading commission: Trading commissions are independent agencies, with the mandate to regulate commodity futures and option markets. Today, Trading commission assures the economic utility of the futures markets by encouraging their competitiveness and efficiency, protecting market participants against fraud, manipulation, and abusive trading practices, and by ensuring the financial integrity of the clearing process. Through effective oversight, Trading commission enables the futures markets to serve the important function of providing a means for price discovery and offsetting price risk. Trading commission mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets.

Supervisory authority: Special organisations formed by State or Commodity exchange with purpose to supervise and control process of trading on exchanges. They authorise new positions (form of contracts) on exchanges, and regulate that someone wouldn't use inside information's and other illegal actions. Most known is U. S. Securities and Exchange Commission – SEC.

Brokerage company: A company with special authorization for trading on stock exchange. They charge a fee or commission for executing buy and sell orders submitted by an investor. An agency broker is a broker that acts as a middle man to the stock exchange, and places trades on behalf of clients. Also, they make analysis and advise their clients what to do. Each exchange has it's own regulation for operating of brokerage companies, but biggest of them operate on many different exchanges through world. Main of them are Merrill Lynch, Salomon Brothers, Dow-Jones, Pierce, Goldman Sachs & Co, Morgan Stanley (USA), Nomura securities, Nikko securities, Daiwa securities (Japan), Deutsche Bank (Germany).

Conclusion

Commodity exchanges exists through the world since 1848., when first commodity exchange was established in Chicago as Chicago Board of Trade (CBOT) which merged together with Chicago Mercantile Exchange in this year, forming far strongest commodity exchange in the world – the CME Group. First commodity exchange in Europe was established in Hungary, only five years after CBOT – Budapest Commodity Exchange BCE, with main focus on grain.

From the begging, till 1994. trading was executed with brokers physically present on the floor (trading pits) of exchanges (so called “open auction”). In 1994., CBOT successfully launched its first electronic trading system.

Volume of trading is enormous – more then 1.5 billion contracts will be traded in next year on CME alone.

As it is shown in this Thesis work, without any doubt commodity exchange is a must for Croatia and Croatian business sector, especially agriculture. Main advantages are that whole sector – for Croatia especially agriculture sector which is very important and still underdeveloped – can get lots of benefits from using commodity exchanges in many ways. These main benefits from using commodity exchange are:

- useable risk management (and transfer of them to those who are willing to except them, mostly those are speculators, who are trying to make a profit out of them),
- fixing prices and protection from unwished changes (it is possible to stipulate future price),
- increased liquidity,
- standardization of commodities,
- equilibrium of supply and demand.

To achieve above mentioned benefits, it is needed to use different tools that will make it possible:

- using futures contracts,
- using options contracts,
- hedging,
- using combination of Warehouse receipt, Public warehouses and banks to get Lombard financing wit hedge on commodity exchange.

Many faults exist without commodity exchange in function:

- risk management is on much lower level,
- profit margins for producers are lower,
- financing of production is problematic to producers,
- it is hard for traders and buyers to fix prices in the future,
- lot of uncertainty exists.

One of the main things that have to be done is Institution of Warehouse receipt issued from Public warehouses (which need to have authorization. Having status of security is one of the basic questions for development of production, and precondition for exploiting commodity exchange fully. Of course, it is not so easy to regulate everything that needs to be regulated to have things running in the proper way.

In this moment in Croatia, Commodity Exchange Osijek is established (in 2006.), but it still doesn't operate. Organizationally, it is formed only on “paper”, without preconditions to start operating. Many issues have to be done before commodity exchange can start operating:

- Law on commodity exchange
- Commodity exchange needs to be regulated,
- Law of warehouse receipt,
- Public warehouses,
- Lombard financing.

Law on commodity exchange: Members of parliament have to adopted Law on commodity exchange that will regulate legal frame for establishment and operating of commodity exchange.

Regulation of commodity exchange: This means that procedures have to be set. It is important to set forms of contracts, because all contracts traded on commodity

exchange are standardised (quality, weight....). Procedure for giving (on the other side getting) and execution of orders for selling / buying have to be set. Supervisory authority and its competences have to be established.

Law of warehouse receipt: This Law has to be accepted by the members of Parliament, but proposal isn't finished yet. It has to give Warehouse receipt power of security, and regulate issuing of it, elements it has to contain... In bottom line, warehouse receipt issued by Public warehouse has to be accepted from banks as security to make a pledge on commodity to use Lombard financing.

Public warehouses: Issue of Public warehouses has to be dealt with. Institution of Public warehouses doesn't exist in Croatia, so complete regulation has to be set.

Supervising of them, procedure for establishment, field warehousing...

Lombard financing. Lombard credits and financing of production by using them is one of the main benefits that Commodity exchange together with Warehouse receipt can bring to market.