Commodity Market and their Importance in India

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INTRODUCTION:

Commodity derivative markets have traditionally been a contentious issue at various policy forums across the world, particularly with the imbroglio created by allegations from various corners that they encourage excessive speculation and are therefore responsible for the recent commodity price escalation. While this suspicion of excessive speculation in the commodity markets has always been there among policymakers in developing nations like India, it has become more widespread since 2008 in the wake of worldwide inflationary pressures on food and energy. The suspicion has reached such a high that even the U.S., the biggest proponent of market forces with the most active commodity exchanges in the world, is considering new modes of regulation, and is also investigating the role of commodity derivative trading in the steep rise in prices of wheat, rice, and crude oil. On the other hand, ever since commodity derivative trading was allowed in India in the new millennium, there has always been a hue and cry against such markets, with the alleged notion of excessive "speculation", though there has rarely been any evidence or it. Rather than recognizing the potential economic utility of commodity derivative markets in price discovery and risk management, the government has been more apprehensive about its alleged ill-effects. As a result, over time, futures' trading has been subjected to strict regulations, and certain commodities have been inflicted with occasional bans. Thus, while the "disutility" of the market is yet to be proven, the overcautious behaviour of the government has never really allowed the market to develop and prove its utility.
Hence, in the midst of doubts and debates on the utility of commodity futures markets and against the background of conflicting views and vista, there is a need to list various issues and concerns in the development of futures exchanges. This presents the agenda for research on commodity futures markets in India, from both theoretical and empirical perspectives. While at a more general level, probably the most succinct statement on presenting a research agenda for commodity markets exists in a paper by Renowned economists have mentioned that trade and exchange allow us to benefit from specialization and obtain welfare gains. Trade and exchange require the existence of markets. India, a commodity based economy where two-third of the one billion population depends on agricultural commodities, surprisingly has an under developed commodity market. Unlike the physical market, futures markets trades in commodity are largely used as risk management (hedging) mechanism on either physical commodity itself or open positions in commodity stock. Forward Markets Commission (FMC) headquartered at Mumbai, is a regulatory authority which is overseen by the Ministry of Consumer Affairs and Public Distribution, Govt. of India. It is a statutory

body set up in 1953 under the Forward Contracts (Regulation) Act, 1952. The objectives of this regulation by the central government were to exclude from forward dealings operators with insufficient financial resources and inadequate experience, and to prevent all forms of price manipulation. The commission sought to achieve the first by recognition for forward trading of selected trader associations and regulation of their constitution and market practices.

COMMODITY:

A commodity may be defined as an article, a product or material that is bought and sold. It can be classified as every kind of movable property, except Actionable Claims, Money & Securities. Commodities actually offer immense potential to become a separate asset class for market-savvy investors, arbitrageurs and speculators. Retail investors, who claim to understand the equity markets, may find commodities an unfathomable market. But commodities are easy to understand as far as fundamentals of demand and supply are concerned. Retail investors should understand the risks and advantages of trading in commodities futures before taking a leap. Historically, pricing in commodities futures has been less volatile compared with equity and bonds, thus providing an efficient portfolio diversification option.

COMMODITY MARKET:

Commodity market is an important constituent of the financial markets of any country. It is the market where a wide range of products, viz., precious metals, base metals, crude oil, energy and soft commodities like palm oil, coffee etc. are traded. It is important to develop a vibrant, active and liquid commodity market. This would help investors hedge their commodity risk, take speculative positions in commodities and exploit arbitrage opportunities in the market.

BASIC TERMINOLOGIES:

Derivatives

Derivatives are financial instruments whose value is derived from the value of something else. The main types of derivatives are futures, forwards, options, and swaps.

Forward contract

A forward contract is an agreement between two parties to buy or sell an asset (which can be of any kind) at a pre-agreed future point in time. Therefore, the trade date and delivery date are separated. It is used to control and hedge risk, for example currency exposure risk (e.g., forward contracts on USD or EUR) or commodity prices (e.g., forward contracts on oil).

One party agrees (obligated) to sell, the other to buy, for a forward price agreed in advance. In a forward transaction, no actual cash changes hands. If the transaction is collateralized, exchange of margin will take place according to a pre-agreed rule or schedule. Otherwise no asset of any kind actually changes hands, until the maturity of the contract.

The forward price of such a contract is commonly contrasted with the spot price, which is the price at which the asset changes hands (on the spot date, usually two business days). The difference between the spot and the forward price is the forward premium or forward discount.

Long Position (Buying a futures contract):

Agree to take delivery of the item at the settlement date for the futures price.

Short Position (Selling a futures contract):

Agree to deliver the item at the settlement date for the futures price.

Futures price:

Future price is today's price for products to be delivered in the future.

Hedge:

In finance, a hedge is an investment that is taken out specifically to reduce or cancel out the risk in another investment. Hedging is a strategy designed to minimize exposure to an unwanted business risk, while still allowing the business to profit from an investment activity. Investors use this strategy when they are unsure of what the market will do. A perfect hedge is to reduce your risk to nothing (except for the cost of the hedge).

Hedgers:

Hedgers have inherent price risk. They wish to reduce or manage risk.They could deliver against futures contract.

Forward contract act:

An act to provide for the regulation of certain matters relating to forward contracts, the prohibition of options in goods and for matters connected therewith.

Over-the-counter trading:

Over-the-counter (OTC) trading is to trade financial instruments such as stocks, bonds, commodities or derivatives directly between two parties. It is contrasted with exchange trading, which occurs via corporate-owned facilities constructed for the purpose of trading.

DIFFERENCE BETWEEN FORWARD CONTRACT AND FUTURE CONTRACT

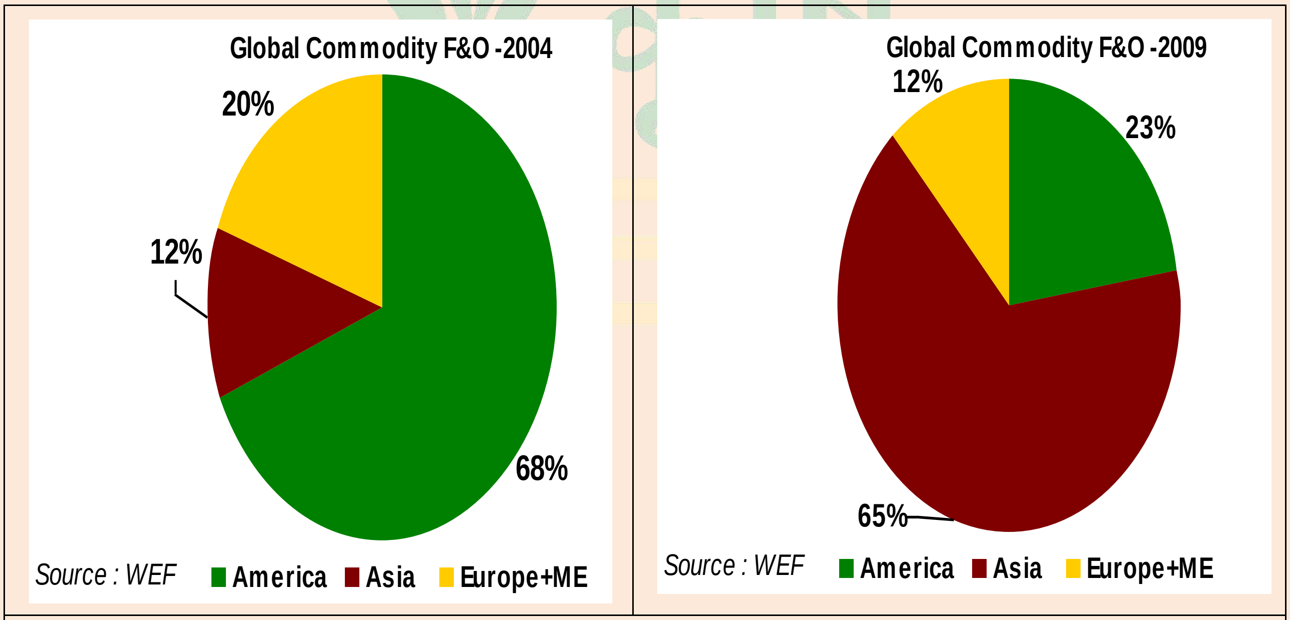
Futures contracts are standardized. In other words, the parties to the contracts do not decide the terms of futures contracts; but they merely accept terms of contracts standardized by the exchange. On the other hand, forward contracts (other than a future) are customized. In other words, the terms of forward contracts are individually agreed between two counter-parties.

Forwards transact only when purchased and on the settlement date. Futures, on the other hand, are rebalanced, or "marked to market," every day to the daily spot price of a forward with the same agreed upon delivery price and underlying asset. Futures are always traded on an exchange, whereas forwards always trade over-the-counter, or can simply be a signed contract between two parties

EVOLUTION OF COMMODITY MARKET IN INDIA

Bombay Cotton Trade Association Ltd., set up in 1875, was the first organized futures market. Bombay Cotton Exchange Ltd. was established in 1893 following the widespread discontent amongst leading cotton mill owners and merchants over functioning of Bombay Cotton Trade Association. The Futures trading in oilseeds started in 1900 with the establishment of the Gujarati Vyapari Mandali, which carried on futures trading in groundnut, castor seed and cotton. Futures' trading in wheat was existent at several places in Punjab and Uttar Pradesh. But the most notable futures exchange for wheat was chamber of commerce at Hapur set up in 1913. Futures trading in bullion began in Mumbai in 1920. Calcutta Hessian Exchange Ltd. was established in 1919 for futures trading in raw jute and jute goods. But organized futures trading in raw jute began only in 1927 with the establishment of East Indian Jute Association Ltd. These two associations amalgamated in 1945 to form the East India Jute & Hessian Ltd. to conduct organized trading in both Raw Jute and Jute goods. Forward Contracts (Regulation) Act was enacted in 1952 and the Forwards Markets Commission (FMC) was established in 1953 under the Ministry of Consumer Affairs and Public Distribution. In due course, several other exchanges were created in the country to trade in diverse commodities.

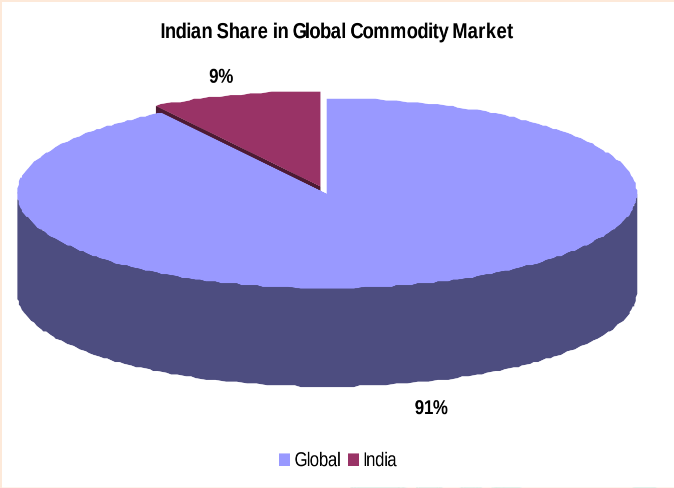
Global growth in Commodities Market -2004-09



Share of Asia has jumped more than 5 times

STATUS OF COMMODITY MARKET:-

In fact, the size of the commodities markets in India is also quite significant. Of the country's GDP of Rs 13, 20,730 crore (Rs 13,207.3 billion), commodities related (and dependent) industries constitute about 58 per cent. Currently, the various commodities across the country clock an annual turnover of Rs 1, 40,000 crore (Rs 1,400 billion). With the introduction of futures trading, the size of the commodities market grows many folds here on.



Global Vs. India

- ✓ Global commodity has relatively long history
- ✓ Size is 9 times larger than India

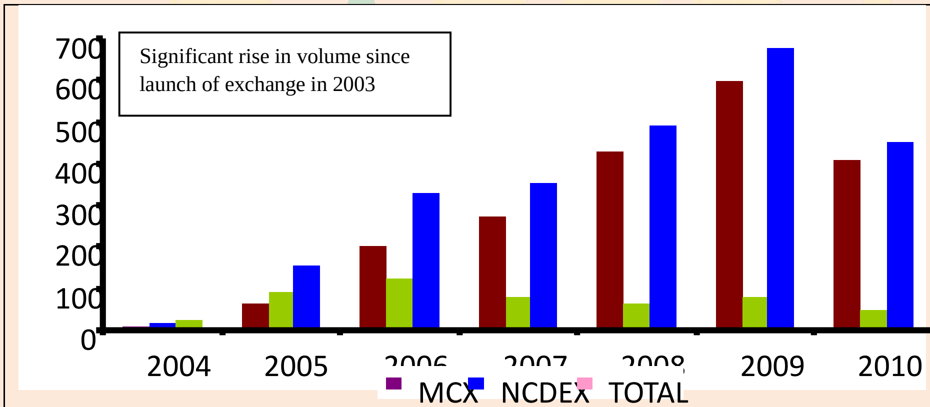
India

- ✓ Commodity futures, though active since 19th century was banned later in 1970's
- ✓ Commodity volumes shoots up significantly after re-launch in 2003
- ✓ MCX emerged as world's Sixth largest exchange
- ✓ Volumes on Indian exchanges are increasing at CAGR of 73.7 percent

Commodity Trading (Value in Million USD)

	2009	2008
Global	14831317	11712611
India	1469673	1067984

Source:FMC,Way2Wealth Research



Source:FMC,Way2Wealth Research

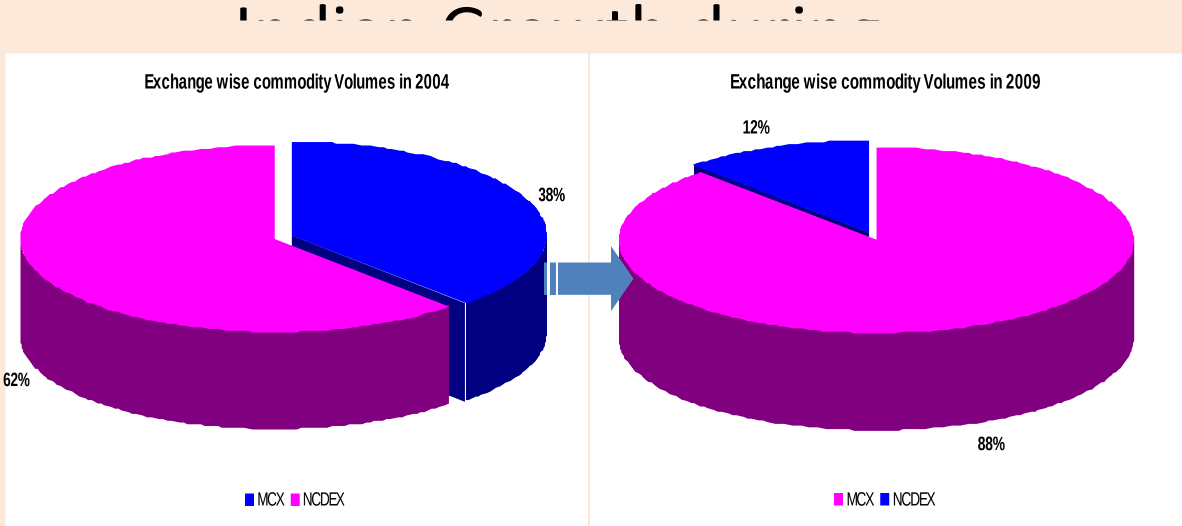
MCX leader in Metals and Energy cap

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Bullion and other metals	31.5	36.1	57.9	64.6	56.7	40.8
Other than bullion metals					-	23.2
Agriculture	68.2	55.3	35.8	23.1	11.9	15.7
Energy	0.3	8.4	6.3	12.3		20.3
Others	0.0	0.1	0.0	0.0	31.4	0.0-

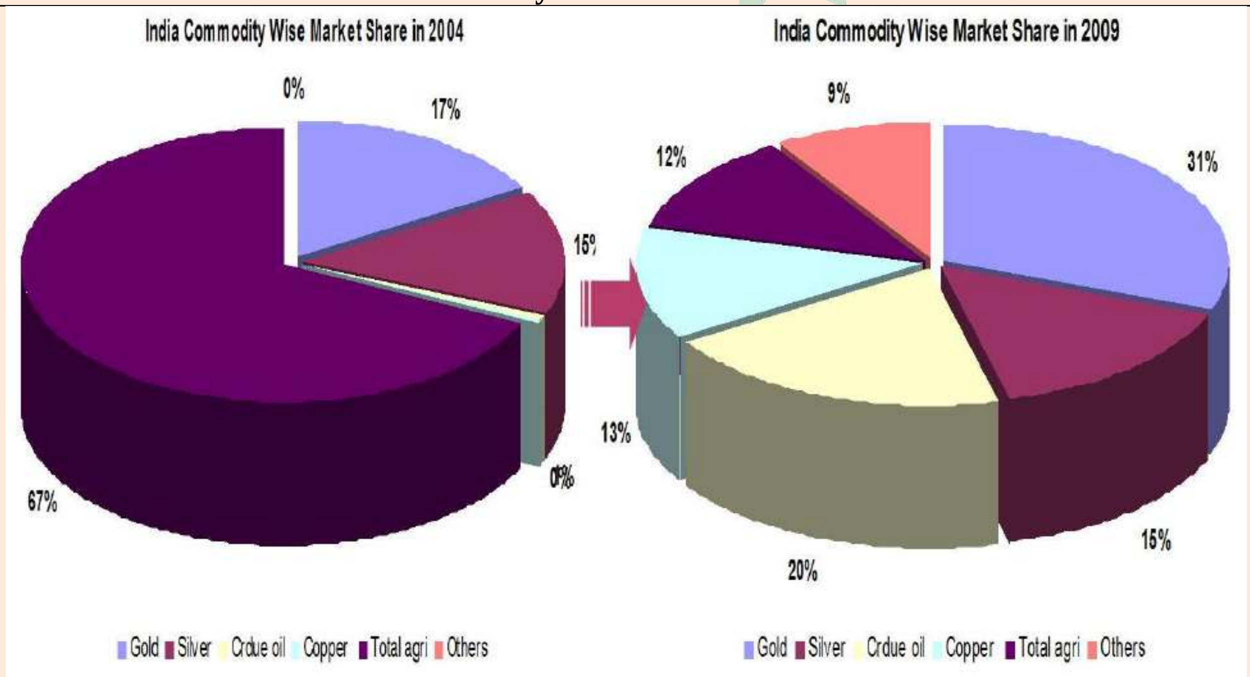
Source:FMC,Way2Wealth Research * 2008-09 other segment includes energy& other metals

NCDEX
Leader in Agri

Status of Commodity growth in India during 2004-2009



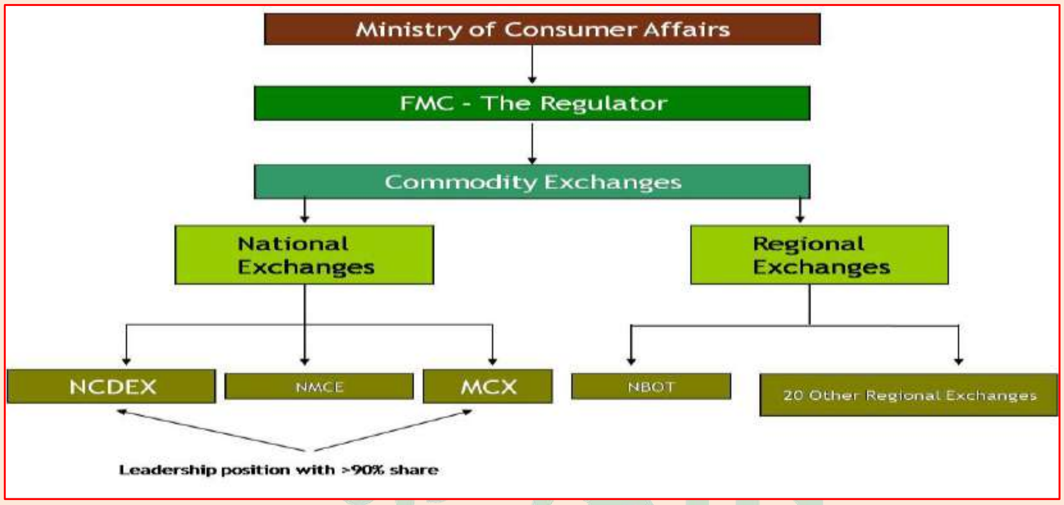
Status of Commoditywise Market share 2004 to 2009



Regulating forward Contracts:

After Independence, the Parliament passed Forward Contracts (Regulation) Act, 1952 which regulated forward contracts in commodities all over India. The Act applies to goods, which are defined as any movable property other than security, currency and actionable claims. The Act prohibited options trading in goods along with cash settlements of forward trades, rendering a crushing blow to the commodity derivatives market. Under the Act, only those associations/exchanges, which are granted recognition by the Government, are allowed to organize forward trading in regulated commodities. The Act envisages three-tier regulation: (i) The Exchange which organizes forward trading in commodities can regulate trading on a day-to-day basis; (ii) the Forward Markets Commission provides regulatory oversight under the powers delegated to it by the central Government, and (iii) the Central Government - Department of Consumer Affairs, Ministry of Consumer Affairs, Food and Public Distribution - is the ultimate regulatory authority. In India currently total 24 commodity exchanges are working of which 3 are national level exchanges and remaining 21 are working on regional level.

Commodity Market- Three Tire Regulatory Structure



First tier, Central government

Central government has been given with highest authority to control FMC as well as exchanges.

a. It has powers to grant / withdraw recognition of Exchanges.

b. It notifies the commodities under section 15,17 and 18(3).

c. It supersedes the governing body of recognized association or exchange.

Second tier, Forward market commission

Forward market commission comes under the second tier of the authority hierarchy. It has control over exchanges and it works under the control of central government. In brief, it

a. Approves Rules and Bye-laws of Exchanges

b. Grants trading permissions subject to appropriate regulatory

c. Monitors and surveys the markets

d. Conducts inspection of Exchanges and their Members.

e. Appoints independent directors on the boards of exchanges

f. May suspend a Member of the Exchange.

g. Informs and assists Police authorities in investigation and prosecution for illegal irregular trading.

Third tier, Exchanges

Functions of the exchanges are,

a. Conduct trading on the basis of the articles, bye laws approved by the commission

b. May take action against any intermediary.

BENEFITS TO THE FARMERS AND OTHER STAKEHOLDERS:

Farmers and growers also benefit through the price signals emitted by the futures markets even though they may not directly participate in the futures market. The futures markets, through advance price discovery lead to a shift in sale-purchase patterns during harvest and lean seasons and thereby facilitate reduction in the amplitude of seasonal price variation and help the farmer realize somewhat better price at the time of harvest. These price signals help the farmer in planning his cultivation in advance as well as to determine the kind of crop which he should prefer to raise. These signals also help him in fine tuning his marketing strategy after the harvest. Empowered with the price information the farmer is able to avoid excess sale immediately after the harvest and is also able to bargain for better prices from trade in the mandi. By providing the manufacturers and the bulk consumers a mechanism for covering price-risks, the futures market induces them to pay higher price to the producers, as the need to pass on the price-risk to farmers is obviated. The manufacturers are able to hedge their requirement of the raw materials and as also their finished products. This results in greater competition in the market and ensures viability of the manufacturing units.

Suitability of a commodity for futures trading:

Futures trading can be organized in those commodities/ markets which display some special features.

The concerned commodity should satisfy certain criteria as listed below:

a) The commodity should be homogenous in nature, i.e., the concerned commodity should be capable of being classified into well identifiable varieties and the price of each variety should have some parity with the price of the other varieties;
b) The commodity must be capable of being standardized into identifiable grades;
c) Supply and demand for the commodity should be large and there should be a large number of suppliers as well as consumers;
d) The commodity should flow naturally to the market without restraints either of government or of private agencies;
e) There should be some degree of uncertainty either regarding the supply or the consumption or regarding both supply and consumption;
f) The commodity should be capable of storage over a reasonable period of time of, say, a few months or more.

LIMITATIONS AND FUTURE OF FMC :

Lowing are the limitations of FMCs
a. Option trading prohibited
b. Functions as a Government department with limited autonomy with respect to :

- Recognition / de-recognition of exchanges
- Regulation of intermediaries
- Financial and administrative autonomy.

c. Market expansion has put heavy pressure on the FMC's coping capacity

ISSUES AND CHALLENGES:

- Increasing the breadth and depth of the market for increasing breadth and depth of market, there is necessity of participation of farmers/ Improving the Governance of Exchanges and Intermediaries Possible way to improve this can be stricter enforcement of legal and regulatory provisions and improvement in competencies and transparency.
- Standardization of contract designs and quality parameters across the market.
- Removal of interstate tariff and non-tariff barriers –Market integration.
- Capacity Building : FMC, Exchanges, Warehouses, Assayers.
- R and D in Commodity market governance and structural issues.
- Sensitization of policy makers / opinion makers with respect to the benefits of the commodity futures market.

CONCLUSION:

In India, the regulatory body of commodity market has taken some initiatives to the general public to understand its various operational conditions which is prevailing in regulation, system of operation and the players involved and promotional activities taken since liberalization has come to the general publics awareness, which would be of immensely helpful not only to the investing community but also to the common man in all respects.

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