Commodity Futures Markets in India

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The Government of India, in an effort to revitalize the commodity futures markets in the year 2002-03, lifted the ban on futures trading in commodities. Following this, the Government of India mandated three nation wide multi commodity online exchanges during 2002-03. Currently, the national level exchanges are providing futures trading in over 100 commodities including, agro-commodities such as rice, wheat, maize, sugar etc., precious metals such as gold and silver, and base metals such as copper, nickel, tin, etc. The Indian commodity Exchanges have made the global Exchanges take note of the Indian market and the global strategic alliances of MCX are a proof of this fact. MCX has been amongst the first few in many global initiatives that are being seen now globally. Extended hours of live market, global cross listing of products, global joint ventures, product innovation, ecosystem development, emphasis on training as a tool for strengthening the ecosystem partners has proved to be a success which many are now proposing to introduce.

MCX, like, all commodities market has been assisting the producers as well as the consumers with a fair price discovery besides enabling them to hedge their price risk. The prices disseminated by these exchanges are expected to be highly reliable and trustworthy as these are discovered after discounting all the information available with various participants. Setting up of the national level exchanges it has created a near-perfect market situation, with wide participation of stakeholders of the entire ecosystem which include, the producers, consumers, traders, exporters, importers, processors, financiers, investors, etc. Unlike the stock markets, the national online commodity exchanges have morning as well as evening sessions of trading, a trend initiated by MCX in India, due to the international linkages in pricing of many commodities such as bullion, base metals, energy, and many agriculture commodities like, cotton, soya oil, wheat, etc.

Role of MCX in development of commodities market

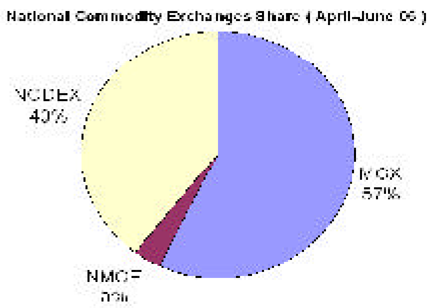
Trading in futures gained immense popularity, and the turnover of the national level commodity exchanges skyrocketed with the MCX as the leading force. MCX took the initiative of introducing evening session for the first time in history of commodities markets in India in an effort to bridge the time zone between the asia-pacific, the key EU markets and USA to provide the missing link in the time zone and the best possible prices for internationally traded commodities. The exchange also formed strategic alliances with leading global benchmark exchanges such as NYMEX, LME, TOCOM, NYBOT, CCX Baltic Exchange, to introduce key global products in the Indian market and to help the domestic spot markets in these commodities to attain global efficiency. In order to take Indian success to global markets, MCX also entered into a joint venture with the Dubai Metal and Commodities Centre (DMCC) and launched Dubai based "Dubai Gold and Commodities Exchange (DCGX)".

In order to create a well balanced eco-system of happy users, MCX initiated National Bulk Handling Corporation (NBHC), a national warehousing and supply chain company to provide warehouse and collateral management services to potential users who were finding the handling of commodities as a deterrent in using the commodities Exchanges for large deliveries. Similarly, the trade expressed need for a spot Exchange in an electronic form so that the trade could use the seamless trading, settlement and trade guarantee system of futures market also in the spot market to have clean and efficient market for large delivery based transactions. Accordingly, National Spot Exchange for Agriculture Produce (NSEAP), was established for spot trading in agricultural commodities and aimed at linking large number of traders in 7500 wholesale centers known as "Agricultural Produce Market Committees" ("APMC") across the country. In order to create a composite ecosystem, MCX believes in a inclusive approach based on which it joined hands with various trade bodies such as the Bombay Bullion Association, the Solvent Extractors' Association of India, the Pulses Importers Association, the India Pepper and Spice Trade Association, the United Planters', Association of Southern India and the Bombay Metal Exchange Ltd.

Today, MCX features amongst the world's top three bullion exchanges. Presently, the daily average turnover of MCX is around Rs 7000 crores, with a peak turnover of Rs 17, 987.65 crores achieved on 20th April, 2006. According to FMC data during January – March 2006, MCX has more than 54% market share of the total commodity derivatives trading in the country.

Growth in Turnover on MCX

Years	Annual T/O (Rs. Crore)
2003-04	2317.50
2004-05	166526.38
2005-06	961646.25
2006-07 (Apr-July)	705487.13



Users of commodities market

The prime role of commodities market is to provide price discovery process and facility for price risk management. Futures market provide a price risk transferring mechanism which is used by the physical and financial market users like, producers, consumers, traders, investors, processors, importers, exporters and speculators to transfer price risk from one to another. These instruments principally provide insurance to the producers (suppliers) of the commodity against price falls and users of the commodity against price rise. In a nutshell, commodity exchanges protect the ecosystem participants against all uncertainties. Apart from this, the participants in the commodity value chain will be benefited from the transparent prices discovery taking place on exchanges. The derivative instruments also encourage investors to invest in commodity markets without holding commodities physically while enjoying the full benefits of the spot markets.

History has demonstrated a very low correlation between commodity and stock markets. Specifically, precious metals essentially gold showed negative correlation with stock markets when considered for a longer period. Empirical studies pointed out that inclusion of commodity component improved the risk-adjusted performance of diversified stock and bond portfolios. Another interesting aspect is that in times of high inflation, portfolios including commodities displayed superior performance, with commodities acting as inflationary shield.

Large Open Interest and the role of speculator in these markets

While the hedgers would wish to take a futures position to hedge their risk, this would be possible only if there was someone on the other side who had a contrary view. It may not always be possible for a producer of a physical commodity to have a consumer of that commodity as a counterparty and in the absence of such arrangement it may not be possible for any hedger to hedge his risk as an when perceived. However, there are many persons in the market who may look at the commodity market as an investment asset and they would be willing to hold commodities, take deliveries and invest in commodities as an asset class merely because they believe that this asset class would give then a better return. Similarly, there are many in the market who may have a view on the commodity prices for a shorter or longer period and may not be interested in taking delivery of commodity but would hold positions only to get the price advantage of the market with making investment in the physical markets. Such speculators can leverage their investment by getting price advantage on commodities by merely blocking margin money instead of blocking capital in inventory to get the same advantage. While it may appear that these speculators are nor providing any important economic function but actually it is their presence which creates liquidity for physical market users to hedge their risk. Our daily trading to open interest position is about 3:1 which indicates that at least 30% of the users are physical market users or investors. This is a more fundamentally sound number. Globally the extent of speculative trading is much more. Therefore, speculators provide the most important economic function of liquidity which attracts physical market users to use an exchange for insurance of their commodity price risk.

Value traded and the Open Interest in select commodities

Date	Rank	Commodity	Value (Crore)	OI (Crore)
28-07-2006	1	GOLD	4105.83	785.78
28-07-2006	2	COPPER	974.31	234.85
28-07-2006	3	SILVER	931.31	362.19
28-07-2006	4	CRUDEOIL	361.30	179.92
28-07-2006	5	NATURALGAS	267.86	67.28
28-07-2006	6	REFSOYOIL	155.73	122.55
28-07-2006	7	POTATO	80.13	62.55
28-07-2006	8	ZINC	71.13	62.94
28-07-2006	9	MENTHAOIL	59.39	122.48

Some myths

It is generally said that the commodities market do not result in large delivery and hence they are only speculative. However, the correct comparison of extent of hedging is the open interest position in the Exchange. An investor or a consumer may decide to take delivery in the Exchange or a producer would like to give delivery in the market only if they find that the spot price on expiration is lower than the futures price and the cost of delivering on the market is not very high. If the spot prices are higher than the futures prices then the delivery would not take place on the Exchange and the deliveries would take place instead on the spot market. Since the futures Exchanges are meant for price discovery and price risk transfer, globally not much delivery takes place on commodities market. Further, futures market trade in a standardized contracts specifications of delivery and quality whereas the physical spot markets are more accommodative to buyers and sellers needs for multiple varieties, commercials terms and multiple delivery conditions which makes all users to take commodities from spot market. Globally, the percentage fo delivery on the futures market is less than one percent.

There is another myth that the futures market participants are mostly speculative and therefore, cause price distortion and hoarding. However, the fact is that the little deliveries that keep taking place on futures market bring alignment in the physical and futures market each month at the time of delivery period partly through delivery and partly through Due Date Rate price fixation which takes into account the spot market prices in delivery center during the last 3-5 days. Further, keeping of large open interest on futures market is not equivalent to keeping of deliveries in physical market which is known as hoarding. Since the advantage of prices increase or decrease in spot market is available only if the commodity is delivered or held whereas it is available on futures market even if the commodities are not held. It is this additional risk which keeps speculators on check and they would participate in the market only if they have large appetite for trading in the market. This also causes most speculators to take a shorter view of the market and they keep changing their strategy depending on the market view. This imparts liquidity and thereby permits producers to hedge their risk in the market.

Commodities Futures markets cause price rise :

Impact of price rise would generally be more sustained and organic only if the physical market fundamentals are impacted and not otherwise. Anyway the commodities market have a fundamental behavior in which commodities are produced in vast geographical areas in some specified period and consumed through out the country across the year. This behavior requires storage and distribution which is either done by the traders and/or by Government. This adds to costs both prior to goods coming from producers to the wholesale market and also while reaching the consumers from the wholesale markets. However, it is seen that the price difference between the producers price and futures market commodities prices is much lower than the price difference between the futures price and the retail prices as seen during the distribution of commodities to retail consumers. The futures markets discover prices based on fundamental economic and technical parameters whereas the consumer prices is a function of storage and distribution costs and also the fundamental factors as affecting the commodities during its life. Further, as commodities markets have a fixed shelf life due to their perishable nature, the commodities cannot be hoarded perpetually and the prices have to get corrected every year.

Therefore, prices variation during the crop season are mostly due to demand and supply factors. Commodities markets are like a messenger which tell all the stakeholders the likely demand and supply situation and the likely prices expected in the larger global context over a long period of time. Therefore while the spot market gives the prices of commodities as perceived by consumption demand of that day or short run, the futures market gives the prices of commodities with reference to investment demand, speculative demand, fundamental long terms consumption demand and global scenario of demand and supply situation. These prices of futures market make end users take long term decisions for buying and holding physical commodities versus holding open interest in futures market as inventory. Similarly, the producers take a decision based on these prices as to when to sell and hold depending the prices available in spot market and futures market. Also, the producer could fix selling prices before the harvest or production due to futures market.

Impending developments

In spite of these encouraging developments, the feeling is that the markets are yet to reach their full potential. Experts pointed out that the commodity markets are restricted to only commodity futures and are restrained from index futures and commodity options. Furthermore, the number of commodities on which futures trading is allowed is restricted to few commodities only. Currently, options were banned in commodity trading. The trading community is eagerly waiting for the green signal for option trading from the statutory regulator, FMC that will offer them one more instrument for insuring their losses. The growth rate of commodity derivatives markets may step on the accelerator, with the freeing of index based derivatives and commodity options.

The permission to launch index based instruments opens the doors for exchanges to come out with derivatives such as index linked futures and options, sector based derivatives and derivatives on intangibles such as weather, freight and other services. Hedging the weather risk is possible by taking positions in the weather derivatives. India being a predominantly agrarian country has the potential to become an international hub for weather derivatives

Yet another development in this industry that may occur soon is the permission for Mutual Funds, Banks and FIIs to participate in commodity futures trading in India. In the past the Association of Mutual Funds of India (AMFI) based on the commodity committee report send a formal request to the SEBI for permitting the MFs to invest in commodities. AMFI, subject to SEBI approval, is very eager to enter the commodity market in a phased manner. To start with AMFI is proposing to take long positions (buyers' position) in bullion, metals and crude oil. The FC(R)A, 1952 has been tabled in the parliament for amendment which will enable many of the above decisions and some would come through policy decisions of RBI, SEBI and FMC.

Conclusion

Considering the changes initiated by the Government, thrust of the government in Agriculture Sector, realignment of trade post WTO and the reforms in the physical and futures market in India, one can conclude that commodities market are in the right growth trajectory. The opportunity it presents is multi-faceted and all pervasive. To reap the benefits of present and future growth potential, MCX is positioning itself as a Gateway of India for the rest of the world. The infrastructural changes initiated in the futures market will now also be witnessed in the physical spot markets and this will be the phase when India will see a common commodities market for the entire country and we would like MCX to be the major catalytic agent in this national development. The benefit of futures market is available to a producer or a consumer through the use of these markets. The farmers as producers who do not use these markets also get benefited indirectly from futures market as the price discovery in the futures market also influences the prices of the spot market and as a result the prices that the farmers gets. Besides, the automatic transmission of the futures prices in spot prices, the farmers also demand these prices or similar parity prices as the Exchange prices are widely disseminated which creates large awareness. The area of influence of the futures market is across the country which was not the case with the fragmented spot market earlier. Also the impact of any information on price is much faster through futures market rather than through the spot market. Sheer velocity of trading on futures market enables it to react to all information as against the few trades that happen on the spot market. Besides, the availability of settlement guarantee, better quality, physical handling and storage system has created demand for futures market amongst the physical market users as they were not accustomed to such efficiency earlier. With the participation of the institutional participants in commodities market would further enhance the efficiency of the market.