

Role of Commodity Derivatives Market for ushering in a Developed Economy



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During the last 3 decades, phenomenal growth of India's capital markets witnessed, and especially during the corona period has surprised the financial sector globally. Our regulator SEBI over the years introduced wide range of measures aimed at developing stable, liquid and efficient capital markets that not only support our domestic economy and but also help the country to attract foreign direct / portfolio investment. The objective is to achieve

financial stability, by initiating reforms in financial markets, promoting liberalization, and providing enhanced market access. From the perspective of a having a strong economy, development of a safe, robust and efficient derivatives market in India is an integral building block.

Commodity derivatives refer to financial instruments whose value is derived from underlying commodities, be it agricultural produce, precious metals, or intangibles like weather. Commodity Derivatives Market is a place where the investor can invest in commodities, instead of buying shares of companies that trade in commodities. In such a market, trade is undertaken through a future or option contract, meaning it is at a future date as specified in the contract that the trade will get completed. A well-developed commodity derivatives market contributes to the economic growth and in a vast country like India, where we talk of one nation one market, it provides integration.

The availability of derivatives contracts allows market participants to access global commodity markets, increasing market connectivity and expanding opportunities for trade and investment. Such integration fosters economic development, and is also a goal shared by the International Swaps and Derivatives Association (ISDA), whose mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivatives products. Though formal and regulated commodities markets are in nascent stage in India, their role in ushering in a developed economy is multifaceted and significant. These markets provide various benefits and contribute to the development of an economy in several ways:

Price Discovery: In the commodities derivatives market a trade takes place post interaction between market participants. Commodity derivatives markets facilitate price discovery by providing a platform where buyers and sellers can trade contracts based on future delivery of commodities. It helps in establishing fair and transparent

prices, reflecting the supply and demand dynamics of the underlying commodities. For any market participants, price discovery enables efficient allocation of resources and helps in informed decision making.

Risk Management: For any business that has a long and complex supply chain including domestic or having international components it is essential to hedge price risk, given the market volatility and unknown factors like war or drought. Commodity derivatives play a crucial role in helping businesses to better manage their price risk especially for those enterprises that are involved in the production, processing, import/export or consumption of commodities. The participants in markets can hedge against adverse price movements, by using derivatives contracts, and reduce their exposure to price volatility. Hedging helps enterprises to predict, and stabilize their revenues, guard profit margins, and make sure of stability in operations. This risk management mechanism enhances resilience within the organisation and ensure stable income/expenditure streams.

Efficiency in Allocation of Capital: A well regulated market attracts domestic and international participants thru foreign portfolio investments that can ensure smooth cross-border transactions. It helps improves the efficiency of capital allocation as it provides a mechanism for participants to manage price risks. Such a market helps in reducing uncertainty and enhances confidence of financial investors. This, in turn, encourages new investment in businesses and industries that utilise commodities as raw material, such as agriculture, mining, and energy. Efficient capital allocation leads to increased productivity, technological advancements, and overall growth of economy.

Market Depth and Liquidity: Commodity derivatives markets enable financial players and hedgers to participate. Such wider participation enhances liquidity and market depth because it attracts large number of participants from wide range of stakeholder groups that could include producers themselves who want to hedge risks, to traders, processors who want to ensure continuity in supply chain, speculators, hedgers, retail investors and even consumers. Increased liquidity permits easy opportunities for buying and selling contracts, reduces bid-ask spreads, and reduces cost per transaction. Market depth and liquidity enables better price discovery, tighter spreads, and can enhance efficiency.

Infrastructure Development: A well functioning commodity derivatives markets often requires the development of supporting infrastructure including storage facilities, logistics and transportation networks, that contributes to the overall development of the economy by reducing wastage, and facilitating efficient supply chains. It helps in developing sophisticated settlement and payment systems like repositories and electronic

negotiable warehouse receipts which eliminate the risks of warehouse receipt frauds. For example when NCDEX declared Gulabghat in Bihar as Maize delivery centre, it saw development of warehousing capacity including a 35,000 metric tonne silo with drying facility. Better infrastructure; procurement through FPOs and price risk management through derivatives paved a new beginning in this backward region.

Standardisation and Quality : Any derivatives contract has specifications related to quality standards, and grading systems. Such specific requirements of derivatives contract ensure that even the primary producers become quality conscious as their return depend on quality. Assaying of good to meet the contract specification ensure that the system promotes quality standards, prescribed by the authorities and in case of food items, our consumers benefit as well.

Price Stability: In a country where inflation is a concern, given the number of poor people who can be adversely affected due to it, Price Stability is a major factor for both - the Government and Reserve bank. Commodity derivatives markets can contribute to price stability by providing a mechanism for managing fluctuations in commodity prices. Because market participants hedge their price risks, it reduces the probability of volatility in prices caused by speculative activities or sudden mismatch between demand and supply of a commodity and resultant shock. Government can be better prepared to handle any expected price rise, either by duty changes, imports or stock limits etc. Price stability fosters a predictable business environment, encourages long-term planning, and promotes sustainable economic growth.

Aggregation and New Financing Mechanism: A big problem that farmers in India have is that their landholding is small. Consequently, their produce is a small quantity. Unless they achieve economies of scale, they can not have strength to negotiate in the market and an aggregator can be their saviour in such a situation. While the role of the aggregator is played by middlemen in physical market, but that does not ensure the transparency of the system. A well-regulated commodity derivative market can prove to be an effective aggregator as it provides a guaranteed aggregation system that facilitates dispersed farmers. Financing from formal channel (banks) in the form of eNWR (electronic negotiable warehouse receipt) is another noteworthy feature of commodity derivatives markets.

Wider participation benefit: The preamble to the 2013 National Policy of Promotion of Farmer Producer Organizations (FPOs) says that “Collectivization of producers, especially small and marginal farmers, into

producer organizations has emerged as one of the most effective pathways to address the many challenges of agriculture but most importantly, improved access to investments, technology and inputs and markets. Collectivizing demand for input and aggregating supply for bulk marketing can bring about substantial change in the rural income level. Encouraged by derivative market players FPOs use commodity derivatives platform as a transparent and fair alternate market platform for ensuring that they are able to manage their price risk and derive benefits of trade. About 500 FPOs and over ten lakh farmers are associated with Commodity market ecosystem today.

Learning from Other Countries

Today, one of the biggest challenges in the agriculture sector is the absence of a well-designed post-harvest system which leads to a substantial loss of food grains during the transmission, affecting the prices and putting the farmers at a loss. Businesses can lose money and fail by not monitoring their production, storage, warehousing, and transportation facilities. Similarly, oversupply of agri produce at the time of harvest weakens the prices, and adversely impact farmers. This can be dealt with by selling futures on the commodity at a price that profits the farmers. Farmers living in Western countries generally use the futures market to hedge the price shifts for agricultural products. Both the business and Farmers (thru FPOs) can derive major benefit from the derivative markets as these markets encourage better investment opportunities in an agricultural ecosystem, which improves the infrastructure of this sector. More than half of the derivatives exchanges in the world offer commodity derivatives in their product suites, the majority of which are futures. While the developed markets in the US and Europe may have taken the lead in terms of number of commodity products offered, the Chinese commodity derivatives exchanges have assumed a leading role in terms of trading volumes. At least one of the three Chinese exchanges were among the top three in terms of trading volume in 2019 for three of the four commodity categories - precious metals, non-precious metals and agriculture.

Conclusion

One can safely conclude that the commodity derivatives market plays a vital role in the development of any economy. Commodity derivative markets facilitate price discovery, risk management, efficient capital allocation, infrastructure development, liquidity, and market integration. By contributing to stability, growth, and efficiency, commodity derivatives markets have the potential to support Indian transition towards a developed economy. All we require is a stable policy, where government does not resort to suspension and bans and perceived threats of consumer reaction and let market maintain equilibrium.