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Evolution of Commodities Markets in India

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Abstract

Commodity markets have been gaining importance in recent years, giving participants an opportunity to go for forward contracting and hedging. In particular, derivative markets have attained more than eighteen times in trading volume when compared to the spot markets. This paper provides an overview of the commodity market in India and its participants, and analyses twelve commodities that are traded in MCX (Multi Commodity Exchange), in terms of price discovery of the spot and futures markets using GARCH model. It also analyses the impact of trading volume, inflation and other macroeconomic factors on spot and futures price movements.

Keywords: Commodities, Exchange,Futures Market, Derivatives, Commodity derivative market

1.INTRODUCTION:

Commodity markets cover physical assets such as precious metals, base metals, energy (oil, electricity), food (wheat, cotton, pork bellies), and weather. The commodities market, in India was for the most part underdeveloped in the years prior to 1990's. The Essential Commodities Act (ECA) of 1955 and the Forward Contracts (Regulation) Act (FCRA) 1952 restricted the trade in commodities, futures contracts and forward contracts to only certain items. Most of the trading is done using futures (total trading volume around 200billion dollars for the year 2002).The economic reforms of 1991 paved the way for the formulation of an expert committee headed by Prof. K. N Kabra; to deal with the development of the sector. The committee gave its report in the June of 1993. This led to the reintroduction of futures which were earlier banned in the year 1966. Agricultural commodities in addition to silver were permitted under

the commodities trade. With the introduction of the National Agricultural policy of 2000, there were substantial reforms in the domestic and external commodities market reforms that led to the elimination of all kinds of unnecessary controls and regulations in the agricultural commodities market.

EVOLUTION OF COMMODITY DERIVATIVES TRADING IN INDIA

Organized trading in commodity derivatives was initiated in India with the set up of Bombay Cotton Trade Association Ltd in 1875. Following this, Gujarati Vyapari Mandali was set up in 1900 to carryout futures trading in groundnut, castor seed and cotton.

Forward trading in Raw Jute and Jute Goods began in Calcutta with the establishment of the Calcutta Hessian Exchange Ltd., in 1919. Later East Indian Jute Association Ltd. was set up in 1927 for organizing futures trading in Raw Jute. These two associations amalgamated in 1945 to form the present East India Jute & Hessian Ltd., to conduct organized trading in both Raw Jute and Jute goods. In case of wheat, futures markets were in existence at several centers at Punjab and U.P. The most notable amongst them was the Chamber of Commerce at Hapur, which was established in 1913. Futures market in Bullion began at Mumbai in 1920 and later similar markets came up at Rajkot, Jaipur, Jamnagar, Kanpur, Delhi, and Calcutta.

COMMODITY FUTURES MARKET IN THE LAST DECADE

Throughout the last decade the commodity futures market has developed significantly in terms of both network and volume. At present, there is a two-tier structure for Commodity Exchanges in India: Regional and Country-Wide. Regional exchanges are permitted to have only a limited number of contracts whose membership is local. Countywide national exchanges are multi-commodity electronic exchanges with a demutualized ownership pattern. Currently, there are three such exchanges, viz., MCX (Multi Commodity Exchange), NMCE (National Multi Commodity Exchange) and NCDEX (National Commodities and Derivatives Exchange).

MCX has evolved as the largest

exchange in the country. MCX started its operations on November 10, 2003 and today it holds a market share of over 80 per cent of the Indian commodity futures market and has more than 2000 registered members operating through over 100,000 trader work stations across India. The exchange has also emerged as the sixth largest and amongst the fastest 6growing commodity futures exchange in the world, in terms of the number of contracts traded in 2009. MCX offers more than 40 commodities across various segments such as bullion, ferrous and non-ferrous metals, and a number of agri-commodities on its platform. The Exchange is the world's largest exchange in silver, the second largest in gold, copper and natural gas and the third largest in crude oil futures, with respect to the number of futures contracts traded. MCX maintains an Insured Settlement Guarantee Fund of about Rs. 100 crores.

Even as reform initiatives are slowly taking shape, turnover in the Indian commodity futures market has increased many times over. The total value of trade in the

Commodity Futures Market has risen substantially in the last few years (Table 1). MCX recorded the highest turnover in terms of value of trade from 2006 to 2010 followed by NCDEX and NMCE.

COMMODITIES ALLOWED FOR FUTURES TRADING IN INDIA

As per the list presented on Forward Market Commission (FMC), there are more than 25 exchanges are in operation carrying out futures trading activities in a wide variety of commodity items under 8 major categories 1.Vegetable oilseeds, oils and meals, 2. Pulses, 3.Cereals, 4. Spices, 5. Metals 6. Energy products, 7. Fibers, 8. Others.

Factors to be considered while trading in order to trade in commodity futures, the participants need to keep certain facts in mind. These factors can be broadly grouped into the following categories.

AGRICULTURAL COMMODITIES

Carryover stocks: Leftover stocks from the previous year's production after meeting the demand.

Expected demand: Average level of consumption and exports during the past few years

Crop acreage: Extent of area sown

under the crop.

Production: Estimated output based on the acreage and weather conditions and pest infestation etc.,

Imports and exports: In case of the commodities that have a sizeable amount of external trade (either imports or exports) such as edible oils and pulses, the traders need to know the details of important sources and destinations of the external trade. Further, the traders have to monitor the crop status in the respective countries.

Government policies: any change in government policy relating to the crops.

Procurement: direct procurement by the government agencies and storage in warehouses change in tariff and base prices of externally traded goods will have a direct impact on the respective commodity prices.

Metals

Currency effects: main source of long-term volatility

Variation in supply and demand for risk capital: Risk capital is largely provided from established routes such as debt and equity.

Shocks: Unexpected changes in production techniques, Massive changes in exploration techniques, Changing geopolitics, Cartel instability, Environmental regulation with respect to production process

CHANGES IN CONSUMPTION TRENDS, DUE IN PART TO PRICE

ELASTICITY

Inflation: change in global inflation as well as inflation in the US and the respective countries.

Crude (energy) futures

- Stocks of Crude Oil and Petroleum Variance from five year average
- OPEC production variance from quota
- Strategic Petroleum Reserve (SPR) variance from target
- Demand factors
- OPEC spare capacity (Saudi Arabia)
- Refinery capacity variance
- Interest rates
- US dollar

INTERNATIONAL COMMODITY MARKET

Commodities future trading have evolved from the need for ensuring continuous supply of seasonal

agricultural crop. In Japan, merchant stored rice in warehouses for future use. In order to raise cash warehouse holder sold receipts against the stored rice. These were know as rice ticket. Eventually such rice ticket became accepted as a kind of general commercial currency rule come into being to standardize the trading in rice ticket.

This concept of trading evolved in the 19th century. In Chicago trading had emerged as a major commercial hub with rice road and telegraph line. It happened in 1848. Gradually the farmers and dealer started to make commitment to exchange the produced for future trading evolved where by the produced would agree to sell his produce (wheat) to the buyer at a future delivery date at an agreed up to price. This

contract became popular very quickly and started changing hand even before the delivery date of the products. If a dealer in not interested in taking delivery of the produce he would sell his contract to someone. Similarly if a farmer who did not able to deliver his crop then he would pass on the responsibilities to another with some more modification. Such contract gradually transformed into an instrument to protect the parties evolved against adverse factors like unexpected price movement, unfavorable climatic factor etc. For example, during bad weather people having contracts to sell wheat would be interested to hold more valuable contracts due to supply shortage conversely. If there is oversupply the sellers contract value would decline.

This prompted the entry of traders in the future market who had no intension to buy or sell wheat but would purely speculate on price movement in the market to earn profit. The hedger's (farmers) who wanted to protect themselves from price fluctuation began to efficiently transfer risk to the dealer trading in future as a result become a very profitable mode of activity that encouraged the entry or other commodities, thereby creating a platform to setup a body that can regulate and supervise these contracts . Thus during 1848, the Chicago board of trade (CBOT) was established. It was initially formed as a common location known both to the buyers and seller to negotiate forward contracts

FUTURE OF THE FUTURES MARKET

Derivative market serves two basic purposes in an economy. It provides hedging opportunities to those who suffer from uncertainties in market prices. It applies particularly to agricultural and primary articles for which supply depends highly on natural conditions such as weather. The producer, in this market, can fix his product price beforehand by agreeing on a forward contract. Buyers can also do the same to confirm the purchase price. In fact, commodity futures evolved as a means of heading, although latter on it was used more for speculation purposes. In India, for instance, over 95 percent of the trading volume in futures today comprises speculative trades. Derivative market performs another economic function, viz, Price Discovery.

Despite its genuine usefulness in the society, however, commodity market has often been criticized on the ground that it involves unscrupulous speculation and hoarding and fuels inflation in the country. Critics raise the point that speculators dominate the futures market and determine the futures price, that is, the price at which the commodity can be traded in future. The futures price, in turn, influences the current market price, that is, the spot price of the commodity. Commodity prices may therefore be guided by futures prices. The problem is acute for most of the commodities traded in futures market are agricultural goods and other primary articles such as minerals. Based on this theoretical underpinning commodity was banned in the early 60s. In recent times also, trading in certain commodities was suspended on this ground.

CONCLUSION

The growth of commodity market is remarkable during last decade. Prices of all commodities are heading northwards due to rapid increase in demand for commodities. Developing countries like China are voraciously consuming the commodities. That's why globally commodity market is bigger than the stock market. 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 being 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. Value of contracts traded in commodity market represents the demand for trading and the people awareness regarding market. The inverse relation of commodity market with stock market shows the alternative ahead investors whenever the feel bearish trend in the same.

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