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"A Study of Commodity Market in India, Its Problems and Difficulties"

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ABSTRACT:

***A** Derivative is a contract whose value is derived from an underlying asset. This underlying asset could be anything such as a share, commodity, and currency. If the value of the underlying asset changes it goes up or down. A commodity is a good or material that is reasonably interchangeable, bought and sold freely as an article of commerce. Commodities include agricultural products, fuels and metals and are traded in bulk on a commodity exchange or spot market. The evolution of organized commodity in India started in the nineteenth century when cotton trade association started futures trading in 1875. As years passed derivative market developed in several commodities in India. Followed by cotton derivative market were expanded by oilseed in Bombay (1900), raw jute and jute goods in Calcutta (1912), wheat in Hapur (1913) and bullion in Bombay (1920). Commodities in reality offer enormous potential to become a separate asset class for market-savvy investors, arbitrageurs and speculators. Retail investors who claim to understand the equity market may find commodities market an unsound one. This paper discuss about the structure of the commodities market in India, the issues and challenges faced by the commodity market in the present circumstances. The government has set up commodity exchange as an legal entity that determines and enforces rules and procedures for trading standardized commodity contracts and related investment products , it is a physical center where trading takes place. Apart from several regional exchanges, India has six national commodity exchanges they are 1) Multi Commodity Exchange (MCX) 2) National Commodity and Derivatives Exchange (NCDEX) 3) National Multi (NMCE) 4) Indian Commodity Exchange (ICEX) 5) The ACE Derivatives Exchange (ACE) and 6) The Universal Commodity Exchange (UCX) .The regulatory body is forward markets commission (FMC) which was set up in 1953. As of September 2015 FMC was merged with the Securities and Exchange Board of India SEBI.*

Keywords: Commodity Markets, Commodity Exchanges, Futures, Options, Swaps, Speculation.

INTRODUCTION

The history of organized commodity derivatives in India goes back to the nineteenth century when Cotton Trade Association started futures trading in 1875, about a decade after they started in

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Chicago. Over the time derivatives market developed in several commodities in India. Following Cotton, derivatives trading started in oilseed in Bombay (1900), raw jute and jute goods in Calcutta (1912), Wheat in Hapur (1913) and Bullion in Bombay (1920). However many feared that derivatives fuelled unnecessary speculation and were detrimental to the healthy functioning of the market for the underlying commodities, resulting in to banning of commodity options trading and cash settlement of commodities futures after independence in 1952. The parliament passed the Forward Contracts (Regulation) Act, 1952, which regulated contracts in commodities all over India. The act prohibited options trading in Goods along with cash settlement of forward trades, rendering a crushing blow to the commodity derivatives market. Under the act only those associations/exchanges, which are granted reorganization from the Government, are allowed to organize forward trading in regulated commodities. The act envisages three tire regulations:
(i) Exchange which organizes forward trading in commodities can regulate trading on day-to-day basis;
(ii) Forward Markets Commission provides regulatory oversight under the powers delegated to it by the central Government.
(iii) The Central Government- Department of Consumer Affairs, Ministry of Consumer Affairs, Food and Public Distribution are the ultimate regulatory authority.

The commodities future market remained dismantled and remained dormant for about four decades until the new millennium when the Government, in a complete change in a policy, started actively encouraging commodity market. After Liberalization and Globalization in 1990, the Government set up a committee (1993) to examine the role of futures trading.

The Committee (headed by Prof. K.N. Kabra) recommended allowing futures trading in 17 commodity groups. It also recommended strengthening Forward Markets Commission, and certain amendments to Forward Contracts (Regulation) Act 1952, particularly allowing option trading in goods and registration of brokers with Forward Markets Commission.

The Government accepted most of these recommendations and futures' trading was permitted in all recommended commodities. It is timely decision since internationally the commodity cycle is on upswing and the next decade being touched as the decade of Commodities.

Commodity exchange in India plays an important role where the prices of any commodity are not fixed, in an organized way. Earlier only the buyer of produce and its seller in the market judged upon the prices. Others never had a say.

Today, commodity exchanges are purely speculative in nature. Before discovering the price, they reach to the producers, end-users, and even the retail investors, at a grassroots level. It brings a price transparency and risk management in the vital market.

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LITERATURE REVIEW

- Barents Group LLC (1997) studied that India's household savings and foreign investors are key sources of this capital and can and will be increasingly attracted to more efficient, safe and transparent market. Retail investors in India are mostly short-term traders, and day trading is not uncommon. To the extent that buying publicly traded equities is perceived as a risky and speculative short-term activity, many potential investors will simply avoid capital market instruments altogether in deciding to allocate savings.

- Patrick McAllister and John R. Mansfield (1998) stated that derivatives have been an expanding and controversial feature of the financial markets since the late 1980s. They are used by a wide range of manufacturers and investors to manage risk. This paper analyses the role and potential of financial derivatives investment property portfolio management. The limitations and problems of direct investment in commercial property are briefly discussed and the main principles and types of derivatives are analyzed and explained. The potential of financial derivatives to mitigate many of the problems associated with direct property investment is examined.

- Yoon Je Cho (1998) showed in his study that increasing turnover figures in the Indian stock exchanges from 1994-95 to 1996-97, implying that they are dominated by speculative investments, which is not unusual in emerging markets. However, trading volumes in the Indian capital market are fairly large compared to those in other emerging markets. The substantial increase in turnover may be attributed primarily to the expansion of the NSE‟s trading network. But this also reflects the fact that the Indian stock market is dominated by speculative investments for short-term capital gains, rather than long-term investment.

- R. Dixon and R.K. Bhandari (1997) said in their study that consequently derivative instruments can have a significant impact on financial institutions, individual investors and even national economies. Using derivatives to hedge against risk carries in itself a new risk was brought sharply into focus by the collapse of Barings Bank. There is a clear call for international harmonization and its recognition by both traders and regulators. There are calls also for a new international

body to be set up to ensure that derivatives, while remaining an effective tool of risk management, carry a minimum risk to investors, institutions and national/global economies. Considers the expanding role of banks and securities houses in the light of their sharp reactions to increases in interest rates and the effect their presence in the derivatives market may have on market volatility.

- Warren Buffet (2002) argued that derivatives as time bombs, both for the parties that deal in them and the economic system. He also argued that those who trade derivatives are usually paid, in whole or p art, on "earnings" calculated by mark-to-market accounting. But often there is no real market, and "mark-to-model" is utilized. This substitution can bring on large-scale mischief. In extreme cases, mark-to-model degenerates into mark-to-myth. Many people argue that derivatives reduce systemic problems, in that participant who can't bear certain risks are able to transfer them to stronger hands. He said that derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear.

Objectives of the study:

1) To study the history and evolution of Indian Commodity Market.

2) To study the different forms of investing in Indian commodity markets.

3) To study the different segments of Indian Commodity Markets.

4) To analyze the regulatory framework of commodity market in India.

5) To study the challenges as faced by commodity market in India.

Research Methodology:

The present study is conducted on commodity markets in India. The study is descriptive in nature. The literature and data are mainly based on a secondary source which has been collected from commodity market and their various publications, text book related topics, reputed journals, magazines, newspapers, and various internet sources like www.mcxindia.com, www.ncdexindia.com, www.nmceindia.com, www.fmce.gov.in and other publications. The various reports and records issues as maintained by Government of India (GOI) are also used in this study. This study is based on historical background of commodity markets in India & its policies and designed to gather descriptive information's. There is no tool applied to values and volume fluctuations of the commodity market.

Types of Commodities Traded

In present day derivative market following are the commodities that are traded

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- Metals (such as gold, silver, platinum and copper)
- Energy (such as crude oil, heating oil, natural gas, gasoline)
- Livestock and meat (live cattle and feeder cattle)
- Agricultural (including corn, soybeans, wheat, rice, cocoa, coffee, cotton and sugar)

Common Forms of Derivatives:

Future contracts are one of the most common types of derivatives. A futures contract (or simply futures) is an agreement between two parties for the sale of an asset at an agreed upon price. One would generally use a futures contract to hedge against risk during a particular period of time.

Forward contracts are an important kind of derivative similar to futures contracts, the key difference being that unlike futures, forward contracts (or "forwards") are not traded on exchange, rather only over-the-counter.

Swaps are another common type of derivative. A swap is most often a contract between two parties agreeing to trade loan terms. One might use an interest rate swap to switch from a variable interest rate loan to a fixed interest rate loan, or vice versa. If someone with a variable interest rate loan were trying to secure additional financing, a lender might deny him or her a loan because of the uncertain future bearing of the variable interest rates upon the individual's ability to repay debts, perhaps fearing that the individual will default. For this reason, he or she might seek to switch their variable interest rate loan with someone else, who has a loan with a fixed interest rate that is otherwise similar.

Options are another common form of derivative. An option is similar to a futures contract in that it is an agreement between two parties granting one the opportunity to buy or sell a security from or to the other party at a predetermined future date. The key difference between options and futures is that with an option, the buyer is not obligated to make the transaction if he or she decides not to, hence the name "option." The exchange itself is, ultimately, optional. Like with futures, options may be used to hedge the seller's stock against a price drop and to provide the buyer with an opportunity for financial gain through speculation. An option can be short or long, as well as a call or put.

Participants in commodity market

Hedgers:

These are investors with a present or anticipated exposure to the underlying asset which is subject to price risks. Hedgers use the derivatives markets primarily for price risk management of assets and portfolios.

Speculators:

These are individuals who take a view on the future direction of the markets. They take a view whether prices would rise or fall in future and accordingly buy or sell futures and options to try and make a profit from the future price movements of the underlying asset.

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Arbitrageurs:

They take positions in financial markets to earn riskless profits. The arbitrageurs take short and long positions in the same or different contracts at the same time to create a position which can generate a riskless profit.

Problems and Difficulties faced by Commodity market

Our country, being strongly agriculture based has to contend with the long-term decline and short term volatility of real commodity prices on international markets and also the price of bullion metals is unpredictable as the prices are volatile therefore the investors have tremendous fear to enter into this market as it is speculative. The long-term decline in real prices reflects the tendency for productivity and production to grow at a faster rate than demand, leading to over-production which hampers the price provided to the farmers. Whereas the volatility reflects the impact of exogenous factors such as weather on our production of commodities. These problems are exacerbated by market distortions, tariffs and subsidies in developed countries, tariffs in developing countries and the market power in some commodity supply chains of large transnational corporations. These distortions also limit our access to lucrative markets and hinder attempts to secure a greater share of the final product price on the part of our producers and exporting community. To summarize in points following are the problems as faced by commodity markets in India: 1) Legal Challenges 2) Regulatory Challenges 3) Infrastructural Challenges 4) Awareness amongst the investors 5) Other challenges regarding trading.

CONCLUSION:

It is found out that the Indian commodity market exists since ancestral period as compared with World market. The organized market in the world started in mid of nineteen century in US Establishing CBOT in 1850, whereas in India contemporarily Bombay Cotton Traders Association (BCTA) was established in 1875. The expansion of trading slowly gained momentum till 1952, because of establishment of Forward Market Commission and passing the Forward Trading Regulation Act. In 1966 due to some obstructions in regulatory and policy issues, the ban on commodity forward trading was continued till 2002. In this aftermath, Government formed some committees to study the feasibility of reintroduction of forward trading as part of second generation reforms and pressure form world economic reform regulators. Then a commodity derivative trading was reintroduced in 2003 with three major national commodity exchanges under the regulation of FMC. The growth of new journey moved with a remarkable attention to all the stakeholders in the market. Within a short span, it reached the stage to compete with global markets in certain commodities, via, gold, silver, platinum etc. At present the number of exchanges moved to 6national

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and 15 regional exchanges with the increase of permitted commodities from 53 to 113for trading in the market. The performance of the commodity market found through the volume and value of market has been growing at average compounded growth in volume and value of futures market by 15 and 29 percent respectively. Such growth is non-linear between estimated and actual volumes and values. On the other hand, the variance between the volume and value of the market follows a reciprocal trend. The trend projection of market over a period of next ten years is linear at a growth rate of 45.65 and 58.71 percent in volume and value of market. Hence, the performance of the market is very considerable and progressive. Hence, the policy market should concentrate to enhance the infrastructure facilities, integration of regional exchanges to National exchanges and penetration of information flow to reach the real users of the commodity Derivatives market. With these changes, the commodity derivatives market can reach a vivacious Market performance in the future provided the requisite facilities are created by the Government.

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