



**BSE**  
The Stock Exchange of India

Annual Capital  
Market Review '03

### SECTION 3 : MARKET TRENDS

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## Commodity Futures in India

Government of India, in 2002-03, has demonstrated its commitment to revive the Indian agriculture sector and commodity futures markets. Prime Minister's Independence Day address to the nation on August 15, 2002, which enlisted nation-building initiatives, included setting-up of national commodity exchange among the important initiatives. The year 2002-03, certainly, was an eventful year in terms of regulatory changes and market developments that could set the agenda for development for the years to come.

### Policy Initiatives

Firstly, Government of India, in early 2003, has given mandate to four entities to set-up nation-wide multi-commodity exchanges. Secondly, expansion of permitted list of commodities under the Forward Contracts (Regulation) Act, 1952 (FC(R)A). This effectively translates into futures trading in any commodities that can be identified. Thirdly, 11 days restriction to complete a spot market transaction (ready delivery contract) is being abolished. Fourthly, non-transferable specific delivery (NTSD) contracts is removed from the purview of the FC(R).

Above four policy decisions have the potential to proliferate futures contracts' usage in India to manage price risk. National level exchanges would make availability of futures contracts across the nation in the most cost effective manner through technology and at the same time would improve the risk management systems to improve and maintain financial integrity of futures markets in the country. Expansion of list of commodities would make available risk management mechanism for all commodities where such a demand exists but never made possible in the past. Abolition of the 11 days restriction on spot market transactions, and removal of NTSD contracts from the purview of FC(R)A would effectively mean unhindered forward contracting among the constituents of commodity trade value chain.

Forward contracting is an important activity for any economy to meet raw material requirements, to facilitate storage as a profitable economic activity and also to manage supply and demand risk; forward contracts give rise to price risk, so to the need of price risk management. Futures markets and forward contracts<sup>1</sup> compliment each other for effective price discovery and

pricing of forward contracts. Price risk in forward contracts can be managed through futures contracts.

### Performance of commodity exchanges

Year 2002-03 witnessed a surge in volumes in the commodity futures markets in India. The 20 plus commodity exchanges clocked a volume of about Rs. 100,000 crore in volumes against the volume of 34,500 crore in 2001-02 -remarkable performance for an industry that is being revived! This performance is more remarkable because the commodity exchanges as of now are more regional and are for few commodities namely soybean complex, castor seed, few other edible oilseed complex, pepper, jute and gur.

Interestingly, commodities in which future contracts are successful are commodities those are not protected through government policies; and trade constituents of these commodities are not complaining too. This should act as an eye-opener to the policy makers to leave pricing and price risk management to the market forces rather than to administered mechanisms alone. Any economy grows when the constituents willingly accept the risk for better returns; if risks are not compensated with adequate or more returns, economic activity will come into a standstill.

With the value of India's commodity economy being around Rs. 300,000 crore a year potential for much greater volumes are evident with the expansion of list of commodities and nationwide availability. Opening up of the world trade barriers would mean more price risk to be managed. All these factors augur well for the future of futures.

### National commodity exchanges and regional commodity exchanges

Demutualization has gathered pace around the world and Indian commodity exchanges are also looking into it. Existing single and regional commodity exchanges have realised the possible threat that the national level exchange may pose on their future. Given the experience of the regional stock exchanges in India, commodity exchanges are becoming proactive to counter such a threat. Commodity exchanges may not face the threat of extinction because of the following reasons.

(1) Commodity exchanges are trading in futures contracts on those commodities, which have some regional relevance. It is not going to be as easy as a share of a company to get listed in a different exchange. (2) Delivery of commodity is a physical activity; delivery of shares is an electronic activity (3) Commodity exchange members are stakeholders in those commodities wherein stock exchange members were never the owners of the stock to control where the stock should get traded. (4) Importance of commodity exchanges are linked to the stakeholders of that particular commodity wherein success of a stock exchange is more on transparency and low transaction cost.

Above reasons are possibilities; national level exchanges could woo the existing commodity exchanges and their members to the national stream. Such exchanges and members are of relevance to the Indian economy as a whole and for the success of commodity futures in particular.

### Nation-wide multi commodity exchanges and regulatory challenges

Forward Markets Commission (FMC) faces the highest challenge with the onset of national exchanges and electronic trading. A national exchange in commodities would give rise to commercial pressures from participants in terms of trade practices followed by exchanges, regulatory measures by the regulator and exchanges and arbitrational aspects pertinent to difference in governing laws among the states. FMC and the exchanges would have to be equipped to deal with such pressures at the shortest possible time so that trade is not distorted. Other

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important aspect the regulator and exchanges should address is the regulatory cost. Unless the regulatory cost is kept low, thriving parallel markets will never join the mainstream exchanges.

### Impact of WTO regime

India being a signatory to WTO may open up the agricultural and other commodity markets more to the global competition. India's uniqueness as a major consumption market is an invitation to the world to explore the Indian market. Indian producers and traders too would have the opportunity to explore the global markets. Price risk management and quality consciousness are two important factors to succeed in the global competition. Futures and other derivatives contracts have significant role in price risk management.

Indian companies are allowed to participate in the international commodity exchanges to hedge their price risk resultant from export and import activities of such companies. Due to the compliance issues and international exchange rules, 90 percent of the commodity traders and producers are not in a position to participate in the international exchanges. International

exchanges have trading unit size, which are prohibitive for many of the Indian traders and producers to participate in the international exchanges. Addressing the risk management requirements of the majority is of concern and the way to address is through on-shore exchanges. In a more liberalised environment, Indian exchanges have significant role to play as vital economic institutions to facilitate risk management and price discovery; price discovery would have greater link to global demand and supply which could assist the producers to decide on what crops they should produce.

#### Way ahead

Commodity exchanges in India are expected to contribute significantly in strengthening Indian economy to face the challenges of globalisation. Indian markets are poised to witness further developments in the areas of electronic warehouse receipts (equivalent of dematerialised shares), which would facilitate seamless nationwide spot market for commodities. Amendments to Essential Commodities Act and implementation of Value-Added-tax would enable movement of across states and more unified tax regime, which would facilitate easier trading in commodities. Options contracts in commodities are being considered and this would again boost the commodity risk management markets in the country. We may see increased interest from the international players in the Indian commodity markets once national exchanges become operational. Commodity derivatives as an industry is poised to take-off which may provide the numerous investors in this country with another opportunity to invest and diversify their portfolio. Finally, we may see greater convergence of markets –

equity, commodities, forex and debt – which could enhance the business opportunities for those have specialised in the above markets. Such integration would create specialised treasuries and fund houses that would offer a gamut of services to provide comprehensive risk management solutions to India's corporate and trade community.

In short, we are poised to witness the resurgence of India's commodity trading which has more than 100 years of great history.

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#### (Endnotes)

<sup>1</sup> Forward contracts are bilateral contracts to manage price risk and quantity risk to certain extent and would act as a boost for futures markets for the following reasons. Forward contracts to sell at a future date would mean a "locked in price" for a future date. To lock-in profit the seller of the forward contract has to "lock-in" the price at which he will buy the commodity to fulfil the future obligation to sell. Such a locking-in will require either of the following actions; (1) Buy the commodity now, store and deliver when the contract is due (2) enter into an agreement to buy the commodity in tune with the contract to sell or (3) enter into a futures contract in a month which is near to the forward contract date. Most likely, and economical action is to enter into a futures contract because of the easy availability of futures contracts and transparent price. Buying and storing commodity may not be a profitable business operation. Forward contracts run the risk of counterparty risk and lack of liquidity. This effectively means futures contracts as the best available option.



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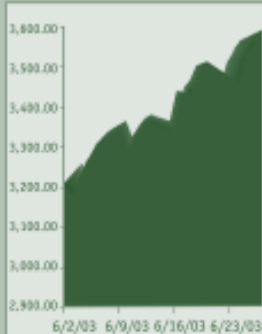
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