

# Working of Commodity Markets in India

Madan Sabnavis



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## Editor's Note

The functions and working of commodity markets has always been somewhat controversial, but very fascinating subject for both academic as well popular debate and discussion. Given the topical importance of this subject, the FORUM is pleased to present to its avid readers the full text of the excellent presentation made by Mr. Madan Sabnavis on this subject at the Seminar jointly organized by it with the Economic Research Foundation of the IMC in February 2010

With his wide-ranging experience in the field of economics and corporate research, as well as his "hands-on" knowledge of commodity markets for having worked in the NCDEX, the author is richly endowed to reflect on various aspects of this subject with competence and deft. Mr. Sabnavis has, thus, done well to set out the complex conceptual framework of commodity markets in very clear and precise terms. While doing so, he brings out several significant advantages of commodity exchanges, especially the prospects of (a) efficient price discovery system; (b) better management of default and risk; and (c) settlement of contracts, etc.

The author has sought to demystify commodity trading by offering very cogent and balanced responses to several fundamental questions that are often raised at various forums. In the process, he has reflected upon issues like (a) divergence between actual production and volume of futures trading; (b) divergence between futures price and spot prices; (c) contribution (if at all!) of futures trading to inflation; (d) role of speculation in adding depth to the market; and so on.

The coverage of this essay of Mr. Sabnavis is, indeed, very comprehensive - apart from his insights on evolution of

*"Free Enterprise was born with man and shall survive as long as man survives".*

**- A. D. Shroff**  
Founder-President  
Forum of Free Enterprise

commodity futures markets in India, he deals with wide ranging issues of regulation, the extent of participation in the market (including mutual funds and foreign investors), the potential of the market, etc. Given his backdrop of expert knowledge and analysis, the author comes to the conclusion that "commodity markets globally have been accepted as being efficient price discovery systems. In India, they can play a very important role provided regulation is more flexible and more participants aware of their existence".

No doubt, this booklet will be very useful and valuable for all those who are keenly interested in understanding the salient features of commodity markets in India - and in particular, to students of economics, commerce and management as well as teachers and researchers. Needless to say, on various contentious issues like the role speculation, efficiency of futures market in price discovery and effectiveness of regulation, there will be continuing need and scope for further research and evaluation!

12 July 2010.

**Sunil S. Bhandare**  
Editor

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## **Preface**

Financial markets are those which operate to determine the price of the product that is being dealt with. There are basically three broad sets of prices in a country: interest rates, exchange rate and prices of commodities. While the first two are relatively narrow in scope in so far as that there are a fixed sets of such rates, the last consists of a large number of products, each with their own characteristics. Further, interest rates can be distinguished as between rates that are fixed by the Central Bank and rates fixed by the banks and other players in the market. Thus, there are rates of lending, borrowing, call, GSecs (with various maturities), CDs, CPs etc. On the other hand, exchange rates are between different currencies at both nominal and real rates, while commodities are distinctively different. Every commodity has its own price, and varies across markets even at the point of first sale, i.e. the wholesale market. There is of course another very active financial market, which has a price that is widely traded, i.e. the stock market. Here shares of companies are traded by investors at prices which are determined by multitude of perceptions.

Each of these financial markets is of two varieties: spot and derivative. The spot market is the cash market where one can buy a currency or bond or commodity and take physical

*\* The author is Chief Economist, CARE Ratings. Earlier he worked with NCDEX for six years.*

delivery for a consideration. The derivative market on the other hand is one where conjectures are placed on future prices by both buyers and sellers based on subjective judgments which in turn helps in determination of the price. Hence, a currency future is the expected dollar-rupee rate; say 3 months down the line, which the two parities hold to be good. Or a 3 month 10-year government bond has a price with an implicit interest rate, which becomes the 3-month futures interest rate. We can also be talking of stock futures where there is a price for stock X 3 months or 4 months down the line. Or it could be for the NIFTY or Sensex. In case of a commodity we could be talking of the transaction of a deal after say 3 months when the buyer and seller agree to swap wheat for cash at a pre-determined price.

### Concepts

The commodity market that is referred to today pertains to the derivative market in the country for various commodities that are dealt with on commodity exchanges. Certain concepts need to be clear before looking at the working of the commodity markets in the country.

- A. Concept of derivatives: Here there are essentially two products that are traded in international markets. Futures is an agreement to buy or sell a particular product at a predetermined date and price that is determined on a real time basis in the market. Hence, when the market starts operating traders put in their bids for a 3-month wheat contract based on the current market price and the expectation of the price after, say, 3 months. Such anonymous decisions taken by a large number of players leads to the determination of the price as the orders are matched by the commodity exchange systems. Therefore, a processor who puts in a price to buy at, say, Rs 1100

a quintal can wait for four months and then collect the product at a pre-designated warehouse of the exchange on the delivery date, which is fixed by the Exchange. In case the price moves up, he would not have to pay the higher price and is hence hedged against adverse price movement. However, if the price at the time of settlement is lower at Rs 1080, he cannot take this benefit when dealing with a futures instrument. However, with 'options', this benefit can be had, as an option gives the party the right but not the obligation to go through with the deal in return for an option premium that has to be paid. Globally options are traded, but the Indian regulatory system does not permit the same.

- B. OTC Markets and commodity exchanges: Traditionally OTC (over-the-counter) transactions have dominated futures trading wherein the two parities transacted on a bilateral basis. However, the price is determined mutually and may not be the one ruling in the market. One party may have more information than the other and the price would be skewed. Further, there is no guarantee that the transaction will be carried out and in case of default, legal recourse is the only solution. The advantage of a commodity exchange is that there are more participants and hence the price discovery system is efficient. Also the Exchange guarantees all transactions and hence any default is taken care of by the exchange. By transferring counter-party risk to the exchange, the parties are able to trade freely.
- C. Risk Policy of Exchanges: While the Exchanges guarantee counter-party risk, they ensure that they are also fully covered through their margining system. Essentially when a person wants to trade, say, Rs 100 in wheat, he has to

put forward a margin of say Rs 5. This margin is based on the historic price volatility of wheat price movement which is based on a concept of Value at Risk (VaR). VaR basically talks of the maximum risk that a party is exposed to due to adverse price movement based on historic price movements. Simplistically speaking, this margin (there are various concepts of margins that are in place to take care of extraordinary movements) is based on, say, 5% price movement. Hence it is assumed that on a single day prices would not move beyond 5% in the worst case, and this amount is collected upfront from the clients. The idea is that in case of default the Exchange can square off this transaction and the maximum price movement would not be beyond 5%. Further, on a daily basis the Exchange does a mark-to-market process wherein the daily settlement price is used to value all positions on the Exchange. All gainers will have their accounts credited while the losers will have their accounts debited. The idea is that losses and gains are adjusted every day so that the risk that is finally carried is only on a one-day basis. Hence, if the price moves to Rs 1105 at the end of the day, this Rs 5 will be distributed across losers and gainers so that all adjustments are made by the end of the day.

D. Settlement of contracts. At the end of the contract, which is the 20<sup>th</sup> of every month on NCDEX (National Commodity and Derivatives Exchange Limited), the contracts are settled. All buyers holding a position have to take delivery and sellers give delivery. Any default attracts a penalty. Normally all parties who do not want to handle the physical good, square off their positions. This means that a buyer of wheat for Rs 1100 would sell his contract at say Rs 1120 (if this is the price on the 19<sup>th</sup>) and move out of the contract. This gain of Rs 20 would have compensated his

MTM loss of Rs 20 on a daily basis. But if physical delivery has to be given, then the seller has to deliver the goods in the NCDEX warehouse at his own cost. The goods are assayed to ensure that they meet the contract specifications and then accepted. Once payment is made, the goods are transferred to the buyer who can take the goods out.

### **Some fundamental questions raised in commodity trading.**

#### **1. *How can volumes traded be higher than the physical underlying?***

Here the issue is as to how is futures trading in, say, soyabean around 40 million tonnes in a year when the actual production is just 10 mn tonnes. The idea here is that when we have futures trading more transactions leads to better price discovery. Hence, the volume of trading has to be very high and globally the ratio could range from 10-30 for farm products and much more for non-farm products such as crude oil, gas and gold. Basically the value chain in agriculture is long. There is the farmer, 3-4 intermediates (arathiya), 2-3 processors, wholesalers and retailers. Intuitively each one would have an interest in covering risk and would have an interest in trading. Hence, this interest level justifies a multiple of 8-10. Then there would be investor and speculator interest too which increases the volumes of trade.

#### **2. *If too many speculators are there, then the trading pattern is amiss.***

Speculators add depth to the market. In case only farmers and processors meet for trading, the farmer would like to get the highest price and the processor the lowest price. Hence transactions may just not go through. Speculators take bets on both the sides and hence add liquidity to enable price

determination. They buy high or low hoping to make gains with prices moving in the other direction and hence add value to the system.

### **3. *Can higher volumes drive prices in one direction?***

Volumes per se are not germane to the issue of price, but open interest is. Open interest is the actual position of quantity of wheat that exists at the end of the day. If person A buys from B at 10 o'clock 10 tonnes of wheat and sells to C who sells to D and so till Z, the open position is 10 tonnes while volume would be 250 tonnes. The 10 tonnes of open interest is what will finally be delivered if not squared off and reflect a price at which wheat will change hands, and hence matters. Now if one were to manipulate the market, then one should be able to actually enforce delivery at the high price to be credible. All the 25 parties cannot believe that the price of wheat would 'move in one direction when these transactions take place and hence, the price will not be driven by these transactions. However, if one party builds a position of say 1 million tonnes and enforces delivery, then the market price will gravitate to his wishes. To ensure that this does not happen, the exchange ensures that position limits are in place and no member can have a position of more than say 10,000 to 20,000 tonnes at any point of time. Market Surveillance ensures that collusion does not take place.

### **4. *Why do deliveries not take place? If this is not happening, then the market is nothing but speculation.***

There are two issues here. The first is that deliveries on a futures platform is not efficient and is expensive. NCDEX offers delivery in say 750 warehouses for 60 products, giving an average of 10 warehouses. But the physical requirement is across the country and this number is miniscule. Hence delivery

is expensive as the seller and buyer at their own cost have to come to the warehouse. Then they have to get the goods assayed. NCDEX offers specific grades for trading which have to be verified. Next, the warehousing charges have to be paid and on delivery carried out at own cost to one's own location after paying all the state duties/taxes. Therefore, unless the buyer and seller are located in the same locality as the warehouse, it would not make sense to handle the goods physically. Therefore, globally not more than ½ % of the goods traded results in delivery.

The second is that even hedgers would not give or take delivery. This is so because of location and grades issues. A textile mill may be located in Mumbai and the delivery centre could be Ahmedabad. If say mill X buys cotton at Rs 100, at the time of settlement, the price is say Rs 120, he would reverse his transaction on the exchange just prior to settlement and make Rs 20 on the futures contract. However, the physical transaction will take place in Mumbai itself in the local spot market at a higher cost of Rs 120 or loss of Rs 20. The mill has hence hedged its risk. Further, hedgers usually use a large variety of grades and the Exchange offers one or two grades which are benchmarks in the industry for trading. Therefore, hedgers use the futures platform as a hedging platform for price risk and not for physical delivery.

### **5. *Increasing margins and reduced prices.***

It is widely believed that in case futures prices are rising sharply in one direction, one can increase margins to drive down prices. Hence, if say the price of wheat has risen from say Rs 1000 to Rs 1200, the Exchange could raise margins from say 5% to 15%. All traders with open positions would have to bring in that much more money as margin capital. They either bring it or exit the market. In such situations,

normally the smaller players are squeezed out of the market as they cannot bring additional capital. But, this action would not necessarily lower the prices in the medium term even though for the first day or two, those exiting would exert selling pressure in the market.

#### **6. Do futures price converge with spot prices?**

The difference between futures price and spot prices is called the cost of carry. This includes interest rate, cost of transport, warehousing etc. Ideally the futures prices for say 3 months should come closer to the spot price at the time of delivery as the interest cost becomes negligible. The problem with the Indian market for farm products is that there is a weak linkage between the spot and futures markets. There are over 7600 organized mandis in the country and multiple centres and grades for each product. The result is that there are no unique prices as in the USA where the USDA announces spot prices every day for products. The Ministry of Agriculture does provide such a service through [AGMARKNET.nic.in](http://AGMARKNET.nic.in) but the prices come with a lag and refer to specific mandis and grades and are not all encompassing. Further, reporting is not always smooth and the price discovery system in mandis is opaque. Hence the convergence process would take time until electronic mandis evolve where prices in the cash market become more robust and transparent.

#### **7. Is futures trading responsible for inflation?**

This conundrum has been raised often about the role of futures trading in contributing to inflation. Futures prices are like a barometer which measure future market conditions. As long as they provide the right signals, which they have done almost always in the last six years, they are a genuine reflection of the state of the product. But, often it has been concluded that

futures trading driven ostensibly by speculators (arguments 2, 3 and 4 have been used) has led to an increase in prices. It is true that when prices are volatile, there is a tendency for more players to come on board especially if it is in the upward direction as hedgers and speculators both play their roles. This is the only time when there is need to hedge because stable prices does not enthrall hedgers as well as speculators. However, to formulate a judgment on futures trading in rising prices, there is need to look at the fundamentals. Lower production of say sugar, wheat or maize has gotten reflected in futures prices prior to the harvest because this is when the signals are provided by the market. Statistical analyses carried out to check on causation using the Granger causality or Error Correction Mechanism (ECM) do not give conclusive results and hence this debate remains.

#### **Evolution of the Commodity futures markets in India**

Commodity futures trading are an old concept and flourished in the late nineteenth century. There were several such exchanges that traded in specific commodities in certain geographies. In the 1960s the futures market ran into trouble as high inflation resulted from a series of wars and droughts in the country which led to considerable speculation and hoarding of agricultural commodities. The government in its wisdom banned futures trading. However, trading went underground and got transformed into forward trading in the grey market. These systems have worked very well and do so even today where the rules of engagement are drawn up and adhered to. While settlement is smooth as any violation of the terms of engagement results in being ostracized, the price discovery system remains opaque and may not reflect the reality. Gradually permission was given to various regional exchanges to emerge dealing with specific commodities and

regions, and came to be called regional exchanges. Here, the owners were the traders and there was considerable conflict of interest in running the operations.

Meanwhile as India went in for economic reforms in 1992, there was considerable progress in the financial sector. Towards the end of the decade, there was talk of reviving futures trading in commodities, and accordingly committees were set up to evaluate these options. By 2003, it was agreed to have this business back and the concept of national level online multi-commodity exchanges emerged. The idea was to have some new exchanges that were provided online trading on lines of the NSE in the stock market across the country and dealt with all commodities. These exchanges were to be demutualized meaning thereby that traders could not be owners and the exchanges had to be professionally managed. Accordingly 3 national level exchanges emerged, NCDEX, MCX and NMCE. Recently another exchange, ICEX has commenced operations.

**Regulation** : Commodity futures markets are guided by the Forward Contract regulation Act (FCRA) which was formulated in 1952. Being an Act that is almost 60 years old means that there is need to revisit the Act and bring about the necessary amendments. The FCRA recognizes commodities to be those that are deliverable and hence have to be tangible. This excludes the use of indices which are very active in the securities market. Further, as the 1952 act spoke of futures only, options are not permitted and hence the sphere of activity is restricted to, a single instrument.

The regulator is the Forward Markets Commission, which is an arm of the Ministry of Consumer Affairs. The FMC is not an autonomous body like the SEBI (Securities Exchange Board of India) and hence has limited powers in terms of bringing about reforms in the country. Further, the Minister in charge

of this Ministry is also the Minister for Agriculture. This is a unique situation since the Ministry of Agriculture would always work towards providing better incomes for farmers while the ministry of Consumer Affairs would work towards lowering prices for consumers. Therefore there is this delicate balance that has to be managed between protecting interests of farmers and consumers.

Over 70 products are traded on these exchanges and the performance of the markets has been mixed. There are primarily two sets of products that are traded on exchanges. The first are farm products which are unique to the country. These products are relevant to the country and have domestic price discovery. The factors affecting these prices are local supply conditions with demand being virtually known as it does not change radically in the short run as tastes change only over a longer period of time like say 5 years. Here price discovery has been robust and accurate signals have been received on the state of the crop.

The second set of products is metals and energy where price discovery is essentially global in nature. The price of gold and silver is determined at COMEX (a wing of New York Mercantile Exchange) while that of crude oil on NYMEX and metals on LME (London Metal Exchange). Here India is a price taker and simply borrows the price on other exchanges. The prices hence reflect what happens on international exchanges.

The non-farm products have almost 10 times the volumes on farm products in the country and the main reason for this has been the hasty decision to ban futures trading in certain farm products since 2007. Higher inflation in the country has led to a debate of the role of futures trading to this phenomenon which has in turn led to the government banning trading in tur, urad, rice, wheat, soy oil, rubber, chana, potatoes and sugar.



Some of these contracts have been restored subsequently but the market has been set back by these bans as they mean a considerable loss for players. Further there is always apprehension on future bans on commodities which had melted the high volumes that were once there for these products.

**Participation on the exchanges :** Presently participation on exchanges is purely retail in the sense that regulation does not permit institutions such as mutual funds, banks and foreign institutional investors to trade in commodities. Institutions especially mutual funds and foreign investors have proved to be very useful in the context of capital markets. They have added depth and liquidity in the system which has enabled the market to become comparable with some of the best in the world today.

While the FMC has given permission to mutual funds and foreign investors to trade in non-agro commodities, the clearance from SEBI is required as they come under the purview of the Ministry of Finance with SEBI being the regulator. Mutual funds would in fact be useful for individuals to invest as presently while there are no restrictions on individuals to trade in commodity futures, the requisite **knowledge** and research does not reside with this constituent. Therefore, just like how individuals do invest in securities market through mutual funds, a similar approach will be useful for this market.

The issue relating to foreign investors is theoretical. As commodity markets are delivery based, the question posed is as to what would happen in case these entities do end up with the physical stock. There would be export-import policy issues. Further, is the market mature enough to have full transmission of global trends to domestic markets?

While a very high degree of correlation has been observed between domestic and foreign prices for most international commodities that are widely traded in the world such as wheat, soybean, soy oil, corn, gold, metals, etc, foreign investors, with their deep research and pockets would factor in this information in the domestic market leading to price upheavals for which we may not be prepared. While these are legitimate concerns, the solution is not to disallow the same, but to create suitable regulation for their operations. They could be made to trade in non-delivery based operations only. Further, there could be **limits** placed on their operations to ensure that their operations do not drive the prices. Therefore, these arguments should not be limiting factors here.

However, given this framework, it is only the retail brokers, processors who participate in the market and the growth witnessed so far is exclusively to their interest.

**Potential of the market :** Futures always trade a multiple times the size of the underlying. As commodities are valued at around a third of our GDP, which would be around Rs 20 lakh crore (at current market prices), futures could trade at least 4-5 times this size or twice the size of the GDP. The reason is that there is a long chain of intermediaries between the producer and the consumer which can vary from 3-4 (metals) to 8-10 for agriculture. Each level would have interest in hedging. Add to this the pure investor or speculative interest, and the multiple could go beyond this number of 5. Several products trade at multiples of 30-40 in global markets on CBOT (now CME of USA) or Dalian (China). The present size of the market is around the GDP of the nation with a limited canvas of products, players and instruments. Intuitively it may be seen that any flexibility in the policy stance would bring about faster growth in the market.

**Investment options :** Investors would find this market very attractive as they offer returns somewhere in between those on safe debt assets like GSecs and equities which would range between 10-20% on an average. However, these returns vary depending on volatility which in turn depends on the season and output based on product cycles. The margins to be upfront are lower in case of commodities between 5-10%. Here the prices, are based more on fundamentals than equities, though the challenge is in tracking these factors. This knowledge is spreading gradually based on regular research reports put forth by exchanges likes KCDEX as well as some large brokers which provide valuable insights on the factors influencing the product outcome.

**Is this growth for real? :** While commodity futures trading has shown impressive growth numbers, it should be realized that over 90% of the business comes from non-agriculture products. This is significant because in all these cases, the price discovery process is not domestic. Being replica contracts from the west, they do not really enhance the price development process in the country. Futures trading were revived in the market with the primary aim of reaching out to the farmers.

However, this road has been tumultuous with several bans being imposed by the FMC on futures trading with pressure being applied from different quarters when inflation has been high. This has pushed back the market as players are apprehensive of trading as there is the constant fear of bans whenever there is an upward movement in prices. The allegation made is that while higher prices do reflect the shortages in the country, the benefit of higher prices go to the intermediates and not the farmer. While this has not been proved, its constant reiteration has led to the ban of futures trading in the requisite commodity.

This mindset has to change because when India does go in for capital account convertibility, and funds flow freely between countries, foreign investors would be interested in trading in India-centric products and not metals or energy products where global exchanges dominate. In fact, even domestic investors would prefer first hand trading in LME or NYMEX (which is not allowed today except for hedgers to the extent of forex exposure). In the absence of paying attention to this market, it would just disappear in course of time in case suitable depth is not created.

**What drives prices? :** Prices are driven by fundamentals unlike the stock market where sentiments dominate. This is so because when one looks at daily changes in prices of any stock, there is not much happening to a company. A company comes into the public radar may be 10-20 times a year when the results are announced or dividend declared or an important policy decision affects its profitability like higher interest rates affecting capital expansion plans or taxes affecting its competitive edge. Yet prices move on a daily basis based on perceived macro sentiment for the country as well as industry. The same does not hold for commodities, as daily news affects the prices. Daily news could be something like arrivals, delays in arrivals, crop failure in some part, higher rainfall in another area, physical stocks getting deplete etc. Therefore, commodity prices are affected more by fundamentals which are monitored by the commodity exchanges.

**What drives business volumes? :** This is a hard question to answer as there are several factors which make a product interesting to trade on an Exchange.

1. Price volatility is by far the most important factor that drives business volumes. Greater volatility leads to more uncertainty relating to prices which creates interest in

hedging for all participants. Stable prices create a more certain environment which obviates the need to hedge or invest.

2. Seasons are important because crops that are out of season would have less trader interest in the market. But, season again ranges from the time of sowing to harvest. News about the progress of the crop from the time of sowing to harvest will provide clues on the state of the crop and hence prices. Based on the efficient market hypothesis, all this information is factored in the price that is seen, which in turn is a clear indication of the expected supply conditions.
3. Direction of prices is also important as business is brisk normally in the upward swing of prices, just like in the stock market where a bull run means higher turnover.
4. Global signals play a role for global commodities like bullion, energy and other metal products. The price of gold is inversely related to the exchange rate. A weak dollar means that money moves to gold which is considered to be a substitute. Geopolitical problems affect the price of crude oil while overall growth scenario for the world economy, especially China has a bearing on the prices of metals products like steel, aluminum, copper, nickel, lead and zinc.
5. Products where the prices are semi-controlled by the Government would tend to follow a different track. For example, the government announces Minimum Support Prices for wheat and rice, which sets benchmarks for the same. Intervention in the sugar market in the form of releases announced by the government further influences interest in the futures market.

6. Regulatory intervention is another factor that affects participation. When the Exchanges, on advice of the FMC, increases margins or lowers position limits, there is a withdrawal from the market by several players which drives volumes southwards. This is often done when it is believed that the increase in price is high due to large scale participation. In such situations, additional margins are imposed which in turn drive some players out of the market, as they have to bring in that much more capital to continue their operations.

Have futures trading delivered?

**Price signals :** Futures trading in farm products have provided certain valuable price signals on the state of the crop to come. Rabi crop price signals can be tracked from November-December onwards and those of kharif from around August-September when indications are available on whether the crop would be normal or not. This has also been the case for sugar in 2009, wheat in 2006 which still led to the ban. For other crops, especially spices, this is probably the only signals that are available in the market today.

**Farmers :** An issue that is raised often is whether or not farmers are gaining. The fact is that farmers are not in a position to participate since they have limited knowledge of futures trading and even if they did, the complexity involved and the size of the contract (typically 10 MT) would make it difficult for them to do so. Farmer participation has to be viewed in three stages. The first is when they are made aware of this concept. This is being done in a phased manner by the FMC with the exchanges where regular programmes are held across the country educating them of the same. The second stage is where farmers are aware of the prices and use them to take decisions in the spot market. This is happening

gradually as price dissemination is high on the agenda of the exchanges which are using various means of reaching out prices to the farmers through TV and radio channels, newspapers, electronic ticker boards etc. The third stage is when they would actually be hedging their price risk for which there is need to create an infrastructure. Typically the farmer produces 1-3 tonnes of the product and there is need for an aggregator who can represent the farmer on the platform.

Farmers, it must be remembered, can really benefit a lot from futures trading. They can choose their crop based on futures prices and hence get away from the syndrome of looking at the past year's price. Then based on the soil suitability, they could switch to better rewarding crops and reduce the risk of oversupplying the product. Farmers should ideally be selling their produce before harvest and banks could play the role of the aggregator (which is not allowed by regulation today). Banks, it should be remembered, already lend to the farmers and the ability of the farmer to service the loan depends on the price received. Hence, there is, prima facie, a strong case for the bank to protect itself by hedging on behalf of the farmer. Also, at the time of harvest farmers could sell ahead in future instead of the present, when typically prices decline due to over supply conditions which go with harvest time. They could get finance against the warehouse receipt to tide over current cash requirements. Intuitively it can be seen that futures trading has the potential to transfer the holding power from the intermediate to the farmer. Presently, all crops are grown once or twice a year and are made available for the rest of the year by the intermediate that has the superior holding power. If the same is provided to the farmer, there could be a revolution in the making. For this, futures markets have to be allowed to grow without interventions.

**Corporates :** Corporates are increasingly looking at the commodity exchanges for hedging price risk. All companies in the manufacturing sector carry raw material risk which ranges from 40-80% of sales value. Traditionally, OTC contracts or forward deals with suppliers have been the norm wherein the price is predetermined bilaterally. Futures exchanges provide a market oriented price for the same which can be effectively used. Presently companies do hedge on international exchanges for metals to the extent that regulation permits them to do so to cover forex exposure on account of exports or imports of the product. This ideology has to spread to domestic price risk cover too.

**Commodity exchanges :** The commodity exchanges have, as part of its own business models, had to create the necessary infrastructure to conduct their operations. This is a social good or externality that has resulted from their operations. NCDEX for instance has created warehousing capacity of 1.3 mn tonnes which meet certain high standards that have to be maintained to meet its own contract specifications. Further, by introducing the concept of assaying and grading, new standards of objectivity have been introduced in this market, which is largely not regulated and driven by subjective views. Further, the vast price dissemination efforts have set benchmarks even in mandis where there are references made to the futures prices before transacting in the mandis. Such investment is of considerable monetary consideration and is an ongoing process which is creating value along the commodity market chain.

### **Concluding remarks**

Commodity markets globally have been accepted as being efficient price discovery systems. In India, they can play a very important role provided regulation is more flexible and

more participants are aware of their existence. While the regulator and exchanges are working on these aspects, the uncertainty relating to certain contracts being delisted or banned has to be removed to make the market more effective.

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*The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.*

## **SHAILESH KAPADIA**

(24-12-1949 – 19-10-1988)

Late Mr. Shailesh Kapadia, FCA, was a Chartered Accountant by profession and was a partner of M/s G.M. Kapadia & Co. and M/s Kapadia Associates, Chartered Accountants, Mumbai.

Shailesh qualified as a Chartered Accountant in 1974 after completing his Articles with M/s Dalal & Shah and M/s G.M. Kapadia & Co., Chartered Accountants, Mumbai. Shailesh had done his schooling at Scindia School, Gwalior and he graduated in Commerce from the Sydenham College of Commerce & Economics, Mumbai in 1970.

Shailesh enjoyed the confidence of clients, colleagues and friends. He had a charming personality and was able to achieve almost every task allotted to him. In his short but dynamic professional career, spanning over fourteen years, Shailesh held important positions in various professional and public institutions. His leadership qualities came to the fore when he was the President of the Bombay Chartered Accountants' Society in the year 1982-83. During his tenure he successfully organized the Third Regional Conference at Mumbai. He was member, Institute of Fiscal Studies, U.K.; member of the Law Committee and Vice-chairman of the Direct Taxation Committee, Indian Merchants' Chamber. He was also a Director of several public companies in India and Trustee of various public Charitable Trusts.

He regularly contributed papers on diverse subjects of professional interest at refresher courses, seminars and conferences organised by professional bodies.

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*"People must come to accept private  
enterprise not as a necessary evil, but  
as an affirmative good".*

**- Eugene Black**  
*Former President,  
World Bank*

# FORUM

of Free Enterprise

The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets, meetings, and other means as befit a democratic society.

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