AMIC – INFOSERIES – 7
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DATE: 10/11/11

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Commodity Futures Marketing: A Primer

INTRODUCTION

The public policy with respect to commodity futures trading has undergone a sea change in India from the restricted trading to the government sponsored multi commodity exchanges in view of the new regulatory environment ushered in by the new economic policy of globalization and liberalization. As a result, futures trading have now been accepted as a way of strengthening the agricultural sector through price discovery and hedging mechanisms. The price uncertainty and the resultant financial insecurity to the farming community in the conventional spot markets made a rethinking imminent on alternate system of risk management.

MEANING

Unlike in a spot transaction, where the payment and delivery are done on the spot, forward markets do not indulge in instantaneous payment and delivery. According to the Forward Contracts (Regulation) Act, 1952, any delivery beyond 11 days is a forward transaction in India. The Forward Contract (Regulation) Amendment Bill 2010 proposes to extend this period of the ready delivery to 30 days. The Government of India approved the proposed amendment on 16 September 2010, and the Forward Contract (Regulation) Amendment Act may come in vogue soon. Futures trading is a variant of forward trade, where the delivery is not mandatory -but optional, within the contract period.

LEGAL FRAMEWORK

Conventionally, commodity futures contract are settled by physical delivery. A Seller with an open position at contract expiry must make deliveries to liquidate the position. Similarly, a buyer must take deliveries to liquidate on open position when the contract matures. If the buyer or seller defaults, a delivery risk may arise. Therefore, the performance of a buyer and the seller will be guaranteed by commodity exchanges

The commodity exchanges in the country are established under the Forward Contracts (Regulation) Act, 1952 (FCRA,1952). Forward Market Commission (FMC) is the nodal agency overseeing the activities related to forward and futures trade in India. The performance of the buyer and seller are guaranteed by commodity exchanges duly constituted under the FRCA, 1952. At present, there are 23 single commodity exchanges in the country. They are regional commodity exchanges operating on single commodity on a small scale. Examples are the Cotton Commodity Exchange (Mumbai) for cotton, Hesine Exchange Ltd. (Calcutta) for jute, Indian Pepper and Spices Trade Association (IPSTA) Cochin for spices like pepper. There are three national multi commodity exchanges now. They are:

- National Commodity and Derivatives Exchange of India [NCDEX], Mumbai
- Multi Commodity Exchange of India [MCX], Mumbai
- The National Multi Commodity Exchange of India [NMCE], Ahemedabad

These exchanges are manned by the Board of Directors, which is composed primarily of the members of the association. There are also representatives of Government and public nominated by the Forward Markets Commission. The Board is headed by a Chief Executive Officer (CEO) for the day to day administration. The CEO will be assisted by a team of employees.

ECONOMIC FUNCTIONS OF FUTURES MARKET

Three salient functions of commodity futures market are:

1. The primary objective for any futures exchange is effective **price discovery**. Prices are determined by successful matching of bid and interactive moves by the trading members.
2. The futures market help in **risk management** by permitting the participants to **hedge their risk** against adverse price movements. Hedging refers to taking a position in a futures market opposite to a position held in the spot market to minimize the risk of financial loss from an adverse price movement.

3. Once the seller gets the price of commodity fixed through contract, they can keep the produce in warehouses and get ware house receipts, which in turn can be submitted as

collateral to avail short term loans to be used as working capital. So, futures trading provides a platform for **collateral financing**.

COMMODITY DERIVATIVES IN INDIA AND TRADE TURN OVER

At present, Government of India permits futures trading in the following commodities only:

SL.No	Commodity	SL.No	Commodity
1	Cotton – ginned and unginned	14	Groundnut oil
2	Jute and jute products	15	Groundnut cake
3	Pepper	16	Coconut
4	Cardamom	17	Coconut oil
5	Soybean	18	Caster seed
6	Soy oil	19	Castor oil
7	Soy meal	20	Potato
8	Rape/mustard seed	21	Coffee
9	Rape/mustard seed oil	22	Gur (Jaggerry)
10	Sunflower seed	23	Rubber (RSS-4 grade sheet)
11	Sunflower oil	24	Precious metals (gold/silver)
12	Sunflower cake	25	Steel
13	Groundnut	26	Non ferrous metals

Turnover on commodity futures markets (Rs. crore)

Name of the exchange	Calendar Year		
	2008	**2009**	**2010 (Up to Nov)**
Multi Commodity Exchange, Mumbai	42,84,653	59,56,656	78,95,404
National Commodity and Derivatives Exchange, Mumbai	6,28,074	8,05,720	9,73,217
National Multi Commodity Exchange, Ahmedabad	37,272	1,95,907	1,80,738
Others	83,885	1,32,173	4,45,366
Total	**50,33,884**	**70,90,456**	**94,94,725**

During the last five years, the Indian commodity market has shown tremendous growth in terms of both number of commodities traded and value of trade. However, while agricultural commodities accounted for 31.67 per cent of the quantity traded, its trade value is limited to just 11.53 per cent of total traded value among the commodity groups. Even though 23 regional commodity markets are operating in India, MCX, NCDEX, MNCE and NBOT together account for more than 98 per cent of the market share.

COMMODITY MARKETS IN EVOLUTION

Among the 23 single commodity exchanges in India, most of them are highly localized except a few. Therefore, these markets lack depth. Commodity futures are still in its infancy in India. There is a feeling that the commodity futures market will overtake the capital market in the near future. Considering the mammoth size of the agricultural sector, they are yet to play a very significant role.

All futures markets centre around two critical functions of price discovery and hedging. But, countering the scathing criticism that futures markets are "dens of speculation" needs more transparency in the critical areas of functioning. For instance, the trade volume of guar seed in the first 5 months in 2005 was 118 times the total physical quantity produced. Evidences of excessive speculation led to the suspension of futures trading off and on by the Government of India. The switch over from "out cry" systems to "on line" systems alone can not ensure transparency in futures trading. Similarly, the ratio of trade volume to production was high in soy oil in many years, in cardamom during 2010-11, and in pepper during 2011-12. FMC should keep track of futures price, as regards to monitor whether it is reflecting market fundamentals, domestic as well as international demand and supply.

Similarly, small and medium farmers are unable to participate in futures market due to large contract size and small trade surplus, rigorous trading procedures, and inability to meet quality standards. Small and medium farmers with small trade surplus may need aggregators as facilitators, who can trade on the exchange and pass the price benefits to the farmers.

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