CHAPTER – IV
EVOLUTION OF COMMODITIES MARKET

4.1 INTRODUCTION

Commodity derivatives made their appearance before financial derivatives in the world and also in India. Informal trading in commodity derivatives was there even in ancient India, but the formal market took shape in the late nineteenth century. However, the growth path of the Indian derivative market was not smooth.

4.2 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.

During the Second World War Futures trading was prohibited. However, after independence, the Constitution of India brought the subject of "Stock Exchanges and futures markets" in the Union list. As a result, the responsibility for regulation of commodity futures markets devolved on Govt. of India and in December 1952 Forward Contracts (Regulation) Act, 1952, was enacted.
1. An association recognized by the Government of India on the recommendation of Forward Markets Commission,
2. The Forward Markets Commission (it was set up in September 1953) and
3. The Central Government.

Forward Contracts (Regulation) Rules were notified by the Central Government in July 1954. The Act divides the commodities into 3 categories with reference to extent of regulation, viz:

1. The commodities in which futures trading can be organized under the auspices of recognized association.
2. The Commodities in which futures trading is prohibited.
3. Those commodities, which have neither been regulated for being traded under the recognized association nor prohibited, are referred as Free Commodities and the association organized in such free commodities is required to obtain the Certificate of Registration from the Forward Markets Commission.

The ECA, 1955 gives powers to control production, supply, distribution, etc. of essential commodities for maintaining or increasing g supplies and for securing their equitable distribution and availability at fair prices. Using the powers under the ECA, 1955 various Ministries/Departments of the Central Government have issued control orders for regulating production/distribution/quality aspects/movement etc. pertaining to the commodities which are essential and administered by them.

In the seventies, most of the registered associations became inactive, as futures as well as forward trading in the commodities for which they were registered came to be either suspended or prohibited altogether. The Khusro Committee (June 1980) had recommended reintroduction of futures trading in most of the major commodities. The government, accordingly initiated futures trading in Potato during the latter half of 1980 in quite a few markets in Punjab and Uttar Pradesh. After the introduction of economic
reforms since June 1991, the government of India appointed one more committee on Forward Markets under Chairmanship of Prof. K.N. Kabra in June 1993 and the Committee submitted its report in September 1994. Following this, the government of India has issued notifications on April 1, 2003 permitting futures trading in commodities. Trading in commodity options, however, is still prohibited. The lifting of the 30-year ban on commodity futures trading in India has opened yet another avenue for investors.

4.3 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 growing 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.

MCX has been certified to three ISO contracts on its platform. Standards including ISO 9001:2008 Quality Management System standard, ISO 14001:2004 Environmental Management NCDEX. 8 Headquarters are located in Mumbai and offers facilities to its members from the centers located the Exchange, is on throughout India. February 9, 2012 offered contracts in 34 commodities - comprising 23 agricultural commodities, 6 precious metals, 2 energy, 1 polymer and 2 other metals. The top 5 commodities, in terms of volume trade at the Exchange, were Soya oil, Gaur Seed, Chana, RM NCDEX seed and Guar gum. The country’s second largest commodity derivatives exchange has been listing contracts since the NCDEX ranked number 32nd in 2010 and the Futures Industry Associations global list of top 53 derivatives exchanges measured by volume, rising as of 2011, India’s TOP National Multi-commodity Exchange (NMCE). Commodity exchanges are: ACE Indian Commodity Exchange ICEX. Multi Commodity Exchange (MCX). Derivatives and Commodity Exchange ACE.

4.4 COMMODITIES ALLOWED FOR FUTURES TRADING IN INDIA


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

4.5 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 hands 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 intention 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.

4.6 HISTORICAL PERFORMANCE

Historical data show that the performance of commodities has been quite attractive, though there have also been periods with little returns. Over the last decade, the performance of the commodity benchmark has been in double digits. The downside to this attractive performance is considerable volatility, which has also delivered some high negative returns in recent years. And some commodity markets are relatively small, adding to the volatility profile.

These dynamics make it crucial for the private investor to approach commodities with caution. Nevertheless, it cannot be denied that the high performance has been attracting investors.
There has been a change in the composition of trade. Initially, agricultural commodities dominated the market, bullions occupying the second place. In 2004-05, for instance, 69% of the total volume of trade was in agricultural commodities and rest was bullions and metals. However, the importance of agricultural commodities has decreased sharply in recent years while that of bullions has increased. In 2010-2011, bullions occupied the first position with 45% share followed by metals with 24% and energy with 19%. The share of agricultural commodities in futures trading has come down to the level of 12%.

FIGURE 4.1: SHARE OF COMMODITY GROUPS IN TRADE VOLUME
4.7 TRACKING THE PERFORMANCE OF COMMODITY MARKETS

There are a number of frequently used benchmark indices, all of which track the general performance of the commodity markets. The benchmark for commodity investments for ABN AMRO Research & Strategy is the Thomson Reuters/Jefferies CRB Index (‘the CRB’). Launched in 1957, this is probably the oldest of all commodity indices.

The performance of the CRB index is shown on the right. Though the considerable price appreciation from 1 February 1999 to 31 October 2011 has reached 12.3% per year, it is worth noting the annual volatility in month-on-month returns is also significant: 18.1%.

The CRB index has a stated objective of providing timely and accurate representation of a long-only, broadly diversified investment in commodities through a transparent methodology. It aims to be a liquid and economically relevant benchmark.

The CRB consists of a portfolio of 19 different commodities Future contracts that are replaced or ‘rolled’ according to a standard monthly schedule. As with most indices, the CRB takes Futures that are close to settlement (i.e. at the front of the Futures curve and close to the Spot Price). As a Total Return index, it also earns a collateral yield equal to the 91 day US Treasury Bill. The weight of every commodity in the overall CRB portfolio is reset every month, at the time of the rolling of Futures contracts. These weights are pre-defined and rarely changed, which is unique to the CRB. Other indices adapt their weights more frequently.

The main difference between the various benchmark indices lies in the specific number and weights of individual commodities. The CRP is a highly averaged, well-diversified index. Other indices have an above-average allocation of certain individual commodities. This is the main reason ABN AMRO Research & Strategy has chosen the CRB as its benchmark.
FIGURE 4.2 Thomson Reuters/Jefferies CRB Index (EUR)

FIGURE 4.3 WEIGHTS OF COMMODITIES IN THE CRB INDEX

Sales

Source: Thomson Reuters
4.8 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 hedging, 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.

Pricing of future contracts are directly related to the spot price and expected price of an underlying asset, which here means a commodity. Simply stated the change in spot price will lead the change in gain or loss of future contracts in the same direction. The gain or loss in future contracts will always be linear. The emergence of commodity derivatives has reduced transaction cost as well as enabled risk free trading for producer, investor, and commodity trader and benefited both market participants and non participants.
4.9 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.