

Chapter – VI

The Indian Commodity Derivative Market: A SWOT Analysis

6.1 Introduction

In this study SWOT analysis is used as a strategic appraisal method to evaluate the Strengths, Weaknesses, Opportunities, and Threats in the Indian commodity derivative market. It involves specifying the objective of the Indian commodity derivative market and identifying the internal and external factors that are conducive to towards the achievement of these objective as well as those that are not.

The SWOT analysis is incorporated into the study in terms of the following parameters.

Strengths: characteristics of the Indian commodity derivative market that give it an advantage over others in the industry.

Weaknesses: characteristics that place the Indian commodity derivative at a disadvantage relative to others.

Opportunities: potentialities of advantages that can be harnessed for the benefit of the industry in particular and the economy in general.

Threats: potential constraint and adversities that might adversely affect the Indian commodity derivative market.

Identification of the parameters involved in the exercise is essential because it provides a perspective regarding the positive and negative forces that are expected to affect in the Indian commodity derivative market and in the process facilitate the formulation of a strategy to avoid or to control the threats and to access the potential benefit.

6.2 Strength of the Indian Commodity Derivative Market

6.2.1 Efficient Price Discovery

The operation of the Indian commodity derivative market provides an efficient price discovery mechanism which guides the spot market with respect to pricing. Prices determined in the local spot markets faces a possibility of prices being distorted given the limited numbers of market participants and the confined size of the market. In contrast the prices in the futures market are determined not only by the local demand-supply conditions but also by the global market forces. Besides the pricing is significant influenced by various sets of parameters such as technical appraisal, political developments, exchange rates, weather forecast etc which is incorporated into the price determination mechanism in the commodity derivative market. Under such circumstances the price that is quoted can be regarded as relatively more efficient. Thus the Indian commodity derivative market has a role in facilitating price discovery which goes a long way in achieving a more optimal allocation of resources.

6.2.2 Exporter Promotion

Indian commodity derivative market helps exporters by extending them hedging facility. An exporter who enters into contract with a foreign buyer has to deliver the goods at a later date at a fixed rate. Since it is not economical or possible to buy and stock the goods in advance of delivery, fearing an adverse movement in the prices, he may insure himself by hedging in the futures market. Besides, the existence of quotations for different future delivery periods based on the expert assessment of the anticipated future supply and demand enable the exporters to quote appropriate prices to foreign buyers for future shipments. The Indian exporters who are, thus,

assured of their normal profits are now in a position to trade on small margins which, in turn, increases their competitive capacity in the world market. Futures markets, thus, help to increase foreign exchange earnings by raising the exporter's competitive capacity, and can therefore, be considered as one of the instruments of export promotion.

6.2.3 Benefits to the Farmers

Hedging facilities provided by the Indian commodity derivative market enable those farmers who grow commodities in very large quantities to hold on to their crops or stocks, spread out the sales of such stocks over a period and thereby realize a better average price for their products. The futures market provides to the Indian farmer the opportunity to undertake proper crop planning by giving an advance indication of the expected level of prices of different commodities during the marketing period, at the time of sowing.

The continuous publication of prices of various commodities in the Indian commodity derivative market all over the country ensure a close integration of prices between different centers and even between allied commodities. Farmers, for instance, are in a position to anticipate the future prices of various commodities which enable them to take an informed decision on the crop-mix they would like to grow. Besides given the knowledge of the future market price, the farmer is also empowered to maximize the profits by selling his product at the place and time of his choosing.

6.2.4 Standardized Prices

Local manipulations of commodity prices are extremely difficult due to globalized markets since prices are benchmarked across different countries and continents. Under such circumstances internationally traded commodities in India are traded at international prices. These provide a level playing field for Indian market participants. For example, gold, silver, crude oil, natural gas, refined soybean oil, wheat etc. are international commodities, which are transacted at international prices in India which are indicative of their position in the global market.

6.2.5 Benefits to Buyers

Indian commodity derivative market is useful for the consumer because it provides an indication of the price at which the commodity would be available at a future point of time. Thus that enables the consumers undertake proper costing/financial planning and also cover their purchases for future price wise by entering into derivative contracts.

Corporate entities can be benefit by hedging their risks if they are using some of the commodities as their raw materials. They can hedge the risk even if the commodity traded does not meet their requirements of exact quality/technical specifications.

6.3 Weakness of the Indian Commodity Derivative Market

6.3.1 Small Market Width

Integration of spot and futures market is another critical requirement for growth of commodity futures in India. Spot markets in commodities are spread throughout the breadth and length of the country. There are over 20,000 regulated mandis for assembling of agricultural produce besides lakhs of village fairs, terminal markets and markets in consumer centers. In comparison commodity derivative exchanges are very few in number and located mostly at major cities, with some terminals for trading in selected towns.

It is difficult for each farmer to know the correct price that is prevailing in surrounding spot and futures markets. This problem is deeply related to the lack of modern institutions in the spot and futures markets. If the spot market operated using electronic trading, then there would be full price transparency in real-time. However, at present, the spot market is characterized by weak institutions, bilateral transactions, and an absence of transparency.

The spot market in commodities is controlled to a large extent by the State Governments. There are restrictions on holding of stocks, turnover, and movement of goods. The market is further fragmented by varying duties levied by the different State Governments. This fragments and isolates the commodity spot markets and impedes the commodity futures market from reaching the market players outside the boundaries of the states, or zones in which the exchanges are located. If standardization of policies across state is not brought into place then it would act as an impediment to the smooth development of the nationwide commodity derivative markets.

6.3.2. Absence of Commodity Options

In India, trading in commodity options contracts has been banned since 1952. The market for commodity derivatives cannot be called complete without the presence of this important derivative instrument. Like futures, options are also financial instruments used for hedging and speculation. The commodity option holder has the right, but not the obligation to buy or sell a specific quantity of a commodity at a specified price or before a specified date. Option contracts involve two parties; the seller of the option writes the option in favour of the buyer (holder) who pays a certain premium to the seller as a price for the option. The option holders will exercise the option only if it is beneficial to him, otherwise he will let the option lapse. Option trading helps in hedging the price risk and also provide investment opportunity to speculators who are willing to assume risk for a possible return. Further, such trading ensuing in price discovery can help farmers in deciding which crop to grow. Thus options markets perform important functions that cannot be ignored in the modern Indian commodity derivative market.

6.3.3 Inadequate Warehousing System

For Indian commodity derivatives market to work efficiently, it is necessary to have a sophisticated, cost-effective, reliable and convenient warehousing system in the country. The Habibullah task force (Government of India, 2003) had admitted that a sophisticated warehousing industry has yet to come about in the Indian economy. Further, independent laboratory or quality testing centers should be set up in each region to certify the quality, grade and quantity of commodities so that they are appropriately standardized and there are no shocks waiting for the ultimate buyer who takes the physical delivery. Warehouses also need to be conveniently located. Central Warehousing Corporation of India (CWC) is operating 500 Warehouses across the

country with a storage capacity of 10.4 million tonnes. This is obviously not adequate for a vast country like India. To resolve the problem, Rural Warehouses (Gramin Bhandaran Yojana) across the country with more storage capacity should be set up to construct new and expand the existing rural godowns. Large scale privatization of state warehouses is also being examined.

6.3.4 Inadequate Holding Period

In commodity derivative trading there is a limited time period for squaring off given position. In Indian commodity derivative trading a client can hold his position up to maximum of 3 months.

6.3.5 Inefficient Grading System

Indian commodity derivative future contract is defined as a legal agreement to buy or to sell a given quantity of a commodity of certain quality at a specified price at the time when the contract is executed. A commodity whose quality is subjective or depends on individual taste will not be easy to grade, and hence it will not be suitable for futures trading. For example tea is a commodity which exhibit huge quality variation because of which a tea futures contracts becomes unviable. Subsequently successful commodity derivative trading in tea is highly unlikely in the Indian economy.

Grading effectiveness measures products in terms of their quality. Alternatively, products could have been measured in terms of time, space, and form. If a commodity is not effectively graded, basic risk will be high and standards of delivery will be hard to establish. Hence the absence of an efficient and adequate system of trading can be construed to be a weakness of the system.

6.3.6 Mutualised Regional Exchanges

Most of the regional commodity exchanges in India are mutual organizations. They are promoted by traders who carry out trading as well as manage the exchanges. The exchange staffs including the chief executive officer/secretary are the employees of the promoters. This structure poses a serious threat to the integrity of exchanges as there is obvious conflict of interest. The structure needs to be altered so as to ensure an effective separation between those who promote and manage the exchange and those who trade in them. This limitation of the Indian commodity derivative exchanges is evident when the leading exchanges in the world like Chicago Mercantile Exchange, International Petroleum Exchange, and New York Mercantile Exchange, etc, are observed to be demutualised organizations where effective separation of management and trading is maintained.

6.3.7 Inadequate Liquidity

In India several commodities registered in derivative exchanges suffer from a lack of liquidity. This is because in many instances Commodities have been selected for futures trading without any assessment of the demand for them. As a result the futures contracts are either too narrow with just a few deliverable varieties and delivery centers or too broad covering divergent varieties deliverable at far too many centers throughout the length and breadth of the country. In narrow contracts, fear of manipulation looms large, apart from the fact that such contracts in most cases are settled electronically rather than physically. Broad contracts in turn create considerable uncertainty which results in a distortion in the spot and futures prices, to the detriment of the risk management strategies. In either event most of the physical market participants shy away from such contracts.

6.3.8 Non Autonomous Regulator

To provide a developmental thrust, the existing Indian commodity derivative market needs a regulator with leadership, vision, capabilities, resources and empowerment. At present, most of the regulatory powers in respect of the commodity derivative markets are vested with the Central Government, and the Forward Markets Commission exercises the delegated powers or plays a recommendatory role. Forward Markets Commission continues to be a subordinate office of the Government department and has no autonomy to garner resources like human, financial and infrastructural to discharge the responsibility expected of a regulator in the dramatically changed environment. The securities market had also faced a similar situation when it was liberalized in the early nineties. Establishment of an independent regulator with adequate resources and empowerment changed the very face of the market, though the path was not smooth and episode-free. Nevertheless, the regulator was able to respond to the challenges of the market. In this context, it is important to consider either a similar step for strengthening and restructuring the Forward Markets Commission, or to institutionalize some form of coordination or convergence with the Security Regulator, whose functions in respect of securities' derivatives have a lot in common with the functions of the Indian commodity derivatives regulator.

6.3.9 Restrictions of Institutional Investors

One of the most important functions of the commodity derivative market is risk transfer. However the prohibition of institutional participation in the Indian commodity derivative market forces the big corporate hedgers to access foreign derivative market for the hedging requirement. For example if Sterlite wants to hedge 100,000 tonnes of copper, it does not find enough buyers in the Indian exchanges (i.e.

MCX, NCDX etc) because the government does not allow institutional players who have the capacity to take the risk and retail it. So Sterlite goes to the London Metal Exchange where its open order gets exhausted in just one trade. Even if big players like Reliance Fresh or Cargill are allowed to enter then also they cannot hedge even a fraction of their needs because of the low volumes of the markets. Thus big institutional players are prevented from participating in the derivative commodity market and even if this restriction is removed the limited size of the market would not allowed the absorption of such a magnitude of risk.

6.3.10 Inaccessible Trading Parameters

The terms and conditions of contracts play a crucial role in the growth and development of trading in any exchange. They should be market friendly in the sense that the terms are affordable to small traders along with the larger traders. Besides these terms and conditions need to be attractive to all prospective beneficiaries of futures trading including growers, processors, merchandisers, consumers, etc. However, the contract specifications (Table-22) in many Indian exchanges are prohibitive to smaller traders which make the market non-inclusive. Thus for instance the lot-size⁵ of cotton contract in East India Cotton Association (EICA) is 55 bales which is equivalent to nearly 10 tonnes of cotton. Similarly, for pepper the pepper exchange, Cochin permits trading at a lot-size of is 2.5 tonnes with 15 tonnes as deliverable quantity. Such enormous lot-size automatically excludes the small traders from the derivative trade from such commodities. Many such example are illustrated

⁵ A measure or quantity increment acceptable to or specified by the party offering to buy or sell. Used also as an alternative term for lot quantity.

in the following table with reveals the exclusive nature of the Indian commodity derivative market.

Table-22: Important Specifications of Futures Contracts

Commodity / Exchange	Contract unit and lot size (LS)	Maximum Price Fluctuation in any Trading Day		Initial Margin (IM)/Variation Margin (VM)	IM Liability for one lot	Clearing	Contracts 1 (Duration in Months)
		A price change of	Result in profit/loss per contract unit				
Cotton: East India Cotton Association, Mumbai	55 bales (93.5 quintals) LS: 55 bales	Rs 150 per 100 kg	Rs 14,025	IM: Rs 10,000 per unit over and above the free limit of 300 units. VM: 2.5 to 7.5 per cent of BMP depending on variation in the BMP2	Rs 10,000	Daily at settlement price	Dec (7), Feb (7) Apr (6), June (5) Sep (6)
Coffee: Coffee Futures Exchange, Bangalore	1,000/600 kgs for raw/processed coffee LS: 1,000/600 kgs	Rs 3/1.50 per Kg for Plantation A/RC AB, Rs 125/Rs 60 per bag of 50 kg for Arabica/Robes Chery	Rs 1,800 for Plantation A and Rs 900 for RB AB Rs 2,500/Rs 1,200 for Arabica/Robes Chery	IM: Rs 6 per Kilo for Plantation A, and Rs 3 per kilo for Robesta Chery AB	Rs 3,600 for Plantation A (Rs 1,800 for Robesta Chery AB)	Daily at settlement price	Jan, Mar, May, July, Sep and Nov 18 months)
Gur: The Chamber of Commerce, Hapur	4,000 kg (40 quintals) LS: 4,000 kg (40 quintals)	Rs 30 per quintal over the clearing rate on the last day of the previous week	Rs 1,200	IM: Rs 500 per unit up to 100 units and Rs 600 for each unit above 100 units VM: 2 to 4 per cent of the BMP depending on variation in the BMP3	Rs 500	Daily at settlement price	Mar (4), May (3), July (3), Dec (6)

Potato, The Chamber of Commerce, Hapur	4,000 kg (40 quintals) LS: 4,000 kg (40 quintals)	Rs 20 per quintal over the clearing rate on the last day of the previous week	Rs 800	IM: Rs 500 per unit up to 100 units and Rs 600 for each unit for above 100 units VM: 2 to 4 per cent of the BMP depending on variation in the BMP3	Rs 500	Daily at settlement price	Mar (6), July (5), Oct (4)
Mustard Seed; The Kanpur Commodity Exchange, Kanpur	2 metric tonnes LS: 2 metric tonnes	Rs 65 per 100 kg	Rs 1,300	IM: Rs 1.5 per cent per unit for net open position ranging between 6-250 and 2.5 per cent for 251.500 VM: 2 per cent of the BMP if closing price rises/falls by more than 10 per cent of BMP and 4 per cent if it is more than 15 per cent	1.5 per cent of the value of contract	Daily clearing	May (6), July (4), Oct (4), Jan (9)
The Bombay Commodity Exchange, Mumbai	1 metric tonne LS: 1 metric tonne	4 per cent of the OCP4 of the previous day	Depends on the closing day	IM: No margin if Gross Exposure $5 < \text{Rs } 10 \text{ lakh}$, 1.5 per cent for Rs 10- 50 lakh, Rs 0.6 lakh +3 per cent of the GE in excess of Rs 50 lakh Delivery period margin: 10 per cent if the GE $< \text{Rs } 50 \text{ lakh}$, Rs 5 lakh + 20 per cent if the GE $> \text{Rs } 50 \text{ lakh}$	Varies depending on the value of contract	Daily at official closing price	Feb, Apr, June, Aug, Oct and Dec 6 (6 months)

Pepper Exchange, Cochin ⁸	2.5 metric tonnes LS: 2.5 MT and 15 MT as deliverable quantity	US\$ 125 per tonne for international contracts and Rs 600 per quintal for domestic contracts	US\$ 312.50 and Rs 15,000 for international and domestic contracts respectively	IM: US\$ 125 and 375 per tonne respectively for net open position up to 150 and from 151 to 225 tonnes Rs 1,200, 1,600, 2,000 and Rs 2,800 per quintal for net open position up to 100, 150, 200 and above 200 tonnes respectively SM: 10, 20 and 30 per cent respectively of the BMP ⁷ if it increases >20 per cent, >30 per cent and >40 per cent	US\$ 312.50 for international contract and Rs 30,000 for domestic contract	Daily clearing and settlement	For all 12 months in an year (6 months)
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Notes: IM and SM represent initial margin and special margin respectively. Price limit and margins vary from time to time.

1. Delivery month of the contract.
2. Bench Mark Price is the average of the opening, highest, lowest and the closing prices of the first three trading days of commencement month of any contract.
3. Bench Mark Price is arrived at by taking the average of the opening, highest, lowest and closing prices of the commencement day of trading of any contract.
4. The official closing price (OCP) is the weighted average price of the trades executed during the last 30 minutes of the trading session.
5. Gross Exposure (GE) means the sum total of net outstanding position.
6. Delivery month relating to international castor oil contracts and all other specifications are common for all commodities traded in Bombay Commodity Exchange.
7. The Bench Mark Price (BMP) is determined by taking the weighted average of the transacted price of all the contracts traded on the first five days of the contract.

Source: Bye-Laws of the respective exchanges.

6.4 Opportunities of the Indian Commodity Derivative Market

6.4.1 Tax Reforms

In the past, speculative and non-speculative businesses in India were treated equally for taxation so far as right to set off or carry forward of loss was concerned. However over the years various forms of tax benefit were extended to other financial assets as well as markets in the Indian financial system. Such incentives were not extended to the Indian commodity derivative market which subsequently was placed at a disadvantage. In this context, the Indian commodity derivative market has been demanding amendments in the tax law correcting this discrepancy which stands in the way of growth of futures trading activities.

Besides the stamp duty provisions on futures trading make the transaction cost higher and moreover, the rates vary from one state to the other. While states like Gujarat, Madhya Pradesh, and Kerala do not impose stamp duty on futures trading, some other states like Maharashtra impose stamp duty on futures trading of certain commodities.

There are at present restrictions on the movement of certain goods from one state to another. These need to be removed so that a truly national market could develop for physical trade as well as for derivative trades on commodities. Besides such an integrated market also requires uniformity in octroi and sales taxes etc, which can be only brought through regulatory changes. Value Added Tax (VAT) has been introduced in the country in 2005, to resolve this problem which however has not been uniformly implemented by all states.

The dichotomy is evident when one considers the commodity derivative market with falls within the purview of the Central government and the physical market which is largely regulated by the state government. Thus two tier of government controlling

two components of the same market using their respective fiscal instrument work against the stated aim of market integration of the derivative and spot market. Coordination of operation of the two tier of government with respect to fiscal intervention can result in reduction cost and time. Besides the inconvenience, inefficiency and inequity of the multiple taxation can be avoided.

6.4.2 Banks Entry

The Banking Regulation Act, 1949 prohibits banks from trading in the Indian commodity derivative market although most of the banks in developed countries are active participants in their commodity derivative markets. Barring banks from entering the derivative market prevents them from fully engaging in the agricultural economy. This is because banks, if permitted to function in commodity derivative market can administer greater credit accommodation in both the farm and non-farm sector by hedging against price fluctuations in agricultural collateral through derivative instruments and hence avoid non-performing asset.

Similarly greater bank participation can be ensured in others sectors on the basis of the similar logic.

Besides direct participation of banks in commodity derivative trading will imparts huge liquidity to the derivative market besides expanding market breath. This will also provide them an opportunity for speculative investment which can significantly enhance their profitability.

Banks are already providing advisory services to their high net-worth customers. While lending to customers, banks, as per their credit policy, makes an appraisal of the credit worthiness of the borrower. In case the borrower is from the commodity sector, he has an exposure/associated risk on the underlying commodities. The

concerned bank can ask the borrower to either hedge his position on a commodity exchange or have a process of directly hedging the underlying credit exposure himself.

A bank's vast network of branches across the country can act as additional information dissemination centers for spot and futures prices of commodities and other related information. This can greatly facilitate the financial inclusion and general awareness process and empowerment of farmers. Commodity price information in this mode will also likely attract target customers to avail of other banking products, especially agriculture-related products such as crop loan, land development loan, tractor loan and so on. Banks can also mobilize the savings accounts of these customers with their relevant products and services under their financial inclusion agenda.

6.4.3 Market Integration

Withdrawal of prohibition on future trading on all commodities in April 2003 has opened up new opportunities and challenges for the Indian commodity derivative market. Subsequently existing infrastructure and institutions are being upgraded; new exchanges have been approved with the mandate to set up world-class infrastructure and systems; more participants with resources, skills and expertise are being attracted from the other derivative markets.

This sudden jump in the growth rate can be given a further fillip if the market participation is extended to include all segments of derivative products like insurance, mutual fund, securities, banking, by way of integration. Such market integration has the potential to provide a massive growth impetus to the commodity derivative market which also extend to other entities that are included into the integrated system. This is

perceivable on the assumption that such integration would enable all these entities, which otherwise are functioning independently, to pool both their human, physical, and financial resources and in the process generate a synergy that could have a multiplier effect.

6.4.4 Commodity Derivative Market in the Global Meltdown

Commodity exchanges the world over, including those in India, had surprisingly registering record turnovers during the 2007-08 global financial meltdown that brought the world economy into its knees. The Indian commodity derivative market also exhibited amazing resilience and steadfastness during that period, despite the initial setbacks in base metals and energy. In contrast there was extensive recession in both financial and real sector across the global economy which virtually left the commodity derivative unaffected.

In the post recession era commodities have emerged as a new asset class for safe and secured investments. Subsequently investments have showed a trend to flow from traditional asset classes to commodity derivatives in the absence of alternative secure avenues of investments. The investment which have redirected from hedge funds, pension funds, index funds, sovereign funds, endowments, banks, and other institutional investments into commodity derivative exchanges present a new era of unbounded opportunities which augur well for the future.

6.5 Threats of the Indian Commodity Derivative Market

6.5.1 Government Intervention

Most government intervention in the Indian commodity derivative market is undertaken to achieve the greater policy goals of the economy. These goals may be economic such as export promotion, price stabilization, and protection of the domestic consumers. However when interventions distort the supply and demand fundamentals or interfere with consumer choices then such steps are detrimental for the economy.

On January 23, 2007, after more than three years of sustain effort to develop Indian commodity derivative, the FMC banned trading in red gram, black gram, wheat and rice because of perceived excessive speculation and subsequent inflation in food grain prices. In the following year the FMC extended the ban to chickpeas, soybean oil, rubber and potato markets on the basis of the same rationale.

Markets are adversely affected when arbitrary regulatory measures are taken without prior warning and discussion with all the stakeholders. Such unwarranted intervention undertaking without any substantive basis inhibit trading on active contract markets in which market participants fear a similar step. While it is extremely difficult to quantify the costs involved in such market interventions however such step do involve significant cost both in terms of financial loss and erosion of confidence. The government has historically undertaken price controls, price supports, buffer stocks, crop insurance, credit controls and external trade restrictions as instruments of maintaining price stability. However by interfering with the working of the commodity derivative market to maintain price stability in commodities the government renders ineffective a system which inherently leads to price discovery and establishment of price that is reflective of the scarcity value of the commodity. The commodity derivative market provides all market participants with the same

information on future price trends leading to a more efficient discovery of the present price. In addition, arbitrage activities reconcile differentials between future and present prices. Hence by suspending the free functioning of such a market the government unwittingly neutralizes a potential tool for managing price volatility.

6.5.2 Declines Volumes of Agricultural Commodities

The ban on trading of specific commodities in the commodity derivative market has had serious consequences for the market. This is evident in the significant decline in the volumes of Indian commodity derivative trade in agricultural commodities. Thus during 2007- 08, it fell by 28.5 percent and the downward trend continued in 2008-09 as well. And a major part of this fall in the trade volumes of agricultural commodities was accounted for by ban on future trade on commodities like chickpeas, maize, mentha oil, guar seed, potato, guar gum, chilly and cardamom, which accounted for 57.9 percent of total futures trade in agricultural commodities in 2006-07.

The share of agricultural commodities almost halved during 2008-09, when the ban on futures trading was extended in to include wheat, rice, black gram, red gram, chickpeas, potato, rubber and refined soybean oil. This is despite the fact that the Abhijit Sen committee (Ministry of Consumer Affairs, Food & Public Distribution, 2008) found no direct link between the price rise and futures trading. The committee also endorses the finding of this study which could not conclusively find a positive correlation between future commodity trade and commodity prices.

6.5.3 Excessive Speculation

Over the years commodity inflation was explained in terms of weak dollar, strong overseas demand, rising oil prices etc. In recent years commodity speculators were also identified as culprit causing rising in commodity prices.

The inherent basis of derivative market is speculation. Hence excessive speculation in the commodity derivative market can lead to price inflation in the commodity spot market causing great disruption and pain in the economy. Although the findings of this study is not conclusive regarding the inflationary effects of commodity derivative trading however existing literature points out the danger of inflation emanating from this form of trading. Hence this can be construed as a demerit of this system.

6.5.4 Unfair Trading Practices

The grey/black market in India, which existed outside the exchange premises during the ban on futures trading for over 30 years, still continues to exist even inside the exchanges. It has been widely believed that at least 25-30 per cent trade in the exchanges go unreported. The unofficial market operating outside the official exchange is much larger. These unofficial traders find the margin, stamp duty, and income tax requirements very constraining which acts as a disincentive for them to come to the formal commodity derivative market. Besides commodity derivative exchanges like any other exchanges always exposed to insiders trading which is an inherent weakness of both stock and commodity exchanges. The parallel commodity derivative market which is operating without any regulations or accountability poses a big threat to the creditability of Indian commodity derivative market which needs to be addressed most urgently.

6.5.5 Non-existent Credit Guarantee Institutions

Another important threat to the Indian commodity derivative market is the non-existence of any form of credit guarantee fund. This implies that there are strong possibilities of default and bankruptcy if existing brokerage and even clearing houses are exposed to market shocks. Thus if a brokerage firm goes bankrupt with net

obligations of Rs.1 billion, this legal obligation is automatically transferred to clearing corporation who now is legally obliged to meet these obligations, or go bankrupt itself. The absence of credit guarantee fund implies that there is no third alternative. Thus the absence of an institutional framework to protect brokerage and clearing houses from going bankrupt constitutes another threat to the commodity derivative market.