

# **Chapter – VII**

## **Summary of the Findings and Conclusion**

## **7.1 Introduction**

The study seeks to undertake a historical review of the development of Indian commodity derivative market. Besides it analyses the working of the Indian Commodity Derivative market, on the basis of which the impact of current policy intervention on the commodity derivative market is evaluated and potential effects of possible future state policies assessed.

Two core issues are sought to be address by the research questions-

- Does commodity derivative trading result in greater price parity between spot and futures markets?
- Would an integration of commodity derivative market and capital market result in more optimal functioning of the two markets?

## **7.2 Summary of the Findings and Recommendation**

### **The historical review of the Indian commodity derivative market:**

Futures trading in commodities have a long tradition in India going back to 1875 when the Bombay Cotton Trade Association was set up. The organized formal regulation of these markets started in Bombay following a central legislation entitled, Forward Contract (Regulation) Act, 1952.

There has been an exponential growth in futures trading after complete liberalization of industry in 2003 and with the setting up of three national level exchanges (i.e. - NMCE, NCDX and MCX). Agricultural commodities constituted a significant proportion of total value of trade till 2005-06. However their postions as a market

leader were overtaken by Bullion and other Metals in 2006-07. Further, there has been a gradual fall in agriculture commodity volumes during 2007-08 in comparison to the previous year because of negative sentiments that was generated by the decision to de-list futures trade in some important agricultural commodities.

The Forward Contract (Regulation) Act passed in 1952 does not offer any major power to Forward Market Commission. These vest solely with the central government which can act even independently without consulting the FMC. As FMC does not wield any worthwhile statutory powers, it functions at present as a subordinate unit of the department of consumer affairs in the ministry of food and agriculture of the government of India. The need of the hour for the development of the commodity derivative market is a new and innovative law, which should replace the age-old Forward Contract (Regulation) Act. The new act should provide for an independent and autonomous statutory Forward Market Commission to serve the price discovery and risk management functions of the commodity derivative market effectively and efficiently. In keeping with the importance of the commission the chairman should be accorded a status which is benefiting of the national importance of the body. The members of the commission need to be professionals who are specialist in the operation of the commodity derivative market. These steps will strengthen the status of the commission as an independent and autonomous entity which would go a long way in enhancing the quality of administration of the commodity derivative market.

**Market distortion and asymmetrical information in the Indian commodity derivative market:**

The development of commodities derivatives markets is impeded on account of some of the market distorting policies administered in the physical markets. These policies include Minimum Support Price, Monopoly Procurement Scheme, Black Marketing Act, Differential Sales Tax, Differential Stamp Duties and entry taxes and permits imposed by various State Governments. These market distorting and fragmenting

policies causes serious impairment to the free and efficient working of the market economy, and hence needs to be reviewed and corrected. A key weakness of the existing framework of commodity markets in India is the presence great asymmetry in market information. Under most circumstances individual farmer are ignorant of the market price in the neighboring spot and futures markets. This problem is aggravated by the lack of modern institutions in both spot and futures markets. Using electronic trading in spot market operations would ensure price transparency in real-time and thus removed information asymmetry. The setting up of National Spot Electronic Exchanges by the National Commodity Exchanges is an attempt to create a national integrated market. The Legal and regulatory hurdles in setting up and functioning of these commodity market institutions must be removed in order to overcome the weakness of the Indian commodity derivative market as well as spot market which is characterized by weak institutions, bilateral transactions, and an absence of transparency.

#### **The globalization on Indian commodity derivative exchanges:**

After the Indian economy embarked upon the process of liberalization and globalization in 1990, the Government of India has assigned international status to two existing exchanges viz., India Pepper and Spices Trade Association (IPSTA) Kochi and the Bombay Commodity Exchange (BCE) Limited, Mumbai to deal in international futures derivative contracts in black pepper and castor oil respectively.

However these international exchanges in the Indian commodity derivative market were not been able to globalize properly as they were unable to attract adequate number of overseas traders or even the existing domestic players, despite ten years of existence. Exposure to exchange rate fluctuations inhibits domestic traders from foraying into the international segment. Besides absence of demutualization, also poses a serious question regarding the integrity of exchanges with reference to conflict of interest.

Besides it was demonstrated in the case of gold that Indian and international commodity derivative prices are highly correlated. In fact it was revealed that 53.4 percent of the variation in Indian gold derivative prices can be accounted by corresponding changes in the international prices.

#### **Selective ban on commodity derivative trading:**

High inflation in 2007-08, led to a close scrutiny into the functioning of commodity derivative market. Acting on the premise that speculation in commodity derivative market was inducing steep price rise in agriculture commodities, the government ordered delisting of futures contracts in red gram, black gram, chickpeas, wheat, rice, potato, refined soybean oil, and rubber. The government justified their action on the argument that futures trading in commodities lead to higher inflation as speculators drive the prices up beyond the true value. The ban resulted in a huge loss of trading volumes for the commodity derivative exchanges, but did not have any significant impact on food prices. It is widely argued that rising inflation rate can be attributed to a number of factors, including supply side constraint, the global rise in prices of food and oil, the diversion of land for bio-fuel production, loose monetary policy in emerging economies, and the adoption of an expansionary fiscal policy by the Government. Hence restricting derivative trading in agricultural commodities must be done only after substantive evidence of its inflationary character is gathered and tested for authentication.

This study tested the impact of future prices of commodities on spot prices for gold, refined soybean oil, wheat and rubber. The test revealed that the future price significantly affects the spot price in case of gold, wheat and rubber. However in the case of refined soybean oil there is no evidence of any significant impact. This implies that empirical evidence in this study generally endorses the view that rising future prices has a tendency to inflate the market price. But it must be pointed out that future prices have different impact on spot prices of different commodities.

Hence a general ban on commodity derivative trading without looking into unique response of individual commodities to the future market can be construed to be unjustified.

**Proposed Commodity Transaction tax on Indian derivative trading:**

The Government of India's proposed commodity transaction tax on futures trading at the rate of 0.017 percent of the value of transaction in budget 2008-09 to generate government revenues, achieve neutrality in government taxation policy between the commodity derivative market and capital market, and to contain price rise and market volatility. The benefits of CTT are likely to be outweighed by its potential costs because it entails a rise of total transaction cost from Rs.2.00 per lakh to Rs.19.25 per lakh, which is a colossal 950 percent increase. This would make the Indian commodity derivative exchanges uncompetitive with a transaction cost which is way above the international exchanges. This would drive away investors to the international exchanges or make them go underground into illegal trading (dabba trading) where traders settle their transaction on exchange prices without paying any margins or taxes.

**Warehouse Receipt as an instrument for financing:**

One of the important aspects of the Indian commodity derivative market is the introduction of warehouse receipts (WRS) as an alternative solution for market participants to access short-term finance. The concepts of the WRS system is based on warehouse receipts which can be used as collateral for accessing finance. The system is made more sophisticated by adopting measures such as grading of commodities according to their quality, rating warehouses according to their size, reputation and integrity etc.

In India receipts issued by Central / State Warehouses are accepted as collateral by banks however those issued by private warehouses are not. Since farmers / traders

will not deposit their goods with a warehouse whose receipts are not financed by banks viability of the private warehouse is at stake. Hence there is scope for expanding the warehousing infrastructure and also WRS system by making it mandatory for the banks to endorse private WRS.

#### **Integration of commodity derivative and capital market:**

In India there is a clear-cut demarcation between the commodity derivative market and the security market, where each market is expected to function independently of one another. However with the impressive growth in the commodity derivative market , especially after 2003, there were growing demands for integration of the two markets, which the proponents claim , would enable both the markets to benefit from economies of scale and also from the synergy generated.

The participation of intermediaries like securities brokers in the commodity futures market is expected to increase the number of quality players, introduce healthy competition, and boost trading volumes. These in turn would provide more liquidity and give greater impetus to the overall growth of the commodity market. Similar benefits are expected to accrue to the securities market if the commodity derivative brokers are allowed to participate in it. Sizeable investment has gone into building India's securities infrastructure. The existing infrastructure in security market, if thrown open to commodity derivative trading, can reap great returns at very low incremental cost. Conversely, the viability of the new multi-commodity exchanges would be enhanced if they could trade derivatives on all underlings.

The integration of the security market and the commodity derivative market is objected to in apprehension of regulatory overlap. However at present, stock exchanges (NSE/BSE) were already operating successfully in more than one market (e.g., cash market, derivatives market, wholesale debt market) on a single platform. As these stock exchanges have achieved necessary segregation of the markets which

ensure adequate risk containment, it is argued that the existing arrangement could be expanded to include the commodity market too.

Though derivatives in commodities resemble securities derivatives and provide many of the same economic functions, there are some major differences. These differences may act as a constraint to the effective integration of the two markets.

A specially constituted task force has identified many legal and regulatory hurdles (Government of India, 2003) in the way of convergence of securities and commodities markets. In recognition to their independent identity and operation, there are two separate Acts viz. Forward Contract (Regulation) Act 1952 and Security Contract (Regulation) Act, 1956 for governing the two markets.

The pace and sequence of integration of markets should ideally be left to the dynamic market forces. International experience shows that markets are converging not only across products but also geographically. Efficiency considerations are forcing markets to converge, as national and regional markets are increasingly exposed to the forces of globalization. Hence the issue that needs resolution is not whether there should be convergence of the capital and commodity derivative market, but how to achieve and reap its benefits with minimal costs.

### 7.3 Conclusion

Commodity derivative trading reduces market risk by facilitating hedging and in the process induces market participants to hold on to underlying commodities. Besides leading to price discovery, commodity derivative trading induces price parity between the spot and the future market.

However the development of the commodity derivative market had historically been constraint by restrictive intervention by the state. After a nearly thirty eight years ban was revoked by the liberalization process, the Indian commodity derivative market exhibited a remarkable upsurge. But a partial ban on selected commodities was imposed in the Indian commodity derivative market on the plea that it encourages speculation leading to price inflation in the spot market. This study conclude that although future prices of commodities do induce inflation in the spot market, however the effects of the commodity derivative market on spot prices varies from commodity to commodity. Hence a blanket ban on derivative trading on all commodities without evaluating each commodity individually is unjustified and inefficient as this could result in the expansion of the parallel illegal market or could induce the stakeholders to shift to overseas market.

There has been considerable debate on the proposed commodity transaction tax (CTT) in the commodity derivative market. While the CTT was proposed to generate revenues and discourage speculative trading, however the benefits are likely to be outweighed by its potential costs because it would increase the cost of capital and reduce market liquidity. Empirical evidence suggests that when a government levies or increases transaction tax on domestic markets, investors shift their trading to overseas markets. Consequently the prime beneficiaries of India's proposed transaction tax on commodity futures trading will likely be India's economic competitors, like China, Taiwan, Malaysia, and Singapore, all which have growing

commodity futures markets. Hence the imposition of proposed CTT poses a real danger of India's foreign competitors appropriating the jobs, wealth, and foreign investment that would have otherwise resulted in the countries. Unless India learns from history it may lose to China or Singapore what Germany lost to England.

Again, Warehouse Receipts (WRS) can greatly facilitate financing of agriculture as it could serve as highly credible collateral for agricultural credit. Hence the widespread acceptability and faith in the integrity of WRS based system is essential for modernization of agricultural financing. The importance of WRS stems from the fact that it can provide surplus-producing farmers (including smallholders) with a market window which can help them secure the best possible deal, by allowing them to deal directly with downstream buyers and financiers, and overcome asymmetric power relationships within the market chain. Farmers (or groups of farmers) can overcome various embedded market constraints by depositing their crops in a warehouse that dries, cleans and grades them according to established standards, and holds them until they wish to sell. WRS issued against the stock can be used by the farmers to access agricultural credit.

However the popularity of WRS is limited by State intervention in agricultural where procurement at minimum support price acts as a disincentive for the private storage industry as it ignores price variations over time or in different regions to allow for profitable storage.

A more extensive use of WRS can be induced by endorsement of private WRS by the banking system and reductions in margins to 10-20 percent if the issues regarding quality & grade and ease of disposing the stocks in case of default are resolved.

After the Indian economy embarked upon the process of liberalization and globalization in 1990, the Forward Market Commission (FMC) up graded two existing exchanges, namely, India Pepper and Spices Trade Association (IPSTA)

Kochi and the Bombay Commodity Exchange (BCE) Limited, Mumbai to international status for dealing with highly export oriented commodities pepper and castor oil respectively. IPSTA as an exchange has all the potential to be a major international marketplace for pepper derivatives as it is the only exchange in the world engaged in trading of derivative, exclusively in pepper. Moreover Kerala being the largest producer of pepper in around in India (around 95 percent) and Cochin being the port city where majority of pepper exporters are operating, IPSTA can have a legitimate aspiration of emerging as a major international market.

In India there is a clear-cut demarcation between the commodity derivative market and the security market, where each market is expected to function independently of one another. However with the impressive growth in the commodity derivative market, especially after 2003, there were growing demands for integration of the two markets, which the proponents claim, would enable both the markets to benefit from economies of scale and also from the synergy generated.

However the integration of the two markets has a potential of increasing the number of quality players, introduce healthy competition, and boost trading volumes. This in turn would provide more liquidity and give a greater impetus to the overall growth of both the market.

The integration of the security market and the commodity derivative market is objected to in apprehension of regulatory overlap. However at present, stock exchanges (NSE/BSE) were already operating successfully in more than one markets (e.g., cash market, derivatives market, wholesale debt market) on a single platform and hence the apprehension of regulatory overlap can easily be overcome by adopting appropriate safeguards.

The integration approach offers the possibility of a market-based mechanism through which informal trading can be curbed. If the legal markets are able to adapt onto sophisticated, liquid, low-cost platforms, then this would spontaneously pull parallel users into their fold.

So far as timing of convergence of commodity and capital markets are concerned, the pace of convergence should ideally be left to the dynamic market forces. International experience indicates that markets are converging, not only across products but also spatially. This convergence is induced by possibilities of accessing economies of scale and also because of the viability of integration, made possible by new technology.