Vested interests and bureaucratic inertia have left India's rich history in commodities trading with a bungled present and a fractured future

EXECUTIVE SUMMARY

- Speculators abound in the futures market while real users — farmers and corporate hedgers — are few
- Banks, foreign corporates and financial institutions must be allowed to trade directly to add depth to the commodity futures market

WHEN MINESH SHAH bought jeera futures in the National Commodity & Derivatives Exchange (NCDEX) last May, he expected to protect himself against rising prices of the spice. To his horror, he found himself foisted with heaps of low-quality jeera instead. "It was nothing but dust!" he says. Shah refused to take delivery; NCDEX, he claims, is yet to address his complaint that sellers stranded him with old stock.

"There is a conspiracy in the commodities market. Nothing else can explain the current status," says Jignesh Shah, chief executive officer and managing director of Mumbai-headquartered Multi Commodity Exchange of India (MCX), which has the highest turnover among the three national commodity exchanges. This statement, from a man who is always subdued in public forums, is an indication of a deepening crisis of credibility in the commodities market.

Unjha jeera, from Unjha in Gujarat, has a shelf life of six months. Minesh Shah alleges the market knew of the stock's bad quality: the near-month futures (contracts that expire in the ensuing month) were trading at a sharp discount to spot prices. Normally, as the date of delivery nears, the future price converges with the spot price. Speculators, Shah insists, knew all along that they could buy cheap in the futures market, sell in the spot market, and profit despite the product's poor quality.

It's not just jeera. In the past three years, investor confidence in NCDEX has eroded with delivery problems in chilli, tur, urad and guar seed as well. In 2007, futures trading in NCDEX dropped a whopping 60 per cent to Rs 7.75 lakh crore, down from Rs 12.43 lakh crore in 2006. NCDEX has an 85 per cent market share in futures trading in agri-commodities.

There are several key reasons for this downslide. The Forward Markets Commission (FMC), regulator for the commodities derivatives market, is poorly equipped and tends to micro-manage. For instance, it arbitrarily hikes margins for members and, at times, reduces open interest positions of near-month futures. "How will corporate hedgers function?" asks Harendra Kumar, head of research at ICICI Direct.com, a large commodities broker.

Should big players such as Reliance Fresh or Cargill enter the market, they are permitted such low volumes that they cannot hedge even a fraction of their needs. "The very existence of the market becomes meaningless," says Jayant Manglik, head of commodities research at Religare Securities, the largest retail broker.

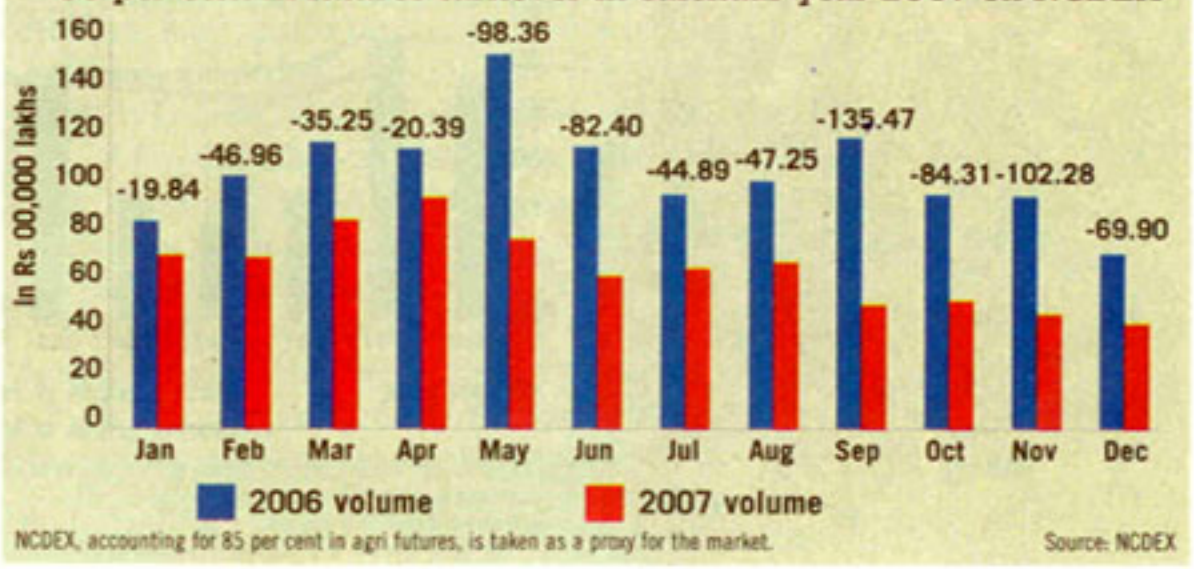
Bureaucratic inertia has ensured that reforms, including foreign direct investment (FDI) for commodity exchanges, remain buried. The markets have little depth since banks, mutual funds and other financial institutions, which are allowed to trade in the securities market, are prohibited. In fact, "Sattebaazi (speculation) rules," says Minesh Shah.

Future In A Spot

A futures contract is an agreement between two parties to buy or sell a commodity at a later date at today's future prices. The exchange is required to standardise and enforce the quality

GROWTH STIFLED

Negative market sentiment resulted in a free fall of more than 60 per cent in futures turnover in calendar year 2007 on NCDEX



NCDEX, accounting for 85 per cent in agri futures, is taken as a proxy for the market. Source: NCDEX

and quantity of the commodity traded. In India, this is becoming a theoretical premise.

Price discovery, one of the two most crucial elements in the smooth functioning of an agri-commodities futures market, does not inspire confidence. NCDEX arrives at a spot price by polling agents, who ask about 20 players and average the prices. On NCDEX website, a disclaimer warns users not to be guided by its spot prices, and use their own wisdom to decide.

FMC Chairman B.C. Khatua admits this is a critical issue. "NCDEX's polling mechanism to arrive at spot prices is not the best. It leaves scope for angularities because those polled include brokers and traders themselves (see 'Ban Helped Nobody' on page 42)." The futures market in India, unlike in developed markets, is used and will continue to be used, as a platform for delivery. This worsens the situation.

NCDEX's MD and CEO P.H. Ravi Kumar is furious when blamed. "First, let me tell you, we poll at least 20 players and polling is done at multiple centres." In the US, he says, the Department of Agriculture announces spot prices everyday, besides guaranteeing quantity and quality of produce at warehouses. "Let the government do it here. It will save me a lot of money."

The spot or physical markets in agriculture are covered by the Agriculture Produce and Marketing Committee (APMC) Act, and are a state subject. But the derivatives markets, where NCDEX, MCX and Ahmedabad-based National Multi Commodity Exchange (NMCE) operate, come in the Central government's jurisdiction.

"APMCs have become clubs for local power brokers. We have been arguing that the APMC Acts should be abolished," says Ravi Kumar.

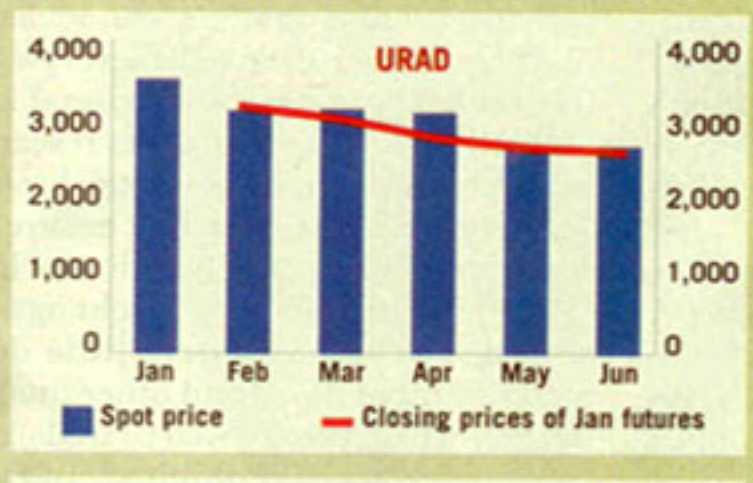
The other critical element is risk transfer. The lack of big financial institutions — which can offer counter-party risk to corporate hedgers — makes the market vulnerable to speculators. "If Sterlite wants to hedge 100,000 tonnes of copper, it does not find enough buyers at MCX, because the government 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," says Joseph Massey, deputy MD of MCX.

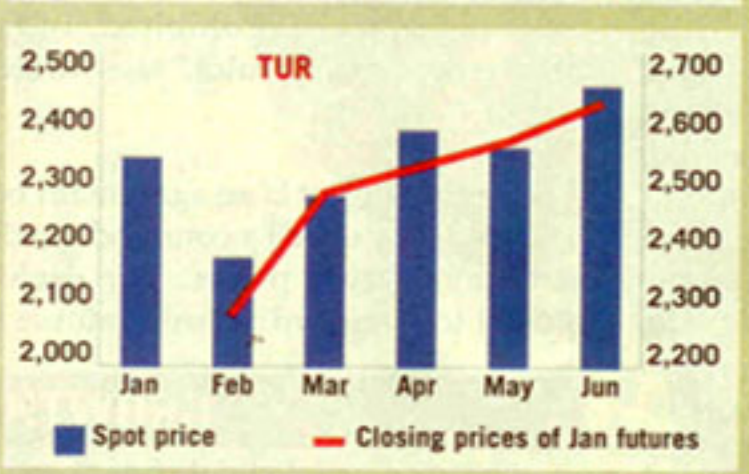
The biggest problem is that the futures markets are sitting atop a grossly inefficient physical market. Troubles blight handling, transportation, warehousing and delivery of agri-products to contract specifications. These lead to disputes on the settlement date over the quality of delivery. "Today, India has the capacity to store only one million tonnes of agri-produce. There is an immediate need to create at least two-three million-tonne additional warehousing capacity," says Ravi Kumar of NCDEX.

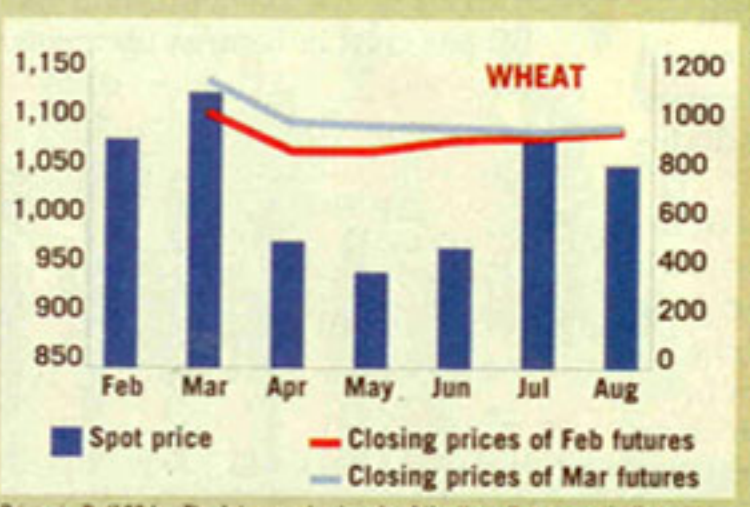
BANNED FOR WRONG REASONS

The spot and futures price of urad, tur and wheat after the ban in early 2007









Prices in Rs/100 kg. The futures price trends of the three items were in line with the actual spot prices in subsequent months.
Source: Forward Markets Commission

Conspiracy Or Jinx?

The government, for its part, has erected artificial barriers such as hedging limits through the FMC, rendering the market platform use-

less in many cases. For instance, Indian companies manufacture 28 million tonnes of sugar annually but the hedging limit per company is just 10,000 tonnes.

"A company wants to hedge its future production today to ensure that a downward price movement doesn't hurt it. Sugar is produced only four months in a year and sold throughout. It is ridiculous to impose a limit of 10,000 tonnes on say, Bajaj Hindusthan, which has a capacity of two million tonnes a year!" says Kiran Wadhwana of International Trading Co, which advises companies on hedging practices.

Regulations impose client and member limits. "The limits are ridiculously low, there won't be enough brokers even if there were just 1,000 big clients in India," says Religare's Manglik. Khatua explains margins were hiked and open positions cut when the markets were overheated. But he is willing to listen. "Market players have a point here. I am addressing these issues."

The increasingly unhealthy rivalry between NCDEX and MCX only worsens matters. Their opposing views on vital issues, such as public listing, delay policy decisions. NCDEX believes that markets have not matured. It sees an exchange as the first-level regulator and vetoes listing at this stage of development. MCX, on the other hand, sites listing of exchanges world over, interpreting this as a readiness for public or investor scrutiny.

NCDEX surely has a tough job on its hands, more so because of the number of agri-commodities it has thrown open for trading. Its rival MCX, which strategically focuses mostly on metals, and within metals, on bullion, does not face delivery or price discovery problems.

"Success finally depends on how credible your settlement price is. I will be foolish not to take the prices of global exchanges as benchmark for trading here," says Jignesh Shah. After MCX provided a platform for bullion and metals trading, the correlation between global and Indian prices has only increased.

A senior official at FMC, who does not want to be quoted, says that ideally, exchanges, especially NCDEX, should not have stretched themselves thus far. There is a more important need to build credibility in a few products by putting in place a strong physical infrastructure of warehouses, quality assayers, etc. Only then should there be a scaling up, and an opening of the platform to more products. But NCDEX has been in a tearing hurry.

Finally, turf fights between the agriculture and finance ministries have felled FDI and institutional participation in commexes. While the finance ministry favoured a convergence of the securities and commodities markets, with a single regulator for both, agriculture minister Sharad Pawar opposed it. The bill to amend the Forward Contract (Regulation) Act of 1952, which would equip the regulator and also allow options trading, has been pending for more than two years now. The anti-markets Left-dominated politics of India has not helped. NCDEX tried to explain to the Left the benefits of the futures market. "But the Left does not believe in the very concept of markets," says an NCDEX board member.



NATIVE TRADITION: Just before WW II, India had as many as 300 commodity exchanges

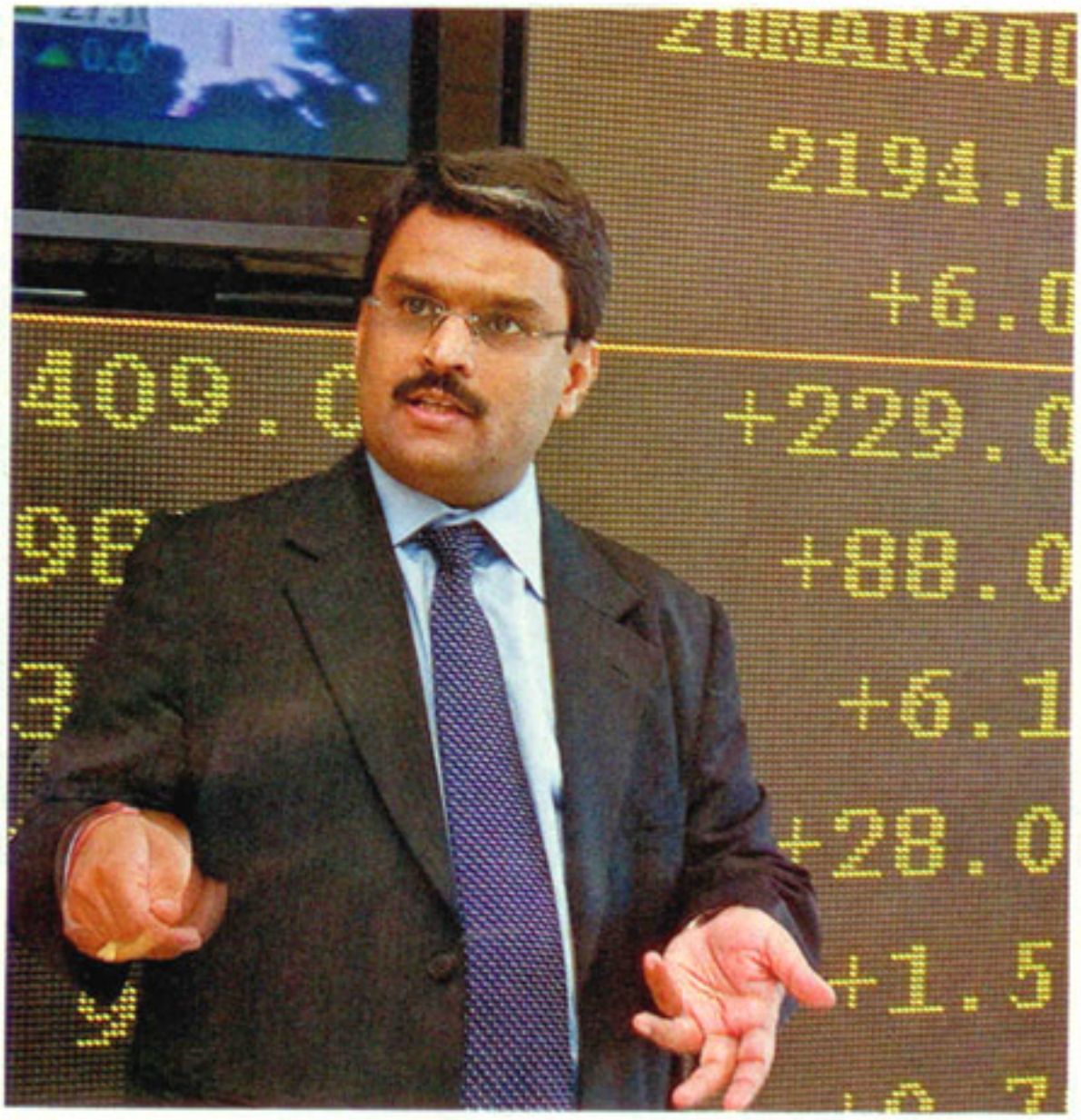
Rich And Chequered History

Unbelievably, India was leading the way in the futures market for commodities as early as the 19th century. According to Prof Gopal Naik of the Indian Institute of Management, Bangalore, Indian cotton traders founded the Bombay Cotton Exchange in 1875 to rival the Bombay Cotton Traders Association, which comprised mainly European merchants, just five years after the Chicago Board of Trade was established.

Dutch navigator Vasco da Gama and the ambitious East India Company came to India to trade in commodities. During the American Civil War (1861-64), when cotton exports from the US to the UK were blocked, India supplied this 'white gold' to Manchester and Lancashire.

MCX's Shah says that the legendary Premchand Roychand, aka the cotton or bullion king, once made a single pay-in of Rs 11.5 crore, which would equal Rs 1,000 crore today! Such single-day transactions by a lone broker are unheard of even in stock markets today.

Just before the war broke out, India had as many as 300 commodity exchanges. But, dur-



MERE MESSENGER:
CEO and MD of MCX
Jignesh Shah

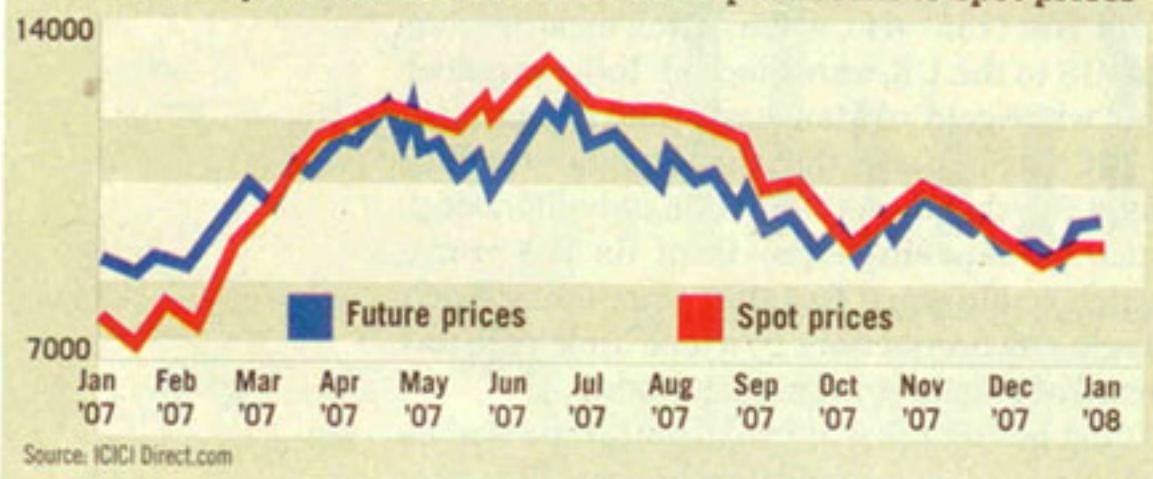
ing WW II, the authorities brought futures trading to a halt when prices spiralled.

The Forward Contracts (Regulation) Act (FCRA) was passed by the Parliament in 1952. "But, the law came about when the government mindset was to control and prohibit the futures market," says Khatua. While trading in a limited number of commodity futures commenced after the FCRA, they were banned again by the Morarji Desai government in 1969.

The National Democratic Alliance government opened the floodgates in 2003 and allowed trading in as many as 100 items. Commexes gained momentum and turnover zoomed, leaving stock markets behind. In just four years, trading value jumped to Rs 40.72 lakh crore in 2006-07, up from Rs 66,000 crore in 2002-03 (see 'Growth Stifled' on page 33).

MANIPULATION OR DISTORTION?

Near-month jeera futures traded at a sharp discount to spot prices



Source: ICICI Direct.com

The Ban: Spoilers Ahead

The January 2007 government ban on trading in urad, tur, rice and wheat was motivated by food-price inflation of over 11 per cent. Unfortunately, it came at a time when all stakeholders were trying to correct infirmities in price discovery and risk management, the two basic reasons why futures exist anywhere in the world.

The United Progressive Alliance government, pushed by the Left and ministers such as Lalu Yadav, followed this with a ban on trading wheat and rice, a day before the 2007-2008 Budget was announced. It was felt that speculators were pushing futures prices, and, hence, the resultant high in spot prices.

It was also felt that real users — farmers and corporate hedgers — were not participating in the market. "It is true the markets are dominated by speculators. We still do not have a critical mass of real users," says Manglik. Opinion, however, is divided on this.

"Nowhere in the world do farmers trade on commexes, except in the US and Australia, where cooperatives do so on their behalf," counters Shailendra Kumar, head of research at Sharekhan, another leading stock and commodities broker.

NCDEX's Ravi Kumar claims that a significant portion of market positions in various agri-commodities is held by hedgers, including exporters and processors. MCX's Shah also says that corporates have started hedging in metals, though in a limited way.

Almost a year after the ban, the FMC has collated data on the price signals emanating from the futures market, and compared it with spot prices of banned commodities in subsequent months. Explaining the data (see 'Banned for Wrong Reasons' on page 34), Khatua says the markets were indeed depicting the trend correctly. In the last few months, the movement of spot prices of these commodities more or less mirrored the trend of future prices before trading was banned.

Shetkari Sanghatan leader Sharad Joshi sees a political conspiracy behind the ban. The move, according to him, came just a day after farmers in Haryana and Punjab announced they would use the futures market to hedge prices and not participate in the Food Corporation of India's procurement plan. In a meeting with Khatua on 18 December, Joshi and many other farmer associations made a strong pitch for re-commencing futures trading in wheat.

"The argument that future trading drives prices up in the spot or real market is meaning-



FUTURE TENSE:
CEO and MD of NCDEX
P.H. Ravi Kumar

less," says Manglik. The wheat delivery before trading was banned stood at 0.001 per cent of total wheat production in India. "In fact, after the ban, wheat prices doubled in the global market to $400 a tonne," points out Shailendra Kumar of Sharekhan. "Farmers were clearly not happy with the price of Rs 1,000 a tonne they got from the government last year, especially after they realised the government had paid 50 per cent more while importing wheat."

Living With Intervention

It's unlikely that the government will not intervene. World over, politicians are concerned about the impact of derivatives market on prices. "In India, the fear of food security is being blown out of proportion," says Manglik.

Futures markets coexist with government policies and interventions that address the spot market, says Kate Hathaway, an international consultant on futures market, in a paper recently submitted to the Abhijit Sen Committee, which is studying the impact of futures trading on price rise in agricultural commodities. "The Indian government's concern about speculation and inflationary trends of consumer prices of food grains is not unusual."

When Hurricane Katrina decimated the Gulf coast in the US, Walter Lukken, a commissioner at the Commodity Futures Trading Commission, was called before a House of Representatives Committee to explain why crude and gasoline prices were rising in the futures and spot markets. Was it because of speculation? Lukken assured the committee that futures markets had been accurately reflecting the underlying fundamentals of these markets, says Hathaway.

In India, the government banned futures in certain products, because they indicated prices would go up. But, "You cannot shoot the messenger because he brought you bad news," says MCX's Shah. Instead, the government should allow options in the market, a must for real users, including farmers. As of now, a farmer can only buy a futures contract and lock in a price. "If the price goes up, he cannot take advantage of the price increase," Khatua says.

"Without any new trigger, the commodities market will continue to be a zero-sum game, more like a casino. But everything can change, despite widespread conservatism, when money comes crashing in this year," says Manglik.

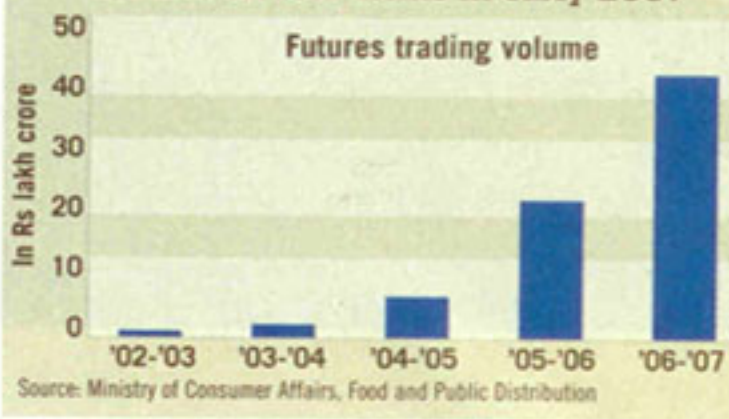
This could well be a classic case of markets forcing changes in the regulations and their own functioning, rather than the other way round. Fidelity and Merrill Lynch have put money in MCX, while Goldman Sachs has invested in NCDEX. Domestic firms such as Reliance, the Aditya Birla Group, Bharti and the Future Group will pump in crores and lend scale to the markets. As MCX's Shah says, "It will always be debated if markets should have users first, or liquidity."

More than anything else, commodity futures offers another investment avenue to individuals, says Ravi Narain, MD and CEO of the National Stock Exchange. In the new year, the government may yet gift Indian farmers a re-start in wheat futures. "There are two lakh clients registered as commodity traders today with the three national exchanges, but, on a daily basis, there must be just about 5,000-10,000 hands trading. Of this, the number of actual users is negligible," says Manglik of Religare.

To put things in perspective, the futures market in cotton alone had as many players way back in the 1860s and 1870s. "There are records to show that over 2,000 people used to gather in Mumbai's Kalba Devi market at 11.30 in the night, because the New York cotton price was available then," says MCX's Shah. It costs a lot more to subdue that spirit than to set it free.

THE RISE BEFORE THE FALL

The futures turnover zoomed before the ban on four items in early 2007



Source: Ministry of Consumer Affairs, Food and Public Distribution