commodities :: Guest Column

The Future of Things



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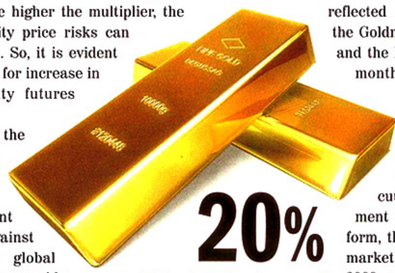
The Indian commodity futures landscape has been evolving and the national commodity exchanges have made a big headway since their inception, with volumes surging with every passing year. The turnover on the Indian commodity bourses has increased 120 times after electronic trading was introduced in 2003, according to the Forward Markets Commission (FMC), the commodities market regulator. The MCX 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.

However, as a whole, exchange-traded commodities account for only a fifth of the total volume of commodities traded in India. Globally, the futures market in commodities is 30-40 times the size of the underlying physical commodity trade. The higher the multiplier, the more thinly the commodity price risks can spread across the market. So, it is evident that there is a large scope for increase in the volume of commodity futures trading in India.

Part of the reason for the rising trade volumes on the Indian commodity futures exchanges is that they provide an efficient platform for hedging against price uncertainty and global volatility. The exchanges provide transparent price discovery and hedging platform for trading futures contracts of different commodities. On these exchanges, the fair value prices are determined through active participation of a large number of stakeholders of the commodity value chain, who have access to information on the demand and supply conditions.

In recent years, with the globalisation of the Indian economy and sensitivity of prices of commodities to global factors, commodities have witnessed heightened price volatility. This has exposed all stakeholders to price shocks, from primary producers, such as farmers, to end-users, such as the manufacturing sector. For instance, in 2010, the high volatility in international prices of most commodities was reflected in the Indian prices.

Volatility in the MCX Comdex, the benchmark index of the MCX, was 17.7% in 2009 and 11.37% during 2010 (January-October), while that for its Agri Index stood at 13.35% and 12.48%, respectively, during the same period. This has prompted a growing demand for hedging among commodity users. The high correlation between domestic and international prices is reflected in the close intertwining of the Goldman Sachs Commodity Index and the MCX Comdex during the 21-month period between January 2009 and September 2010 (*see graph*).



20%

of the total volume of commodities traded in the country is done through the exchanges. Globally, the futures market in commodities is 30-40 times the size of the underlying physical commodity trade.

With heightened volatility in commodity prices and increasing execution of price risk management through the exchange platform, the Indian commodity futures market grew by 38% in 2008, 41% in 2009, and by 51% between January and October 2010, in comparison with the corresponding period of the previous year. The commodity futures trading volumes, taken as a whole, have risen at a compounded annual growth rate of 97.9% between 2003-4 and 2009-10.

The MCX has developed different contract denominations to accommodate the needs of varied market participants, ranging from all types of traders such as hedgers (jewellers, importers, retailers, and others from the physical market), and speculators, to investors (HNIs and retail) and arbitrageurs.

UNTAPPED POTENTIAL

Although India has to cover a long distance to be able to harness the potential in many commodities, it has substantial opportunities to develop consumer demand and uncover latent consumption. Despite having significant benefits, commodities trading has been mostly limited to large corporates, trading houses and high net worth individuals (HNIs). The key reason that discourages retail investors from actively participating in commodities trading is lack of familiarity.

Moreover, the current tax regime is not favourable for investors. Finally, the institutional and policy-level issues associated with commodity exchanges have to be addressed by the government in coordination with the FMC. This will help take necessary measures to pave the way for a significant expansion and further development of the commodity futures markets.

HIGH CORRELATION

The coefficient of correlation between the MCX Comdex and the Goldman Sachs Commodity Index was 97.6% between January 2009 and September 2010.



Source: MCX, Bloomberg

REGULATED GROWTH

The FMC has initiated several measures to stimulate active trading interest in commodities. Steps such as lifting the ban on futures trading in commodities, approving new exchanges which offer modern infrastructure and systems, and removing legal hurdles to attract more participants have increased the scope of commodity derivatives trading in India. This has boosted both the spot market and the futures market in the country. The trading volumes are increasing while the list of commodities traded on the national commodity exchanges also continues to expand.

The FMC has continued its efforts to broad-base the market by undertaking various regulatory measures to facilitate hedgers' participation and promote delivery in agricultural commodities. These include introduction of Exchange of Futures for Physicals (EFP), Alternate Futures Settlement Mechanism and introduction of an early delivery system in select commodities. In addition, efforts have been made to develop an aggregation model in collaboration with the commodity exchanges to promote participation of farmers (these will become feasible once options are allowed, which requires amendments to the Forward Contracts (Regulation) Act, 1952).

GOING FORWARD

The commodity markets are at a juncture where investment in education and research is important to sustain their growth. The MCX has been taking various initiatives to systematically develop markets through continuous innovation, education and research focused on spreading awareness of the modern trading mechanisms facilitated by commodity exchanges. The MCX, in association with the FMC, conducted 95 joint awareness programmes during January-October 2010 for physical market participants, especially farmers, who are the primary beneficiaries of this market, for hedging against price risk or for future price discovery.

To widen and deepen our commodities market for the future, policymakers need to strengthen the institutional infrastructure through market-friendly policies on taxation, enabling of institutions, such as banks and mutual funds, to participate in the commodity futures market, and the provision to initiate trading in options and intangible commodities. These would fructify as and when the Forward Contracts (Regulation) Act, 1952, under which the commodity futures market operate, is amended by the Parliament. Besides, innovative application of ICT, increased awareness programmes and outreach initiatives, best-in-class technological advancements by bringing solutions that address our customers' top trading needs, product innovation in line with the changing market dynamics and emerging challenges, and domain knowledge would ensure that the Indian commodity futures market scales global heights.

