Manage commodity price risk via hedging

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Uncertainty and volatility in commodity prices is a source of risk inherent in most business activities. Commodity price risk is the outcome of many economic and political factors, such as changes in demand and supply fundamentals, changing world trade patterns, geopolitical risks, changes in government regulation, etc. This risk affects both economies and stakeholders and hence, commodity price risk management assumes great importance.

Individuals need to manage this risk to protect their real incomes, firms need to protect their bottom lines and competitiveness, and the economy needs to protect its macroeconomic stability.

Here come in commodity derivative exchanges which provide an efficient platform for price risk The solution

The process of risk management by using commodity derivatives, or 'hedging', is comparable to the concept of insurance. Just as insurance offers financial cover against specified risks, hedging offers producers, consumers, traders and all other stakeholders a financial cover against the risk of commodity price fluctuations. Thus, to reduce the risks of



price fluctuations, people trade on commodity derivative exchanges, which offer products like futures and options.

Technically, hedging is described as a trading activity which allows someone to reduce the price risk of physical commodities by taking a position in the derivatives market which is opposite to his position in the physical market. Thus, if a consumer buys a commodity in the physical market, he hedges by simultaneously selling a derivative contract on the commodity exchange.

The idea is to offset the loss in one market with profit in other market. Similarly, a processor, who requires a commodity at a future date, can protect himself from the risk of a possible price rise by buying a commodity futures contract on the commodity exchange platform at a pre-determined price. A producer who plans to sell a commodity at a future date, but fears a potential price fall, can sell a commodity futures contract on the exchange platform at a pre-determined price. Thus all categories of participants: consumers, producers and processors can avail of the hedging mechanism through commodity exchange platform to protect themselves from adverse price movements. This platform of the exchange is electronic, regulated, and transparent.

In India's gold market, hedging is quite popular and effective. An importer of gold, contracting an import order, takes a 'sell' position on MCX at the time of opening a Letter of Credit, to cover his price risk till the physical gold arrives and he sells in the physical market. At the retail level, a jeweler is exposed to price uncertainty between the time he takes order from his customer and his actual purchase of gold from a wholesale trader. He manages this risk by locking the price by hedging on MCX, as the example in the box shows Importance of risk management The world's first-ever organised commodity futures exchange was set up in Chicago in 1848 as a platform for hedging in grains. A similar body that traded futures in cotton came up in Mumbai in 1875, called the Bombay Cotton Trade Association. Currently in India, stakeholders can hedge their price risks across segments like precious metals, energy, base metals and agriculture through commodity exchanges such as MCX. In developed markets, hedging has emerged as the most common way for corporations to manage commodity price risk. Oil majors such as British Petroleum, aviation firms such as Southwest Airlines and major miners such as Polyus Gold International are known to have a well-structured hedging policy. Hedging is critical for stabilizing incomes of organisations and individuals. Hence, in an increasingly globalised and competitive market, amid persistent high volatility in commodity prices, it becomes imperative for commodity stakeholders to hedge their price risks.

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