Insight into Commodity Markets

The commodities futures market in India is growing rapidly. There are more than 80 commodities on which futures trading is allowed. Domestic institutional investors, foreign players and mutual funds, are, as of now, not allowed to trade in the $500 billion futures market. The market is gaining acceptance as a new investment asset class.

The basics of commodity markets and futures trading will be explained in this series of articles.

Commodity

By definition, a commodity is an undifferentiated product, which can be traded in a structured market (exchange platform) or *bazaar* in exchange for currency or another commodity. In a simplified sense, commodities were things of value, of uniform quality, that were produced in large quantities by many different producers; the items from each producer are considered equivalent (by specification). Commodities can be categorized from the user's/ processor's perspective. For example:

Fibre crops: cotton, jute
Plantation crops: tea, coffee, rubber
Other agricultural products: oilseeds, spices, pulses, wheat, rice.
Soft produce: sugar, orange, mango
Industrial products: crude oil, base metals, cement, iron ore, plastics, steel
Precious metals: gold, silver, platinum

Commodity Market

Commodity markets are markets where raw or primary products are exchanged. These raw commodities are traded on regulated commodities exchanges, in which they are bought and sold in standardized contracts. In India, all agricultural produce is auctioned at the Agriculture Produce Market Committee (APMCs, commonly known as *Mandis*), where a farmer comes to sell his produce; a wholesaler or commission agent examines the quality and quotes a price for it. After some negotiation, a settlement is arrived at.

Modern commodity markets have their roots in the trading of agricultural products. While wheat, cotton and sugarcane have been traded in *mandis* across the country historiclly, India has a *haat* system in small towns, where, on a specified day, a producer will bring his wares. Trading in standardized contract form started during the British Raj.

Futures Market in India

The first organized commodity market in India was established in the late 19th century; the Bombay Cotton Association Ltd. being set up in 1875 by the Bombay Cotton Exchange Ltd. in 1893. Futures trading in oilseeds started in 1900 with the establishment of the Gujarati Vyapari Mandali, which carried out futures trading in groundnut, castor seed and cotton. Futures trading in wheat was set up in Hapur in 1913. In 1919, the Calcutta Hessian Exchange was established for trading in raw jute and jute goods, followed by the establishment of East India Jute & Hessian Ltd in 1927.

Mumbai became the hub of bullion trading in India during the early '20s. During the post- Independence period, commodity trading saw various regulatory decisions. The Forward Contract (Regulation) Act was enacted in 1952 and the FMC or the Forward Markets Commission was established in 1953 under the Ministry of Consumer Affairs. The FMC acts as a regulatory body for commodity markets in India.

The mid-1960s witnessed an unprecedented rise in the prices of major oils and oilseeds due to a sharp fall in output. Futures trade was banned in most commodities to contain speculation, which the government thought was fuelling inflation.

In 2002-'03, the government of India decided to revive

the commodity futures markets after studying its various aspects within the country. The first step it took was to set up nationwide multi-commodity exchanges ; and secondly, it expanded the list of commodities permitted for trading under the FC(R) Act, 1952, whereby various hurdles in free movement, storage and handling under the Essential Commodities Act were removed. Today we have three nationalized exchanges in India viz. MCX, NCDEX and NMCE; we also have more than 21 regional exchanges in India.

Commodities markets offer immense potential to become a separate asset class for market-savvy investors, arbitrageurs and speculators. They are easy to understand as far as the demand and supply fundamentals are concerned as they guide these markets. Investors have to understand its risks and advantages before jumping on the bandwagon.

Commodities futures are less volatile compared to equity and bonds. They are better risk-adjusted; they're a good hedge against inflation, and against downfall in equities or bonds as there is no or very little correlation.

Types of Contracts in Commodities Markets

Derivative Contract:
A derivative contract is an agreement whose value is derived from the value of an underlying asset; the underlying asset can be a commodity, precious metal, currency, bond, or stock. In general, examples of derivative instruments are forwards, futures, options and swaps/ spreads. Currently, the government allows only forwards and futures trading in India.

Forward Trading Contract:
This is an agreement between two parties to buy or sell a commodity at a predetermined moment in the future. Forward trading is a bilateral and non-standardised contract specification.

Futures Trading Contract:
This is a refined forward contract between two parties to buy or sell a commodity, but contract specification, quality values and other things are standardised.

NTSD contract:
The Non-Transferable Specific Delivery Contract is a bilateral agreement under which the terms of contract are customized and the performance of the contract is done by giving specific delivery of goods. The rights or liabilities under this contract cannot be transferred by transferring the delivery order (CHK) through railway receipts or warehouse receipts.

TSSD contract:
The Transferable Specific Delivery contract is a customised agreement, where, unlike known transferable specific delivery contracts, the right or liabilities under the delivery order, railway receipt, bill of lading, warehouse receipts or any other documents of title to the goods, are transferable. The contract is performed by delivery of goods by first seller to the last buyer.

The demand and supply scenario are the prime drivers of the price movement of the commodity. A producer, to hedge his future losses due to a price decline in his product, uses the commodity futures market. It provides an efficient and transparent price discovery mechanism. Futures trading is purely a hedging instrument and should (CHK) be looked upon as a profit-making one.

Commodity exchanges in India will contribute significantly towards the development of the Indian economy as a whole. The government of India is considering reforming the futures market in India by permitting options trading, weather derivatives, and participation by banks, mutual funds and other financial institutions.

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