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Discovery of Golden Sparrow in India through Vibrant Market

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Background

The genesis of the title the "Golden Sparrow" given to "Bharat" has very deep spiritual significance: When God descends at the end of the Iron Age to re-establish the Golden Age, thousand of years ago, India was filled with abundant natural resources, economic surplus and sophisticated designed commodity trading techniques. India was never the top producer of gold as a metal and yet was considered to be Golden Sparrow because at one time, India was having around 20% of the world trade with large trade and balance of payments surplus. As the international trade at that time was mainly barter and net difference was settled through gold, India was in a position to accumulate its reserves.

Organized commodity trading including forward in India started as early as 1875 and kept on flourishing till world war. Economic recession resulted after world war resulted into shortages, disruptions and non conducive atmosphere for growth of trade and no financial recovery package was available to India which was not a free country. Post independence also India faced the issues of shortages, hoarding and black marketing and policy makers feared that free trade fuelled unnecessary speculation and were detrimental to the healthy functioning of the markets for the underlying commodities. As a result, after independence, commodity options trading and cash settlement of commodity futures were banned in 1952. A further blow came in 1960s when, severe draughts forced many farmers to default on forward contracts (and even caused some suicides); forward trading was banned in many commodities considered primary or essential. Consequently, the commodities derivative markets dismantled and remained dormant for about four decades until the new millennium when the Government, in a complete change in policy, looked towards forward market for efficient price discovery and hedging mechanism. Policy makers had full faith in vibrancy of Indian commodity market and, were fully confident that Indian market will create a niche for itself in international market and would not be subservient to the market abroad.

After, the Indian economy embarked upon the process of liberalization and globalization, in 1990, the Government set up a Committee in 1993 to examine the role of futures trading. The Committee (headed by Prof. K.N. Kabra) recommended allowing futures trading in 17 commodity groups. It also recommended strengthening of the Forward Markets Commission, and certain amendments to Forward Contracts (Regulation) Act 1952, particularly allowing options trading in goods and registration of brokers with Forward Markets Commission. The Government accepted most of these recommendations and, future trading was permitted in all recommended commodities, and finally a realization that derivatives do perform a role in risk management, led the government to change its stance. The policy changes favoring commodity derivatives were also facilitated by the enhanced role assigned to free market forces under the new liberalization policy of the Government, to reduce the intermediation cost as trading, undoubtedly, is a matrix of logistics management.

Since 2002, the commodities futures market in India experienced an unprecedented boom in terms of the number of modern exchanges, number of commodities allowed for derivatives trading as well as the value of futures trading in commodities, which now crossed the Trillion marks. Recently, India has achieved sixth rank in turnover of global commodity derivatives exchanges which was seventh until 2009. However, there are several impediments to be overcome and issues to be decided for sustainable development of the market.

Why are Commodity Derivatives Required?

India is among the top-5 producers of most of the commodities, in addition to being a major consumer of bullion and energy products. Agriculture contributes about 22% to the GDP of the Indian economy and is an important factor in achieving a GDP growth of 8-10%. All this indicates that India can be promoted as a major center for trading of commodity derivatives. However post independence economic factors particularly the shortages of agricultural products and economic isolation of India forced government to take an opposite view and it suppressed the very markets which were the backbone of India and could have resulted into valuable foreign exchange through value additions. Even today this trading has been accused of fuelling the speculation and inflation. Such suspicions might normally arise due to a misunderstanding of the characteristics and role of derivative product. It is important to understand why commodity derivatives are required and the role they can play in risk management. It is common knowledge that prices of commodities, metals, shares and currencies fluctuate over time. The possibility of adverse price changes in future creates risk for businesses. Derivatives are used to reduce or eliminate price risk arising from unforeseen price changes. A derivative is a financial contract whose price depends on, or is derived from, the price of another asset. Thus it gave advance information to stack holders to take alerts for remedial action. The very character of commodity market is distributive and whenever there is an artificial barrier in free flow of services or goods it distorts the market. This market provides an alternative to Mandis which are infected with inefficiency, high cost of intermediation and by nature are not producer friendly. Once a producer has come to mandi he hardly has any option but to sell the crop. No storage facility is available; no interim financing is available which can take care of his operational cost. This futures market has resulted into lowering the difference between what producer gets and what consumers pay. This has created pressure on physical markets to reduce wastage in storage, transportation and intermediation costs.

Unresolved Issues and Future Prospects

Even though the commodity derivatives market has made good progress in the last few years, the real issues facing the future of the market have not been resolved. Agreed, the number of commodities allowed for derivative trading have increased, the volume and the value of business has zoomed, but the objectives of setting up commodity derivative exchanges may not be achieved and the growth rates witnessed may not be sustainable unless the following real issues are sorted out as soon as possible.

a. **The Warehousing and Standardization:** For commodity derivatives market to work efficiently, it is necessary to have a sophisticated, cost-effective, reliable and convenient warehousing system in the country. Further, independent labs or quality testing centers should be set up in each region to certify the quality, grade and quantity of commodities so that they are appropriately standardized and there are no shocks waiting for the ultimate buyer who takes the physical delivery. Warehouses also need to be conveniently located. Central Warehousing Corporation of India is operating 500 warehouses across the country with a storage capacity of 10.4 million tonnes. This is obviously not adequate for a vast country. To resolve the problem, a Gramin Bhandaran Yojana (Rural Warehousing Plan) has been introduced to construct new and expand the existing rural godowns. Large scale privatization of state warehouses is also being examined.

b. **Pass FCRA Amendment Bill:** FMC should be empowered on the lines of SEBI as an autonomous body with its own team & cadre of staff, funds and vigilance system. SEBI helped in rapid growth of stock market, accelerated the activities of debt market, encouraged overall progress toward modernization and prevented undesirable transaction in securities. These were possible only because SEBI is empowered under SCRA and SEBI Act. With the passing of FCRA Amendment bill, FMC will have more powers and resources to handle the issues of commodity market. Although bill was notified earlier but it lapsed due to it's not being tabled in the Parliament. We need to create opinion so that bill can now be presented in the Parliament.

c. **Allow participation of FII's, Banks and Mutual Funds:** At present, domestic mutual funds and FII's are not allowed to participate in commodity markets. In fact, mutual funds' role in commodity markets is of very recent origin, globally, and is very limited or absent in emerging markets. FII's and Mutual Funds participation should be allowed in bullions, while banks should also be permitted to hedge in agricultural commodities. Moreover, Indian investors should be allowed trading in overseas market to give them a level playing field. Participation from both the sides will bring liquidity and transparency in the market and Indian commodity market will mature in a very short period. It would also bring more depth and liquidity and will enable farmers to hedge their risks and fight vagaries of unpredictable weather.

d. **Introduction of Options and Contracts of Indices, Weather, Freight etc:** Options being a more sophisticated hedging tool than futures, should be introduced. Intangible commodities like weather derivative, indices derivative, freight rates, etc. should be allowed. These instruments will help in reducing risk involved in the dependence of agro commodities on weather. Some agro-commodities prices viz., guar, chana, etc. are heavily dependent on weather.

e. **Many other Commodities Contract should be introduced:** There are many commodities viz., coal, iron ore, cement etc., in which India is the largest producer, consumer, importer and export, which are not traded at domestic exchanges. These should also be introduced.

f. **Cash versus Physical Settlement:** It is probably due to the inefficiencies in the present warehousing system that only about 1% to 5% of the total commodity derivatives trade in the country is settled in physical delivery. Therefore the warehousing problem obviously has to be handled on a war footing, as a good delivery system is the backbone of any commodity trade. A particularly difficult problem in cash settlement of commodity derivative contracts is that at present, under the Forward Contracts (Regulation) Act 1952, cash settlement of outstanding contracts at maturity is not allowed. In other words, all outstanding contracts at maturity should be settled in physical delivery. To avoid this, participants square off their positions before maturity. So, in practice, most contracts are settled in cash but before maturity. There is a need to modify the law to bring it closer to the widespread practice and save the participants from unnecessary hassles.

g. **The Regulator:** As the market activity picks-up and the volumes rise, the market will definitely need a strong and independent regular; similar to the Securities and Exchange Board of India (SEBI) that regulates the securities markets. Unlike SEBI, which is an independent body, the Forwards Markets Commission (FMC) is under the Department of Consumer Affairs (Ministry

of Consumer Affairs, Food and Public Distribution) and depends on it for funds. It is imperative that the Government should grant more powers to the FMC (with a long term view of making it independent) to ensure an orderly development of the commodity markets. The SEBI and FMC also need to work closely with each other due to the inter-relationship between the two markets with common KYC and trading mechanism. As a matter of fact now commodity has emerged as an alternative investment module. The same money keeps on shifting between bullion base metal and stock market based on the perceptions of the investors.

h. **Lack of Economy of Scale:** There are too many (6 national level and 21 regional) commodity exchanges. Though over 80 commodities are allowed for derivatives trading, in practice derivatives are popular for only a few commodities. Again, most of the trade takes place only on a few exchanges. All this splits volumes and makes some exchanges unviable. This problem can possibly be addressed by consolidating some exchanges. Recently the government has decided to fix the limit for national commodity exchanges at 8 which, is on very high side. Fittest will survive in the long run but society will have to pay heavily for the failure of the remaining. It is felt that convergence of these derivative markets would bring in economies of scale and scope without having to duplicate the efforts, thereby giving a boost to the growth of commodity derivatives market. It would also help in resolving some of the issues concerning regulation of the derivative markets. However, this would necessitate complete coordination among various regulating authorities.

i. **Tax and Legal bottlenecks:** There are at present restrictions on the movement of certain goods from one state to another. These need to be removed so that a truly national market could develop for commodities and derivatives. Also, regulatory changes are required to bring about uniformity in octroi and sales taxes etc. VAT has been introduced in the country in 2005, but has not yet been uniformly implemented by all states.

j. **Proper implementation of Warehousing Development & Regulation Act (WDRA):** Though the Act has been passed by parliament but rules and regulations are yet to be specified. We suggest that there should be one regulator of warehousing and commodity market so that there is united regulation, which would result in healthy development of the commodity market.

k. **Integration of Spot and Future Market:** Integration of spot and future market is needed for a hassle free trading environment and to encourage more participation. Also, hi-tech national level electronic spot markets should be developed.

l. **Allow PMS:** Like in equity markets, PMS should also be allowed in commodities, particularly in bullions.

m. **Tax Reforms:** Income from commodity market is considered to be speculative in nature therefore not adjustable with other market transactions. Hence, we request the government to notify the income from commodity transactions as "Business Income" under the Section 43(5). This notification is required to be brought through CBDT.

n. **Curtail Dabba Trading:** Curb on "Dabba Trading" should be strictly implemented. This is widely prevalent in many parts of our country. A dedicated taskforce should be setup to identify such cases and strict action should be taken.

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o. **Creating awareness and take Educational Initiatives:** For inclusive participation, some authentic steps has to be undertaken to create awareness about this market so that the real benefit can reach to all the participants, viz., farmers, traders, corporate, stockiest etc.

Conclusion

India is one of the top producers of a large number of commodities, and also has a long history of trading in commodities and related derivatives. The commodities derivatives market has seen ups and downs, but seem to have finally arrived now. The market has made enormous progress in terms of technology, transparency and the trading activity. Interestingly, this has happened only after the Government protection was removed from a number of commodities for valid reasons, and market forces were allowed to play their role. This should act as a major lesson for the policy makers in developing countries that trade will not grow with the development of the economy but, economy will grow only with the development of trade. The management of price risk is going to assume even greater importance in future with the promotion of free trade and removal of trade barriers in the world. All this augurs well for the commodity derivatives markets to be decentralized, decontrolled and to be taken as a priority. Recent report of RBI has negated any correlation between futures trading and inflation.

It is heartening to note that policy makers has realized that time has come to give special attention to boost this sector, as this sector alone can recall golden sparrow to India.