Future Trading in Essential commodities in India: Beneficial Neither to Consumers nor to Farmers

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Abstract

The main objective of Future trading in commodities is to provide an efficient and effective mechanism to manage price risk for both the parties, producers and consumers of the commodities. Future contracts should protect them against unfavorable price changes. Speculators who are neither consumers nor producers seek to profit from changes in price during the contract period. Some influential players, having large financial and other infrastructure base, manipulates the essential commodity markets, resulting in sharp rise in prices in short duration, affecting the interest of common men. These manipulators extract undue benefits from insufficiently developed infrastructure and base, that is far below from the required levels for achieving the objectives of future trading in Agro commodities. Majority of farmers in India, being marginalized and illiterate, do not benefit from manipulated price rise of their agro-produce and at the same time, consumers end up in paying high retail prices.

Key Words: *Future trading, essential commodities, organized sector, delisting, marginal farmers.*

Introduction

In India we have total 25 commodity exchanges out of which three commodity exchanges are at national level, viz., National Commodity and Derivatives Exchange ltd. (NCDEX), Multi Commodity Exchange (MCX) and National Multi Commodity Exchange of India Ltd. (NMCEIL). Most of the commodities are regularly traded and latest information about demand and supply with respect to individual commodities are available. The primary purpose of future markets is to provide a platform to suppliers and buyer for hedging their future supply/requirement position against fluctuations in prices. There are two important derivatives - futures and options.

1. Commodity Futures Contracts:

A futures contract is an agreement for buying or selling a commodity for a predetermined delivery price at a specific future time. Futures are standardized contracts that are traded on organized futures exchanges that ensure performance of the contracts and thus remove the default risk. The major function of futures

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markets is to transfer price risk from hedgers to speculators. For example, suppose a farmer is expecting his crop of wheat to be ready in two months time, but is worried that the price of wheat may decline in this period. In order to minimize his risk, he can enter into a futures contract to sell his crop in two months' time at a price determined now. This way he is able to hedge his risk arising from a possible adverse change in the price of his commodity.

2. Commodity Options Contracts:

Like futures, options are also financial instruments used for hedging and speculation. The commodity option holder has the right, but not the obligation, to buy (or sell) a specific quantity of a commodity at a specified price on or before a specified date. Option contracts involve two parties - the seller of the option writes the option in favor of the buyer (holder) who pays a certain premium to the seller as a price for the option. There are two types of commodity options: a 'call' option gives the holder a right to buy a commodity at an agreed price, while a 'put' option gives the holder a right to sell a commodity at an agreed price on or before a specified date (called expiry date).

Futures and options trading therefore helps in hedging the price risk and also provide investment opportunity to speculators who are willing to assume risk for a possible return. However, it is true that too much speculative activity in essential commodities would destabilize the markets and therefore, these markets are normally regulated as per the laws of the country.

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. The Habibullah (2003) task force admitted, "A sophisticated warehousing industry has yet to come about". 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 tones. This is obviously not adequate for a vast country. To resolve the problem, a Gramin Bhandaran Yojana (Rural Warehousing Plan) was introduced to construct new and expand the existing rural godowns.

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 are 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. It is desirable that, all outstanding contracts at maturity should be settled in physical delivery. 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 practices in developed countries and save the participants from unnecessary hassles.

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.

Impact of future trading on retail prices of commodities: Few instances where future trading was banned because prices were allegedly manipulated and affected the consumers, are cited below-

- In January 2007, Government had banned futures trading in tur and urad in the wake of steep rise of these products.
- In wake of high inflation in 2008, Government had banned forward trading in potato, soya oil, chana and rubber.
- Government imposed ban on future trading of Wheat in 2007 due to high rise in prices and then after nearly two years, ban on future trading was removed on back of bumper production.
- In 2009, sugar prices skyrocketed from Rs.16 per Kg to above Rs.50 per Kg and then Government imposed ban on its future trading in May 2009 as part of its measure to control prices
- There are other manipulations in agro products due to mismanagement like a recent case of onion price skyrocketing from Rs.15 per Kg to Rs. 70 to Rs.80 per Kg.
- In January 2011, Sugar prices shot by 5.44 percent immediately on MCX counter as future trading began after market regulator lifted the ban after nearly one and a half year. Traders indulged in building up huge positions in anticipation of further rise in prices.

The above cases are just tip of the huge manipulation and rigging operations behind the counters of future trades. Every now and then it becomes vogue to talk of market manipulation and how the mighty bosses have rigged the market prices in their favor.

Recommendations of PM's Working Group on future trading:

The Working Group on Consumer Affairs, set up in April, 2010, to find ways to control retail prices, had submitted the report to Prime Minister on March 2, 2011. Apart from Gujarat, the chief ministers of Andhra Pradesh, Tamil Nadu and Maharashtra were members of the group. The report submitted by the working group, called for ban on futures trading in essential items and favored liberalizing agro- markets via organized retail. The report suggests delisting essential commodities like rice, pulses and edible oils from future markets to contain inflation. The working group has also recommended liberalization of agriculture markets for improving efficiency of distribution channels by increasing participation of the organized sector and cooperatives in retail, agro-processing and post harvest infrastructure.

Earlier in the year 2007, Abhijit Sen Committee, constituted by the Indian Government, had favored continuation of ban on future trades on wheat, rice, tur and urad, in light of the fact that the desired conditions for reaping the benefits of the future commodity markets does not exist in India.

Reality about cost of agro food products, high retail prices and farmer's plight:

The reality of the cost of agro products is that consumer pays four times the price a farmer gets for vegetables he sells. In case of cereals, the gap between cost to consumers and the

price a farmer gets is about 100%. There is hefty mismatch between the output price a farmer gets for his produce and the consumer pays for it, and the main cause attributed to this phenomenon, is the dubious role played by middle man.

In future commodity market, Indian farmer is unlikely to participate directly as these markets are complex and support infrastructure of warehousing and commodity finance is also inadequate and beyond the reach of marginalized farmers. Obviously, the benefits of these future markets do not percolate to farmers.

Farmers need to have holding capacity to sell produce at the most opportune time at the best available prices. This requires availability of warehousing and credit facilities so that the farmer can time his marketing. His bargaining strength increases when he has not presold his produce to the traders/ wholesalers for meeting his requirement for cash to meet his farm input and consumption needs. Banks participation is required not only to extend finance against warehouse receipts but also to enable small and marginal farmers to access the commodity market.

Conclusion:

Farmers' Groups, cooperatives, state agricultural marketing boards, warehousing corporations commodity development boards which work in the rural areas and have close association with the farmers should be allowed and encouraged to act as aggregators. These institutions should be roped in to act as intermediaries to promote the interest of farmers in future markets.

The Government should be sensitive and firmly deal with issues causing high inflation in essential commodities and take concrete actions to remove the misery of farmers and common man. Followings are few suggestions that government should implement on priority to derive benefits to the farmers-

1. Managing prices of agricultural commodities
2. Transport, storage and distribution of food commodities
3. Make middle man role minimal. Allow aggregators in commodity exchanges on behalf of the farmers
4. Linking of warehouse financing to future position
5. Exemption from margins for stocks deposited in commodity exchange warehouses
6. Allow higher position limits for delivery based trading
7. Educate the farmers about the benefits and risks of future markets to help them take better informed decisions.

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