Spice

POST GRADUATE PROGRAMME IN AGRI BUSINESS MANAGEMENT

VOL. 1 NO.5 : MAY 2003

Introduction

Operational efficiencies have reached a peak with most companies in the top league having, to a more or less degree of success implemented various strategies towards this end. Of the three major activities in the value chain, the manufacturing and marketing links have received more than their due share of attention. Increasingly, companies today are finding that there is more value per rupee to be extracted by focusing on the procurement function. This is especially true for companies in the agri business sector.

True, there is wide fluctuation in availability, prices and even quality, but these very same constraints offer an opportunity for achieving significant savings. The volatility in commodity prices can build or destroy a firm's competitiveness through both, the cost of inputs and the price of outputs. It is due to this double-edged impact that management of commodity price risk has a history older than risk management in other areas such as foreign exchange or stocks. The genesis of derivative instruments can be traced back to the commodity price fluctuation and its management mechanisms. Several methods ranging from vanilla products like simple commodity forwards and futures to exotic commodity swaps and commodity-linked financing have been in use for managing commodity price risk in various developed and developing countries depending upon the regulation and sophistication of markets. *The basic pre-requisite for a resilient futures market however, has been found to be a centralized, transparent, technologically driven market.* This is because futures contracts perform two important functions of price discovery and risk management with reference to the underlying commodity (or asset).

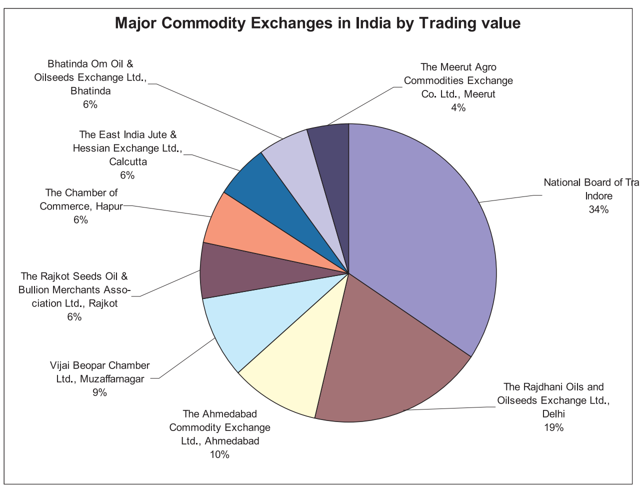
Status in India

The commodity trading in the Indian market has meandered with contrasting regulatory interventions at various points of time. Based on the recommendations of several committees constituted for developing the markets in a more systematized manner, the regulatory authorities such as Forwards Markets Commission (FMC), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI) have made efforts in the following directions:

1. Increasing the number of commodities permitted for futures trading.

Presently futures trading is permitted in all the commodities. Trading is taking place in about 50 commodities in 22 exchanges/ associations (See figure1). The encouragement of futures markets also assumes importance, as "India's obligation under WTO to open agriculture sector to world trade would require futures trade in a wide variety of primary commodities and their products to enable diverse market functionaries to cope with the price volatility prevailing in the world markets"[1]

Fig 1.



[1] *http://www.fmc.gov.in/default800.html*

"Spice is a bi-monthly publication from The National Institute of Agricultural Extension Management (MANAGE), an organisation of the Ministry of Agriculture, Govt. of India.

2. Strengthening the institutional structure for Futures trading

Setting up of multi-commodity online exchanges and demutualisation of exchanges are important steps in this direction. Demutualisation is the change in legal status of an exchange from a mutual association with one vote per member, into a company limited by shares, with one vote per share.

3. Revamping the legal framework for Futures trading

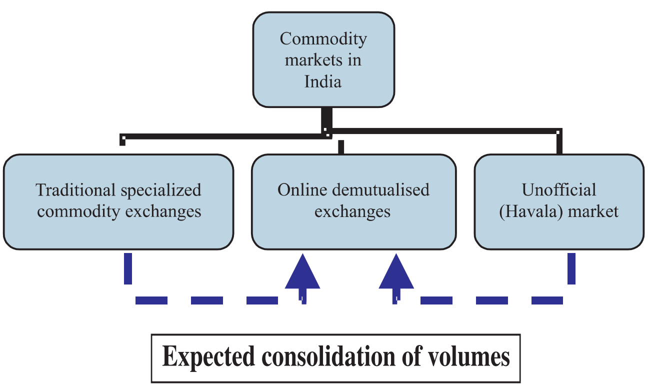
This will include having a relook at the stamp duty structure and at other taxes.

Currently three types of trading systems are simultaneously operating in the Indian commodity markets:

1. New online multi commodity exchanges

Four such exchanges have been authorized namely National Multi-Commodity Exchange (NMCE), National Commodity and Derivatives Exchange (NCDEX), National Board Of Trade Ltd. (NBOT) and Multi Commodity Exchange (MCX). Of these NMCE is operational and the other exchanges are in various stages ranging from setting up to stabilization. The salient features of these exchanges are online transactions with automated order matching, guaranteed settlements and demutualisation.

Figure2 : Structure of commodity market in India



2. Commodity specific trading exchanges

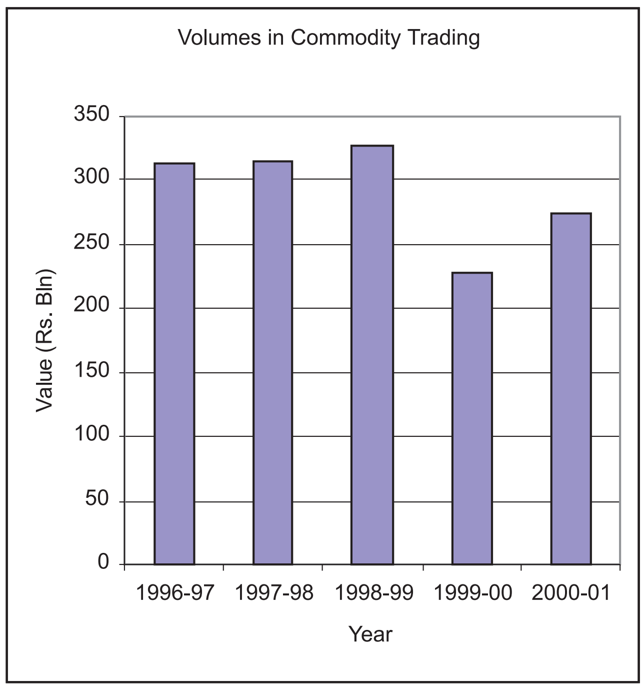
Twenty two traditional exchanges are currently operational in which about 50 commodities are traded.

3. Havala (Unofficial) markets

These are the unofficial commodity exchanges, which, have operated for many decades and have built up a reasonable reputation in terms of integrity and liquidity and some of these trade upto 20 to 30 times the volume of the official futures exchanges.[2]

Despite the different systems of exchanges, the combined volumes of trading of all exchanges are marginal compared to production levels.[3] This may be due to the fact that as of now only one online exchange is operational and the traditional trading suffers from a number of limitations such as:

1. Limited and closed nature of membership
2. Absence of transparency



[2] *Integrated report on commodity exchanges and Forward market Commission (FMC)*

[3] *Data for graph obtained from "Report of the group on Forward and Futures Markets"*

3. Absence of legal frame-work for Warehouse receipt system, its negotiability and transferability.
4. Limitations of other regulation.

Government and the FMC have begun the process of implementing reforms in the commodity exchanges. These are similar to those adopted in the commodity exchanges in developed countries (and also the Financial Securities exchanges in India), and include the following measures for inculcating system-driven discipline in the market:

- Online trading
- Daily mark to market margining
- Time stamping of trades
- Creation of trade guarantee fund
- Back-office computerization
- Demutualization of Exchanges
- Professional representatives on the Board
- Daily reporting

In most instances, with reference to the experience[4] in international markets, there was an initial opposition to the measures. However, gradually the volumes improved over the previous levels substantially in the new environment.

Demutualised exchanges in commodities

Amongst the recently authorized National online multi-commodity exchanges, the National Multi Commodity Exchange (NMCE) is the only operational exchange which can boast of a significant level of monthly volumes (in the region of Rs.4000 crores in July 2003) since its commencement in Nov 2002 . Some of the features of this exchange are:

- Trading mechanism – Order matching is performed by the Exchange without the necessity of disclosing the identity of the counter-parties. This makes the process of price discovery efficient.
- Marking to market and trade guarantee – The Clearing house provides guarantee of financial performance of outstanding contracts to its clearing members. Outstanding positions of all the trading members are marked to market on a daily basis. This ensures that the default risk is limited to profit or loss of the last trading day.
- Classes of commodities – A total of 47 commodities are being traded in this exchange. The commodities are currently categorized into Seeds, Oils, Oil cakes, Metals, Spices, Pulses and others.

The Way Forward

- Initially, the reaction to the discipline imposed and the new set of practices in the online demutualised exchanges is likely to range from cautious to negative. This will have a negative impact on the volumes and consequently on Price discovery.
- There may be consolidation in the market structure through either merger of several of the exchanges or online linking.
- Dematerilisation of the delivery based transactions with the standardization and usage

[4] *For details of Case studies, please contact .....*

of warehouse receipts system will emerge as one of the main issues for further development.

- Several teething problems can be expected with reference to the process, technology, regulatory aspects, implementation. This will be followed by a learning phase during which prospective participants will acquaint themselves with the possibilities in the new environment.

- The large institutionalized buyers are likely to step in once the teething problems are sorted out. Their entry into the market will provide the volume and depth to the exchange.

- Once the initial resistance is overcome, these exchanges are likely to see a surge in volumes especially in the Futures segment. This is expected to pave way for increased types of products available both in terms of basic commodities and types of derivative instruments.

- With expansion in the derivatives segment, speculation as well as price discovery for various periods will shift to this segment. As the market efficiency improves it will get reflected in the convergence of Spot rates in the cash segment with the maturity rates in the derivative segment. This will in turn result in optimal procurement cost for buyers and appropriate prices for the sellers.

About the Author

Dr. B. D. Tripathi has taken over as the new Principal Coordinator of the Post Graduate program in Agri Business Management (PGPABM) at MANAGE. holds two Graduations & two Post Graduation degrees, besides PhD in Management. He did his Masters in Chemical technology (Specialising in Food Technology) with first position from Harcourt Butler Technological Institute, Kanpur in 1974. Later he served as Lecturer in Food Technology at the same Institute for a brief period before joining Modern food Industries India Ltd. In 1979, he joined Department of Food & Civil Supplies, Government of India after selection through UPSC and served till the year 1989. Dr. Tripathi joined National Institute of Agricultural Extension Management (MANAGE), Hyderabad in 1989 as one of the founding members in the capacity of Program officer.

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