Commodity Futures Market

for School Students

COMMODITY FUTURES MARKET

A market is a place where forces of demand and supply operate, and where buyers and sellers interact (directly or through intermediaries) to trade goods, services, or contracts or instruments, for money.

The commodities market has two segments. The first where goods/ commodities are traded directly between buyers and sellers. This market is usually prevalent and popular for trading in agricultural commodities and is known as the mandi/ **spot market or ready market** in India. These markets are established and regulated by the State Government.

The other segment of the commodities market is the **forward market** where buyers and sellers enter into contracts. Contracts are of two types. Ready delivery contract and a forward contract. **Ready delivery contract** is one, which provides for the delivery of goods and the payment of price therefor, either immediately or within such period not exceeding eleven days after the date of the contract. **Forward contracts** on the other hand is a contract for delivery of goods and payment of price after a period of eleven days. Forward contracts are regulated by the Central Government under the **Forward Contracts (Regulations) Act 1952**.

The Rationale for Forward Contracts.

The demand and supply of agricultural commodities varies according to seasons. The farmer usually finds that the price of the commodities produced by him is at the lowest soon after the harvest time due to supplies being abundant and prices are high during the lean season when supplies are low. This fluctuation in the prices of commodities adversely affects the farmers (as they realize lower prices of their produce in the harvest season) and consumers (as they have to pay higher prices in the lean season to meet their requirements). Forward contracts provide a market mechanism to balance this imbalance of the supply - demand pattern of agricultural commodities.

There are different types of forward contracts.

Forward contract is a derivative contract. A **derivative contract** is defined as an enforceable agreement whose value is derived from the value of an underlying asset. The underlying asset can be a commodity, currency, bond, stock, or, indices of commodities, stocks etc. **Futures contract** is one type of forward contract. Futures contract also known as hedge contracts are highly standardised. These contracts are traded on recognised Commodity Exchanges just like stocks are traded over Stock Exchanges. Futures contracts are used generally for protecting against risk of adverse price fluctuation.

Regulation of commodity futures market in India.

India has a long history of commodity futures trading. Commodity futures contracts and the commodity exchanges are regulated by the government under the Forward Contracts (Regulation) Act, 1952. The nodal agency to regulate the future market is the **Forward Markets Commission (FMC),** situated at Mumbai. Futures trading is organized in such goods

or commodities as are permitted by the government. Trading in commodity futures contracts can be done between, with and through the members of the recognised Exchange. At present, 113 commodities are allowed for futures trading under the auspices of the commodity exchanges recognized under the FCR Act.

Role of an exchanges in futures trading.

The exchange provides a trading platform which converges the bids and offers emanating from all over the country. This creates competitive conditions for trading. The Exchange also provides facilities for clearing, settlement and arbitration. The Exchange may also provide financially secure environment by putting in place suitable risk management mechanism and guaranteeing performance of contract.

Participants in commodity futures markets.

- **Hedger** enters into futures contract to manage the risk of adverse price fluctuation in respect of his existing or future asset. Examples could be stockists, exporters, producers and farmers. They require some people who are prepared to accept the counter-party position (speculators)**.**
- **Speculators** are those who trade without having exposure in the spot market, with the sole intention of earning profit. They see an opportunity of price movement favourable to them. They are prepared to accept the risk being transferred by hedgers. They provide liquidity to the market.
- **Arbitrageurs** simultaneously purchase and sell in two markets so that the selling price is higher than the buying price by more than the transaction cost, resulting in risk-less profit. Their behaviour helps in removing price imperfections in different markets.

Benefits of commodity futures market.

Forward/Futures trading performs two important functions, namely, price discovery and price risk management.

- **Price discovery:** Trading in commodity futures is transparent and a large-scale participation ensures that the most efficient futures price is discovered. Futures prices give an advance forecast of the likely prices at a future point of time. This could be a useful input for the stakeholders in taking business decisions. The price signals emanating from the futures market help farmers in deciding the cropping pattern. In the absence of a proper mechanism for forecasting future prices or their dissemination, the farmers have to base their decision on the prices of the last harvest which often leads to a situation of over production followed by a fall in production.
- **Price risk management:** The need for price risk management arises from price risks in most commodities i.e. the risks of value losses resulting from adverse price variations. One can cover the price risk by entering into a futures contract which

would lock-in the price of the commodity (hedging). Producers, traders and processors, exporters/ importers get an online platform through exchanges for price risk management.

Major commodities in which futures trading is being conducted in India.

- Edible oilseeds and Oils- Mustard seed, Soy oil, Coconut Oil, Crude Palm Oil, etc.
- Food grains – Wheat, Gram, Bajra, Maize etc.
- Metals - Gold, Silver, Copper, Zinc, Aluminium, Nickel, Lead, Steel, etc.
- Spices - Turmeric, Pepper, Jeera, Cardamom, Red Chilly, etc.
- Fibres – Cotton, Jute etc.
- Others – Sugar, Rubber, Natural Gas, Crude Oil etc.