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Has Indian Commodity Future Market Lost Steam? Existing Scenario and the Way Forward

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Abstract

Commodity futures were introduced a few years into the beginning of the millenium. After a healthy run, signs of corrections were seen in the Indian commodity markets in 2012. But, unearthing of the NSEL Spot Exchange scam of Rs 5,600 crore in July 2013 had disastrous consequences on the volume and value of trade. After the revelation of scam, turnover of the exchange reduced to almost 50% till February 2015. Though several measures were adopted by FMC to restore confidence among investors but there is mounting suspicion on whether the commodity futures market will be able to be as buoyant in its growth as before. The present paper chronicles the trends of Indian commodity markets by using past data of volume and value of trades of the commodity traded from 2003 till date. Further, the paper employs a qualitative method of inquiry (Delphi technique) to seek policy suggestions from experts in the area of Indian commodity markets. The analysis of the archived data on volume and value of trade indicates a downward facing trend, demonstrating the rapid need for reforms to salvage the commodity futures market. The second part lists the regulatory, legal, and operational issues identified by experts for the downfall of the market. The paper then presents the collated the opinions of several experts on areas which require immediate attention and novel policies which could improve the scenario.

Keywords: Commodity Markets, FMC, Delphi Technique, India

JEL Classification: Q02, C25

Introduction

In the process of economic liberalisation and deregulation in Indian commodity futures markets, futures trading in commodities have been reintroduced since 2003. The two major factors leading to such reform were their ability to manage price risk and efficient discovery of future prices of commodities. With their reintroduction, the regulator also considered it important to modernise the existing regional exchanges. The regional exchanges not only lacked transparency but dealt mainly with few commodities and had a limited user base. Even after considerable efforts of the regulators, the existing regional exchanges failed to modernise and provide fair and transparent trading platform. The failure of regional exchanges to cater to national needs leads to the setting up of new modern demutualised nation-wide multi-commodity exchanges with investment support by public and private institutions. Three national level exchanges were driven by the best global practices of professionalism and transparency to provide a world class commodity exchange platform for market participants to trade in a wide spectrum of commodity derivatives.

At present, there are six national and 22 regional commodity exchanges in India, which have been allowed for derivatives trading of agricultural, metal, and energy contracts. Further, commodity prices over the years have turned volatile, dynamic, and complicated. Potential gains from large moves in commodity markets have attracted investors, speculators, and arbitrators to take advantage

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of the current scenario leading to increased activity in the Indian commodity derivatives market.

After a healthy run, signs of corrections were seen in the Indian commodity markets in 2012. But unearthing of the NSEL Spot Exchange scam of Rs 5,600 crore in July 2013 had disastrous consequences on the volume and value of trade. After the revelation of scam, turnover of the exchange reduced to almost 50% till February 2015. Though several measures were adopted by FMC to restore confidence among investors but whether commodity markets will be able to revive and regain the previous high growth trajectory is still questionable. In the same line, the paper studies the trends of Indian commodity markets by using past data of volume and value of trades of the commodity traded from 2003 till 2014. The paper employs a qualitative method of inquiry (Delphi technique) to seek policy suggestions from experts in the area of Indian commodity markets which could make futures market more efficient in the long run and perform their role of price discovery and risk management more efficiently and effectively.

The remainder of the article is organised as follows. The second section presents a brief review of literature. The third section describes the data source and the methodology adopted in the paper, and the fourth section presents the empirical results. Finally, the fifth section provides a summary and concludes.

Literature Review

Several studies in the past have studied the Indian commodity markets with the objective of investigating the issue of market efficiency. Examples of research on the efficiency of the Indian commodities markets include Sahadevan (2002), Sahi and Raizada (2006), Lokare (2007), Bose (2008), Kumar, Singh, and Pandey (2008), Sahoo and Kumar (2009), Iyer and Pillai (2010), Ali and Gupta (2011), Sehgal, Rajput, & Dua (2012).

Sahadevan (2004) performed tests on futures and spot prices for six agricultural commodities traded at different regional exchanges between January 1999 to August 2001 and obtained results rejecting $\boldsymbol{\beta}_o = 0$, $\beta_1 = 1$. Sahi and Raizada (2006), however, tested futures and spot prices for wheat contract traded at NCDEX between July 2004 to July 2006 and obtained results rejecting $\boldsymbol{\beta}_o = 0$, $\beta_1 = 1$.

Further, several studies have examined using Johansen's cointegration approach whether spot and futures prices are cointegrated, and found significant cointegration in spot and futures prices of various commodities contracts traded on Indian commodity exchanges (see Lokare, 2007; Kumar *et al*., 2008; Sahoo & Kumar, 2009; Ali & Gupta, 2011; Sehgal *et al*., 2012.) whereas Bose (2008) obtained results against market efficiency and price discovery of Indian agricultural indices between June 2005 to September 2007.

Further, Iyer and Pillai (2010) found evidence for price discovery in futures market in five out of six commodities using a two-regime threshold vector auto regression (TVAR) and a two-regime threshold auto regression model from October 2005 to March 2008. Furthermore, Ali and Gupta (2011) examined the price discovery of 12 major agricultural commodities contracts using cointegration and granger causality analysis between July 2004 to January 2007 and found significant cointegration between futures and spot prices for all the selected agricultural commodities excluding wheat and rice.

Although specific studies by Sahadevan (2004), Sahi and Raizada (2006), Lokare (2007), Bose (2008), Kumar *et al*. (2008), Sahoo and Kumar (2009), Iyer and Pillai (2010), Ali and Gupta (2011), Sehgal *et al*. (2012), Inoue and Hamori (2012); Soni (2014) have been done in Indian context, but Indian literature is limited to quantitative studies and has ignored the qualitative measures of enquiry. The approach of this study is to utilise mixed-method research to explore new thoughts to explain the existing crisis in Indian commodity markets.

Data and Methods

The paper can be broadly divided into two parts: first part of the paper empirically examines the pattern of growth over the years across different sections in the Indian commodity markets. It studies the past trends and patterns using monthly and yearly data of volume and value of trade at all the exchanges. Finally, qualitative approach (Delphi method) was employed to draw more precise and seek policy suggestions from experts in the area of Indian commodity markets which could make futures market more efficient in the long run and perform their role of price discovery and risk management more efficiently and effectively.

Data

To analyse the efficiency of futures market in Indian scenario, we focus on volume and value of trade on all the national level exchanges for food, non-food, precious metals, other metals and energy contracts traded in India. The period of study is from 2003 to December 2014. The data comprises of yearly as well as monthly volumes of the selected groups of commodities collected from FMC website and annual reports. The descriptive statistics such as mean, standard deviation, skewness etc. for value and volume series for all the commodities are presented in Table 1 and Table 2.

Delphi Method

Rather than following a conventional process, the paper employs a qualitative method of inquiry (Delphi technique) to understand the problems of Indian commodity markets and seek policy suggestions from selected experts which could make futures market more efficient in the long run and perform their role of price discovery and risk management more efficiently and effectively.

The Delphi method is very useful and reliable method of inquiry in case of new areas of research or areas with uncertain surrounding (Dalkey & Helmer, 1963; McKenna, 1994; Çipi, Llaci, & Ferreira, 2014). It was originally developed by the RAND Corporation in the 1950s and was applied to assess the direction of long range trends, with emphasis on science and technology and their effects on society; to forecast likely inventions, new technologies and the social and economic impact of technological change. Nowadays the method has been used in social science research.

It is defined as "a method for structuring a group communication process so that the process is effective in allowing a group of individuals, as a whole to deal with a complex problem." (Linstone & Turoff, 1975). It is based on the assumption that group judgement is better than individual judgement and capitalises on the collective opinions of experts (Linstone & Turoff, 1975; Moore, 1987; Murry & Hammons, 1995; Jones et al., 2000). The Delphi can be further be classified into following categories.

The Classical Delphi (a Forum for Establishing Facts)

It is a type of Delphi where data are collected from the participants in a series of rounds and the results are fed back to the participants until stability in responses among the participants has been achieved. The main aim of this Delphi is to reach consensus keeping in mind anonymity, through iteration.

The Policy Delphi (a Forum for Generating Ideas)

Policy Delphi is mainly used in social and political issues and is suitable for application in the social sciences. The aim of policy Delphi is not to reach stability (consensus) in response but generate policy alternatives. Here the Delphi is used as an instrument for policy development and promoting participation.

The Decision Delphi (a Forum for Making Decisions)

Decision Delphis are used for decision making on social developments. In this type of Delphi, it is crucial that all decision makers involved in the problem participate. They are selected according to their position in the hierarchy of decision makers. The aim is to structure thinking so that consensus can be achieved.

The Group Delphi (A Face-to-Face Meeting)

This type of Delphi differs from the classical Delphi only on the point of anonymity.

Delphi Process

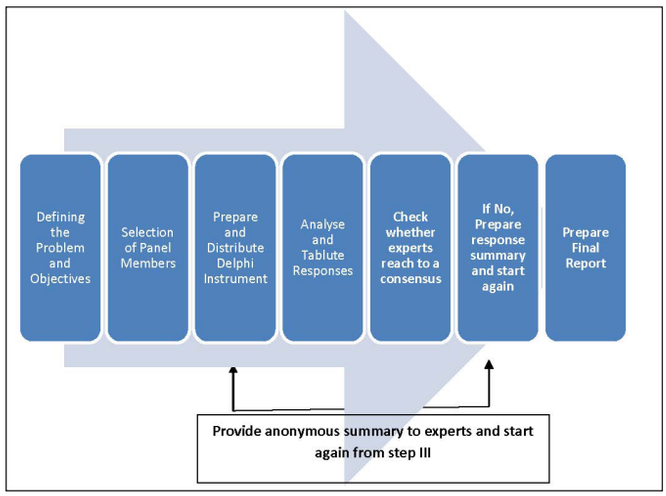

Fig. 1: Delphi Process

In our case we have used the 'Policy Delphi' approach to take response from experts in the field of commodity

markets. The experts were chosen on the basis of their contribution to the field of Indian commodity derivatives markets. The letters of requests were sent by email and four experts were chosen among the pool of experts which accepted to participate.

The study was conducted in three rounds. In the first round, the Delphi was initiated by few simple open-ended questions (Appendix 1) on the chosen theme. In the second round, the problems and suggestions from the first round were compiled. The anonymous compiled answers were sent again to the experts so that group could arrive at a consensus. In the third round, the experts placed a value on the importance on suggestions at which consensus was formed.

Results and Discussion

To start with the descriptive statistics such as mean, standard deviation, skewness etc. for spot and future series for each commodity contract are presented in Table 1.

Table 1: Volume in (Lakh Crore)

Year	*T.Val*	*% Change*	*Agri.*	*% Change*	*Metals*	*% Change*	*Energy*	*% Change*
2003-04	1.29		-		-		-	
2004-05	5.72		3.9		1.8		0.02	
2005-06	21.55		11.92		7.79		1.82	
2006-07	36.77	70.63	13.17	10.49	21.29	173.3	2.31	26.92
2007-08	40.65	10.55	9.41	-28.55	26.24	23.25	5	116.45
2008-09	52.49	29.13	6.27	-33.37	35.96	37.04	10.26	105.2
2009-10	77.65	47.93	12.18	94.26	49.66	38.1	15.78	53.8
2010-11	119.49	53.88	14.56	19.54	81.82	64.76	23.11	46.45
2011-12	181.26	51.69	21.96	50.82	130.79	59.85	28.51	23.37
2012-13	170.47	-5.95	21.56	-1.82	111.23	-14.96	37.68	32.16
2013-14	101.45	-40.49	16.02	-25.7	60.7	-45.43	24.72	-34.39
2014-15*	56.436	-44.370	9.920	-38.070	31.660	-47.841	14.841	-39.964

** Till Feb 2015*

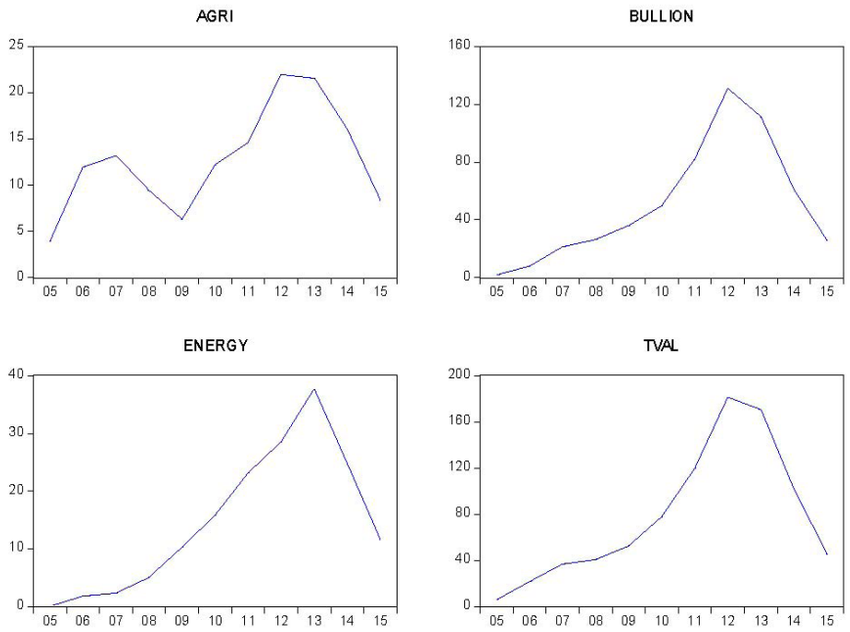

Fig. 2: Volume of Trade in Lakh Crore

Table 3: Descriptive of Volumes in Lakh Crore

Measure	*AGRI*	*BULLION*	*ENERGY*	*Total Value*
Mean	12.67	50.26	14.62	77.55
Max	21.96	130.79	37.68	181.26
Min	3.9	1.8	0.02	5.72
Std. Dev.	5.73	42.06	12.45	58.9

As observed in Table 1 and Fig. 1, the Indian commodity markets grew at a tremendous rate from 2006-07 till 2011-2012. The policy makers were skeptical whether the markets could sustain such a high growth rate. The slight weak trend was observed in 2012-13 when the value decline by 5.95%; however several reasons were attributed for the decline including decline in prices of commodities along with ban of several non-food items which were traded in the previous years. The negative trend continued and in fact took over after the NSEL scam was surfaced.

The 2014 witnessed the steepest fall in the history of Indian commodity markets wherein in the volume fell by 40.5 %. The metal segment has experienced the greatest set back where volumes fell by about 45%. Even though different measures were adopted to restore confidence despite the response has been poor. Further, all the three categories have been badly hit with an overall fall in value by 44%. In the current year the metal sector saw 47% fall from the previous year. The energy sector experienced a dip of 39% and 38% in Agriculture sector. Till February 2015, the market value has shrunk to 56 lakh crore which is almost at the same level of 2008-09.

Furthermore, the analyses of monthly data from April 2012 onwards also illustrate interesting patterns in the value and volumes of trade for four categories Fig. 2 and Fig. 3. The downfall can be clearly seen in 2013. The plots also reflect patterns of seasonality especially in Agriculture and Metal sector.

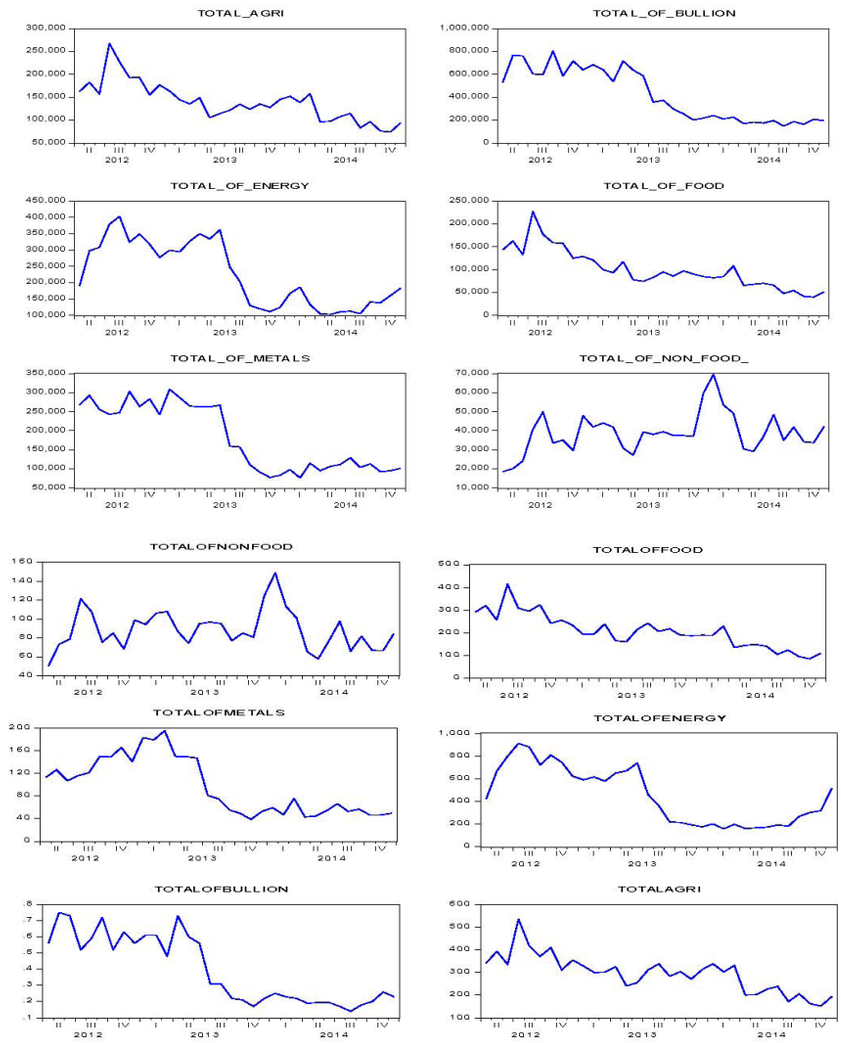

Fig. 3: Monthly Value of Trade from April 2012 till December 2014

Table 4: Descriptives Statistics of Monthly Value and Volume of Trade from April 2012 till December 2014

	AGRI		*BULLION*		*ENERGY*		*METALS*	
Mean	139260	417761	139260	0.4	224260	450.78	180878	96.36
Max	267431	803367	267431	0.75	403248	910.48	308911	195.14
Min	73656.5	147111	73656.5	0.14	102970	158.2	76127.1	38.54
Std. Dev.	42808.2	229996	42808.2	0.21	99895.4	252.85	85626.1	49.94

After studying the trends and patterns, we proceed with the Delphi study to get inputs from experts. The Delphi lets us understand the problems faced by markets and some solutions to the problems outlined. The study was initiated by posing open ended questions related to the following themes including major challenges faced, novel policies that could improve the scenario, areas which require immediate policy intervention, any upcoming unprecedented events that might pose new challenges to Indian commodity markets and how to address the identified problems. The open-ended nature of the questions provided ample scope to the experts to express their views on the above-identified themes.

After the completion of first round the responses were collected and summarised to know the commonalities and patterns. The summarised responses are attached in Appendix 2. The responses of the first round were used to get more information from the experts in the consecutive rounds of Delphi. From the analysis of responses in case of the problems related to Indian commodity markets, the experts in total listed 34 problems which could be broadly be classified into regulatory issues, legal and operational issues. In case of novel policies which could improve the situation, 11 measures were identified. Further, four areas which require immediate policy intervention were also identified. Furthermore, three common solutions were also identified from the responses of the experts. Finally, experts were also asked to give further explanation in case of some responses which required further discussion and clarity were sent back seeking comments from the experts.

Among the different problems identified, high volatility, lack of transparency and trust, high speculation, inefficient commodity futures, Obsolete Forward Contracts (Regulation) Act, 1952 (FCRA), ambiguity in establishment and regulation of spot exchanges, levy of commodity transaction tax, less powers given to the regulator were among the prominent challenges faced by the commodity markets. Further, in reply to the question which inquired inputs on areas which require immediate policy intervention, commodity transaction tax, integration of timing of commodity market with stock market, Amendment to Futures Contract Regulation Act and measures to minimise the volatility of the market were among the identified areas. Furthermore, in terms of suggestion to novel policies that could improve the scenario of Indian commodity and derivative markets, launching of long term contracts similar to international markets, waive off of CTT which could help improving liquidity in commodities trade, allowing options on commodity futures, permit entry of institutional investors, including foreign institutional investors, amending FCRA to make FMC autonomous, inducting independent chairman, qualified economists & professionals and half the members of FMC from private sector, promoting FMC a development institute rather than just a regulatory institute, and establishment and regulation of spot exchanges so that scams like NSEL can be prevented were among the important suggestions given by the experts to improve the current scenario.

Summary and Conclusion

In the present paper, we have studied the trends in the Indian commodity markets by analysing archived data of volume and value of trades of the commodities traded since 2003. The paper adopted a mixed method approach wherein the qualitative inquiry incorporates a different angle to the existing literature on Indian commodity markets. Through the usage of the Delphi technique the paper has tried to gather policy suggestions from a panel having in-depth expertise in the area of Indian commodity future markets.

The analysis of past data indicates a steep fall in volume and value of trade in Indian commodity markets especially after 2013. Further, the substantial decline in volume of trade indicates an urgent need for revival of Indian commodity futures market. Furthermore, from the perusal of qualitative information collected from experts, certain

short run and long run measures which could improve the scenario were identified. Among the areas discerned, specific issues like amendment to Forward Contracts (Regulation) Act, 1952, regulation of spot exchanges, levy of commodity transaction tax, launching of contracts similar to international markets, allowing options trading on commodity/futures, permitting entry of institutional investors; could aid in potentially spurring discussion and debates among policy makers and other stakeholders to improve the efficiency of the existing exchanges.

Further, other measures like appointment of an independent chairman, recruiting a panel of qualified economists & professionals could also be a suggested measure that could aid in improving the current scenario. Furthermore, the regulators should follow a preventive & protective approach rather than adopting remedial recourses by means of spreading awareness about the importance of commodity exchanges to small and marginal farmers, educating the owners/ managers about how they can hedge the price risk and minimise the risk of higher input cost using derivatives. Further improving infrastructure like storage warehouses, road connectivity can also facilitate delivery system which can further improve the acceptance of these exchanges. Furthermore, use of latest and user friendly technology like mobile trading, installing kiosks at strategic locations can encourage mass participation leading to better price discovery and dissemination.

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Delphi round I

Respected Sir

This study is part of a departmental research project, being conducted as a Delphi study in three rounds (with feedback to participants after each round). The objective of this three round Delphi study is to ***identify the problems and bottlenecks in the Indian Commodity Derivative Markets and acceptable strategies for improving the scenario***.

You were chosen to participate in this process because ***of your expertise and contribution to the field of Indian commodity derivatives markets***. Your knowledge and comments, along with others, will be invaluable.

The data collected from the Delphi survey will be used for ***research purposes only***. Results will be published only as ***aggregate statistics, allowing no inference on any particular individual.*** To provide an additional safeguard, the information will be stored and ***analysed in anonymised form,*** where your name and email address will be removed from the database when we analyse the responses.

The study will be conducted in ***three rounds***. In the first round, we will start the Delphi by few simple ***open-ended questions*** on the chosen theme. In the second round, our team ***will compile the problems and suggestions from the first round***. The second round will allow you to place a ***value on the importance of all submitted suggestions***. You should receive round two within a week.

A third round of the form will be distributed by the last week of ***January 2015.*** This will include: 1) the distribution of scores for each of the responses and 2) any additional responses and comments from the participants. Once again, you will be asked to rank the data elements in light of the scoring and comments from the other participants. This will allow you to reconsider your opinions in relation to the other participants. If there is convergence of core data elements after this round, we will tabulate and report the results to you. Otherwise, there will be one more round so that we can reach a consensus. ***The responses for all rounds should take less than an hour of your time.*** At the completion of the data input, I will send you a summary of the findings.

The results of this research will help **i*nform policymakers, regulators at national and international level*** about the key challenges faced by the Indian commodity markets, areas which require intervention and the probable novel solutions which would aid in improving the current scenario.

If you have any questions, please don't hesitate to contact me at tarunksoni86@gmail.com or +917725941828

To participate in the Study click on the link below

http://goo.gl/forms/XOY5M7u2rw

Delphi Round I Questions

1. In your opinion what are ten major challenges faced by Indian commodity and derivative markets?
2. Can you suggest some novel policies that could improve the scenario of Indian commodity and derivative markets?

3. Can you suggest areas which require policy intervention?
4. How you would address the areas suggested by you which require policy intervention?
5. Do you see some upcoming unprecedented events that might pose new challenges to Indian commodity markets? If yes, list down those events.

Delphi Round II Questions

Dear Panelist,

We kindly invite you as member of the Delphi panel, to participate in the second round of our Delphi questionnaire study. The summary of the results of our first round have been included in the attached response sheet.

For this second Delphi round, *we would like you to strike out the responses which you consider are not relevant among the given options*. Please answer the questions based on your experience and knowledge within a week followed by a third and final round.

We are very grateful for your participation in the Delphi Panel and your contribution to this project. Your opinion will support the development of policy recommendations in the area of Indian commodity markets which could make futures market more efficient in the long run enabling them to perform their role of price discovery and risk management more efficiently and effectively.

Thank you very much for your participation!

Instructions: Mark those options which you consider as not relevant/inappropriate

Procedure: Double click on the check box and change the default value, Click ok the check box will appear as to and save your word file before exit

In your opinion what are major challenges faced by Indian Commodity and Derivative Markets?

1. Volatility of the Derivative Market
2. Inefficiency of the Commodity Market
3. Inconsistency of the available data
4. Transparency of the Market
5. Inefficient market
6. Increasing risk in participation in the market
7. Effect of increasing prices of fertiliser etc .on agriculture commodities
8. World prices on the return of commodity prices
9. Us Dollar Exchange rate
10. Excessive financial speculation
11. Commodity Transaction Tax
12. Compulsory Delivery Provision for Agro-Futures Contracts
13. Reckless regulation by FMC
14. Obsolete Forward Contracts (Regulation) Act, 1952 (FCRA) .
15. Absence of Options Trading
16. Absence of Institutional Investors
17. Absence of Foreign Institutional Investors
18. Narrow Agro-Futures Contracts
19. Absurd Futures Contracts in most Commodities
20. Lack of Depth in Agro-Futures Trading.
21. Absence of Full Rupee Convertibility
22. Fear of Merger of FMC & SEBI
23. Use of commodity derivative market for speculative purposes
24. Lack of research in the field
25. Lack of integration of regional exchanges
26. Less knowledge of market players.
27. Unorganised spot market
28. Less powers given to the regulator FMC
29. Lack of availability of high frequency data.
30. Ambiguity about registration of spot exchanges.
31. Establishment and regulation of spot exchanges.
32. Non-tradability of commodity indices.
33. Liquidity issue with many commodities
34. Lack of transparency and trust by many user classes

Can you suggest some novel policies that could improve the scenario of Indian Commodity and Derivative Markets?

1. Longer term contracts can be launched as are seen on established international commodity markets
2. CTT can be waived off. This was the reason for drying up of liquidity in commodities trade.
3. Allow options on Commodity Futures
4. Permit Entry of Institutional Investors, including Foreign Institutional Investors
5. Develop relative broad based derivative contracts, especially for agro-futures.
6. Make Rupee Fully Convertible.
7. Amend FCRA to make FMC autonomous.
8. Induct Independent Chairman and half the Members of FMC from private sector.
9. Induct Qualified Economists & MBAs as Chairman & Members of FMC
10. Make FMC a development Institute rather than just a regulatory Institute.
11. The Market should be an Efficient market

Can you suggest areas which require immediate policy intervention?

1. Commodity Transaction Tax
2. Integration of commodity market with stock market, like timings etc.
3. Amend FCRA
4. Steps should be taken to minimise the volatility of the market

How you would address the areas suggested by you which require policy intervention?

1. Commodities are fairly young market place in India in terms of products like Futures. Levying any tax will discourage the real users from use of the products.
2. Most important is the establishment and regulation of spot exchanges so that scams like NSEL can be prevented.
3. Amend FCRA to permit option trading and allow trading by institutional, including foreign institutional, investors.

Do you see some upcoming unprecedented events that might pose new challenges to Indian commodity and derivative markets? If yes, list down those events.

1. Challenges from the international markets.
2. Threat of merger of FMC & SEBI.

Lack of educational institutes specialising in commodity derivative trading theory, practice & regulatory and development laws.