Indian Commodity Market: Performance Evaluation and Future Opportunities for Economic Expansion"

Sonia[1], Tilak Raj[2]
[1] Research scholar, Department of Commerce, M.D.U. Rohtak.
[2] Professor, Department of Commerce, M.D.U. Rohtak.

Abstract

The commodity market is one of the key components of every nation's financial sector. A wide range of goods including metals, crude oil, and agricultural commodities including cotton, wheat, rubber, maize, sugar, maize, and coffee, are traded on the Indian commodity market. The Indian commodities market has a long background, but it hasn't grown much because of an intermediary prohibition on commodity trade. These days, the trading volume in this new market is expanding more quickly, which will help the Indian economy flourish. The present study aimed at examining the Indian Commodity Market's steady expansion, finding investment opportunities in commodities and exploring the various methods to get exposure to commodities. It is concluded that India's economic expansion in the next twenty years will mostly be led by a diverse range of commodities, such as energy products (both traditional and alternative), several types of metals (industrial, foundational, and valuable), polymers, and agricultural items. Therefore, exchanges, regulators, and policy makers should priorities this objective to enhance agricultural livelihoods and ensure food security.

Keywords: Commodity Market, Diversification, Hedging, Risk Management

1. Introduction

An important constituent of the financial market is the commodity market. It comprises an extensive assortment of commodities, such as energy, metals, petroleum oil, precious metals, and agricultural products such as coffee, wheat, and cotton etc. Approximately 120 different products are transacted on the commodity market in India. Futures contracts comprise the vast majority of market dealing. The commodity market functions as a mechanism for price discovery, whereby the dynamic interaction between supply and demand determines the prices of commodities. In the commodities market, the underlying asset is a commodity. Commodity derivatives comprise instruments that are traded both over-the-counter and on exchanges. Margin accounts are an essential component of standardized contract trading, as they provide investors with protection against counterparty risk. The commodity market functions as a price discovery mechanism, where the commodity prices are being determined by the supply and demand for the commodity.

2. History of Commodity Market in India

Commodity trading in India has a long history, dating back to the Bombay Cotton Trade Association Ltd.'s establishment in 1875. The 'Gujarat vyapar mandli' was established in 1900 to facilitate future trade in oilseeds, pulverized nuts, castor seed, cotton seed, and other commodities. The Calcutta Hessian Exchange facilitated the exchange of jute raw materials and jute products in 1919. To regulate the commodity exchange, the Forward Market Commission was established in 1952 and began its operations with cotton jute, oil seeds, ground almonds, wheat rice sugar, and a number of other commodities.

As a result of numerous regulations, trading in forwards was banned entirely in 1996. Following the Khusro committee's recommendation, the Indian government reinstated forward trading in 1980 for a limited number of commodities, including cotton, rubber, jute, and others. The process of liberalisation revitalised commodity trading in India. Subsequent to the Kabra committee's recommendation, commodity futures trading commenced in 2003 and commodity trading in India was streamlined. The government granted permission for future trade in all of the proposed commodities and adopted the majority of the recommendations. Three national exchanges were granted authorization by the government for future trade. It elevated itself to compete with international titans such as NYMEX, CBOT, CME, LME, etc. on the global market. The commodity market has historically been a topic of concern on a global scale due to the fact that commodity transactions promote excessive speculation, which is consequently accountable for the escalation of commodity prices.

In the past, the Indian government had placed significant limitations on forward and prospective commodity derivatives trading. However, in the current context, the government has eliminated restrictions on numerous commodities, leading to a substantial expansion of the commodity market in India. At the outset, derivatives were acknowledged primarily as a mechanism for mitigating risk. However, their utility has since been expanded to encompass safeguarding investments, particularly in the realm of regulated commodity exchange.

3. Literature Review

Neharika Sobti (2019) attempted to ascertain the possible outcomes of ban on trading in futures in certain agri-commodities in India. The researcher examined the consequences of the ban on future trading and re-launch or resumption on its spot volatility of five selected commodities by using parametric and non-parametric methods of analysis. To explain the effect of ban on agri-commodity futures te sample period ranging from 2003 to 2011 has been selected and divided in three different phases: Pre-ban, during the ban and After re-launch. By considering the view of the increasing examples of prohibition of the agri-commodity futures trading across the sample period, the researcher also tried to explore the cause of underperformance of the Indian agricultural commodity market.

In their investigation, **Hariharan and Karunakarareddy (2018)** sought to comprehend the structure and development of the Indian agricultural commodity market, as well as price volatility and market efficacy. According to the findings of the researchers, MCX exhibited the greatest turnover in terms of transaction value, with NCDEX, NMCE, and ICEX following suit. Over the course of five years, from 2009-10 to 2013-14, the research uncovered a decline in agricultural commodity trade in 2008-09. This decline was attributed to the government's imposition of bans on four specific commodities, namely poultry, potatoes, rubber, and soy oil. Agriculture being the backbone of the country, the researchers also recommended that a national exchange be established to ensure operational transparency and efficiency, and that farmers and merchants be educated on how to manage hedging practices and obtain a higher return, in order to facilitate better returns.

Gupta, Choudhary and Aggarwal (2017) endeavoured to analyse the hedge ratio and hedging effectiveness in NCDEX and MCX-traded agricultural (guar seeds, castor seeds) and non-agricultural (nickel, copper, gold, silver, crude oil and natural gas,) commodities. The findings of the study indicate that the Indian futures market offers superior hedging efficacy for precious metals (gold and silver) in comparison to energy and non-precious metals. Additionally, the researchers suggested that policymakers consider transaction cost, the quality of underlying assets, and the quantity of delivery centres.

Raveendarnaik (2017) attempted to identify significant challenges in the evolution of the commodity derivatives market in India. The researcher gathered significant data from a variety of sources, including the internet, journals, articles, textbooks, and newspapers. The study presented annual trade and value development for each exchange. It was stated that MCX has documented the highest growth rate, followed by NCDEX. The researcher further elaborated on a range of obstacles, including regulatory and legal changes, infrastructural challenges, and lack of awareness among investors. The study proposes that policymakers prioritise the integration of regional and national exchange.

In their study, **Shivakumar and Kotreshwar (2017)** sought to ascertain the efficacy of the maize future market. The primary objective of the research was to empirically examine the long-term and short-term relationships between the spot and future markets. Additionally, the causal relationship between the two markets, namely the maize spot market and the maize future market, was investigated. Daily closing prices of maize for two kharif seasons were obtained from the NCDEX for this purpose. Utilising the unit root test for stationarity and the Granger causality test, the researchers analysed the short-run and long-run relationship between spot and future prices.

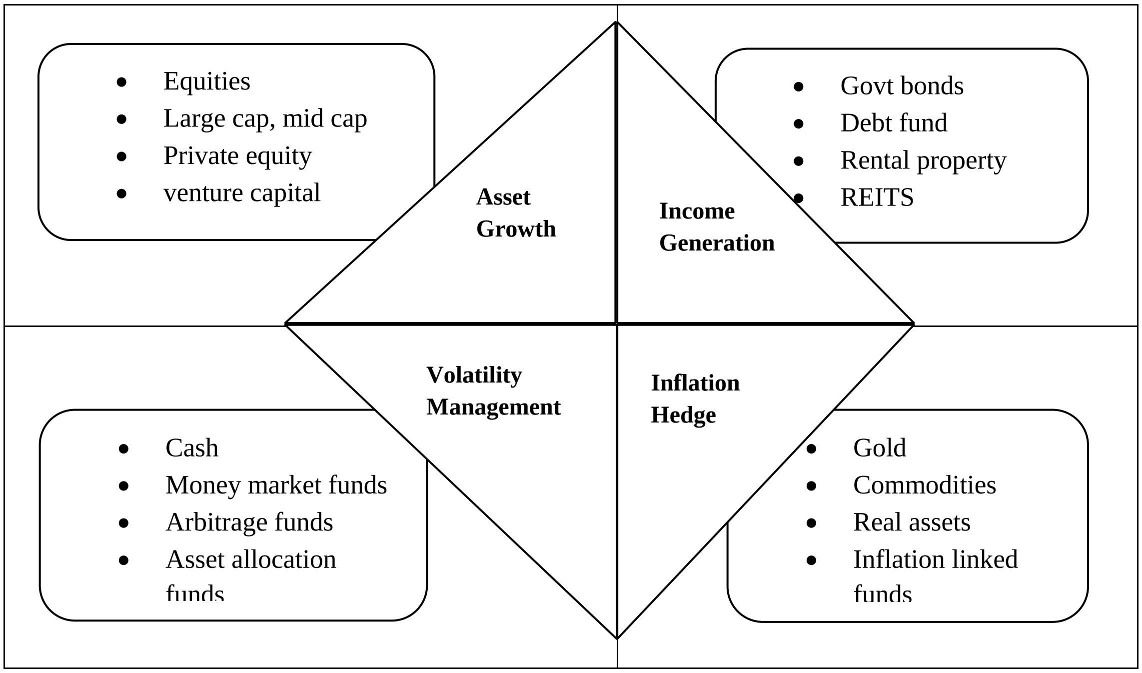
4. **Finding Investment Opportunities in Commodities**

Given their continued relevance over hundreds of years, commodities are perhaps one of the oldest asset classes in human history. The potential for inflation-adjusted returns and, in the present era, as a tool for portfolio diversification have been the main reasons why commodity-related investments have been well-liked by investors. Energy (crude oil, natural gas, heating oil, etc.), animals and meat (cattle, lean hogs, etc.), and metals (aluminium, copper, gold, silver, etc.) are the four main categories into which commodities may be generally divided. An essential component of a well-diversified portfolio is the many investment products and structures that give investors direct or indirect exposure to commodities. All of the main commodity classes are available as financial instruments, depending on the region and the significance, but precious metals are the only class of commodities that the average investor may obtain in physical form. While sovereign gold bonds (SGBs) and exchange-traded funds (ETFs) have enabled more "non physical" gold and silver to be stored, precious metals like silver and gold are still typically held in physical form in the Indian setting.

- **Diversification:** Commodities can help investors lower the overall risk of their portfolio and guard against volatility since they have a low connection with traditional asset classes like debt and equities.
- **Hedge against inflation :** Commodities are frequently viewed as an inflation hedge, especially precious metals like gold and silver. Commodity prices naturally tend to rise during periods of inflation, when fiat currency loses buying power. Purchasing commodities-based products can help investors preserve the value of their portfolio and act as a potential hedge against inflation.
- **Possibility of Large Returns:** Long-term price volatility in commodities might present chances for gains that could be quite large.
- **Commercial Risk Management**: To guard against changes in the price of input raw materials as well as finished goods, commercial operations might employ commodities derivatives as a risk management strategy. To achieve their commercial objectives, farmers, miners, and processing facilities might profit from employing derivatives for hedging.
- **Global Exposure:** Because commodity prices are linked globally, investing in commodities can give investors exposure to global markets. This can help investors diversify their holdings across different geographies and possibly increase returns by taking advantage of opportunities in some regions that are otherwise unattainable for local investors.

5. **Asset Allocation Framework**

Investing in all four quadrants of a sound asset allocation framework—asset growth, income generation, hedge against volatility, and hedge against inflation—is what is termed as Permanent Portfolio. Investing 25% of portfolio in each of these quadrants enables to take advantage of different market cycles and diversify the investments one hold.



Source: Commodity Insights yearbook 2022-23

The **Asset Growth** quadrant includes investments in large, mid, and small-cap equities, enabling investors to profit from rising equity markets. The **income generation** quadrant includes debt funds and bonds, which enable investors to make consistent profits regardless of the state of the equity markets. Investments in cash or dynamic asset allocation funds, which lessen portfolio drawdowns, particularly during unstable equity markets, are included in the **Hedge Against Volatility** quadrant. The **Hedge Against Inflation** quadrant includes investments in hard assets, such as agricultural commodities, base metals, gold, silver, and oil, which enable investors to earn a higher real rate of return by overcoming inflation, as well as diversification (low correlation with equities and bonds). Purchasing or selling actual resources, such as gold, oil, and agricultural goods, is what it means to invest in commodities. Commodities have some risks, such as price volatility, but they may also diversify a portfolio and serve as a safeguard against inflation. Purchasing real commodities, making investments in futures contracts, or purchasing commodities-related equities or exchange-traded funds (ETFs) are some of the ways one might invest in commodities.

6. **Methods to Get Exposure to Commodities**

- **Spot (cash transaction):** The physical commodity is bought on the spot, i.e. the investor receives the commodity immediately in exchange for cash. Private investors can perform cash transactions in precious metals like gold, silver, platinum, and palladium.
- **Futures and Options:** They are exchange-listed and standardized contracts for the delivery of a specific quantity of a commodity at a specific location, on a certain date, and at a specified price. Futures are derivatives, and investors first of all need to open a margin account in order to be able to trade in them. In addition, futures positions must be

actively monitored because they need to be closed before maturity in order to prevent an unwanted physical delivery. While one needs to maintain sufficient margin to be an Option seller, one can buy Options with a small premium amount.

- **Index products:** Index products bundle several commodities futures, with a wide range of products and strategies available. The benchmark indexes generally follow a buy-and hold strategy and hold futures in all commodity sectors. Besides the changes in the spot rate, the roll yields have an impact on the index performance.
- **Funds / exchange traded funds:** Exchange traded funds (ETFs) are investment funds that are listed on an exchange and are traded in the same way as equities. Most ETFs are index funds that replicate an index. They provide a cost-effective way of investing in physical commodities or in a commodity index based on at least one or multiple commodities.
- **Equities:** Investing directly in equities from commodity producing companies makes it possible to invest indirectly in commodities that are difficult to access. The development of the share price can, however, deviate from the performance of commodity. the underlying of all the above, Index/ETF investing offer several benefits making them a popular choice when it comes to commodity investing.

7. The Role of Commodity Exchange in Facilitating Revolutionary Shifts

Commodity derivative trading plays a crucial role in the economy. It offers a tool for hedging. Manufacturers who handle commodities that can be either inputs or outputs face significant price risk, particularly in today's turbulent global market. It has been noticed that the commodity cycles have exhibited shorter amplitudes. In 2021, there was a significant increase in commodities prices following the outbreak of the pandemic, resulting in a boom. In 2022, prices fell despite the fact that they rose during the Ukraine war. Currently, prices are rather stable, but it is uncertain how they would respond once the global economy gains speed. Specifically, the prices of metals such as steel, aluminium, and copper have seen significant fluctuations, with the influence of China playing a key role. Crude oil has always been a source of uncertainty, with prices experiencing substantial fluctuations. Thus, it is imperative for any consumers or dealers involved in trading these commodities to have a means of hedging. Consequently, commodity exchanges in India have created significant price standards for traded commodities. Participation has been on the rise, evident from the increased engagement of value chain actors and the number of deliveries occurring. The contribution that has been made by the commodity markets is that while the exchange ostensibly provides a platform for futures trading where contracts are devised and participants buy and sell them, there is a major infrastructure contribution that has silently built up in the background which is rarely acknowledged. This has been done by the exchanges in a very comprehensive manner.

MCX has positioned itself as the dominant exchange for metal and energy products, with a strong and accurate price discovery process that aligns with international market prices. The actual price discovery occurs on exchanges such as LME (London Metal Exchange) or CME (Chicago Mercantile Exchange) Group. The main objective is to enable participants to mitigate risks by trading on an Indian exchange instead of worldwide markets. Furthermore, the decreasing cost of operations has resulted in organisations increasingly using this platform. However, any profit or loss experienced in the spot market is counterbalanced by the opposite outcome in the futures market, resulting in a successful hedging strategy. The contracts have been developed by exchanges in collaboration with the value chain partners to ensure the suitability of the product selection.

8. Conclusion

The purpose of the appeal is to advocate for the elimination of restrictions on futures trading in agricultural commodities in order to maximize the economic benefits. The primary factor contributing to the inadequate growth of these sectors is mostly attributed to regulatory measures. Unforeseen restrictions on trade or the introduction of new contracts might disrupt hedging programmes. The government may gradually shift its focus from directly managing big quantities of food grains and instead rely on exchanges to support trading. Companies should adopt a more assertive approach in mitigating their exposure to pricing fluctuations. With an increase in participation and a more robust mechanism, trade costs would decrease and all players would gain. This is the essence of the possible social and economic revolution. Developing agricultural derivatives markets is essential in the framework of free markets. Therefore, exchanges, regulators, and policy makers should prioritize this objective to enhance agricultural livelihoods and ensure food security. Creating futures contracts that effectively fulfill their roles of transferring risk and establishing market prices is an essential initial stage. India's projected economic expansion over the next 2-3 decades, which will heavily rely on commodities, should serve as an awakening for policymakers. They should priorities the commodity sector and develop policies that promote sustainable and growth-oriented strategies for the long term.

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