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COMMODITIES
Futures Perfect
Inflation at two-year high + political compulsions = a ban on certain commodity futures trading
 MOBIS PHILOPOSE & POOJA MESWANI



ANTHONY LAWRENCE

On 19 January, data compiled by the Office of the Economic Adviser showed that inflation reached a two-year high of 6.12 per cent. While the repo rate has been increased once again to contain inflation, another move made by the government to curb inflation has been the rather extreme step of delisting all contracts of urad and tur on commodity futures exchanges.

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The ban was not completely unexpected, though. For one, the Standing Committee on Food, Consumer Affairs and Public Distribution seeking amendment to the Forward Contracts (Regulation) Act had stated in a recent report that futures contracts on agri-commodities must be banned. What probably added fuel to the fire was that the rise in prices of these agri-commodities was among the highest in the wholesale price index (WPI). Led by urad, which rose by 39.8 per cent over the past year, the pulses family jumped by 27.5 per cent. What is strange, however, is that tur and urad have been targeted — together, they have a meagre 0.23 per cent weight in the WPI. Also, futures trading cannot be entirely held responsible for inflation. For example, the price of moong, on which futures trading is not available, has risen as much as 35.7 per cent in the past year. Similarly, the prices of a number of cereals on which futures trading is not available, such as jowar and bajra, have risen in double-digits (see 'The Futures Link').

So, what led to the price escalation? Here are some facts: the production of foodgrains has been on the decline (see 'Crop Fail'). And things have just got worse this fiscal. The first advance estimates for production of tur in fiscal 2006-07 stand at 2.47 million tonnes, about 4 per cent lower than the production of 2.57 million tonnes in FY2005-06. In fact, most kharif cereals have also taken a hit. Production of jowar, for instance, is estimated to drop by 9 per cent, while that of maize is set to drop by 8 per cent. Production of ragi might drop by over 50 per cent. At the same time, demand has been on the rise, thanks to a growing population. It is no surprise, therefore, that the prices of agri-commodities have gone up, regardless of whether futures trading is available or not.

However, there is a notion, especially in political circles, that futures trading is responsible for the situation. The Standing Committee report states: "Most analyses of the recent sharp increase in the prices of essential commodities have linked the inflationary pressures to the speculative spree in these commodities in the futures markets. In many of these, the hoarders have taken future positions at high prices to prosper by their hoarding operations."

BW has yet to come across an analysis that links the rise in commodity prices to the futures market. Outstanding positions accounted for only 3 per cent of annual production of urad and tur. First, it is unlikely that futures prices would give a lead to spot prices with such a low level of open interest. Second, even if hoarding is taking place in the spot market, it is unlikely that the futures market has a major role to play.

Worldwide, position limits are used to tackle the problem of manipulation. In India, they are probably more stringent than anywhere in the world. For both urad and tur, trading members are allowed a limit of 15,000 tonnes, or 1.5 per cent and 0.6 per cent, respectively, of annual production. The position allowed in near-month contracts is a tenth of that amount. Unless various trading members collude, prices cannot be manipulated. Says Madan Sabnavis, chief economist, NCDEX: "There has been no evidence of manipulation."

According to Susan Thomas, assistant professor, Indira Gandhi Institute of Development Research, if there was manipulation, one would have seen a pattern called 'burying the corpse'. Pulses have an expiry date, and cannot be hoarded endlessly.

So, once the profit on the futures market is made, say, on expiry of the futures contract, the hoarded stock would have been offloaded, leading to a drop in spot prices. But no such pattern has been observed.

Also, the current spot prices of urad and tur — Rs 3,450 and Rs 2,150 per quintal, respectively — are only about 3 per cent and 8 per cent lower than they were prior to the de-listing. Sabnavis says that spot market prices are always driven by current demand and supply, while futures prices are based on expected supply conditions in the market. Tur, for instance, had risen at a higher rate in the past three months because of lower production.

THE FUTURES LINK				
Prices of agri-commodities like moong, on which futures trading is not available, have also risen sharply in the past year.				
WPI* sub-indexes	Trading status	1-year change	3-month change	
PULSES				
Gram	Not traded	30.1	-4.5	
Tur	Traded	8.5	-0.5	
Moong	Not traded	35.7	-7.0	
Urad	Traded	39.8	-4.3	
CEREALS				
Wheat	Traded	17.4	6.6	
Jowar	Not traded	10.0	-3.2	
Bajra	Not traded	10.8	9.9	
Ragi	Not traded	12.8	2.8	

*WPI: Wholesale price index; All figures are in per cent. Source: Office of Economic Adviser, Ministry of Commerce, Government of India

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CROP FAIL Both the kharif and rabi crops have been declining.							
Crop	2003	2004	2005	Crop	2003	2004	2005
	-04	-05	-06*		-04	-05	-06*
Kharif pulses	6.17	4.72	4.66	Kharif cereals	110.83	98.59	105.04
Rabi pulses	8.74	8.41	8.45	Rabi cereals	87.45	86.64	90.15
Total pulses	14.91	13.13	13.11	Total cereals	198.28	185.23	195.19

Figures in million tonnes *4th advance estimates Source: Department of Agriculture & Cooperation

Finally, the Standing Committee has noted that since small farmers do not participate in commodity futures markets, there is no need for these markets. But the world over, futures markets are used by large farmers, traders, banks and insurance companies that have an exposure to the sector. India is no different. As and when banks and insurance companies are allowed to participate in futures markets, they can hedge their exposure to farmers and give better terms to them. Apart from this, farmers can also benefit from the important function of price dissemination.

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