

Rethinking suspension

Futures trading is not a source of inflation

To combat high food inflation and increased spot price volatility, the Securities and Exchange Board of India (Sebi) in 2021 suspended derivatives trading in seven agricultural commodities — wheat, soybean, crude palm oil, paddy, moong, chana, and mustard oil/seeds. Subsequently, the suspension was extended till the end of this year. As the rate of retail inflation surged to a 14-month high of 6.2 per cent in October, driven by food prices, a reality check is in order for evaluating the merits of the ban and its extension. In this context, two recent studies — by researchers at Birla Institute of Management Technology, and Indian Institute of Technology Bombay — have done well to examine the effectiveness of the futures trading suspension on retail prices.

Contrary to expectations, the studies showed that the wholesale and retail prices of the commodities did not decline after the suspension. The retail-to-wholesale price difference in the post-suspension period also turned out to be much higher than in the pre-suspension period. Higher price spreads not only inflate the price paid by end consumers but also affect farm prices, thereby rendering farmers more vulnerable. The seven suspended commodities constituted more than 70 per cent of the traded volumes in the Indian agri-commodity futures market before the ban. In fact, immediately after the suspension, the daily turnover of the National Commodity and Derivatives Exchange declined from about ₹2,000 crore to ₹300-400 crore.

Rather than dealing with the immediate transfer of goods, a futures market is based on buying or selling commodity contracts at a fixed price for delivery at some future date. The settlement can also be done in cash. Commodity futures contracts (CFCs) offer myriad benefits in terms of hedging against sudden price volatility and aid in price discovery for market participants. By assuring farmers of a fixed value for their agricultural produce, CFCs act as an effective price-risk hedging method and protect farmers from price fluctuations. Previously, the Abhijit Sen Committee report in 2008 and a study conducted by the Reserve Bank of India in 2010 had found that futures trading in agri-commodities had no significant impact on their spot prices. Instead, the inflationary pressure on agri-commodities could be attributed to supply-side issues, import dependency, and global price movements. Additionally, in the absence of commodity derivatives markets, large traders and farmers tend to take over the market, becoming the main influencers of prices, which smaller traders and farmers are forced to follow. Thus, commodity exchanges remain crucial in avoiding exploitative practices by private traders or other intermediaries.

The attempt to engage in price control through suspension of trading has been unsuccessful. However, it is also correct that there have been instances of manipulation in some commodities because of thinly traded volumes. The reliability of a derivatives market's price discovery function is dependent on trading volume. Thinly traded markets are susceptible to price manipulation. Thus, the regulator needs to be mindful of these limitations, but that cannot be the reason for not having a market at all. India is one of the largest producers of many agricultural commodities and should not be denied the benefits of a derivatives market.