# GOVERNMENT OF INDIA
# CONSUMER AFFAIRS, FOOD AND PUBLIC DISTRIBUTION
# LOK SABHA

UNSTARRED QUESTION NO:2605
ANSWERED ON:10.08.2010
REGULATION OF FORWARD TRADING
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**Will the Minister of CONSUMER AFFAIRS, FOOD AND PUBLIC DISTRIBUTION be pleased to state:**

(a) whether the World Food Programme/Food and Agriculture Organisation have suggested to regulate forward trading to check food inflation;

(b) if so, the details of the said report alongwith the reaction of the Government thereto;

(c) whether the Government is contemplating to regulate or ban the forward trading of food items and agriculture products in view of the report of the World Food Organisation;

(d) if so, whether the Government has also received suggestions from various social organisations in this regard; and

(e) if so, the details thereof and the reaction of the Government thereto?

## Answer

THE MINISTER OF STATE IN THE MINISTRY OF AGRICULTURE AND THE MINISTER OF STATE IN THE MINISTRY OF CONSUMER AFFAIRS, FOOD AND PUBLIC DISTRIBUTION (PROF. K. V. THOMAS)

(a) & (b): Yes Madam, the Food and Agriculture Organisation (FAO) in its Policy Brief of June, 2010 on the topic 'Price surges in food markets − How should organised futures market be regulated?' has advocated adequate regulation of futures market to foster market performance, given the fact that the futures markets have become an integral part of the Food Market and perform an important role for many market participants.

The policy brief analyzes the global price surges in food market between 2006 & 2008. While attributing the rise in food prices to macro economic factors, such as high crude oil prices, strong demand for crops from the bio-fuel sector, falling stockpiles of food and lower cereal production, it stated that the upward swing may also have been amplified in the short term by speculation in organised futures market. However, it clarified that longer term equilibrium prices are ultimately determined in cash markets where buying and selling of physical commodities reflects the fundamental supply and demand forces that ultimately determine the prices. The policy brief stressed the benefits of futures contracts by stating that these contracts provided an important instrument to hedge against price risk in commodity markets and were basically used by all traders of physical commodities as part of their normal trading behavior. While commodity futures had become increasingly appealing to non- commercial investors (speculators), these speculators provided important liquidity to the market.

While debating on whether speculation in commodity futures increased price volatility on food markets, the policy brief puts forth the viewpoint that futures markets have stabilizing effect as traders merely react to price signals that eventually depend on market fundamentals. In this way, speculation could even accelerate the process of finding an equilibrium price. On the other hand, there is a possibility that, in the short term, powerful investors such as index funds might be attracted by the opportunities offered by the upward trend of a commodity price, thereby strengthening the trend and pushing the futures price further from its true equilibrium. The policy brief, however, could not find sufficient empirical evidence for both the hypotheses and felt that there were a number of reasons to believe that speculation might not have been the main driver of the food price surge. For one, price volatility had also been high for commodities that did not have futures markets or where these markets were not important (e.g. steel & rice). Furthermore, as excess demand in well functioning futures markets could easily be met by sufficient supply (i.e., by issuing futures contracts), the effect of speculation on the equilibrium price is relatively small and short compared to price swings of a physical asset where supply is less elastic or even fixed.

It must be noted that these observations are in the context of global market and not specifically premised on any particular country. The government is in agreement with the policy brief of the FAO. The futures market has become an integral part of the global food market and serves as an effective mechanism for price discovery and price risk management. The long term equilibrium price of food commodities is determined by fundamental supply and demand forces as reflected in the buying and selling of physical commodities in the cash market. As the futures markets plays a very important role of mitigating price risk in the commodity markets and emitting price signals for not only its users but also for the non-user stakeholders, effective regulation of the market becomes paramount. In India, the commodity futures market is closely regulated by the Forward Markets Commission by using stringent regulatory measures, such as margins, position limits, price circuit limits etc. that limit unrealistic movement of futures prices in the market. Also, unlike in developed markets, large investors such as hedge and index funds having the ability to invest large amounts of money in the futures market and thereby swing the futures prices away from its true equilibrium are Not Permitted to participate in the Indian market. The conservative regulatory framework in the Indian commodity futures market and absence of big fund investors ensures that the market performs its economic functions efficiently.

(c): The policy brief of the FAO does not recommend banning of futures trading of food items. The report recognizes the need for and economic utility of the futures market and recommends adequate regulation of the commodity futures market for improvement in market performance. The government and the market regulator are already effectively regulating the commodity futures market in India through the use of appropriate policy framework by the former and stringent regulatory tools and close supervision of the market on a daily basis by the later. The government does not contemplate banning of futures trading in food items nor does the FAO suggest any such thing.

The futures market, by serving as a platform for price discovery and price risk management helps various stakeholders in the food market such as farmers, producers, processors and exporters to plan their production or purchase / sale, get better value for their produce and mitigate the price risk. In addition to its aforesaid utility for the market players, price information emanating from the futures market is useful for policy makers to take timely corrective policy interventions on the supply or demand side, as the case may be, to redress the supply − demand gap (which is responsible for price rise in food items). For example, if a future shortage trend is indicated by the futures market, policy action to incentives the farmers for higher acreage and / or to liberalise the import regime etc. can be taken to ease the supply constraints in order to control the prices. Similarly, in an over supply situation, encouragement of exports, increased consumption by the consumers / processors etc. will ease the downward pressure on prices (to the detriment of producers). Thus, the futures market also acts as an indicator or enabler of potential policy changes to manage prices of food items in future. In view of the above, the government does not contemplate to ban futures trading of food items.

(d): No Sir, the government has not received any suggestion from any social organization in this regard.

(e): In view of answer (d) above, the question does not arise.