

IMPORTANT FACTOR CONTRIBUTING TO THE GROWTH OF DERIVATIVE AND OPPORTUNITIES OF DERIVATIVE MARKET

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Introduction

Factors contributing to the explosive growth of derivatives are price volatility, globalization of the markets, technological developments and advances in the financial theories.

Price Volatility: A price is what one pays to acquire or use something of value. The objects having value maybe commodities, local currency or foreign currencies. The concept of price is clear to almost everybody when we discuss commodities. There is a price to be paid for the purchase of food grain, oil, petrol, metal, etc. the price one pays for use of a unit of another person's money is called interest rate. And the price one pays in one's own currency for a unit of another currency is called as an exchange rate.

Prices are generally determined by market forces. In a market, consumers have "demand" and producers or suppliers have "supply", and the collective interaction of demand and supply in the market determines the price. These factors are constantly interacting in the market causing changes in the price over a short period of time. Such changes in the price are known as "price volatility". This has three factors: the speed of price changes, the frequency of price changes and the magnitude of price changes. (Pati et al., 2009)

The changes in demand and supply influencing factors culminate in market adjustments through price changes. These price changes expose individuals, producing firms and governments to significant risks. The breakdown of the BRETTON WOODS agreement brought and end to the stabilizing role of fixed exchange rates and the gold convertibility of the dollars. The globalization of the markets and rapid industrialization of many underdeveloped countries brought a new scale and dimension to the markets. Nations that were poor suddenly became a major source of supply of goods. The Mexican crisis in the south east - Asian currency crisis of 1990's has also brought the price volatility factor on the surface. The advent of telecommunication and data processing brought information very quickly to the markets. Information which would have taken months to impact the market earlier can now be obtained in matter of moments. Even equity holders are exposed to price risk of corporate share fluctuates rapidly. This price volatility risk pushed the use of derivatives like futures and options increasingly as these instruments can be used as hedge to protect against adverse price changes in commodity, foreign exchange, equity shares and bonds.

Globalisation of Markets: Earlier, managers had to deal with domestic economic concerns; what happened in other part of the world was mostly irrelevant. Now globalization has increased the size of markets and as greatly enhanced competition. It has benefited consumers who cannot obtain better quality goods at a lower cost. It has also exposed the modern business to significant risks and, in many cases, led to cut profit margins. In Indian context, south East Asian currencies crisis of 1997 had affected the competitiveness of our products vis - à - vis depreciated currencies. Export of certain goods from India declined because of this crisis. Steel industry in 1998 suffered its worst setback due to cheap import of steel from south East Asian countries. Suddenly blue chip companies had turned in to red.

The fear of china devaluing its currency created instability in Indian exports. Thus, it is evident that globalization of industrial and financial activities necessitates use of derivatives to guard against future losses. (Hansda et al., 2002) This factor alone has contributed to the growth of derivatives to a significant extent.

Technological Advances:

A significant growth of derivative instruments has been driven by technological breakthrough. Advances in this area include the development of high-speed processors, network systems and enhanced method of data entry. Closely related to advances in computer technology are advances in telecommunications. Improvement in communications allow for instantaneous world-wide conferencing, Data transmission by satellite. At the same time there were significant advances in software programmed without which computer and telecommunication advances would be meaningless. These facilitated the more rapid movement of information and consequently its instantaneous impact on market price.

Although price sensitivity to market forces is beneficial to the economy as a whole resource are rapidly relocated to more productive use and better rationed overtime the greater price volatility exposes producers and consumers to greater price risk. The effect of this risk can easily destroy a business which is otherwise well managed. Derivatives can help a firm manage the price risk inherent in a market economy. To the extent the technological developments increase volatility, derivatives and risk management products become that much more important.

Advances in Financial Theories:

Advances in financial theories gave birth to derivatives. Initially forward contracts in its traditional form, was the only hedging tool available. Option pricing models developed by Black and Scholes in 1973 were used to determine prices of call and put options. In late 1970's, work of Lewis Edington extended the early work of Johnson and started the hedging of financial price risks with financial futures. The work of economic theorists gave rise to new products for risk management which led to the growth of derivatives in financial markets. (John et.al., 2004)

Opportunities of The Indian Commodity Derivative Market

Tax Reforms In the past, speculative and non-speculative businesses in India were treated equally for taxation so far as right to set off or carry forward of loss was concerned, However over the years various forms of tax benefit were extended to other financial assets as well as markets in the Indian financial system. Such incentives were not extended to the Indian commodity derivative market which subsequently was placed at a disadvantage. In this context, the Indian commodity derivative market has been demanding amendments in the tax law correcting this discrepancy which stands in the way of growth of futures trading activities.

Besides the stamp duty provisions on futures trading make the transaction cost higher and moreover, the rates vary from one state to the other. While states like Gujarat, Madhya Pradesh, and Kerala do not impose stamp duty on futures trading, some other states like Maharashtra impose stamp duty on futures trading of certain commodities. Movement of some goods from one state to other is restricted at present. If it is removed then truly national market can be developed for physical trade as well as for derivative trades on commodities. Besides such an integrated market also requires uniformity in octroi and sales taxes etc, which can be only brought through regulatory changes. Value Added Tax (VAT) has been introduced in the country in 2005, to resolve this problem which however has not been uniformly put into force by all states.

The dichotomy is evident when one considers the commodity derivative market with falls within the purview of the Central government and the physical market which is largely regulated by the state government. Thus two tier of government controlling two components of the same market using their respective fiscal instrument work against the stated aim of market integration of the derivative and spot market. Coordination of operation of the two tier of government with respect to fiscal intervention can result in reduction cost and time. Besides the inconvenience, inefficiency and inequity of the multiple taxation can be avoided.

The Banking Regulation Act, 1949 prohibits banks from trading in the Indian commodity derivative market although most of the banks in developed countries are active participants in their commodity derivative markets. Barring banks from entering the derivative market prevents them from fully engaging in the agricultural economy. This is because banks, if permitted to function in commodity derivative market can administer greater credit accommodation in both the farm and non-farm sector by hedging against price fluctuations in agricultural collateral through derivative instruments and hence avoid non-performing asset. Similarly, greater bank participation can be ensured in others sectors on the basis of the similar logic.

Besides direct participation of banks in commodity derivative trading will impart huge liquidity to the derivative market besides expanding market breadth. This will also provide them an opportunity for speculative investment which can significantly enhance their profitability.

As per the credit policy of the banks make an appraisal of the credit worthiness of the customer. If he is from the commodity sector, the bank will ask the borrower to hedge his position on a commodity exchange.

Bank's large network of branches can provide information related to spot and future prices of commodity. This will facilitate farmers awareness and empowerment. Commodity price information will attract customers to get other banking products like crop loan, land development loan, tractor loan, etc. Bank can also open savings account of such customers.

Market Integration : Withdrawal of prohibition on future trading on all commodities in April 2003 has opened up new opportunities and challenges for the Indian commodity derivative market. Subsequently existing infrastructure and institutions are being upgraded; new exchanges have been approved with the mandate to set up world-class infrastructure and systems; more participants with resources, skills and expertise are being attracted from the other derivative markets.

This sudden jump in the growth rate can be given a further fillip if the market participation is extended to include all segments of derivative products like insurance, mutual fund, securities, banking, by way of integration. Such market integration has the potential to provide a massive growth impetus to the commodity derivative market which also extend to other entities that are included into the integrated system. This is perceivable on the assumption that such integration would enable all these entities, which otherwise are functioning independently, to pool both their human, physical, and financial resources and in the process generate a synergy that could have a multiplier effect.



References

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