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Market Equilibrium through Commodity Futures

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Abstract:
A commodity forward contract is an agreement between counterparties for the delivery of a physical asset at a certain time in the future for a certain price that is fixed at the inception of the contract. On the other hand, commodity future contracts are highly uniform and well-specified commitments for a carefully described good to be delivered at a certain time and place and in a certain manner and the permissible price fluctuations are specified. Commodity market is a place where raw and primary products are exchanged. These raw commodities are traded on regulated commodity exchanges, in which they are bought and sold in standardized contracts. It is similar to an equity market. The forward commodity prices have a strong relation with the prices of commodities prevailing in the spot commodity market. In addition to that the forward commodity prices are supported from the stock market stability, rate of interest, economic condition of the internal and external environment etc.
From the price signal of the commodity forward market the producer and the consumer get an idea of the future price of the commodity. With this price expectation the producer can plan for his production budget and similarly the consumer can plan for his consumption budget. As the production and the sales budget of the producer and the consumption budget of the consumer both are planned from the same price signal, there is a good chance for the equality of production and consumption in the market. Therefore, with the help of commodity forward trading and commodity future, the market may attain equilibrium easily with less speculation and price fluctuation.
In this article an attempt has been made to find out the relation between the commodity forward and future market in the general market equilibrium.

Keywords: *Commodity, future, forward, market equilibrium*

1. Introduction

Over the time the trading system has developed throughout the world. One of the interesting developments in financial market over the last few decades is the arrival of derivatives. Forward contracts are mostly OTC agreements to purchase or sell a specific amount of commodity on a predetermined future date at a predetermined price. It is very helpful to the farmers and stock holders of the agricultural commodity to discover the future price of the products. Like stock, commodities trading are two of types, cash and option trading.
Price discovery of the agricultural products is very difficult to the farmers. They have to take the decision of harvesting on the basis of tradition. Instability of commodity prices is a major problem in India.

1.1. What is Commodity Future Trading?

Commodity futures are contracts to buy or sell specific quantity of a particular commodity at a future date. Like stock market trading, commodity trading is two of types, cash or spot trading and option trading. It is similar to the index futures and stock futures but the underlying happens to be commodities instead of stocks and indices.
Example: Suppose you purchased 10 grams of gold of from MCX (December 2013) at Rs 26,500 on 1/6/2014. Now you can wait till December 2014 or you can sell within December. If On 19/6/2014 the price of 10 grams of gold (December 2014) reaches Rs 27, 150, you can sell the same. The profit from this transaction is 27,150-Rs 26,500=Rs 650
So the commodity trading is very simple as trading in the stock market over the OTC platform. You can go for delivery of the commodity. For this purpose you have to put delivery option at the time of biding and you have the option of taking the delivery through specific warehouse.

1.2. Role of Commodity Future Trading in Market Mechanism

In market there are two forces operating side by side in terms of demand and supply. When these two forces act in a unidirectional way, the market attains the equilibrium situation. In the market equilibrium producers and consumers reach the equality of supply and demand with a less price fluctuation.

Future trading performs two important functions. Firstly: price discovery and secondly: price risk management. From the commodity future trading all segments of the economy can be benefited. Following are the advantages of commodity forward trading.

1. Price Foresting: It enables the 'Consumer' in getting an idea of the price at which the commodity would be available at a future point of time.
2. Production/ Storage Planning: The farmers or producers can make their production plan for the next period considering the price signals from the commodity market.
3. Proper costing: The price signals of the commodity market may help in cost planning of the producer.
4. Export Promotion: The exporter can contract for future delivery for exporting using the data of commodity market.
5. Price Stability: The price stability of the product may be attained as prices in the commodity market regularly adjusted with the economic sentiment updated from time to time.
6. Matching demand and supply: The advance price signals make a matching between demand and supply condition of the commodity throughout the country.

1.3. How Are Futures Prices Determined?

Future prices evolve from the interaction of bids and offers emanating from all over the country which converge in the trading floor or the trading engine. The bid and offer prices are based on the expectations of prices on the maturity date. In addition to that the prices of the spot market take a leading role in determining the future commodity prices. The prices of the spot market are supported by the demand and supply of the specific commodity in the economy in the current period.

The commodity future trading provides a price signal in advance in the market. The producer may make his production plan based on price signal available in market. Similarly, the consumer may make his consumption plan in the same way. In a nutshell, the two market forces i.e. demand and supply balance each other in the market over a long period of time adjusting with the commodity future signal and there is a chance of balance in the market in the economy as a whole.

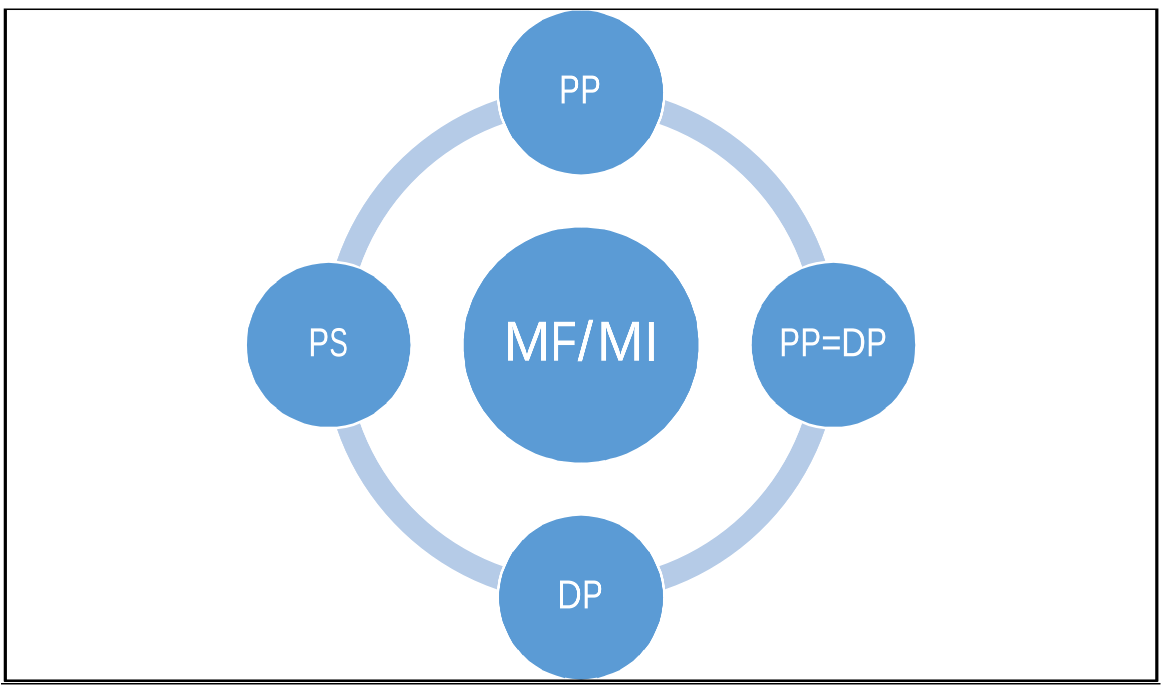

Figure 1: Market Equilibrium through Commodity Future

- PS-Price Signal from Future Contract
- PP-Production Planning =Future Supply
- DP-Demand Forecasting=Future Demand
- MF/MI-Market Forces/ Market Interaction

- Demand: Demand of a particular commodity is predicted by the commodity traders on the basis of their expectation about the future consumption of the specific commodities and future price is backed by supply estimation of the underlined commodity.
- Supply: Supply of a particular commodity is predicted by the commodity traders on the basis of their expectation about the future production of the specific commodities and future price is backed by demand estimation of the underlined commodity
- Market Equilibrium: The producers and sellers can get advance information from the future market contracts regarding market movement, expected demand and supply and accordingly they reschedule their production and sales budgets. Over the time the expectation about the market gets its shape and the future contracts are adjusted accordingly. Therefore, the marketers have a long time to adjust their demand and supply. In a crisis situation they plan for import decision or export decision to cope with imbalance.

  Actually, future contracts information is the result of market condition and economic research which is accounted through the trade volumes and signals to the producers, and consumers about the future market situation.

2. Conclusion

Commodity Future Trading is a new way of investment to the investors. The agricultural economy can also be benefited from commodity trading. The farmers get price signals of the crops in advance. They can take the decision of farming and storing or selling of the agricultural products. A matching between demand and supply of the commodity can be made with the help this system. The price stability of the overall economy can be maintained if the commodity market performs perfectly.

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