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Study of Derivatives in India

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A Study of Derivative Market in India

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Abstract Since 1991, due to liberalization of economic policy, the Indian economy has entered an era in which Indian companies cannot ignore global markets. Before the nineties, prices of many commodities, metals and other assets were controlled. Others, which were not controlled, were largely based on regulated prices of inputs. As such there was limited uncertainty, and hence, limited volatility of prices. But after 1991, starting the process of deregulation, prices of most commodities are decontrolled. It has also resulted in partly deregulating the exchange rates, removing t he t rade cont rols, reducing the interest rates, making major changes for the capital market entry of foreign inst itut ional investors, introducing market based pricing of government securities, etc. All t hese measures have increased t he volatility of prices of various g oods and services in India to producers and consumers alike. Further, market determined exchange rates and interest rates also created volatilit y and instability in portfolio values and securities prices. Hence, hedging activities through various derivatives emerged to different risks. This paper will study t he capital market in India with reference to Derivatives.

INTRODUCTION

Financial system is a complex set up for any county, which includes financial institutions like banks, NBFCs (Non-Banking Financial Companies), regulators, products etc. Broadly the Indian Financial System can be classified in to two heads, viz, the institutions and regulators in the field of banking and allied services and the institute ion and regulators in the field of financial market. Banking sector institutions include Reserve Bank of India, Pubic Sector Banks, Private Sector Banks, Co - operative Banks, and Foreign Banks. NBFCs and organizations like LIC, GIC etc also play a major role in the financial system.

The past decade has witnessed the multiple growths in the volume of international t rade and business due to the wave of globalization and liberalization all over the world. As a result, the demand for the international money and financial instruments increased significantly at the global level. I n this respect, changes in the interest rates, exchange rates and stock market prices at the different financial markets have increased the financial r isks to the corporate world. Adverse changes have even threatened the very survival of the business world. It is, therefore, to manage such risks; the new financial instruments have been developed in the financial markets, which are also popularly known as financial derivatives. Not only this, they also provide opportunities to earn profit for those persons who are ready to go for higher risks. In other words, these instruments, indeed, facilitate to t transfer the risk from those who wish to avoid it to those who are willing to accept the same

OBJECTIVES OF STUDY:

To explore the evolution of Capital Market in India.

To assess performance of Indian Derivative Market.

RESEARCH METHODOLOGY

It is always important to be critical of the information presented in sources, especially since the material might have been gathered to address a different problem area. Moreover, many secondary sources do not clearly describe issues such as the purpose of a study, how the data has been gathered, analysed and interpreted making it difficult for the researcher to assess their usefulness. In order to address this problem I have t r ied to t riangulate the secondary data by using numerous independent sources.

The information about the problem is collected from the Research Journals, Trade Magazines, Annual Reports of Banks and the Internet. For evaluating „Evolution of derivatives and important factors! ‟, I have focuson as recent material as possible. In order to get access to latest developments in this area I have used a number of articles published in academic journals and t rade magazines. We have also used secondar y information from Internet based discussion forums.

FINDINGS AND DISCUSSIONS

Since 1991, due to liberalization of economic policy, the Indian economy has entered an era in which Indian compa nies cannot ignore global markets. Before the nineties, prices of many commodities, metals and other assets were controlled. Others, which were not controlled, were largely based on regulated prices of inputs. As such there was limited uncertainty, and hence, limited volatility of prices. But afte 1991, starting the process of deregulation, prices of most commodities are decontrolled. It has also resulted in partly deregulating the exchange rates, removing the t rade controls, reducing the interest rates, making major changes for the capital market entry of foreign inst itut ional investors, introducing market based pricing of government securities, etc. All t hese measures have increased the volatility of prices of various goods and services in India to producers and consumers alike. Further, market determined exchange rates and interest rates also created volatilit y and instability in portfolio values and securities prices. Hence, hedging activities through various derivatives emerged to different r isks.

FUTURES TRADING

offer a risk- reduction mechanism to the farmers, producers, exporters, importers, investors, bankers, t rader, etc. which are essential for any country. In the words of Alan Greenspan, Chairman of the US Federal Reserve Board, "The array of de r ivative products that has been developed in recent years has enhanced economic efficiency. The economic function of these contracts , is to allow r isks that formerly had been combined to be unbundled and t ransferred to those most willing to assume and manage each r isk components." Development of futures markets in many countries has contributed significantly in terms of invisible earnings in the balance of payments, through the fees and other charges paid by the foreigners for using the markets.

Further, economic progress of any country, today, much depends upon the service sector as on agriculture or industry. Services are now backbone of the economy of the future. India has already crossed t he roads o f revolution in industry and agriculture sector and has allowed the same now m services like financial futures. India has all the infrastructure facilit ies and potential exists for the whole spectrum of financial futures t rading in like stock market indices, t reasury bills, gilt - edged securities, foreign currencies, cost of living index, stock market index, etc. For all these reasons, t here is a major potential for the growth of financial derivatives markets in India.

EVOLUTION OF DERIVATIVES IN INDIA

may be tracked starting from a controlled economy, India has moved towards a world where prices fluctuate every day. The introduction of risk management instruments in India gained momentum in the last few years due to liberalisation process and Reserve Bank of India‟s (RBI) efforts in creating currency forward market. Derivatives are an integral part of liberalisation process to manage risk. NSE gauging the market requirements initiated the process of setting up derivative markets in India. In July 1999, derivatives trading commenced in India. Commodities futures trading in India were initiated long back in 1950s; however, the 1960s marked a period of great decline in futures trading. Market after market was closed usually because different commodities' prices increases were attributed to speculation on these markets. Accordingly, the Central Government imposed the ban on trading in derivatives in 1969 under a notification issue. The late 1990s shows this signs of opposite trends-a large scale revival of futures markets in India28, and hence, the Central Government revoked the ban on futures trading in October, 1999. The Civil Supplies Ministry agreed, in principle for starting of futures trading in Basmati rice, further, in 1996 the Government granted permission to the Indian Pepper and Spice Trade Association to convert its Pepper Futures Exchange into an International Pepper

FACTORS CONTRIBUTING TO THE GROWTH OF DERIVATIVES

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 persons 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.

Globalization 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 set back 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 losses5. 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 break through. 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.

CONCLUSION

A derivative product, or simply 'derivative', is to be sharply distinguished from the underlying cash asset. Cash asset is the asset which is bought or sold in the cash market on normal delivery terms. Thus, the term 'derivative' indicates that it has no independent value. It means that its value is entirely 'derived' from the value of the cash asset. The main point is that derivatives are forward or futures contracts, i.e., contracts for delivery and payment on a-specified future date. They are essentially to facilitate hedging of price risk of the cash asset. In the market term, they are called as 'Risk Management Tools

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