A first step: On Multi Commodity Exchange

With the introduction of a new financial instrument, India is a step closer to building a vibrant market for commodities. Success in the long journey, however, will require avoiding some policy mistakes of the past. The Multi Commodity Exchange has introduced gold option contracts for the first time in India. The derivative instrument allows investors to enter into contracts to either buy or sell gold some time in the future at a pre-determined price, thus allowing investors to hedge any volatility in the price of the metal, for a price. The fact that options usually also turn out to be cheaper than binding future agreements will help in the wider participation of investors in the realm of commodity speculation. As Finance Minister Arun Jaitley stated during the launch of the derivative at the MCX, gold options will also help bring into formal channels more of the gold that is traded. Notably, the introduction of gold options is in line with the government's announcement last year that it would take steps towards introducing new varieties of commodity derivatives in the market. MCX, in fact, has said it might seek permission to write options contracts on other commodities which, based on their current futures trading volumes, satisfy rules set by SEBI. To improve market efficiency, the market regulator is also mulling the entry of mutual funds and portfolio management services into the business of investing in commodity derivatives.

Naturally, some concerns have been expressed over financial speculation. The benefits of well-regulated commodity speculation, however, are likely to outweigh the potential systemic risk from asset bubbles. Options, like other financial derivatives, allow price risks to be transferred between market players in an efficient manner. The business of anticipating prices in the future is left to professional speculators while their clients benefit from the prospect of stable prices. In the process, financial derivatives can facilitate the conduct of real economic activity in higher risk segments — including in agriculture and industrial activity — that would not happen otherwise. Confusion over this has led to an unjustified hostility towards financial speculation, as well as some hasty policy measures. Almost a decade ago, a rapid increase in food prices pushed the government to impose a blanket ban on any speculation on agricultural products. While it may have been relevant for the specific circumstances, the wide-ranging nature of the move slowed the development of a healthy market for commodity speculation. The government should now resist similar temptation and focus instead on real-time monitoring systems. Apart from the standardised derivatives approved by SEBI for trading in exchanges, a framework that promotes over-the-counter products will help improve the scope for risk mitigation. The debut of gold options should be seen as a step towards greater reforms.

Rajasthan's ordinance shields the corrupt, threatens the media and whistle-blowers

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