ROLE OF FUTURES IN REGULATING COMMODITY PRICES

Derivative securities are contracts that derive their value from the level of an underlying interest rate, foreign exchange rate, or price. Derivatives include futures, forwards, options and swaps. In the last thirty to thirty five years' financial derivatives have been an important, and controversial, product. These securities are powerful instruments for transferring and hedging risk. However, they also allow agents to quickly and cheaply take speculative risk.

The primary function of the futures market is the hedging function which is also known as price insurance, risk shifting or risk transference function. Futures markets provide a vehicle through which the traders or participants can hedge their risks or protect themselves from the adverprice movements in the underlying assets in which they deal.

In short span of time, Nepal has also witnessed the development of derivative instruments in commodities market. The private sector initiative in this market provided Nepalese investors to hedge and speculate the price risk in commodities market. Government of Nepal (GoN) also has committed to introduce rules and regulation for this market and also has included in tax network.

Developments of the futures market in commodities provide many benefits to the investor, society and government. Firstly, futures market enhances price discovery mechanism. In futures market contarct, a trader agrees to receive or deliver a given commodity or asset at a certain futures time for a price which is determined now. Thus futures market creates a relationship between the futures price and the price that people will expect to People of Nepal will get rid of from current artificial pricing mechanism of commodities and services with manifestation of well-developed futures market. Secondly, investors will get risk hedging and speculating opportunities from this market. Accordingly, this market will provide backward and forward linkages in Nepalese financial markets. The trading of standardized and graded of commodities will help to introduce quality products in the market that protects consumer's right.

THE WELL-DEVELOPED COMMODITIES MARKET ALSO SUPPORTS TO GROW FINANCIAL MARKET IN THE COUNTRY

The well-developed commodities market also supports to grow financial market in the country. The godowns and warehouses are required to store the commodities for future trading. This arrangement also helps to maintain the buffer stock of commodities in the market. The warehouse receipts might also be the good instruments for bank financing. Thus, the bank credit might flow toward the agricultural sector- the backbone of Nepalese economy. Ultimately, the market helps to boost the employment opportunities in the country in agricultural, trading and business and financial sector.

Along with the benefits there are some risks of the commodities futures market as well. Moreover, these markets are also blamed for Global Financial Crisis-2008. In the absence of high-tech people and well-developed regulatory and supervisory framework, these markets are only threats in the economy rather than opportunities. The need of the time is to support, develop and enhance the well-functioning and regulated futures market in Nepal.

Dr. GOPAL PRASAD BHATTA
Chief Manager, Janakpur
Nepal Rastra Bank

MERCANTILE EXCHANGE NEPAL LTD. AND COMMODITY MARKET EFFICIENCY

Recently, I have found 1st publication of the educational program series published for their traders by this company. I'm glad to get opportunities of reading this. Now, Nepalese people will also take interest on it and will be considered on investment. The history of commodity market in Nepal isn't long. It came in operation just before 2 years. This company has not long experience and Nepalese people are not also well aware regarding how to trade in this market in such condition various problems can arise on the trading in this market.

Information and services provided by this company to the investors will be beneficial for the producers, intermediaries and consumers. The existing situation for not getting relevant price by the producers of their products, cheating with consumers and the way of getting benefits only by the intermediaries will be no longer. The role of agriculture in Nepalese economy is extremely significant. Millions of farmers are dependent in this profession and they are just cropping for their own livelihood. This market will play key role to develop commercial and market oriented agriculture profession. Thereby the investment in agriculture, production, employment will be increased and consumer can be able to buy commodities in less prices, this market will help to create such atmosphere.

Futures market helps in realizing instant profit for investors once they settle their contracts. This eliminates the risk that an organization may have to bear should they transact in credit.

The development of this market helps give a new ray of hope to the rural farmers who are under constant threat of poor yield. Thus this company helps in developing the agriculture sector, minimizing rural indebtness and helping to eliminate poverty in the real sector. It is also expected to contribute to the "Haat market" the main market in rural area.

The establishment of Chicago Board of trade in the US in 1848 helped to bring together the producers and business man in one place. It helped to raise productivity as well as find market for the products. This company now deals in commodities derivatives and help to mitigate exchange rate risk as well as risk of price fluctuation. As a result, it believed that they have helped in social welfare of producers, intermediaries as well as consumers. Even in Nepal, it is expected to foster such sorts of services.

By trading through MEX Nepal, Nepalese commodity market will get integrated with international commodity market. This will foster to make Nepalese commodity competitive in international market. This will help the import and export sector of Nepal and import and export can take advantage of such benefits. This will lead to further integration of Nepalese and international commodity market.

Regulation:

Commodity market is proposed to be regulated by Securities Exchange Board of Nepal (SEBON). SEBON should implement the policy frame for the commodity market and should establish different act for smooth operation of commodity market. Nepal need extra research for formulating completely different act for commodity market as it is very important this market

Similarly in order to foster competition in the commodity market through the proper functioning of such exchanges, proper monitoring and supervision has become a compulsion.

Tax Provision:

To encourage the transaction done through this exchange and to spread the services throughout the country it is necessary to relax the tax provision implied in commodity market. if the tax provision are relaxed then transaction in commodity market will be increased, that is why government is supposed to put special emphasis on commodity market. To encourage the transactions through MEX, the government should also provide necessary monetary and financial support.

Research and Development

The development of commodity market in Nepal is in an infant stage. As a result, there is an acute shortage of required human resources and infrastructure in this field which needs to be addressed by the government. The development of commodity market will must definitely help in the development of agricultural sector of Nepal. So it is highly imperative that the policy makers start making policies for the sustained development of this market.

It is important that a country with an open market economy has developed institutionalized market place. The development of such market place will enable development and consumption of natural resources. This will further push the economy of a country toward self-sustained. Due to this it is important that all the stakeholders participate actively for the development of this sector.

TRILOCHAN PANGENI
Executive Director
Internal Audit Department
Nepal Rastra Bank

COMMODITY MARKET AND EARNING MANIPULATION

Background

Originally, commodity markets started off as a way for farmers to sell their goods at a guaranteed price in the future. Because farmers had no way of knowing whether the harvest would turn out good or bad, it provided a way for them to lock in some profits before going to market. Commodity markets also provided a way for buyers to get a price they thought was fair.

Commodities market provides a place for buyers and sellers to trade in raw products and natural resources. The marketplace used to be only physical however, the internet has allowed for a virtual electronic exchange nowadays in the world. The four major types of commodities traded in the international commodity market are energy (including crude oil, heating oil, natural gas and gasoline), metals (including gold, silver, platinum and copper), livestock and meat (including lean hogs, pork bellies, live cattle and feeder cattle) and agricultural commodities (including corn, soybeans, wheat, rice, cocoa, coffee, cotton and sugar) but the Nepalese market is moving bare of regulation provisions and fixed structure as prescribed by government or any regulating agencies.

These markets bring together two types of investors like hedgers and speculators in the international market. Hedgers, those affected by the changing price of the commodity, are generally users of the raw product or companies associated to the use of it. For example, the price of oil has a major impact on both the airline industry and the motor manufacturers. Both groups have people who trade in oil to reduce its impact on their business. Speculators attempt to make money by predicting the direction of the commodity price. However, they don't necessarily have any other practical use for the raw goods.

The history of the commodity market as a structured form started from the U.S. commodity market. The market began from the 19th century with the trading of staples such as cattle, wheat, corn and pigs. Later on, the list of food products included products such as soybeans, sugar, coffee and cocoa. Eventually, the list of commodities evolved to include natural resources such as timber and metals. The very first commodities markets began in Sumer, dealing with sheep and goats.

As risky as stock market

Given the unpredictable nature of the world, with floods, wars, hurricanes, earthquakes and droughts, predicting the price of a given commodity can pose a challenge. Although we have plenty of factors to study such as trends, economic and agricultural reports, unexpected natural catastrophes can cause prices to spike or drop suddenly. A small percentage of speculators can make a substantial amount of money trading commodities, but the majority loses money. Thus, the real value in the commodities market comes from the ability of users and producers to hedge their profits through the use of commodity exchanges.

Commodity pricing and earning manipulation

Commodity market price is also determined as a reflection of fundamentals of the market. Given the pattern of cash flow, combined with an appropriate discount rate, the commodity market will decide the price. Theories also suggest that commodity prices can also affect fundamentals. A high commodity price can be good for both hedgers and speculators. A higher commodity price may signal that the farmers and such companies has a good product and induce consumers to adopt its product to start a positive feedback (Subrahmanyam and Titman, 2001).

A higher commodity price can also make the term of equity-related transactions more favorable. For example, it can increase the proceeds received from seasoned equity offerings or it can increase personal wealth. Given its benefits, a higher commodity price will certainly bring its cost. But trying to maintain a higher valuation of commodities in the market, market regulator can take actions that will reduce long-term firm value. That type of action is called earnings manipulation (Barth et. all, 2007)

One question naturally arises is the purpose of the earnings manipulation on two types of transactions related to commodity: seasoned commodity offerings by companies and commodities selling by investors (Black, 1973). Evidences have been found that high valuation companies that issue commodities are especially aggressive in accounting enlargements. On the other hand, there is no evidence that investors use enlargements to make personal gains by selling their own commodities in the market.

Conclusion

The popular beliefs on the earning manipulation state that high valued commodities have stronger incentives to manipulate future earnings from its transaction in the market and production in the industry in comparison to low valued commodities but few studies found the beliefs is only half true. A positive relationship between valuation and future discretionary accruals only exits for commodities receiving limited attention in the market.

References

Barth, M., D. Cram, and K. Nelson, 2007, Accruals and the prediction of future cash flow, The Journal of Accounting Review, 80, 27-58.

Black, F., 1973, The pricing of options and corporate liabilities, Journal of Political Economy, 84, 532-561

Subrahmanyam, A. and S. Titman, 2005, Feedback from commodity prices to cash flow, Journal of Finance, 60, 238-251

GOPAL KRISHNA ACHARYA
Officer, Planning and Development
SEBON

GOLD PRICES: IS SKY THE LIMIT?

As we all know that gold is not just a commodity but is also an investment instrument. In the world of big money, gold is always considered as a safe haven't for investment and an investment against inflation and rising consumer prices.

In the month of October & November 2010 gold has continued to make all time new High. The spot price of gold at COMEX made a historic life time high of 1425$ per ounce and is still hovering around it at 1404$ down 21$ from its all time high. But now we are observing gold December futures contract's Open Interest is less compared to October. What conclusion can be made from the data of the various Commodities Exchange?

The biggest bull driver of the gold prices has been the US Federal Reserve as the USD has declined a lot and they are injecting more money into the financial cycle which means that they are printing more money, and a lot of it. If currencies get devalued, it means higher prices for gold and other precious metals. It means gold will move further up, but what is the upside limit of gold? Is sky the limit for gold?

When we invest in a stock we determine the fundamental value of the stock, which means we look at the company financial details and make an estimate of its future earnings and based upon that we translate that estimate into present price. Based upon that value and the current market price if we find huge discrepancy then we take a decision to BUY or SELL. But how to determine the fundamental value of gold?? How much return can we expect when we invest in gold?

SO WE CAN SAY THAT THE SKY IS THE LIMIT FOR GOLD AS LONG AS PEOPLE ARE WILLING TO PAY HIGHER PRICES FOR IT. BUT THIS PRINCIPLE WORKS BOTH WAYS WHEN WE SAY SKY IS THE LIMIT FOR GOLD.

Around the world, most of the gold is stored in vaults which never generate any cash flows. Infact, investment in gold is unproductive from an economic point of view. This principle might have also triggered NRB also to put a ban on bullion import and led to the auctioning of bullions stored in their vaults. When we inject equity in a company, the company uses that equity to employ people and make finished and unfinished products. Even when we deposit our money in banks, financial institutions or a cooperative savings account, that money is lent out to people who want to start their own businesses, buy a home, etc. But when we buy gold, it just lies there in the vaults and doesn't do anything productive.

The above statement puts us in a dilemma as to how to place a value on something that doesn't generate any value for itself? Is there any alternative that can be used to determine the fundamental value of gold? When we look at the historical data – it gives us a clear picture of how gold is different from stocks and other form of investments. So how can we determine the value of gold relative to other variables based on historical data? Valuing gold through other assets is helpful, but still it does not provide us the fundamental value of gold. It still doesn't tell us how much value is it worth if we consider it as an asset on its own.

When we try to answer what the upside limit of gold prices are, the clear answer is that it does not have a limit at all because there is a in deriving its fundamental value. It is impossible to say whether it is overvalued or undervalued at the moment. Therefore, there is no limit to how high it can go. So we can say that the sky is the limit for gold as long as people are willing to pay higher prices for it. But this principle works both ways when we say sky is the limit for gold. There may be no upper limit and at the same time there is no lower limit as well. One has to recollect that limit works in both ways, when we are unable to determine its fundamental value.

The conclusion is that though gold has yielded high returns to its investors, it could be a risky investment in the coming days. It can also provide high returns but at the same time can crash down easily.

DEEPAK SHAH THAKURI
GM
Axis Broking Solution Pvt. Ltd.

COMMODITY MARKETS AND BANKS

Commodities, like other asset classes whose prices are determined by all the various information that flow into the markets about their fundamentals, inherently carry price volatility. Globally, banks participate in the equity and commodity futures markets to mitigate risks or exploit business opportunities by establishing trading desks. They do actively participate in various derivatives markets such as OTC (over-the-counter), forwards, futures, and swaps to mitigate various systemic risks to a certain extent. Further activity in commodity derivatives is rapidly growing and is increasingly being looked as an investment opportunity by many of international financial services providers including banks and their investment arms.

In our country, where agriculture has been providing the livelihood of more than half of the total national workforce, commercial banks are traditionally mandated to maintain an adequate credit flow to the agriculture sector. Even then, banks' lending to the priority sector has remained low leading to low value realization in adhering to the norms set by the central bank. There are several reasons like: banks' poor penetration in rural areas, lack of effective collaterals among farmers, perception of risk due to uncertainty over agricultural yield, market related factors. From farmers' standpoint, on the one hand, low prices are limiting their incomes and, therefore, the necessary investment in the overall farming process. On the other hand, price volatility is making it difficult for them to plan their production activities, allocate resources efficiently and obtain credit from organized sector. Also, risk perception of banks can partially be mitigated if they are allowed to participate in the organised commodity futures market to hedge their exposure to agricultural lending arising out of price fluctuations that their debtors would face in their incomes. So, this produces a win-win situation for both producers and lenders/banks. This win-win situation can be a reality only after a full fledged regulation is brought into practice with liberalizing the markets regularly ensuring appropriate opportunities to both public and private players, including banks, in the price discovery and price risk management mechanism that an organised platform of commodity futures exchanges provides.

Commodities a global perspective

The rebound in commodity prices that started at the beginning of 2009 continued into 2010 as the global economy recovered. Increased demand from China, significant production cuts (metals and oil), and some weather-related factors (agriculture) also contributed to higher prices. As a result, energy prices increased by 60 percent in the first quarter of the year 2010 while metals and agricultural prices increased by 62 percent and 19 percent, respectively, when compared to a year earlier. Energy prices are projected to increase 25.1 percent in 2010. After five consecutive quarters of decline, world oil demand rose in the final quarter of 2009-led by strong demand in emerging economies. China has been the primary driver of metal prices this decade, as Chinese consumption of the main base metals (aluminum, copper, lead, nickel, tin and zinc) rose by 17 percent per year. During the year 2009, Goldman Sachs had generated revenue of USD 3 billion from commodities followed by Morgan Stanley USD 3 billion, Barclays Capital USD 2 billion and JP Morgan USD 1.5 billion.

Nepalese Context

Nepalese banks have limited exposure towards commodities. Although commercial banks have been importing precious metals, but trading activity has been negligible. At present context, where there are adequate financial institutions in market catering limited customer segments, trading in commodities would be a new segment where Nepalese banks could hedge themselves with exposure within the sectors and can also be a medium to generate revenue. However, considerable awareness is required before exposing towards this sector which is regarded as one of the most volatile and riskier than other sectors.

NIROJ SINGH THAPA
Treasury Head
Bank of Kathmandu Ltd.

TDS ON COMMODITY TRADES, A THORN IN THE FLESH

ACCORDING TO INCOME TAX ACT 2058, SECTION 88 (1)(6) "ANY ENTITY OR INDIVIDUAL TRADING ON COMMODITY FUTURES MARKET, 10% TAX WILL BE LEVIED ON THEIR PROFIT OR INCOME"

The present system of Tax Deduction at Source (TDS) in Commodity trades has become a great threat to the future of Commodity Traders in Nepal. This system when announced in Finance budget 2066/67 was welcomed by all commodity traders. It was a great green signal from the government which said Commodity Market is also a part of Nepal economy. But since then the traders are paying more money as Tax and ending with less profits. It has made a psychological impact on Nepal commodity bourses as well as those trading on them.

According to the budget 2066/67 Tax deduction at source (TDS) 10% should be deducted from each profit earned on commodity trades. But the loss on trades is not being considered. The present tax system is untenable because it has the potential to drive commodity futures business overseas.

It must be noted that the top 100 commodity derivative exchanges in the world are not subject to TDS on transactions. TDS will certainly have an adverse bearing on Nepal's commodity exchanges that are struggling to grow. Profits gained by commodity trades are treated as capital gain Tax in almost all countries worldwide. And these profits are calculated on net. Imagine if a trader makes 100 trades in a year, and he gained 10 Millions profits in 50 trades and he lost 6 Millions in other 50 trades. Here he/she need to pay tax only for the net, i.e. 4 Millions, at the end of the fiscal year. Here in Nepal, traders need to pay on each profit earned trades, but losses are not taken in to account. Simply if 10 trades make a loss of 10 Millions, and next 1 trade made a profit of 1 Million, TDS is deducted on this profit earned trade, simply trader needs to pay 10,000 as Tax. Here the first incurred losses are not considered.

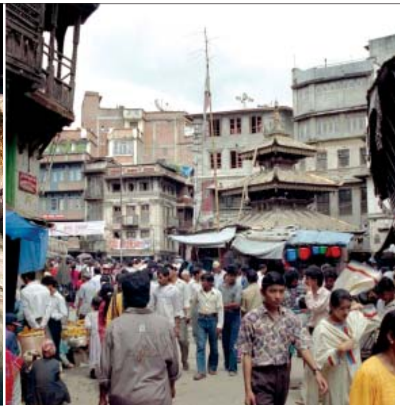
Immediately after the Budget 2066/67, there was a hue and cry over the implemented new tax system. Mercantile Exchange Nepal Limited, Himalayan Commodity Brokers and all other members of MEX, pitched for withdrawal of the proposal. The talks are going on with higher officials still. The coming budget will be the last opportunity for modifying the relevant provision from the Finance Act.

As per our request, financial advisors has come up with helping hands to guide us how these extra tax can be returned back to the traders. As per them, all traders should get registered under PAN. At the end of the year traders can file their income tax. These profit/loss trades can be added in the income tax return file. The profit earned the whole year will be calculated on net. If any trader has paid extra tax, they can carry forward it till next 7 years or can request for reimburse (but the time limit for this is still a question mark). This is certainly a relief for the traders.

What's needed at this juncture is to allow futures markets to play a more meaningful role in helping Nepalese farmers to realize higher prices for their produce. Market participants, especially the farmers need to be encouraged to make additional investments in marketing infrastructure such as price dissemination networks, warehousing, storage facilities and testing laboratories. Strong futures and spot markets are essential for creating the conditions conducive for such investments, for which Nepal Government should re-think very seriously about the Tax implementations on Commodity Markets.

MEHABOOB MOHAMMED
General Manager
HCB Nepal

CHALLENGES OF NEPALESE COMMODITY MARKET



Commodity market, one of the oldest markets of the world, is in practice since the civilization of human being. For centuries, it remained as the core business of the society, physically transferring both the goods and ownership of them. Over time, the commodity market turned virtual one, as it is at present. The goods are traded very frequently by transferring the ownership but moved from one place to another is much less often. They are bought and sold through standardized contracts in organized commodity exchanges.

Although, CFD (contract for difference) of different commodities, FOREX and other financial instruments are traded by the selected parties in unorganised ways for centuries, the organized commodity market is very recent development for Nepal. The trading in the commodity futures formally started in Nepal since December 2006 with the establishment of the Commodities and Metal Exchange Nepal Ltd. (COMEN). Mercantile exchange Nepal limited (MEX) started its operations from January 2009. Though it is the second commodity exchange of Nepal, it is the first to provide the electronic trading platform. Recently, another commodity exchange named Nepal Derivative Exchange Ltd. (NDEX) has started operation.

The trading of commodity CFD has been growing rapidly with a number of commodities listed in the three commodity exchanges. The turnover of these futures exchanges is much higher now than that of the Nepal's Stock Exchange while the stock exchange is decades old whereas the futures exchanges have not completed even a decade.

It is a well known fact that a structured and efficient commodity market plays a complimentary role in the overall development of a country's economy. To realize such positive outcomes, it is essential to ensure growth and sustainability of such market. The Nepali commodity market is facing the following challenges which need to be addressed for the country to derive benefit from this market.

First, as per the evidences of the last four years, the growth of Nepal's commodity market was good. But the challenge is to maintain the positive momentum by generating a viable and sustainable spot market with the mechanism of physical delivery of the traded commodities. For this, the market is facing some structural as well as institutional bottlenecks such as weak and poor infrastructures including roads, power, irrigation and warehouses; lack of skilled man power; lack of suitable government policy etc.

Second, in order to rationalize the expansion of any sector the stakeholders of the sector concerned should benefit by one or another way. This is likely only through the vigorous involvement of such stakeholders to maximize their own interests. In the context of Nepal, the stakeholders of an organized commodity market such as farmers, wholesalers, manufacturers, processors, consumers etc. are not fully aware of the benefits they can derive from such market. So, they are not confident about the operation of the market and its favorable impact to them. Therefore, creating, retaining and accelerating the public awareness and confidence to the market is more challenging.

Third, the commodity market should play the role of the facilitator to the growth of the so-called 'real' sectors of the economy rather than just being a platform for speculators. Because of this reason, the commodity market should be mainly be based on the domestic products of the country and should be guided to raise the wellbeing of the producers as well as end users of such products. But the Nepal's commodity exchanges are highly concentrated in trading of foreign market-based metals, fuels and agro-products. Based on this bitter truth, another challenge of Nepal's commodity market is to discourage the speculation on commodities grown and traded in distant lands and simultaneously encourage the trading of domestic products by providing price discovery mechanism and developing physical delivery system.

Fourth, the prices in the commodity market change very fast as the goods are not delivered, the purchases are made in document only and the rumour plays a very important role to drive the price up or down. When a rumor causes serious and unfounded rise in prices of basic goods such as petroleum and food grains, the final users will be adversely affected. This has led the governments in some countries, including India, to ban trading in the futures contracts of some daily essential commodities. Another point to be kept in mind is that the commodity market is not totally risk free, it carries considerable amount of risk that must be minimized. Currently, the market participants or more specifically the speculative investors are benefiting due to the persistent bull phase in the market in general and in metals in particular. It is not necessary that this Bull Run will continue for long. The moment it starts falling down, it will hurt the small investors very badly.

Fifth, in order to avoid such shocks and protect the small investors, there is need for a regulator of the commodity market of Nepal with clear rules and full autonomy.

MADAN LAMSAL
Chairman
New Business Age

COMMODITY TRADE AND ITS BENEFITS IN CONTEXT OF NEPAL

In today's unstable global financial market, traders and investors are seeking for innovative investment alternatives for diversifying their portfolio. Commodity derivative market provides such novel platform as it provides wide range of investment alternatives for Nepalese investors. As from the global prospective, commodity derivative market is growing by 500% annually.

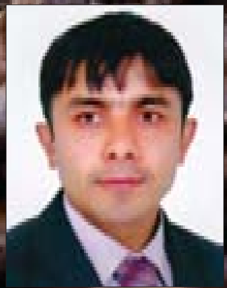
Many people have capitalized the benefits of the commodity market and have earned huge amount of profits. It is one of a few investment areas where an individual with limited capital can make extraordinary profits in a relatively short period of time. Nevertheless most of the people lose money, indicating bad reputation of commodity trading as it is too risky for a normal individual. However, the truth is that commodity trading is only as risky as you want to make it.

Commodity market in Nepal is in very early stages. It is an emerging market, with a vast growth potential and can become one of the prominent markets in Nepal. Introduction of commodity trade in Nepal has provided a new level of investment opportunity to the traders. In recent years commodity trading has shown substantial growth. People from the various fields have started investing in the commodity trade. It has created employment opportunities to the general public and the government as well, by paying huge amount of tax.

Though commodity market in Nepal is growing at a rapid pace, the major hurdle in its expansion is the absence of regulatory body for its proper regulation. However, Security Board of Nepal (SEBON) is taking initiatives to regulate this market with the help of existing exchanges. But, the situation in other countries is different, because a separate entity is set up for regulating and monitoring the commodity market. As for Nepal, commodity market is like an orphan, which seriously needs a Guardian to look after. Traders, Investors, and Exchanges are eagerly waiting for a proper regulatory body to be established, so that commodity market can become a major contributing sector in Nepalese economy.

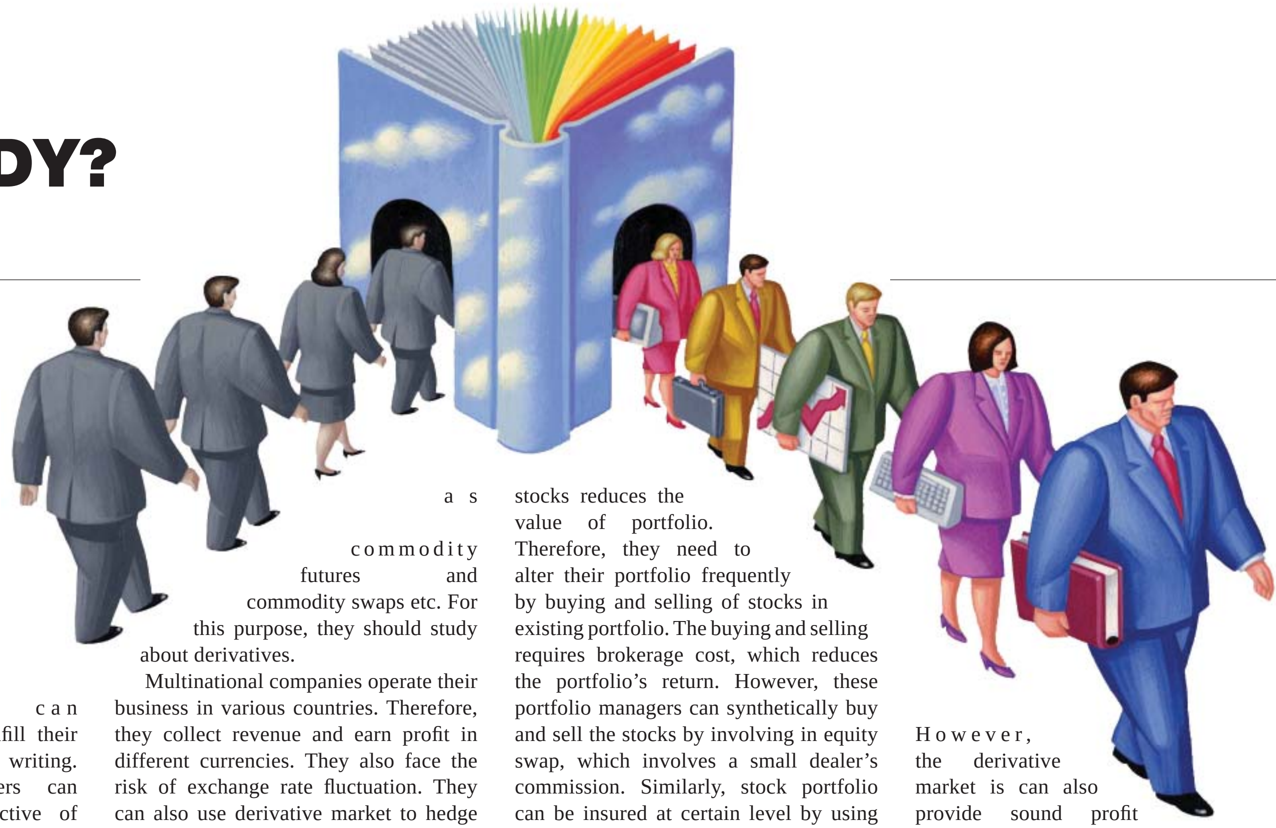
In current point of time, where investors have second thoughts on the stock market and other investment alternatives, commodity market is emerging as a trustable investment platform for the investors. Investor invests their knowledge to collect information about market and trade only by investing 3 to 4% of face value in any commodity and enjoys huge leverage. This means, investors are not required to invest the whole face value of the contract. So, we can say that investors having sound knowledge about the market will be able to make profit with their small investment rather than the other investor having large amount of money.

The real benefit of commodity market is that it will assist the country to improve and upgrade its economic condition without any help from other countries. And it is possible through introducing wide range of agro products in commodity market, in which Nepal has potential to meet the global demand. For e.g. Ginger, it can be introduced in a trading list, as Nepal has potential to meet the global demand as for being 4th largest ginger producing country. Inclusion of such agro product in commodity trading platforms will help producers to hedge against the price risk. And if the government seriously invests some of it's time and gives a clear picture to commodity exchanges, it can justify the most prominent sector of the country, which is non-other than the "Agriculture". If this happens it will not only benefit the government through tax revenue, but also to the traders, as it provides new investment opportunities which will further generate huge opportunities for the improvement of Nepalese economy. On the same hand, Farmers can capitalize their agricultural investments by defining correct price for their product in the commodity derivative market as it will provide them a platform to hedge their price risk.



PRAKASH SAPKOTA
Lecturer
Prime College

DERIVATIVES - WHO NEED TO STUDY?



"Initial Public Offering (IPO) has over-subscribed by 85 times." "NEPSE index increased by 26 points and then transactions have been closed before the time of closing of market." "XX bank has declared 20 percent bonus and 3:1 right shares." Nowadays, we can hear such talk everywhere in cities. This shows that the awareness among Nepalese people toward financial investment has been increasing whether they have sufficient investment knowledge or just following the rumors. However, less people speak about derivatives market.

Formally started in 1848 from America with the establishment of Chicago Board of Exchange as futures exchange, derivatives market have gained popularity in very short period and is growing very fast. It is a 24-hour market and trade takes place worldwide. Developed and developing countries have futures and option exchanges. Various assets have been listed in the menus of the exchanges. These include agriculture commodities (such as wheat, cattle, soybean, egg, rice, lumber etc), natural resources (such as crude oil, coal, copper, weather etc), precious metal (such as gold, silver etc.), financial assets (such as treasury security futures, stock index futures, stock options etc.) and more other assets.

Even though, derivative market is a recent development, most universities in the world offering courses in finance and economics are also offering derivatives courses. In Nepal, some universities have recently included derivative course in bachelor and master levels. However, the course is in specialization under finance category. Thus, most of the MBA graduates do not have the knowledge about derivatives and their functioning. The basic level of derivative course should be included in core study so that all students could have basic knowledge about it.

Derivative market in the world has been changing and making various innovations. Financial engineers have been developing new instruments day by day. Since the derivative market in Nepal is now available, researchers can study about this market to fulfill their degree requirement of thesis writing. Other independent researchers can also research on the prospective of development (new area of trade, new instruments development, applicability of tools and techniques of trade that are being used in foreign country etc.) of derivatives market.

Farmers can get various benefits from derivatives instruments. They can hedge against the price risk of their productions. By managing risk with derivatives, they can get better value of their productions. However, most of the farmers in Nepal are illiterate and they do not have any knowledge of derivatives and their advantages. They should also study about derivatives. Derivatives exchanges with the help of government should make farmers aware about these instruments. Similarly, the merchants can also use derivatives market to hedge their risk. The possible loss on their inventory can be hedged by using various derivative instruments such as commodity futures and commodity swaps etc. For this purpose, they should study about derivatives.

Multinational companies operate their business in various countries. Therefore, they collect revenue and earn profit in different currencies. They also face the risk of exchange rate fluctuation. They can also use derivative market to hedge against this risk. Banks and financial institutions hold liabilities and assets in the form of deposits and loans respectively. Generally, the maturity period of liabilities is less than that of the asset or loans they provid. This sort of maturity mismatch is risky in a market where the interest rates are volatile. Such type of interest rate risk can be managed by using interest rate swap. By using swaps, an institution can transform floating-rate asset or liability into fixed-rate and vice versa. On the other hand, banks also hold the foreign currency in their treasury. For managing the risk of currency fluctuation, they can use derivative market. Hence, bankers should also study about derivatives.

Stock traders, bond traders, portfolio managers, investment companies and insurance companies hold stock portfolios. The decrease in the price of stocks reduces the value of portfolio. Therefore, they need to alter their portfolio frequently by buying and selling of stocks in existing portfolio. The buying and selling requires brokerage cost, which reduces the portfolio's return. However, these portfolio managers can synthetically buy and sell the stocks by involving in equity swap, which involves a small dealer's commission. Similarly, stock portfolio can be insured at certain level by using option market. This protects portfolio from loss in bear market but allows gain in bull market. Thus, they should study about derivatives.

The government can also use derivative market. The central bank that holds foreign currency reserve can use foreign currency market forward/futures and foreign currency potions to hedge against exchange rate fluctuation. The government has also the responsibility of regulating the derivative market. To make policies, rules and to issue instructions to the market participants including exchanges, the government should have knowledge more than the participants have. Therefore, the government should continuously study about the derivatives market.

The paragraphs mentioned above focused only on the risk management part. However, the derivative market is can also provide sound profit opportunities. The investor who can speculate on price can earn handsome profit. The arbitrageurs can also get benefits from short-term market inefficiencies. Thus, they need to continuously study the market and the movement in market variables.

JHABIINDRA POKHAREL
Lecturer, Nepal Commerce Campus