

INTERGOVERNMENTAL GROUP ON TEA
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Working Group on Futures Market Discussion Paper1

# Introduction

The mandate of the Working Group was to study the feasibility of introducing futures trading in tea, either as a commodity or as a tea price index. India was to chair the group, and Kenya, Sri Lanka, the United States of America were assigned as Co-chairs, while the Members of the Working Group are Indonesia and Rwanda. An action plan was to be drawn up and presented at the next intersessional meeting of the IGG on Tea.

Since the knowledge of most of the IGG participants in the field was limited, India volunteered to share its experiences with its new tea marketing strategies. The assistance of experts in the field at IIM Bangalore and IIM Calcutta was sought by the Working Group’s Coordinator, along with experienced hands in futures market.

# Results

Tea being extremely heterogeneous would not lend itself to classic commodity futures trading. Although 99.9 percent of commodity futures contracts are closed out by marking to market, they can theoretically be closed out by actual delivery. Since delivery would almost inevitably result in perceptions of, or actual quality discrepancies between, the buyer and the seller of the contract, disruptions in trading would occur frequently.

The only alternative would be to set up a financial future based on a tea price index which would also serve as an effective hedge for tea growers against non-seasonal price declines.

The index future could be based on the price of specific grades of a basket of tea estates sold in a specific auction centre or group of auction centers, these baskets being commonly referred to as “medium Assam” or “South India low grown”.

The necessary conditions for the success of such a futures contract, apart from the obvious ones – like being listed on a popular exchange and having an efficient market maker/product manager –would be having the bulk of produce of that basket moving through the auction system so that auction prices are a true barometer of the market conditions and having a consistent and simple grading system followed by all estates under consideration for being included in the index.

Neither of these conditions exists in the Indian tea market. Furthermore, the regulatory climate presently prevalent in the producing countries is not conducive to the introduction of speculative derivative instruments.

It is also a fact that the existence of futures or index futures contracts related to a particular commodity has not been conclusively demonstrated to have either a positive impact upon the corresponding spot prices, nor to reduce their volatility.

In the absence of confirmatory empirical data, support from the tea grower community also may not be forthcoming.

Hence, a thorough analysis of available empirical linkages between the introduction of futures contracts and more specifically, index futures contracts upon the spot price levels and variability of the underlying commodity needs to be carried out. This is both time consuming and analytically challenging apart from requiring adequate funding.

The Group may advise on how the required funds are to be raised, and once these are tied up, an appropriate market and commodity may be identified and the analysis of the empirical data as described in the preceding paragraph outsourced to a consultant.

The model should be designed around the hypothesis that the introduction of futures contracts in an existing commodity spot market will have a positive or at least a benign effect upon the spot price of that commodity, and that the variance of the same will also decrease or at least remain at the same level.

The next step will depend upon the validation of our hypotheses by the empirical data. If it is validated, a tea futures contract based upon a suitable index may be introduced in a suitable commodity or stock exchange. The index design may be outsourced to a consultant with sufficient experience/expertise in the area, and the requisite government approvals may be obtained before embarking upon the launch.

The crucial aspect of monitoring the relationship between the introduction of tea index futures contracts and spot tea prices will have to be tracked over a period of at least two seasons before a definitive conclusion of their beneficial impact on spot prices can be derived. The regulator should ensure that the instrument can be withdrawn in case detrimental or destabilizing linkages are recognized.