2014: More Power to Indian Farmers

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India's agri-food chain is awash with profits. On the one end, the fertilizer and seed companies, traders and processors, branded food and beverage companies, grocery stores and fast-food franchises are all making money. Total food production is likely to double in the next 10 years and the country's domestic food market estimated to reach $258 billion by 2015. Yet, at the other end of the chain, farmers are suffering losses. How does one explain this crisis?

People blame low productivity, crop selection, export levels, effi ciency, mandi regulations, and technology adoption. But the farm income crisis does not have its causes on the farm. While those issues do affect a farmer's gross revenues, his net income is decided by his relative bargaining power—by his ability to wrestle his fair share of the profits out of the hands of the traders and corporations that dominate the other links of our food chain. To a significant extent, the farm crisis is a result of farmers failing to win these battles.

Since the crisis is not caused by farmers producing the wrong products or producing them in the wrong ways, the crisis cannot be solved by new techniques, better technology, or by bigger farms. What it needs is market structures that empower the farmer.

While farmers operate in near-perfect competition, which keeps profits to the minimum, buyers are far fewer in number and drive a hard bargain. Farmers face barriers of geography and state laws, risk from counterparties and price volatility, lack of grading and storage infrastructure, and limited access to bank finance. So every farmer first seeks an assured market at whatever price.

A forward contract is useful here because it is a private negotiation developed to establish the price of a commodity to be delivered at a specifi c date in the future. Such an agreement locks in the price for both the buyer and the seller of the commodity and, therefore, eliminates the risk of price fluctuation that both sides of the contract face without the benefit of a forward contract. In theory.

In practice, forward contracts have had a chequered past in India. The most rudimentary one is selling the harvest in advance to the village arhtiya. Fruit orchards are contracted on this basis in Himachal Pradesh. It saves the farmer the effort of hunting for a buyer and transportation cost. But the arhtiya rarely pays the actual one prevailing at the time of delivery.

Contract farming – a forward contract between a company and a farmer – is more equitable. Retailers and processors have contractual buyback arrangements with farmers that specify quantity, quality, and a pre-agreed price. Farmers stand to gain from the lower transaction costs, assured market, and better allocation of risks. On the other hand, contracting firms have the advantage of assured supply, and reasonable control over quality and other specifications.

But forward contracts reduce price risk only if both parties to the arrangement live up to their end of the agreement. Because forward contracts depend on the performance of the two original parties to the contract, these contracts are often diffi cult to transfer. In other words, there is no protection against default.

Most often, it is mutual understanding and faith that drives contractual relationships and it takes a long time to win mutual trust and confi dence. There have been instances of farmers refusing to sell to contracting firms when market prices exceed the contract price, and of firms refusing to purchase contracted quantities or pay contracted prices due to market conditions. Neither the contracting firm nor the farmers are keen to contest these issues in a court. Contract farming arrangements are also often criticized for being biased in favour of firms or large farmers, while exploiting the poor bargaining power of small farmers.

The only other widely available kind of forward contract was futures trading on commodity exchanges. Futures trading eliminates counter-party risk and allows a farmer to lock in his price. But futures trading requires a certain level of fi nancial literacy, standardization and cash flow that puts it out of bounds for the average grower. In short, traditional forward contracts remain an imperfect solution because they do not ensure the best price, or do not eliminate counter party risk, or are difficult to use.

Now this is set to change. In September, the Modi government allowed commodity exchanges to launch a new type of forward contracts that will combine the advantages of all existing varieties minus the downsides. And though it was a low-key policy push, it has the potential to radically overhaul agricultural marketing and bring hope to India's 119 million farmers.

Here is how it will work. Suppose farmers in Gulbarga, Bihar, who plant corn in October-November for harvesting in March, want to protect themselves from price risk and also want an alternative marketing channel to the village arhtiya. Their forward contracting decisions can be seamlessly integrated in their agricultural decision-making process.

Through their farmer producer company, they can take a membership for trading in forwards on a commodity exchange such as Ncdex. At the time of planting, farmers will estimate the cost of production. To this cost they will add a profit margin after taking a cue from prevailing forward market prices for corn and the likely size of their harvest. The FPO can immediately place an offer to sell the forthcoming harvest for this price on the exchange-traded online forward platform and cover its price risk. Or it can wait till the harvest and then place the offer to take advantage of the prevailing scenario. The timing, quality, quantity and price will be decided by the FPO. Either way, it will be freed from the trader cartel.

Farmers with better quality corn will be able to find takers willing to pay a premium through forwards instead of settling for the average quality price at the Gulab Bagh mandi. Though quality premium was also possible under contract farming, there was one major drawback. Only a few hundred villages were lucky to find corporate buyers at their doorstep. With forward contracts, farmers need no longer be passive. Instead, the national platform will give them freedom to choose buyers from across the country.

The Forwards Markets Commission has decided to allow 24 cash crops to be traded through forward contracts. Once forward contracts gain volumes, their daily price will effectively become the benchmark for prices everywhere. Close to 4000 tonnes of corn and sugar were traded on NCDEX forward platform in the first six weeks after launch. No longer will farmers be exploited because of information asymmetry and geographical boundaries.

When the delivery time arrives, the corn will be tested by an exchange-nominated assayer to ensure that it meets the promised specifi cations. Then it will be transported by rail or road to the mutually agreed destination or stored in an accredited warehouse. Once the buyer receives the crop, money will be transferred to the FPO's account by the exchange.

But the FPO need not wait that long to get finance against its crop. It can use the warehouse receipt issued by the warehouse service provider to get pledge finance from banks. The receipts will be electronic and tamper-proof. This will increase liquidity in rural areas and encourage better price risk management of agriculture commodities.

To resolve the issue of traders and farmers defaulting on forward contracts, each party of the transaction will submit a good-faith deposit, or margin. In the case of failure to comply with the contract, the party suffering the loss would receive the funds deposited in good faith to cover the inconvenience and at least part of the financial loss. Moreover, there will be timely arbitration and guaranteed settlement through a well-financed clearing house.

In other words, forward contracts can be the perfect marketing tool for Indian farmers because they have safety, scale, and flexibility.

Of course, the same advantages will extend to traders, companies and the government. Commodity processors, food and beverage companies, hotels, restaurants, fast food chains can use forward contracts for direct raw material procurement. Traders can buy on the forward platform and sell downstream, while simultaneously hedging their price risk on the futures platform. Public sector companies such as Nafed, STC, MMTC, Food Corporation of India, state government entities can use forward contracts to buy and sell food crops in a transparent and cost-effective manner for both MSP operations and ration shops. All market participants will enjoy a high level of assurance over the price, ownership, delivery, and payment, and contracts will be appropriately sized and balanced to meet each one's needs.

The social benefit of forward contracts will be infinitely greater. Forward contracts can be the instrument for gender justice. Women farmers have become a dominant force throughout India, as more and more men migrate to earn money. But they fare even worse than male farmers when it comes to market access. Forward contracts can bring the national market to women farmers with the click of a mouse. Among the first FPOs to take membership of the forward segment on NCDEX was the Jeevan Sangini Krushi Vikas Women Farmers Producer Co Ltd, based in Buldana, Maharashtra.

To meet the current growth target of 4%, farming urgently needs reforms that make it more competitive and better integrated with the market. Forward contracts will initiate the much-needed shift towards the adoption of grades and standards; credible, enforceable and tradable contracts; adequate storage facilities; and an open and efficient market environment. This alone can contribute substantially to agriculture-led economic growth. Misallocation of profits within the agri-food chain is at the heart of India's farming crisis. Ultimately, forward contracts will give back farmers some of their lost power.