

## Box 2.2: Commodity Market in Pakistan

Commodity exchanges operate in many countries around the globe, providing a platform to buyers and sellers for trade of commodities. Some of these commodity exchanges, having a long history and offering diverse products along with efficient and cost effective trading platforms, have become international/regional hubs. Leveraging upon the use of information technology, these exchanges offer the ease of trading irrespective of geographical location and time zone. While exchanges like Inter Continental Exchange (ICE), Chicago Mercantile Exchange (CME), Dubai Gold & Commodity Exchange are globally well known, exchanges of smaller scale operate in other countries as well.

In order to provide a regulated platform for trading of commodities and enhance the confidence of the investors, the Securities and Exchange Commission of Pakistan (SECP) allowed the creation of Pakistan Mercantile Exchange Limited (PMEX) (erstwhile National Commodity Exchange Limited) as the country's first demutualized exchange, where ownership and trading rights were completely segregated. The initial key stakeholders included Karachi, Lahore and Islamabad stock exchanges and leading financial institutions. In the beginning, only cash settled contracts of a few actively traded international commodities were listed and offered for trading, but, at present, both cash settled and deliverable (future) contracts are being traded.

Currently, PMEX has 300 plus members<sup>109</sup>. During FY17 the total trading volume reached PKR 1.3 trillion with crude oil, currency pairs and gold constituting the major chunk of trading volume.<sup>110</sup> The healthy trading is reflected through the surge in PMEX index which touched 3,232 points at the end of CY17, depicting a YoY growth of 5.57 percent.

PMEX is designed to connect the participants of the real economy with the investors. Although various agri-based commodities are traded on the exchange, the direct

participation of farmers seems to be low owing to lack of financial literacy, capital and access to the market itself.

Apart from that, PMEX can potentially become an important platform to manage the liquidity placement needs of Islamic financial institutions (IFIs) and mitigate settlement risk in some of the Islamic financial products.

In December 2017, SBP and SECP allowed the launch of three-month pilot commodity Murabaha trading product<sup>111</sup> facilitated through PMEX Shariah Compliant Murabaha Trading Platform (**Figure 1**). The country's first electronic Murabaha transaction was conducted between two Islamic Banks<sup>112</sup> in December 2017. Thus, PMEX can become an effective intermediary to cater to the long-standing issue of excess liquidity held by Islamic banks.

**Figure 1**  
Transaction flow of Commodity Murabaha Trading



Source: PMEX Newsletter, Oct-Dec 2017

Besides, several products of Islamic modes of finance e.g. Salam, Murabaha, Istisna require that, in case of default, the underlying (promised) commodity be delivered through spot buying from the market. Thus, the development of wide ranged commodity market

<sup>109</sup> <http://www.pmax.co/wp-content/uploads/2018/04/PMEX-Membership-Database-Web-Site.pdf>

<sup>110</sup> PMEX Annual Report, 2017  
<http://www.pmax.co/wp-content/uploads/2017/12/00-PMEX-AR-2017-web-version.pdf>

<sup>111</sup> This is an Islamic alternative to traditional repo transaction (in Arabic: Bai Ina)

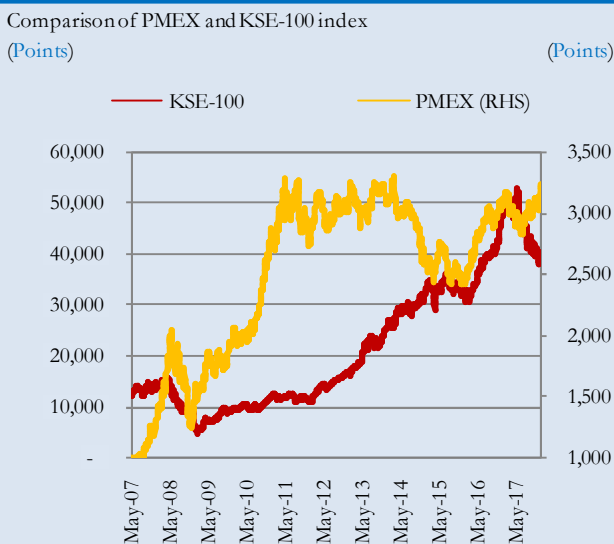
<sup>112</sup> PMEX Newsletter, Oct-Dec 2017

<http://www.pmax.co/wp-content/uploads/2018/04/NL-PDF.pdf>

exchange will also reduce the settlement risk (which is the risk due to unavailability of commodities in the market) and promote Islamic Banking as well.

In the context of financial stability, a robust commodity market (as an alternative investment avenue) may provide an effective hedge through diversification against downturns in the returns of traditional financial assets (e.g. equity, bonds, derivatives etc.).<sup>113</sup> In case of Pakistan, a comparison of historical data of PMEX and KSE-100 indices suggests that the correlation between the two (based on daily data) is negative 0.21 during the past five years (**Figure 2**). This reflects that during the period that witnessed a downturn (with high volatility) in KSE-100 index, the PMEX gained.

**Figure 2**  
PMEX and KSE-100 index show countercyclical behaviour



Source: SBP, PMEX

Furthermore, prior to the commencement of formal commodity exchange in Pakistan, traders were more exposed to foreign exchange risk. In fact, they had to carry out trading through international exchanges involving payment in foreign exchange. PMEX offers an advantage in this respect as well because it allows the participants to pay margins in local currency despite the

fact that the prices of many commodities are denominated in US Dollar.

An efficient technology based operational framework along with a strong risk management practices are the two prerequisites for a robust commodity market. It is worth mentioning that during CY17, PMEX has instituted a technology overhaul program whereby it has migrated its core technology architecture on cloud computing to provide efficient services to its members. Moreover, PMEX is also working towards strengthening its risk management regime. The Exchange has put in place a comprehensive 'Enterprise Risk Management' framework, developed a code of conduct for the brokers and elaborated market regulations to protect the interest of all the stakeholders.

In addition to providing a trading platform, PMEX also facilitates the clearing and settlement of transactions. As this entails settlement risk, PMEX requires its members to maintain historical Value at Risk (VaR) based margins with it and has also established a 'Settlement Guarantee Fund', which amounted to PKR 68.84 million at June 30, 2017<sup>114</sup> to mitigate the possibility of any systemic event.

Notwithstanding, there is a need to enhance the outreach of the market by bringing in more participants from the real sector (particularly farmers) within its domain to enable them to get the benefit from the fair-price mechanism. As PMEX develops, it could provide a risk-hedging platform especially during distress episodes in the financial markets.

<sup>113</sup> Source: Bhardwaj, Gorton and Rouwenhorst (2015): NBER Working Paper no.21243, "Facts and Fantasies about Commodity Futures Ten Years Later" <http://www.nber.org/papers/w21243>

<sup>114</sup> PMEX Newsletter, Oct-Dec 2017 <http://www.pmax.co/wp-content/uploads/2018/04/NL-PDF.pdf>