The Purpose and Potential for Agricultural Commodity Exchanges in Africa

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Commodity Exchanges

The problem

Transactions costs

- search, screen, discover price, enforce contract etc.

Thin markets and risky markets

Reduce transactions costs, increase market activity and make risks more manageable

Commodity Exchanges

What are they?

Centralized location for orderly transactions

- Must have organized rules for bidding and other activities
- May or may not have physical product present
- May trade contracts for future delivery

Commodity Exchange

- Why Centralize?

Increase competition,

Reduce search costs and

Avoid thin markets, potentially reducing price volatility…

Commodity Exchange

- Why Centralize?

Chicago Board of Trade, USA

Tahoua market, Niger

Commodity Exchange

- Why have rules for coordination
  - Limit membership to reduce screening cost

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Commodity Exchange

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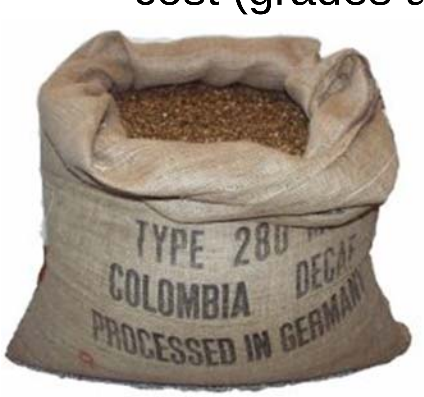
  - Limit membership to reduce screening cost
  - Specify product form to reduce information cost (grades and standards)




Commodity Exchange

- Why have rules for coordination
  - Limit membership to reduce screening cost
  - Specify product form to reduce information cost (grades and standards)
  - Govern form of bidding to reduce disputes & raise transparency

Commodity Exchange

- Why have rules for coordination
  - Limit membership to reduce screening cost
  - Specify product form to reduce information cost (grades and standards)
  - Govern form of bidding to reduce disputes
  - Specify obligations and arbitrate disputes at low cost

Commodity Exchange

- Why have rules for coordination
  - reduce screening cost
  - reduce information cost
  - increase transparency
  - reduce disputes
  - arbitrate disputes at low cost

- Plus, trade in futures contracts allows new tools for risk management.

Commodity Exchange

Promise

Easier price discovery and more price information

More intensive market activity and less price volatility

Lower costs of doing business and more business done

New tools for managing price risk

Expanding Mission of a Commodities Exchange

1. Collect and disseminate market information
2. Establish rules for exchanges
3. Certify grades and standards
4. Manage spot trades in kind (and back to 1)
5. Manage warehouse receipts system
6. Manage spot trades in warehouse receipts
7. Trade in futures contracts (and back to 1)

ComEx: Required Conditions

1. Volume of trade

Costs and Benefits depend on volume.

Need sufficient volume of trade to cover costs through modest service charges and membership fees

(eg. 0.2% of value, ZAR200/delivery)

Need sufficient numbers of traders to achieve efficient price discovery & competition.

ComEx: Required Conditions

2. Commodity conditions

Storable

Homogenous within grades and standards

Active existing spot markets

    Evidence of trader interest

    Information for structuring contracts

(contracts not linked to functioning markets fail)

ComEx: Required Conditions

1. Volume of Trade.

2. Commodity conditions.

Large agricultural value added not sufficient, must have

large volumes of

stable, graded product

trading in active open markets.

ComEx: Required Conditions

Volume of right commodity is a BIG Challenge:

935 tons maize traded on Ethiopan ComEx in 2008

600,000 tons maize traded in SAFEX in July 2010

1,049 maize contracts trades daily in SAFEX in July 2010.

Problem:
Exchange needs volume to be effective
Exchange attracts volume by being effective

ComEx: Required Conditions

3. Physical and Institutional Infrastructure

Physical needs:

- Storage and transportation
- Communications and information

Institutional needs:

- Grades and Standards
- Contract enforcement
- Organized smallholders
- Financial sector services

An exchange is infeasible without these and expensive if they must be provided

ComEx: Required Conditions

4. Policy Environment
Macroeconomic stability
(inflation, currency valuation)
Trade and Price Policy
Cannot expect participation if prices subject to control, product subject to confiscation or trade policy highly erratic.

Existing Conditions: Volume

Which commodities offer enough volume?

1. Primary Cereal (Maize)

Politically sensitive and unlikely to be free of price intervention.

Volatility of prices in commodity exchange be intolerable.

Price Volatility in Staple Food

Mozambique food price protests, 2008

Mozambique food price protests, Sept 1, 2010

Price variability implied by a ComEx likely intolerable for consumers and government.

Direct price controls incompatible with ComEx.

Existing Conditions

Which commodities offer enough volume?

1. Primary Cereal (Maize)

    politically sensitive

2. Primary Export crops

    But they have auction floors and exchanges abroad and

    Potential for other effective contracting mechanisms

IN MANY COUNTRIES DEMAND FOR EXCHANGE IS NOT APPARENT

Challenge

What is the problem?

Is it the "Walk before you run" problem

Strategy would be:

- Invest in infrastructure and policy environment
- Wait for agents to establish exchange independently

This has been the normal pattern…

Challenge

Is it the "Chicken and Egg" problem?

Strategy would be

- Invest in infrastructure and policy environment
- Subsidize exchange until enough trade is attracted to make it viable, OR
- Coerce participation to force adequate activity

ComEX Risk

The “Chicken and Egg” strategy

In a “Walk before you run” situation

Leads to “Cart before the horse” outcome

?

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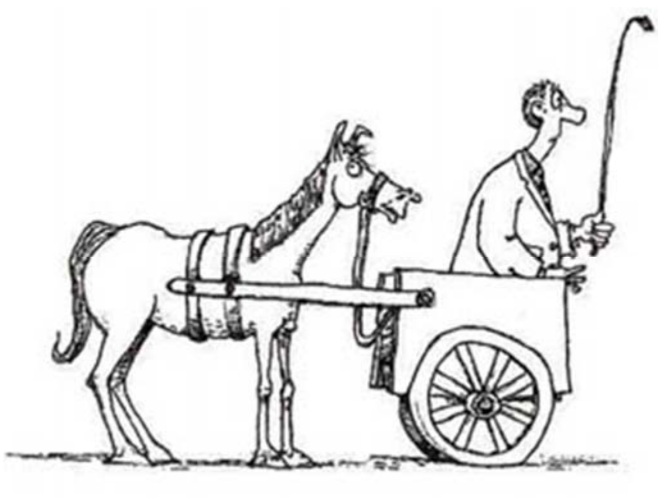

Alternative ComEx Approaches

Offshore exchanges

exchange rate risk

inappropriate contracts

Regional exchanges

governance & policy environ difficulties

only addresses volume issue

Conclusion

- Commodities Exchanges can provide lower transactions costs and new mechanisms for risk management.
- Commodities Exchanges require particular market, policy and environmental conditions to thrive.
- Limits to the capacity to create those conditions in the absence of a critical level of market development and scale.

Thanks