Price Hedging & Food Security

Government of Malawi's SAFEX-based Option Strategy

Presentation to USAID / MSU Roundtable Discussion

"Regional Trade, Growth and Emergency Response: Strategic Options for Dealing with Recurrent Food Crises in Southern Africa"

The World Bank
With support from SECO and the Dutch Development Corporation

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Agenda

- The Problem
- The Product
- Limitations
- Advantages

The Problem

Although South Africa has 6 million metric tons surplus, commercial imports are not moving

…Leading to…

Increasing local prices

…Leading to…

Potentially higher levels of humanitarian need

…Leading to…

Intervention to maintain sales at subsidized prices

…Leading to…

Continued disincentives to private sector trade

Government needs:

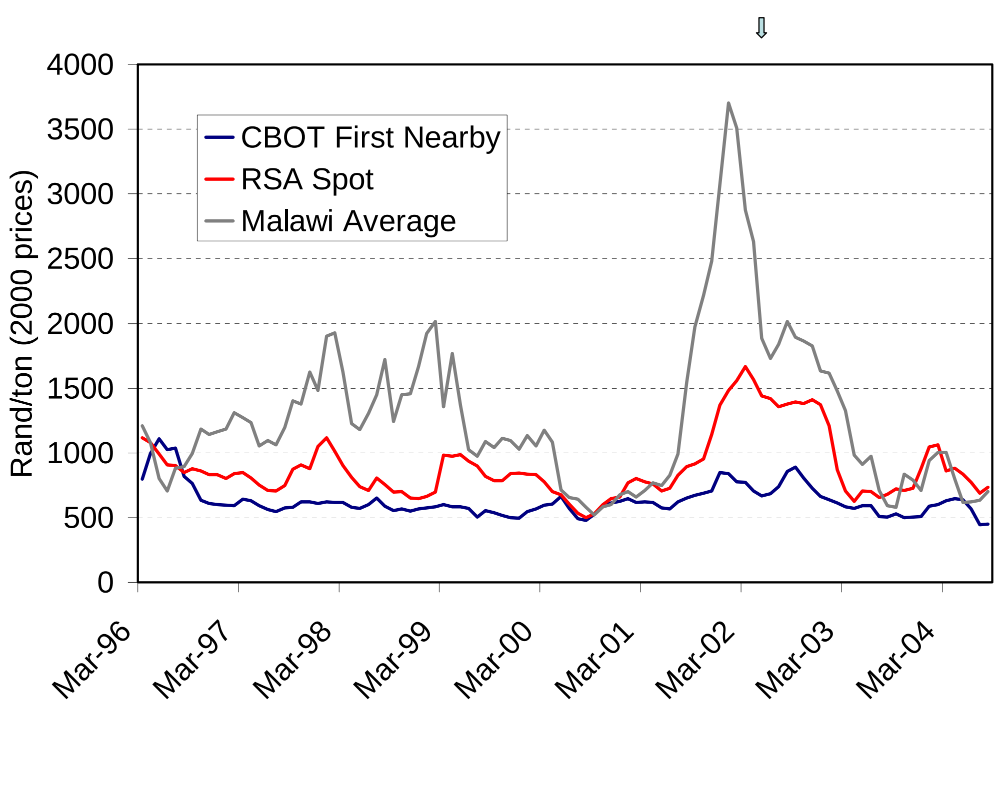
-to be seen to be taking action

- an operating mechanism that provides:
  - Less expenditure for Treasury,
  - Less panic because maize will be secured,
  - Less distortion in the market

Private sector needs:

- Consistent and non-restrictive trade policy
- Clear signals about government intentions
- Information about who is going to buy, when, and how much
- Coordination & planning to avoid transport bottlenecks

Price Relationships



MVAC estimates of Malawi needs

Scenario	Price Level	Humanitarian needs
#1	Local prices 18-25 Mk/kg	270,000 MT
#2	Local prices >30 Mk / kg	350,000- 400,000 MT

Why did Government want a risk management approach?

- Concerned about local price increases
- Concerned about SAFEX price increases
- Concerned about private sector's ability & willingness to bring in commercial imports
- Concerned about response to humanitarian appeals

➢ Wanted a back-up plan in case any of the above went wrong

The Product

- A call option
  - Gives Gov't the right but not the obligation to buy
  - Gives Gov't protection against prices moving up

Two Types of Options:

- Financial – SAFEX based only
- Physical – SAFEX + transport

The Contract

- SAFEX price capped + plus Delivery costs fixed, i.e:
  - Transport cost
  - Cost of bagging, etc.
  - Premium for GMO free Maize
- Flexibility on volumes – in 5,000 mt increments
- Two expiration dates / two delivery periods

Limitations

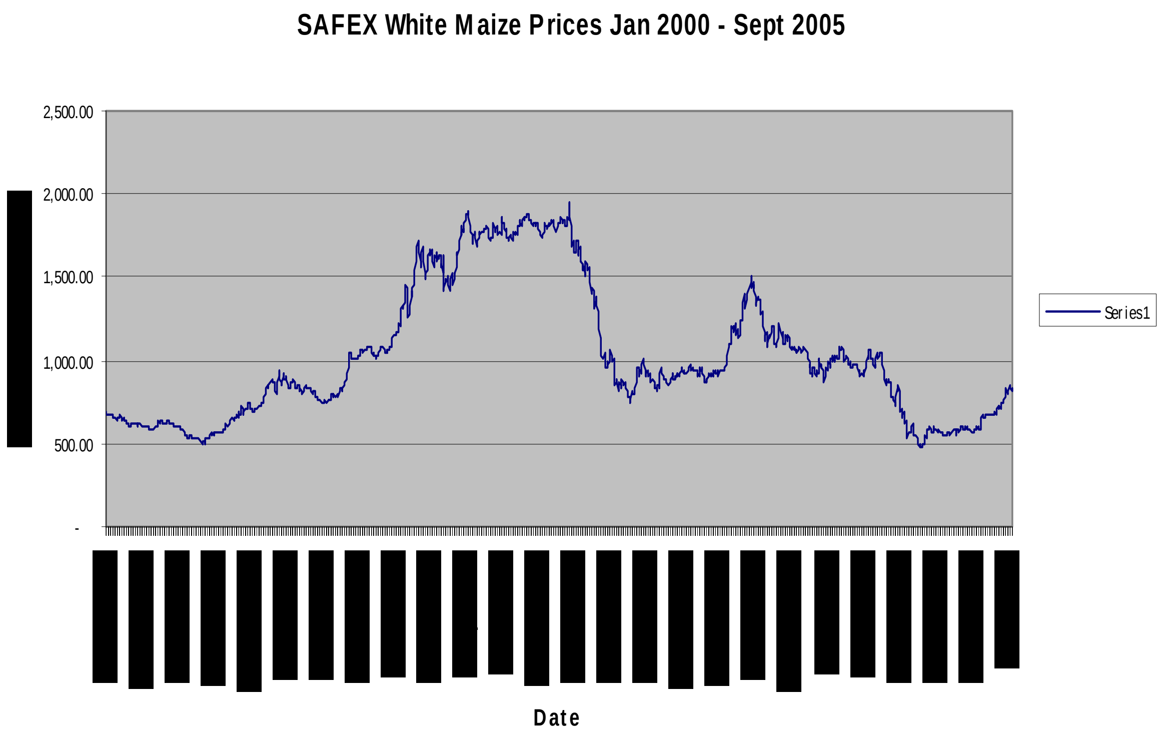
- In General
  - Has a cost; generally 8-10% of price level protected
  - Is somewhat complex – requires capacity building
  - Requires planning
  - Requires cash in advance for payment of premiums
  - Doesn't solve problems of transportation constraints
  - Counterparty risk exists
- Specific to Malawi this year:
  - Prices (local, SAFEX, and transport) had already experienced some movement up by the time the option was purchased

Advantages

- Is a planning tool
- Provides protection against price increases (SAFEX, CBOT, or local)
- Provides predictability on budget for imports
- Gives government a commercial alternative to ad hoc policy intervention
  - Provides signal to the public & market about government action
- Improved definition of space between public & private sector imports
- Can be implemented in different ways:
  - Once option is exercised, government can sell product back to private sector for commercial distribution
  - Has application for strategic grain reserves (financial v. physical)
- Regional traders positive about the approach and interested in exploring other applications

Conclusions

- Governments have difficulty giving up interventionist policy without good alternatives
  - ➢ Market solutions exist, need to be tested in practice
- Donor investment in risk management strategies may help maximize value of food aid dollar
  - ➢ Better coordination and ex ante planning needed so not always operating in crisis mode


SAFEX White Maize Prices Jan 2000 - Sept 2005
2,500.00
2,000.00
1,500.00
1,000.00
500.00
-
Series1
Date