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Commodity Exchange Developments

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Executive Summary

Commodity exchanges are diverse. In practice no two are the same – each is a reflection of its specific environment. Types of exchange include the spot exchange trading physical commodity for immediate or near-immediate delivery; the forwards exchange trading physical commodity for future delivery; and the futures and options exchange which is a financial exchange for price risk management where deliveries are rare or in some cases non-existent. Each serves a specific purpose and offers a specific set of benefits and challenges.

Commodity exchanges are well established in developing countries – some exchanges in parts of North Africa, Asia and Latin America have existed for over 100 years. A substantial literature based around this experience highlights a range of benefits that a commodity exchange can generate in the context of a developing country. An UNCTAD impact assessment study from 2009 surveyed the leading exchange in each of five developing regions. Over 70 distinct positive impacts are identified, falling into four broad categories: improved price discovery and transparency; stimulating better access to finance; generating more efficient trade and competitive markets; and facilitating good risk management, including price risk management through hedging.

With respect to value chain finance specifically, a commodity exchange can – if designed and operated effectively – provide the following benefits: the warehouse receipt enables farmers to have liquid collateral; banks can value the collateral against an exchange-generated 'live' market price; banks can easily liquidate collateral through the exchange's markets; the warehouse receipt system ensures collateral can be pledged only once; the exchange manages performance through a defined settlement cycle; and for all the above reasons, interest rates on loans can be lower because risks are lower (and particularly, with the presence of a futures exchange, this effect is substantial when a position is 'hedged' to lock in a forward price).

For Sub-Saharan Africa, experiences with commodity exchanges are comparatively recent. Accordingly, the lessons are still emerging. There are today only three African commodity exchanges which could be considered functional: Johannesburg Securities Exchange (JSE), South Africa; Agricultural Commodity Exchange of Africa (ACE), Malawi and the Ethiopian Commodity Exchange (ECX), Ethiopia. Initiatives in many other jurisdictions have either failed or not as yet established themselves.

- JSE is a mature platform, operated on a purely commercial basis, serving a largely commercial farming and trading sector, utilising developed infrastructure, and a light touch but internationally respected regulatory framework.
- ACE has organically developed as an NGO, based on small-scale donor funding, serving a smallholder farming sector, intermediated by both small-scale and large commercial traders, with under-developed infrastructure, in the absence of a legal-regulatory framework but rather based on the exchange's own rules and regulations.
- ECX is effectively a public agency, based on large-scale donor funding, with what is understood to be a reasonably developed (donor-funded) infrastructure, serving a largely smallholder farming sector, intermediated by both small-scale and large commercial traders, with an extensive legal-regulatory framework.

It is positive to note that in such different conditions and circumstances, all three exchanges are generating prices and disseminating them to farmers; facilitating direct access by farmers to storage, finance and markets; enabling farmers to store and sell later in the season when prices are higher, supported by Warehouse Receipt finance; and providing the basis for trade in quality-standardised commodity which is accepted by traders, exporters and offtakers alike.

Perhaps the most important factor that differentiates the JSE, ACE and ECX from the other initiatives has been a warehouse receipt system which acts as the bridge between the physical market, the financial sector and the exchange platform. Perhaps this is demonstrated most clearly with respect to ACE (Malawi), where the introduction of the WRS stimulated a sustained period of growth and acceptance after earlier struggles.

Another key building block has been the dissemination of market information through a range of channels, including to smallholder farmers. ACE and ECX have placed particular emphasis on this activity, which is mainly supported by donors. Irrespective of whether farmers actually use the exchange itself, pricing can bring direct benefit to the farmer, who becomes empowered to negotiate prices with traders that are closer to the ruling market price.

Other key lessons from the experience in Africa include:

- Alignment of the exchange with government policy – in particular to understand which forms of market interventionism and restriction are compatible with an exchange;
- While understandably prioritisation in the policy discourse focuses on the needs of farmers, attention also must be paid to creating value for traders, processors and offtakers;
- To obtain acceptance from the commercial market, an exchange needs to offer guarantees and access to finance through strong default management and a functional WRS;
- That many African national markets tend to be small – a regional market may better create the liquidity and economies of scale that attract buyers and reduce transaction costs.