


What can the international community do to help food dependent developing countries deal with continuing global food market volatility?

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The sudden increases in many internationally traded food commodity prices in late 2007 and early 2008, and repeated in 2010-11 highlighted the continuing vulnerability of net food importing developing countries (NFIDCs), to unpredictable food price spikes, and the threat to their food security. While there are several policies that national governments can pursue to reduce or mitigate the impact of external high food prices, there is a lot that the international community can do to instill more confidence in global food markets, and hence make the climate for decision making of NFIDCs more stable.

While market price variability is of concern to many market participants, what matters most for NFIDCs is unpredictability, as this may lead to unplanned and unwanted responses that may affect negatively welfare. This, however, presents a problem in identifying ex-ante periods of large or excessive market volatility, as there are not many or easily computed empirical measures of ex-ante market unpredictability. There exist sophisticated techniques for doing this, but further work is needed to make such measures reliable as triggers for policy interventions. Compounding this problem, the nature of commodity market prices is rather complex and hence one cannot easily form reliable predictions of future market developments.

Despite these empirical difficulties there are ways to monitor global commodity market developments so as to alert policy makers about the high probability of impending market upheavals in the near future. Market upheavals can be defined as situations where market fundamentals, such as prices in organized or other representative markets, cross boundaries that are considerably outside normal market variations, and occur infrequently. All of these rather vague terms can be defined in ways that can be monitored. These ways need to be enhanced and organized, so as to provide a permanent body of freely available information concerning food commodity market developments.

The risks facing public or private agents in NFIDCs include the difficulty of estimating domestic food requirements, well in advance so as to plan imports and relevant financing. This difficulty is compounded by the unpredictability of external prices, which may lead to excessive food import costs, unavailability of additional import financing in times of spikes, as well as counterparty contract performance risk in the face of rapidly changing prices. Any system to deal with market volatility must deal with these risks.

In the past the major policy emphasis relating to undue market volatility concerned various forms of stockholding with a view to manage market prices within prespecified ranges. Such policies have been instituted in several national contexts, and in many cases have been instrumental in keeping domestic food staple commodity prices stable or within a narrow price band. However, they invariably entail a large cost, as there are occasions when the public interventions must counteract the market fundamentals, a situation that pits the government against the market, and depending on the context, it may be very difficult and/or expensive to control the market. The same, and more, difficulties present themselves in an international context, and this is why the various calls in the past to organize international agreements to stabilize commodity prices have either not been implemented, or if implemented did not manage to effectively discipline the relevant markets.

Given that excessive market volatility is undesirable, there are generally two types of measures that can be taken. The first set aims at lowering the probabilities of food market upheavals, and the second aims at facilitating the management of such spikes when they occur. In the sequel measures that can be adopted in these two broad classes are outlined. These are not all the measures or policies that have been proposed, but those that seem to have a better

chance of implementation, as well as not distorting the orderly evolution of existing market fundamentals.

▶ A. Measures to lower the probability of food market upheavals

Preventing food market price upheavals and spikes, or lowering their probability of occurrence, involves changing the fundamentals of the market. This can be done either directly, by for instance making the public sector take positions in the actual market, or giving incentives and information to the private sector to modify their positions and market strategies. Direct market interventions on a global scale to alter the fundamentals of the market via public stock holding policies are too costly and of doubtful success. Therefore, what is mentioned below relates to measures that would affect market incentives indirectly.

1. Support the establishment or enhancement of existing systems for the availability of national and global market information and monitoring.

A better information and market monitoring system, especially as it pertains to stockholding, government trade and market related policies, including short term policies, would go a long way towards preventing the build-up of expectations based on wrong signals, as well as unnecessary destabilizing short term private and public hoarding and speculative behavior.

2. Establish a global early warning system of impending food price spikes.

The basic role of such a system would be technical, namely to analyze and publish the best estimates of the probability of a price spike in the near future. This could be done by an appropriate and impartial team of analysts hosted in some international organization.

3. Provide technical assistance to vulnerable food dependent developing countries to analyze the food risks they face in the global food market system.

Such analysis could include both market and sectoral information on the different degrees of exposure of the country and vulnerable segments of the population to international food related risks. It could also provide policy options to deal with the relevant risks.

4. Revise the WTO rules to limit or prevent export bans of basic food commodity products.

Export bans are very disruptive to international markets, as they disturb established trade flows and cause significant losses to traditional trading partners of the countries that import from those imposing export bans. As export bans are a trade measure, the appropriate international forum to discuss this is the World Trade Organization (WTO). Currently export bans are not forbidden by the WTO agreement, and would cost little to implement such an agreement among WTO members, and it would involve a small change in existing WTO rules.

5. Revise the rules of existing organized commodity exchanges in developed countries to prevent excessive speculation

This has been called for by many analysts, as well as market participants, and could help prevent situations where the organized exchanges lose their relevance and connections to the physical commodity markets. Relevant rules that could be reviewed, for instance, concern position limits on various types of trades.

► B. Proposals to help needy food importing developing countries to manage the impacts of a price spike

1. Create a fund for the establishment of an internationally coordinated “Global Financial Food Reserve” (or GFFR) of basic food commodities

The major problem with all proposals that have been proposed to deal with market volatility is that they purport to try to prevent the occurrence of a price spike. This, however, is very difficult to accomplish within a globalized market system, and may need very large and uncertain amounts of financial resources, that rightly makes donors uneasy and unwilling to consider. However, if the major objective of a system to deal with market volatility is to prevent the weakest members of the international community from paying the price for an upheaval, which for the most part is not their fault, then one could consider a limited and much cheaper safety net system to ensure support only for those countries.

The proposal made here would be an agreement by a group of a few important world grain market participants that would include members of the G8+5 as well as major grain exporters and other donors, to commit funds that could be utilized to hold specified amounts of publicly owned long positions in organized exchanges. In other words the proposal calls for the establishment of an international publicly held “global commodity fund” specifically targeted to basic foods. Given low margin requirements, this fund could assure, with relatively modest financial resources, control over a considerable amount of physical reserves. This could then be considered to be a “virtual commodity reserve”, and would basically act as a dormant physical reserve. The fund’s positions would be rolled over from period to period, much like the commercial commodity funds do.

The fund’s positions and resources would not be used for any “stabilization operations”. However, when markets go into an unusual spike, the fund would have the option to either take physical delivery, so as to utilize the physical stocks for prespecified safety net purposes, or to sell off the long positions. In either case the fund would command at a time of a price spike either physical stocks or financial profits from its long positions, if liquidated under market spike conditions. These physical stocks or profits could be utilized to promote a global safety net to assist most affected poor countries in obtaining food commodity imports at lower than spiking market prices. Given that the fund’s purpose would not be to stabilize markets, the GFFR could be restricted in size to what is estimated as needed for additional or extraordinary assistance to needy food importing countries in times of a food crisis.

The cost of such a reserve would be modest, as the funds needed, because of low margin requirements, would consist of only a fraction of the physical value of the underlying virtual stock held. The GFFR major market operation would be to roll over positions in each period if needed, hence it would not interfere in the normal functioning of the commodity markets. The allocation of the proceeds or the profits of the GFFR from any price spike to needy developing countries could be a separate process, that would entail allocation according to some pre-specified development criteria.

2. Create a dedicated Food Import Financing Facility (FIFF) to increase trade finance for low income countries in times of food price spikes

A major problem facing least developed countries (LDCs) and some NFIDCs is financing by both private and parastatal entities of food imports, especially during periods of excess commercial imports. The financing constraint arises from the imposition, by both international private finan-

cial institutions and domestic banks that finance international food trade transactions, of credit (or exposure) limits for specific countries or clients within countries. These limits can easily be reached during periods of needs for excess imports, or periods of high prices, thus constraining the capacity to procure finance for food imports and as a result, food import capacity.

The purpose of a food import financing facility (FIFF) would be to provide financing to importing agents/traders of LDCs and NFIDCs to meet the cost of excess food import bills. The FIFF is not intended to replace existing financing means and structures; rather it is meant to complement established financing sources of food imports when needed. The financing will be provided to food importing agents. It will follow the already established financing systems through central and commercial banks, which usually finance commercial food imports using such instruments as letters of credit (LCs). The extra contribution of the FIFF would be to provide guarantees to these financial institutions so that they can increase their exposure to the importing countries. It will do so by inducing the exporters' banks to accept the LCs of importing countries in hard currency amounts larger than their credit ceilings for these countries. A key aspect of the FIFF is that it will not finance the whole food import bill of a country, but only the excess part induced by a food crisis. In this way "co-responsibility" will be established, so that only real and likely unforeseen needs will be financed, and the cost of excess financing will be kept at a low level.

The costs of a FIFF would be minimal through risk pooling for a large number of countries and food products, and low operational costs owing to its risk management activities. Rough estimates suggest that even in an extreme price spike year, the guarantees provided would be a very small fraction (less than 0.5 percent) of the public debt of, for instance, the G7 group of developed countries.

3. Support the establishment of a physical emergency reserve of about 300,000 to 500,000 tonnes of basic grains

The purpose of these reserves would be to assure the smooth flow of humanitarian food related aid. The World Food Program (WFP) would manage this reserve and use it solely for humanitarian and emergency response.

4. Assist food importing developing countries to develop market based strategies to manage the risks of their food imports.

Developing countries can go a long way in managing the risks of their food import needs by engaging in market based risk management strategies. However, they lack the expertise, and also may face credit and other financial constraints in dealing with the institutions that are available. This offers considerable opportunity for developed countries to assist them in this technically and financially demanding area. Apart from technical assistance, developed countries could offer to share part of the cost of engaging in modern risk management strategies, as a way of facilitating adoption.

5. Promote the organization of appropriate commodity exchanges in developing countries

The use of market based risk management strategies by developing countries would be facilitated considerably if appropriate commodity exchanges existed in several geographic locations, closer to developing country markets, so as to lessen the basis risk for many food importing poor countries. Such exchanges can promote market development and also facilitate the linkage of developing country markets with those of more developed markets.

6. Promote the establishment of international standardized commodity contracts in basic food commodities and

an International Grain Clearing Arrangement as a way to guarantee food import contracts

A problem that is acute during food crises is counterparty performance risk, namely the risk of renegeing on a delivery contract, faced by many food importers. There seems to be no contract enforcement mechanism in international staple food grain transactions. The basic missing institution is an international contract together with an international clearing house type of arrangement similar to the clearing houses of the organized commodity exchanges, which ensure that all contracts are executed. The key question is whether an international contract along with a clearing type of mechanism can be envisioned to ensure the performance of staple food type of import contracts.

A global contract rather than tracking prices in one geographical region, would track “cheapest to deliver” commodities, by designating delivery points in several places in the world. The traders who could deliver on such a contract would be those with relatively low prices. There are precedents to this type of global contract, namely the global sugar futures contracts of the Intercontinental Exchange and the Euronext Liffe.

If global contracts are not instituted by an international exchange then the next best way to implement something on an international scale resembling the functions of an international contract and the clearing house of existing organized exchanges, would be to link existing or envisioned commodity exchanges, with their respective clearing houses, or to have international exchanges list contracts with several international points of delivery. In other words, it maybe appropriate to think of how parts of contracts bought in one exchange could be guaranteed for delivery not only by the clearing house of the exchange in question but by clearing houses of other linked exchanges.

One way to do this would be to establish

links between various commodity exchanges around the world, via some kind of International Grain Clearing Arrangement (IGCA) so that the price difference between grain stocks in different locations would be equal to the relevant cost of transport and other transactions charges. The IGCA would try to guarantee that physical supplies around the world deliverable at various exchanges are available to execute the international contracts in its member exchanges. The IGCA would guarantee the execution of contracts by pooling the resources of several exchange related clearing houses. This would ensure that there would be liquidity in terms of physical reserves to honor individual contracts in case of non-performance by a participant.

7. Promote the creation of permanent global safety nets relating to food price spikes

Considerable funds were committed to developing countries in the three year period following the 2007-8 food crisis. However, these funds, useful as they have been, are not scheduled to continue. This will leave the countries most vulnerable to food price shocks vulnerable to the continuing gyrations of the international food markets. What is needed are safety nets that act as insurance against global food price spikes. What was suggested above in the form of a GFFR is a case in point, but other country based safety nets could be considered.



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