An Overview of Commodity Exchanges in Africa

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Introduction

A commodity exchange is an incorporated association that operates on a non-profit basis to put in place rules and regulations for the trade of commodities and investments[1]. Commodity exchanges trade mainly in primary products rather than manufactured products, and since Africa is chiefly an agricultural continent, African farmers stand to benefit from an increase in involvement on commodity exchanges both on the continent and worldwide. Coffee, wheat, maize, sugar, oil and cocoa are a number of the products that are traded on the commodity exchange and these are products that are prevalent on the African continent. The supply and demand for a product will determine whether its volume of trade on the commodity exchange, and the product's price will be determined by the demand for it[2]. Commodity exchanges operate on a contract basis, such as spot prices, forward prices, future contracts as well as options on future contracts[3]. These contracts offer farmers stability and consistency of prices for their produce, in particular future contracts protect farmers against drops in prices.

History of Commodity Exchanges

Commodity Exchanges are believed to have existed since the 17th century, such as in Amsterdam in 1695 and the Dojima rice market of Osaka in 1730, but it was only in the 19th century that successful commodity exchanges began to emerge. The first five successful commodity exchanges in the world traded in cotton futures contracts and were connected by cable, this was in New York, Liverpool, Alexandria, La Havre and New Orleans (Baffes, 2011). However, these commodity exchanges were derailed after the Second World War, which first highlighted the weaknesses of commodity exchanges that are primarily policy interventions. Post World War Two, heavy government intervention brought about the collapse of commodity exchanges in China, Egypt and India while changes in trade agreements and government policy led to the failure of commodity exchanges elsewhere such as in various parts of Europe (Baffes, 2011).

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[1] http://www.investopedia.com/terms/c/commoditiesexchange.asp
[2] http://valuestockguide.com/guide-stock-commodities-exchanges/
[3] http://valuestockguide.com/guide-stock-commodities-exchanges/

Before 1990, commodity exchanges were generally restricted to the industrialized nations, but since then the liberalisation of markets, the rise in affordable technology as well as deregulation have enabled the growth of commodity exchanges worldwide (Rashid et. al., 2010). In fact according to United Nations Conference on Trade and Development (UNCTAD, 2007), by the mid 2000s, most of the world's functional commodity exchanges existed outside Europe and North America notably in Asia and Latin America, Africa regrettably has not been as successful in the adoption of commodity exchanges.

Benefits of commodity exchanges

The centralisation of trade for a particular commodity is one of the most important tools of commodity exchanges as it facilitates title transfer, price discovery and market transparency (Rashid *et. al.,* 2010).One thing to note before developing a commodity exchange is to understand the nature of the specific contracts that are to be traded (Rashid *et. al.*, 2010). The most basic contract is one of warehouse receipts which involves a title transfer at a specific location of an agreed upon quality and quantity of a commodity (Rashid *et. al.*, 2010). These kind of contracts help to solve the financing issues of farmers because these receipts can then be used as a financial instrument to gain capital for another cycle (Whitehead, 2013).

Future contracts, on the other hand, can help strengthen market liquidity, improve price discovery as well as manage price risks (Rashid *et. al.*, 2010). Market liquidity is strengthened as both buyers and sellers are willing to hold and exchange money through the financial instrument that is provided by the futures contract (Rashid *et. al.*, 2010). It should be noted that futures contracts do not entirely remove the risk attached to the sale of farmers' produce but they just reduce the risk from a price risk, which is usually attached to spot contracts and forward contracts, to a basic risk (Mbeng Mezui *et. al.*, 2013).

Currently one of the greatest problems faced along the agriculture value chain is the price discovery mechanism, farmers sell their produce at a price that is determined by how desperate they are for cash at the time and not the market price (Whitehead, 2013). Through a commodity exchange, farmers will gain better knowledge of the market and therefore the prices of their produce which will increase farmers' earning potential. Commodity exchanges also help to reduce transaction costs and increase the flow of information through the market which will increase the returns to market agents as well as reduce the short term variability of prices and spatial price dispersion (Rashid *et. al.*, 2010).

Commodity exchanges in Africa

Commodity exchanges began to emerge in Africa in the 1990s. Uganda, Zimbabwe, Kenya, Zambia and South Africa were pioneers in launching commodity exchanges but the only successful exchange was the South African Futures Exchange which was birthed from the Johannesburg Stock Exchange (Mbeng Mezui *et. al.*, 2013). Zambia and Zimbabwe were both originally successful but following unprecedented increases in prices of commodities and successive government intervention, their commodity exchanges collapsed (Rashid *et. al.*, 2010). Uganda was more successful but could not generate sufficient trade volumes forcing the Uganda Commodity Exchange (UCE) to function only as a regulator of some warehouses on behalf of the government (Rashid *et. al.*, 2010). Kenya also faced the same problem as Uganda limiting the Kenyan Agricultural Commodity Exchange (KACE) to operate only as a provider of information on prices in Kenya (Rashid *et. al.*, 2010).

The 2000s saw a new wave of commodity exchanges in Africa. Nigeria set up the Abuja Securities and Commodities Exchange (ASCE) and Malawi set up the African Commodities Exchange (ACE), Zambia also created a new exchange the Zambia Agricultural Commodity Exchange (ZAMACE)[4] (Rashid *et. al.*, 2010). And then in 2008, Ethiopia set up its Ethiopian Commodities Exchange (ECX) which has quickly grown to be a model for other African countries (Whitehead, 2013).

The ECX is a government owned exchange: it is a spot market built on standardised warehouse receipts (Mbeng Mezui *et. al.*, 2013). Initially the exchange was unable to bring in significant volumes of trade when it was focusing on maize, beans and wheat so it began to focus on export commodities in December 2008 (Rashid *et. al.*, 2010). Through the support of policies that discourage export through arrangements other than the exchange, trading volumes went from $1 billion in 2011 to $1.4 billion in 2012 (Whitehead, 2013). The ECX is said to have benefited farmers through access to real time pricing information, better profits and profitability, increased quality of exports and lesser market segmentation (Whitehead, 2013).

Coffee exports in Ethiopia increased from $529 million in 2007/2008 to $797 million in 2011/2012 and the absolute value that Ethiopian farmers were paid increased by 79% to 115 cents/pound during this period (Whitehead, 2013). However, there are reports that claim that

[4] But this failed as had the Zambian Agricultural Commodities Agency (ZACA) of the 1990s

farmers are not benefiting as much from the exchange as is claimed. Farmers were taking home 57.1% of the export price for coffee by September 2007 but by September 2012, this figure was down to 51.6% (Whitehead, 2013). It appears the rest of the profit is taken by the middle men who manipulate the information given to the farmers in order to continue to earn more. Though the ECX has set quality controls in place for the coffee exports, the reduction of market segmentation has removed the traceability of coffee coming from Ethiopia which does not appeal to some importers of coffee who prefer to know exactly who they are buying from (Mbeng Mezui *et. al.*, 2013).

Ghana's Cocoa Board provides transparency and guarantees of prices to farmers directly which negates the need for middle men and in Tanzania and Kenya coffee auctions provide better differentiation and traceability than the Ethiopian bourses (Whitehead, 2013). So in order to build commodity exchanges that provide maximum benefit to farmers, the successes and failures of the various commodity exchanges in Africa must be considered to discover the most fruitful way forward.

<u>What is the way forward?</u>

First and foremost it is important to note the need for each community before a commodity exchange is built as one of the chief problems faced has been insignificant trade volumes. It is important to understand the conditions of supply and demand for commodities so that the exchanges can create economies of scale and improve liquidity (Whitehead, 2013).

Secondly, it is far more important to reduce transaction costs than to manage the prices of commodities (Mbeng Mezui *et. al.*, 2013). Farmers in Africa struggle to transport their goods from their farms to the market place due to poor infrastructure. As infrastructure is improved, transaction costs will fall which will reduce the stronghold of the middle men, improve the finances of the farmer for the next cycle and improve price discovery.

Government involvement in the past has led to the downfall of a number of exchanges but it has proved to be helpful in Ethiopia. Therefore government involvement is an important aspect in commodity exchanges but should only be limited to policy intervention (Mbeng Mezui *et. al.*, 2013).

Alternatively, African farmers can look into offshore commodity exchanges. Though use of an offshore commodity exchange carries exchange rate risk, this can be stifled through hedging and trading in foreign currency (Rashid *et. al.*, 2010). Offshore commodity exchanges also create added basic risk and limiting contract specifications (Rashid *et. al.*, 2010). However a well-established offshore commodity exchange can benefit African farmers by increasing liquidity, allowing for better integration with world markets and providing hedging opportunities (Rashid *et. al.*, 2010).

Regional commodity exchanges are also of benefit to farmers. Rwanda hopes that its exchange, the East African Exchange (EAX) will grow to serve farmers in the whole East African region (Whitehead, 2013). Regional commodity exchanges will increase market size at the same time establishing regulatory consistency but in order for them to be successful, infrastructure between countries must be improved as well as their market relations (Rashid *et. al.*, 2010).

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