Creating mass awareness needs to be a priority job

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A commodity exchange is simply a central place where sellers and buyers

meet to transact in an organised fashion under certain clearly-specified and transparent "rules of the game". More elaborately, a commodity exchange system (CES) is an organised market place where trade, with or without the physical commodities, is channeled through a single mechanism, allowing maximum effective competition among buyers and sellers. The single market mechanism, which brings together the myriad buyers and sellers at any point in time, effectively results in the greatest concentration of trading for a given commodity. This market mechanism, such as a price bidding system or an auction system, results in what is known as price discovery. The mechanism thus brings out the true market-clearing price for a commodity at a particular point in time due to the highest possible concentration and competition among buyers and sellers.

The major objectives of a CES are to: (i) bring together the largest number of buyers and sellers of any product at any point in time to allow maximum effective competition, (ii) find out the true market-clearing price for a good at a particular point in time via the highest possible concentration and competition among buyers and sellers, (iii) remove the fundamental problem of achieving self-coordinating market order in the trade of agricultural products, which by their nature, are risky, and (iv) increase market volume and liquidity and reduce risks via a low cost environment.

Most CESs, even when they have a virtual or electronic trading system, operate in a physical place, with an exchange 'floor' on which trading takes place. A common misperception is that a CES establishes prices of traded commodities. This is incorrect. Prices are determined solely by supply and demand conditions. If there are more buyers than sellers, it will force the prices up and vice versa. Thus, purchase and sale orders, which are channelled to the exchange floor for execution, are what actually determine prices. CES operates under a certain set of rules or conventions that are widely known. These rules pertain to four key dimensions of the market: (i) the product; (ii) its price determination; (iii) the actors, and (iv) the contractual relations that bind them. These rules and modalities together create much-needed integrity and trust in the system.

In order to ensure adherence to prescribed rules, exchanges operate with membership-based trading. The membership in an exchange is fixed to avoid chaos which may arise if membership is continuously open to an increasing number. In addition to an annual fee, the actual membership on an exchange floor is paid for with an initial price, much like a share, and can be bought or sold on the market. This ensures that members have a stake in the performance of the market and thus uphold its trust and integrity. Although, membership is limited or fixed, participation of a large number of buyers and sellers is ensured by the Brokers. Brokers are the key set of actors in a CES who trade on behalf of an unlimited number of buyer and seller clients. The function of brokers is to advise their clients on buying or selling subject to the best market opportunities and information. The integrity of brokers is at the core of the integrity of the exchange itself.

Following the speed of market liberalisation across the globe, emerging exchanges are rapidly growing in developing or transition countries to fill the gap left by the marketing boards and the fixed price systems. There are currently more than 100 of these exchanges

across developing countries: 28 in Latin America (15 of them in Brazil), more than 20 in Asia, 3 in Africa, 4 in Eastern Europe, and several in Russia. Most of these exchanges have been created since 1992. Among the South Asian countries, such exchanges are being operated in India, Pakistan and Nepal (UNCTAD, 2002: "Farmers and farmers' associations in developing countries and their use of modern financial instruments"). One relevant question is related to the proliferation of CES across countries, especially among the emerging and developing nations. The answer may lie in perceived benefits of a well-functioning CES.

Global Experience: Establishing correspondence between the key development indicators and the potential direct and indirect benefits (i.e. functions) of the CES is a challenging task. Development approaches usually focuses on two broad goals: economic growth and poverty reduction. The World Development Report (the World Development Report 2000/2001: Attacking poverty, Washington: Oxford University Press) identifies 3 priority areas for action to achieve these goals. It has been argued by UNCTAD (2002) that most of the direct and indirect benefits arising from the commodity future exchange may help achieve these development goals. It is thus conjured that a well-functioning commodity future exchange is likely to promote the two broad development goals. The lists of priority actions for attaining development goals and functions of the commodity future exchange are presented in Table 1 for easy reference.

In order to examine the impacts through fulfiling the functions of the CES a study on "Development Impacts of Commodity Futures Exchanges in Emerging Markets", was conducted by UNCTAD in 2007 (the development role of commodity exchanges". This was a comprehensive study covering 5 markets of emerging economies-Brazil, China, India, Malaysia and South Africa. The prime objective of the study was to identify, analyse and assess the impacts arising out of a CES on economic growth, and poverty reduction with particular attention to the agricultural sector and small commodity producers – areas which lie at the heart of developmental concerns of developing nations. The afore-mentioned study provides a conceptual approach to identifying and assessing 81 developmental impacts of agricultural commodity futures exchanges by assembling them into a coherent framework. This study also identifies indicators and data sources-both quantitative and qualitative-for their measurement. Moreover, the impacts, that have occurred as a result of commodity futures contracts, have been assessed from both quantitative and qualitative perspectives.

In the UNCTAD study, in total, 81 impact hypotheses were examined-37 were specific or mainly for the farmers, and the remaining 44 were for the wider commodity sector or for the overall economy. The results of the survey are summarised in Table 2.

The survey findings thus suggest that all five exchanges generate positive impacts in the core functions of price discovery, price risk management and as a venue for investment. Each exchange offers liquid markets, a central counterparty to all but eliminate counterparty risk, market data that is freely and transparently disseminated, and futures markets that are well-correlated with spot markets to enable effective price risk management. The above findings tend to vindicate the positive contributions of commodity future exchanges on broad developmental goals adopted in the study.

It is also argued that CES is an effective mechanism to benefit the small farmers. The UNCTAD study concludes that small farmers benefit from dissemination of market data. Each exchange cooperates with its members and the media to disseminate information through a range of channels to small farmers. The increasing use of SMS messages, sent for free, direct to farmers' cell-phones is an important trend in this respect. Activities at two exchanges are worth noting in particular. In China, price dissemination has been the focus of efforts to help small farmers through the futures market. A major educational campaign run by Dalian Commodity Exchange (DCE) was launched in 2004 involving 1,000 villages and 10,000 farmers. By early 2007, over 40,000 farmers had been educated on how to use future prices to make optimal planting decisions. With support from the government at all levels, the DCE encouraged farmers to use futures market information to determine cropping patterns for the next season. The future market has also helped farmers negotiate better prices from intermediaries. In India, MCX and other national multi-commodity exchanges have invested substantially in disseminating market information on electronic price display screens in 'Mandis' and other highly visible locations. Moreover, MCX's partnership with the India Post to disseminate market information to rural villages is a ground-breaking initiative. Information is now reaching small farmers in areas remote from major trading centres that sometimes lack even basic transportation and telecommunications infrastructure. In India, as in China, farmers are receiving better prices from intermediaries, and becoming increasingly aware of futures market information to determine cropping patterns for the following season.

Against the backdrop of positive impacts, a cause of concern in India (perhaps elsewhere as

well) was whether speculations in spot markets spill over to fuel inflation, particularly food inflation. To assess this concern, the 'Department of Consumer Affairs' formed a committee under the chairmanship of Professor Abhijit Sen, member of the Indian Planning Commission (The report can be accessed at the following URL http: //www. livemint.com /2008/04/29235240/ 90E86794-2780-49D4-A1FF-59552D10AC40Art VPF.pdf). The report stated that "it was not possible to arrive at any conclusive answer to this question (Did futures trading cause spot agricultural price to increase?), particularly on the matter of causation, since the period of operation of futures trading was too short to provide statistically meaningful results." The committee further concluded that it was clearly illogical to claim that futures trading would generally tend to improve prices received by farmers and yet maintain that futures trading could never contribute to inflation of spot prices. The committee was in conformity with both the UNCTAD-World Bank Joint Mission and the Guru Committee who had noted that commodities such as rice, wheat and sugar, for which there has been substantial government intervention, may not be suitable for futures trading.

Bangladesh Perspective-Background: Agriculture and processed food account for about 23 per cent of the gross domestic product (GDP) employing around 54 per cent of the total workforce and 64 per cent of rural workforce (BBS 2011). Despite their important roles and contribution, these sectors have been beset with impediments such as low investment, poor state of rural market infrastructure, market imperfections, absence of risk minimising instruments, fragmented markets, information asymmetry, inadequate technical know-how and financial resources of farming communities. These constraints resulted in incoherent supply responses, fluctuation of prices, unfair prices faced by the farmers, presence of a large number of speculators driving a significant wedge between farm gate and retailers' prices, low productivity and exposed to risks affecting rural development, rural welfare and poverty situation.

Against this backdrop, the government of Bangladesh in general and the Ministry of Commerce (MOC), in particular, have been exploring ways to mitigate uncertainties of farmers by reducing their risks, dissemination of prices, attracting investments and improving the state of rural market infrastructure. The widespread adoption of CESs across many emerging economies and developing countries as an effective tool to address the above-mentioned impediments encouraged the MOC to assess the feasibility of introducing such a system in Bangladesh. As part of this exploration, the MOC fielded missions to various

commodity exchanges as well as conducted a comprehensive assessment of the system incorporating local market perceptions, views and conditions for establishing the system in Bangladesh. The state of strength and weakness of various pre-requisites is essential for successful implementation of a CES. The observed strengths are-stable macro-economy, broad market infrastructure, presence of an active regulatory institution with adequate provision to incorporate other derivatives. Weakness may lie in the areas of ware housing, quality assurance facilities and banking network.

Pre-requisites: A stable macro economy had been one of the strongest areas in Bangladesh during the last decade. Most of the key macro-variables either experienced improvement or remained stable during the last decade. Macroeconomic performance has been reasonably stable in a period of global economic uncertainty and elevated food and fuel prices. During the 1990-2011, the growth rate expanded significantly leading to over 5 per cent per annum on a 10-year average, but importantly exceeding the 6 per cent for a number of years in 2000-2012. The rising long-term growth trend gives optimism that even higher growth (i.e. over 6 per cent) is possible, provided policy reforms further strengthen the determinants of past growth.

Bangladesh is also well placed to attain most of the millennium development goals. Moreover, the economic outlook over the medium term also was projected to be strong and stable.

The Perspective Plan targets 8 per cent GDP growth rate by 2015, and 10.0 per cent by 2021 with a significant improvement in living standard through a substantial rise in employment, higher output and export growth as well as drastic reduction in poverty while maintaining macroeconomic stability.

There is an extensive network of agricultural markets in Bangladesh with diverse economic activities and market players including producers, collectors, and a myriad of traders, wholesalers and retailers. Furthermore, compared to most countries in the region, the density of market network in Bangladesh is very high, surpassed only by some of the more developed Indian states such as the Punjab. For example, in the northwest of Bengal, the population served the average of around 16,000 persons per market (Action Research Proposal & Scoping Report, for KATALYST from HB Consultants, Ltd. p. 23).

According to the Upazila-based Local Government Engineering Department (LGED) of Bangladesh, there are 17,121 rural markets, while a survey by the Department of Agricultural Marketing (to see more, please visit http://www.dambd.org/welcome.htm) has reported that there are 16,476 rural markets (Rural markets in the coastal char region, (MALLORIE/ASHRAF, IFAD, 2005). Rural markets can very broadly be classified, in terms of size and economic activity, as follows; (i) primary markets; (ii) assembly markets; (iii) secondary markets; (iv) terminal/wholesale markets; and (v) other channels. In a survey of markets in 1994-95, the DAM identified around 5,000 rural primary markets, 3,000 assembly markets, 55 urban wholesale markets, 182 urban retail markets and 40 urban combined wholesale/retail markets. In reality, few, if any, Haats are purely primary, secondary, or terminal in function. However, the majority of high valued crops are sold by farmers at assembly markets (66 per cent) and through on-farm or “farm-gate” sales (20 per cent). Distances to both primary and secondary markets in the northwest of Bengal, for example, are very short, averaging 2.4 km and with catchment areas of around 10 villages per market.

The Securities and Exchange Commission has been regulating the financial derivates since its inception in 1993. The rules and laws of the SEC allow regulation of commodity derivates in addition to the financial derivates. Relevant sections are found in the existing laws which make possible for the part of the Securities and Exchange Commission of Bangladesh to promote and regulate derivatives markets.

Information on ware housing and quality assurance facilities in Bangladesh are sketchy and hence it is difficult to delineate a clear status of these linked elements of a commodity market system (there are about 297 cold storages across the country with a capacity to preserve 22 lakh tonnes of potato, including 4.5 lakh tonnes of seed). However, growth of these linkage industries (or facilities) is likely to happen with satisfactory performances and growth of the commodity exchange system. Their growth will be demand driven. The Indian experience is worth mentioned in this case. Even if these facilities are inadequate at this stage, on the basis Indian and global experiences it may be safe to suggest that adequate and propose facilities in the areas of ware housing and quality testing would come up fast with the expansion of the commodity exchange market.

Local level Perceptions: As part of the comprehensive study, a primary survey was conducted to obtain information on value chains on two selected commodities – potato and jute – with a

view to examining the possibility of introducing CES for these two types of commodities. Field surveys were conducted during September-October, 2008 with the help of structured pre-tested questionnaires. Around 500 respondents were interviewed in the field survey. In order to gather market participants and farmers' views on some key attributes of the commodity future exchanges some questions were listed keeping in mind the field situations, market conditions and potential benefits. More specifically, we asked them: (i) if they were getting fair prices or returns from their activities; (ii) if they think options for future sale of their products under formal arrangements may reduce the risks; (iii) if they get benefits using ware housing facilities; and (iv) what is the current state of quality control facilities at the warehouse. Most of the respondents of both potato and jute surveys reported that they were not getting fair prices of their products. Almost all the respondents favoured future selling and buying options since this may reduce their risks and uncertainties significantly. Most of the respondents opined that provisioning of well functioning ware housing system would help improve production and supply response.

A separate structured questionnaire containing eleven questions was also used to gather perceptions of the 'stakeholders' drawn from business communities, think-tank and research institutions, and academicians. An information package consisting of one questionnaire and a brief note on commodity exchange was sent to the selected stakeholders before the interview was conducted. The selection of stakeholders was done to cover a broad spectrum of them-representatives of business community; derivatives market experts, representatives of think-tank, representatives from the Better Business Forum, researchers and academicians. Most of them in principle favour introduction of a commodity future exchange in Bangladesh since they believe a properly regulated future exchange would benefit agriculture sector through price discovery, risk management, coherent supply response, inflow of investment to improve rural market infrastructure (i.e. spot market, warehousing and quality control etc). There are some differences regarding identification of commodities for futures trading. Some of commodities identified by them are: (i) Potato; (i) Jute; (iii) Tea; (iv) Sugar; (v) Gold; and (vi) Silver etc. Although most of them opined about having a separate regulatory body to oversee the commodity future exchanges, some of them preferred a phased progress towards an independent regulatory body. That is, at the initial stage the Securities and Exchange Commission (SEC) may oversee the activities of a future exchange through a specialised division which in due course based on market expansions and needs is turned into a separate regulatory body.

Concluding Observations:

Although, in principle, any commodity fulfilling certain conditions may be traded on a CES, to avoid complexities of handling large numbers as well as sensitive commodities, trading in a limited number of commodities is recommended in the initial few years of its inception. The choice (mainly of agricultural commodities) is governed by the evidence of distress selling (e.g. Potato and Jute), encouraging production via risk management (i.e. hedge) and discovering fair prices, and linkage with global market. More specifically, these are: (i) Potato, (ii) Jute, (iii) Spices, (iv) Pulses, (v) Gold, and (vi) Silver.

Experiences in other countries suggest that effective regulation overseeing contract, monitoring actions of the actors, finding out innovative solutions are critical for success of a CES. Majority of the respondents who took part in the perception survey recommended that a "specialised regulatory commission" should oversee the operations of a commodity exchange. Agreeing to their view, we recommend formulation of a new 'Specialised Regulatory Framework' in phases commensurate with the expanding operations of the commodity future exchange. Our suggestion is that the SEC may act as a regulatory body through formation of a separation division during the initial stages. In due course, depending on demands, the volume of transactions and the nature of contract, a full-fledged regulatory body may be established.

It is noted that investment requirements are large and a significant part of the resources will be used for acquiring automation and related technology. This is a technology and human resource-based activity and hence success of this venture would depend critically on engagement of experts and technology. There is little scope for experimenting with the technical aspect of the commodity exchange. Both local and foreign entrepreneurs who are conversant in this field would most likely come forward to investment in this venture. Warehouse/cold storage receipts may be allowed to be traded on the proposed commodity exchange. We believe this measure will encourage rural financing via warehouse/cold storage as well as create a scope for direct participation of the producers in commodity sale. Quality and quantity control of commodities traded on an exchange is an integral component of the exchange. Quality and quantity control task may be only entrusted to the private sector organisations thereby paving the way for participation of private institutions.

Trading in commodities on commodity futures exchanges is a new concept in Bangladesh. The responses received during field/perception surveys indicate the low level of knowledge about potential impacts of a commodity exchange. As is true with any instruments, the success depends on optimal use of an instrument. Lack of knowledge could surely bar stakeholders from taking full advantages of the system. Thus to reap full benefits with wider participation of stakeholders a massive awareness campaign must be initiated at all levels of the system. Government, private sectors, media, development partners, non-government organisations, and civil society activists should be encouraged to participate in the awareness programmes.