CHAPTER I : COMMODITY MARKETING

1. INTRODUCTION

Over the past decade the prices of commodities traded on the world market have fluctuated considerably. The spectacular boom in commodity prices after 1972 was following by a steep decline by 1975. Since then, against a background of speculative activity, uncertain prospects for industrial growth, and political upheavals in producing countries , instability has continued.

For producers, as well as for consumers, this market instability has been a major problem. In the recession, developing countries see export revenues slashed as the market value of their output has plummeted. Consumers of metals, agricultural raw materials and food products have been faced with sudden unpredictable cost rises to pass on to a resistant market. For producers, consumers and merchants, price fluctuations have also brought the risk of heavy financial losses with the changing value of stocks and raw material in process.

What have been the causes of the instability in commodities markets? Changes in consumption, buying patterns of purchasing divisions of major user industries, over-expansion of productive capacity or crop failures and other supply interruptions continually cause mismatching of supply and demand. In addition, there have been other non-industry influences popularly judged to be causes of price fluctuations and market vagaries. These can loosely be grouped together under the heading of 'speculation'.

As it stands, the term 'speculation' covers everything from gambling on the price of commodities through buying or selling ahead of requirement or ahead of production, through dealing in

the paper transactions of commodity exchanges to physical or paper deals designed to "corner" markets so as to dictate prices and make huge capital gains. The discussion which follows examines the influence of these "outside" interests upon commodity markets. To do this it is necessary to look more closely at the patterns of commodity marketing.

We shall focus particularly on the last decade and attempt to pinpoint some of the factors behind the increased market volatility, in particular how far this can be associated with increased activity on commodity terminal markets. In the remainder of this chapter, we shall set out the general characteristics of two commodity marketing systems, producer pricing and terminal market pricing. Then we can look empirically at the trends of development in a diverse range of markets for commodities, before we go on to explain these trends and their implications for market stability.

2. PRODUCER PRICING AND TERMINAL MARKET PRICING

2.1 Two Systems

There are two major systems for determining the prices at which the bulk of commodities are traded: producer pricing and terminal market pricing. Producer prices, as the name suggests, are set by the major producers of a commodity for the sale of their output to customers. Producers may set a range of prices, rather than a single 'producer price', to reflect differences in quality and other factors. In some countries, producers are forbidden by law from agreeing on prices amongst themselves, but often one supplier effectively dominates pricing. Producers take account of prevailing market conditions, but they do not necessarily follow every fluctuation in the market with an alteration in price.

A producer price will, in general, be for immediate delivery of the commodity, but the producer will often enter into an unpriced contract to deliver (perhaps monthly) to the consumer over a period of a year or more. The price for the delivered commodities will be that prevailing at delivery dates. In practice, on both spot and contract sales, discounts may be offered on the published producer price to certain consumers if market conditions are weak.

Terminal market pricing is a little more complicated. A forum is provided where dealers operating on behalf of producers, consumers and merchants, exchange offers and bids until a price is reached at which the day's demand and supply are equated. In principle, neither producers nor any other group should have direct control over this price-setting mechanism.

Commodity exchanges may determine various prices: a daily 'spot' or 'cash' price, the price for immediate delivery of the

commodity; a monthly 'spot' price, for delivery in the current month; a daily or a monthly 'future' price, for delivery on a future specific day or month. Terminal markets are those which set prices for future delivery; however, since forward delivery contracts can themselves be bought and sold at any time up to the day of delivery, exchanges can provide the means of determining prices for any day back to the present. This is formally recognised in the London Metal Exchange (LME), which reports daily spot prices and prices three months in the future, while the New York Commodity Exchange (Comex) has a monthly spot price and a monthly future price for up to thirteen months ahead.

It should be noted that some commodity markets may conduct only spot business and issue daily prices (e.g., the special tin concentrate market operated by the smelters in Penang) although this is rare, while others may deal only in futures or give prices for specified delivery months (e.g., the New York Mercantile Exchange). In this report, we are concerned with futures markets which provide for secondary dealing in contracts.

A further point to note is that some producers may operate a modified exchange/producer price system. Instead of charging the exchange price for the day of delivery or fixing their own price, they may quote a price based on a premium over one month's average exchange prices. For example, Latin American copper producers in the past based their prices directly on the LME daily quotations, but today sell their copper at fixed premia to monthly average LME prices.

There is another system for determining commodity prices, which stands between producer pricing and terminal market pricing. This is where producers and consumers of a commodity enter into an agreement to keep the price within a specified range. The price is allowed to fluctuate within the limits agreed, according to commodity exchange quotations, but measures are

taken to boost prices when they fall to the lower limit and restrain prices when they rise to the upper limit. These measures may include production or export quotas for producers, rationing of available supplies to consumers, and purchases or sales of the commodity from a buffer stock.

In practice, this form of price determination has had only limited success. Agreements have tended to become inoperative or break down under pressure from changes in the market. This has happened with International Coffee Agreements and the International Cocoa Agreements. The more comprehensive measures of the successive International Tin Agreements have been unable to prevent prices from rising to well above the agreed range.

We shall not deal with these international commodity agreements separately, but incorporate an analysis of the problems these face into our discussion of producer pricing in a later chapter. This is a justifiable procedure, even if for many commodities international agreements have been more common than attempts at producer pricing. A discussion of producer pricing, and the problems that arise for this system, when in conflict with the free market, will bring out the difficulties of administering prices more clearly than a separate analysis of international commodity agreements.

2.2 Producer Pricing

A system of producer pricing can clearly only be effective if producers can maintain a dominant position in the market. For this reason, producer pricing is found only in those countries which are not sizeable net importers of the commodity in question. Among the metals, the USA provides perhaps the best historical example of a country with effective producer price setting, with the examples of copper and lead. In Western Europe, the zinc market is controlled by producers setting a European producer price.

The main advantage claimed for producer pricing is a greater price stability than occurs when prices are determined on a commodity exchange. Overall, the producer price changes less frequently than the commodity exchange price and follows a lower amplitude cycle, remaining above the free market price in times of recession and below in times of booming demand.

Producers benefit from the price stability and their control over the market since this creates a better climate for investment planning. Consumers can also benefit by being more certain of supplies of raw material at a known price. In so far as both are satisfied with the system, there need be no recourse to specialist dealings in commodities (e.g. via futures markets) to guard against damaging price fluctuations. Any temporary advantage, through maintaining an average level of prices above or below the free market price, is of course a disadvantage to the other and cannot be cited as a general advantage of producer pricing; but it has tended, in the past, to be the case that producer pricing systems for non-fuel commodities, because of their vulnerability to political pressures in times of inflation, have given rise to lower average prices than terminal market systems. Thus, the recent experience has been that consumers of these commodities have benefited more from producer pricing systems than have producers.

As noted above, the producer price is not determined entirely independently of prevailing market conditions. If producers decided to raise prices when demand was falling, they would be faced, either with mounting levels of stocks, or the need to cut back production, perhaps to uneconomic levels of capacity utilisation. If, on the other hand, prices were cut when demand was increasing, then supplies to customers would have to be rationed, unless significant increases in output were possible.

The pressure of the free market is particularly felt when purchases and sales of a commodity can take place at commodity exchange prices as well as at producer prices. This is very often the case in countries with producer price systems. Even if the domestic free market were not used, dealers may import or export the commodity to profit from a difference between the local producer price and a commodity exchange quotation. For example, producers would be straining the loyalty of their customers if they posted prices which greatly exceeded the price at which consumers could buy from other sources. On the other hand, if the producers underprice their supplies, purchasers could resell on a commodity exchange for an easy profit. Pressures such as these have been major elements in undermining producer price systems, as we shall see below.

2.3 Terminal Market Pricing

The recognised prices for many commodities are determined on commodity exchanges. Here, dealing between traders is conducted under formal rules drawn up by the governing body of the exchange, and official prices are announced each trading day. Evidently, considerable fluctuations in prices are possible. Under 'normal' market conditions, the price would tend to change by only a small amount from day to day, balancing small changes in supply and demand. But in response to news of production problems, strikes and other factors, the price could oscillate sharply.

Terminal markets perform three basic functions to producers, consumers and merchants of a commodity. They act as institutions to set prices for transactions in particular commodities; they offer facilities for hedging price risks; and they can be used as a physical market for buying from and selling into registered warehouses. The price setting function is clearly important, but how widely the prices quoted are used in commodity trade depends on a number of factors, not least the existence of

alternative producer pricing systems. We shall return to these in a later chapter. The most important function of terminal markets is, however, that of hedging. Hedging business by far outweighs that for physical delivery to or from exchange warehouses; and it is in the nature of hedging that most contracts to receive or deliver commodities traded on the exchange are cancelled out by opposing contracts to close a hedge position.

To understand this important role played by commodity terminal markets, it is first necessary to appreciate that, while making price fluctuations possible, they also offer a means of insuring against adverse price movements. Because their markets set future as well as spot prices, it is possible to 'hedge' price risks. The basic principle of hedging is to buy a future delivery or supply contract, which is equal and opposite to the trading commitment entered into outside the exchange. Then, any loss on the latter deal, resulting from a disadvantageous movement of prices, is offset by a profit on the exchange transaction.

A simple example of a hedge can be given for a fabricator, purchasing copper wirebars for conversion into wirerod to sell in three months time, with the selling price of the wirerod based on the ruling cash price of wirebars on the day of sale, plus a fixed charge for transformation costs and profit. The fabricator is at risk if the future cash price falls, since his revenue would not cover the costs of his raw material purchases.

By balancing his physical transactions with transactions on a commodity terminal market, such as the LME, the fabricator can insure against adverse price movements. He sells a contract to deliver three months in the future the same quantity of wirebars that he originally bought for production of wirerod. Then, when delivery of the wirerod is due, he meets his contract to deliver wirebars by purchasing a cash contract for wirebars for

delivery on the due date. The LME transactions (a sale followed by a purchase) cancel out, but the fabricator has managed to arrange that the final LME purchase is at the same price as the base price he receives for wirerod. If the wirebar price on the LME fell during the three months, he would have made a loss on his wirerod deal, but would have made a profit of exactly the same amount on his LME deal. The result of the hedging and physical transactions is that the effect of price fluctuations are neutralised, since gains would also be cancelled out. If the LME quotation rose £10 per tonne over the period, the fabricator will make a £10 per tonne capital gain on his original purchase of wirebars for processing, and an exactly counterbalancing £10 loss on his LME dealings.

The transaction is not without costs, of course. Apart from brokerage fees, other costs may be involved. If the forward price for wirebars is less than the LME cash price at which the fabricator buys wirebar for conversion, i.e. if there is a 'backwardation', the cost per tonne equals the size of the backwardation. However, if a 'contango' is present, i.e. if the forward price exceeds the cash price, then the hedger benefits. But, here again, the relevant consideration is that the ruling backwardation or contango is known, so that, whether giving a cost or a benefit, it can be incorporated fully into the fabricator's margin, and there is no risk involved.

Hedging is very often confused with speculation. They are related, but they have the relationship of opposites. Hedging, as we have seen, is essentially a means of insuring against price risk. Speculation, on the other hand, involves deliberately taking a risk on price movements, up or down, in the hope of profit. In our example above, the wirerod maker would have been guilty of extreme speculation if he had not sold wirebars forward on the LME. By hedging, he ruled out the chance of a speculative gain as well as a speculative loss. The buyer of his wirebar contract could have been another trade hedger, or a speculator taking a different view of the future spot price, and

wishing to profit by it. Without this active difference of opinion, no bargain could have been struck.

Hedging and speculation thus both involve the purchase and sale of cash and futures contracts. Since, on commodity exchanges, a dealer may be operating on behalf of a client, it is difficult to separate the two types of business when looking at the total market turnover in a commodity. In addition, a hedger may advance or delay the closing of his hedge transaction to become a speculator himself at the margin, on very short term price movements.

Selling the futures contract will be difficult unless someone either happens to be setting up an opposite hedge, or wants physical metal on the future date, or believes that the commodity price will rise. The purchaser in the third case is a speculator. Acting against the market trend or view, he is willing to bear the risk or loss on a fall in the price, and so provides the necessary complement to the hedge transaction.

Speculation may be carried out by producers, consumers or merchants in the commodity trade. But it is also conducted by 'outside interests' - bankers, stockbrokers, insurance companies, and industrialists with short-term money assets they wish to invest in commodities.

For these outside interests, the standardisation of contracts on commodity exchanges greatly simplifies dealing. To deal profitably, it is more important to understand the merchanisms of the exchange than the characteristics of any particular commodity. It is only with the price aspect of a commodity that one is concerned when dealing on commodity markets. Quality considerations are guaranteed by the acceptability of a particular brand of commodity (e.g. lead from a certain refinery, coffee from specific countries) for trading on the exchange; differences in quality between different brands, for which

consumers may be willing to pay premia, are of little concern to the non-trade speculator, who merely wants an easily liquidated asset.

Two other factors also facilitate non-trade interest in commodity exchanges. Firstly, dealing is conducted in terms of 'warrants', which are receipts representing stocks of the commodity in the exchange warehouse. Therefore, as long as the purchaser of a contract is willing to pay warehouse charges, he need never actually take delivery of the copper, cocoa, wool, rubber etc. The warrant can then be resold without the buyer ever having seen his original purchase. This is clearly a convenient service provided by commodity exchanges, particularly for speculators, who are more likely to receive and hold contracts than are hedgers, whose aim is to cancel out their exchange dealings.

Secondly, when buying a futures contract through a broker or exchange dealer, the buyer does not have to advance the whole value of the contract. He gives the broker only a 'margin', equal to perhaps 10 per cent of the value of the contract. The size of the margin fluctuates according to the brokers' estimate of the risk involved in the purchase, but rarely exceeds 50 per cent. At a low percentage, the speculator, who profits by buying a futures contract at a low price, and selling at a time when the price rises higher, has made a considerable profit in relation to the capital actually advanced. However, since the speculator is still liable to pay for his purchase, no matter what the margin, all of the capital value is still at risk if the market moves adversely. Margin requirements enable the speculator to gamble with commodities whose value is several times that of his available money-capital. As we shall see, 'margin-calls' - a broker's request for more funds to protect his position if prices move adversely for his clients - can add a further element to market volatility.

The comments on terminal markets in this section have served both to bring out the general points of contrast with producer pricing systems and to provide an introduction to our assessment of the influence of terminal markets on commodity trading. The chapters that follow will describe and attempt to explain the relative growth of terminal markets, and judge their overall impact.