

## STATEMENT TO THE PRESS

On

Rising Prices and the Role of Commodity Exchanges

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### **Are commodity exchanges leading to food price inflation?**

There are three fundamental aspects to price trends in the market: first, actual underlying factors of supply and demand, second, expectations regarding the underlying fundamentals, and third, market conduct such as speculation and/or manipulation.

The reason for having commodity exchanges in the first place is to create a fair, orderly and efficient system for matching supply and demand in order to enable what we call price discovery. However, what influences price discovery are the other two factors: expectations and market conduct. Expectations and how they are formed and informed is a science unto itself. However, part of what a commodity exchange can and must do is to regulate market conduct, which is its purview. To do so, in addition to creating the trading mechanisms to match supply and demand, an exchange also sets up certain risk management instruments designed to ensure that market conduct is in alignment with the principles of a fair, orderly, and efficient marketing system. These instruments, based in the Rules of the Exchange and market surveillance and compliance monitoring, have to do with setting limits on trading positions, adjusting the margin deposit requirements, price circuit filters to limit price movements, among others. The role of market regulation is to ensure that exchanges do indeed carry out this function.

Currently what is happening on global commodity markets suggests that all three of the above factors are coming into play to influence dramatic upward price movements. That is, the well known shifts in the underlying fundamentals having to do with historic lows in global cereal stocks, reduced production in major Western countries, higher demand linked to bio-fuels and rising energy prices, and the India-China rising income effect. In addition, I believe that rising expectations and the involvement of hedge funds in the commodity markets both contribute to the situation. What exchanges need to do and are doing is to ensure that market conduct is not out of line with fair and orderly price discovery. To do so, recently, several exchanges have taken appropriate measures, such as raising margins, and pushing for compulsory delivery in food grains, in the case of India. These measures are

intended to curtail market speculation. Whether the measures taken are sufficient or whether other regulatory measures need to be taken by government is a continuing topic.

## **Why start an exchange now? Impact on inflation? Benefits to Ethiopian economy?**

Coming to the case of Ethiopia, the first point is that the decision taken nearly 3 years ago to start a national commodity exchange had absolutely nothing to do with the current price inflation. Rather, the overriding objective then and now is to ensure a fair, orderly, and efficient marketing system to encourage smallholder farmers to produce more for the market, to benefit domestic agro-industry through a more efficient and reliable supply chain, and to enhance Ethiopia's export competitiveness through getting the domestic market in order.

As we come to the present, in which we are in the rollout of our Exchange operations in the context of sharply rising domestic and domestic prices, the key questions are first, whether, given the current situation, this is a good time to launch a commodity exchange, second, whether our Exchange will solve or worsen the price inflation crisis, and third, whether our Exchange will itself be negatively affected by this crisis.

My answer to the first is that the need to improve domestic markets remains an imperative with or without a global food price crisis, and in fact, all the more so, as noted by several international experts around the world. Second, the forecasts that price trends are likely to continue due to structural shifts in the underlying fundamentals of global supply and demand in the foreseeable future imply that producer countries such as Ethiopia must look to this as a medium to long-term opportunity to expand production and exports to the global market. To the extent that our Exchange provides this incentive, then it is very timely that our Exchange is launched at this time.

Coming to the second, it is not my view that launching an Exchange will in itself solve the problems facing those adversely affected by higher prices. That is, while the Exchange will over time enable the better alignment of supply and demand and similarly better regulate market conduct, it will not solve the short term problem of the urban poor and rural net buyers who must be supported by increased safety net programs. So the dual strategy is to get the Exchange off the ground to provide short term solutions to market conduct and medium term solutions to price discovery and incentives while also accelerating short terms solutions to the crisis. Where the two objectives meet through the establishment of the Exchange is in helping food aid procurement increase in efficiency in order to mitigate the shock of the higher food aid bill, and this is a subject of our recent discussion with WFP.

Finally, as regards whether the present crisis is prompted by speculation which may also adversely affect the success of our Exchange, let me first state that we are perhaps the only exchange in the world, to my knowledge,

that is starting out as a spot exchange with the intention to later develop futures contracts. In hindsight, that is perhaps the best decision we made and one that plays very much to our favor now in this crisis. Recent concerns regarding the futures exchanges is that there is excessive speculation, which essentially means a misalignment between the underlying physical market and the futures market. We believe we are the only exchange in the world that has designed a set of spot contracts that are structured just like futures contracts but with a 100% margin for immediate delivery. That is why we say ECX is the first of its kind in Africa, perhaps in the world. Many of the emerging exchanges, who have started only as futures markets, are now facing the problem that the spot market is not aligned. Looking at the Indian case, there is now a better understanding that it is the spot market that drives the futures market and not the other way around. Now Indian exchanges are imposing compulsory delivery and higher margins, essentially coming to where we are starting. In essence, by first introducing a spot exchange, we get the benefits of the orderly, fair, and efficient marketing system created by an Exchange, without the risks brought on by excessive speculation. For Ethiopia's stage of development, and the challenge of turning the current food price crisis into a growth opportunity, we think this is the way to go.