Development of Commodity Exchange Markets as an Avenue to Foster Economic Development in Africa

Sostine Ngabirano
Lecturer of Law, Uganda Christian University

Available at SSRN:
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2660948

This paper argues that meaningful economic development in Africa could be achieved through the establishment of commodity exchange markets. Further the paper makes a moral case for such institutions since they would be expected to reduce the informational disadvantage besetting poor rural farmers. The paper discusses the relevance of the establishment of the Chicago Board of Trade in mid-nineteenth century frontier America, but also notes the limitations of using this example for African countries. Instead, the author argues that the Ethiopian model for commodity exchange development may be most relevant for other African (and developing) countries, particularly in Uganda.

Introduction

African economies underwent a series of economic reforms in the 1980s. These reforms were intended to correct the inefficiencies of the centrally planned economy and bring about an efficient system where prices would be determined by the market forces. The result of this was the liberalization of almost all sectors of the economy. It was generally agreed that agricultural marketing systems should be liberalized to allow the private sector to unleash the power of the market, gain efficiency in the sector, and stimulate higher production volumes and standards. Unfortunately, the market system, as implemented, has exposed farmers to intense market risks and has failed to address informational asymmetries. The purpose of the paper is to explore the potential of commodity exchange markets to correct such problems and to analyze under what conditions a commodity exchange can actually work in Africa.

Case Studies

The paper explores the historical development of the Chicago Board of Trade, but also notes the limited applicability of this example for contemporary Africa. The paper then notes how the Ethiopian commodity market may be a more relevant model for other African countries, particularly in Uganda.

Chicago Board of Trade (CBOT)

A number of the factors that led to the creation of the CBOT in 1848 are similar to what is currently occurring in many African countries. The agricultural regions of 1840s America faced:

- Bumper harvests that led to a collapse in prices,
- Poor storage facilities, and
- Market risks that were beyond the ability of individual merchants to manage.

Arguably, this is not only the case in Africa, but it is perhaps worse than what was prevalent in frontier America.

The Chicago markets *evolved* over a century-and-a-half to not only resolve the problems of transaction costs and risks faced by farmers, but also to coordinate the exchange of agricultural goods across participants, locations, and time. State regulation increased in scope as the market grew; importantly, regulation *followed* market developments rather than occurring in advance.

The evolutionary nature of the Chicago futures markets is also emphasized in the *Global Commodities Applied Research Digest* article, "Brief Case Studies on Futures Contract Successes and Failures," in the *Contributing Editor's Collection*. That article discusses how futures markets and contracts were developed in a trial-and-error fashion with numerous failures accompanying periodic success.

In contrast, the author of "Development of Commodity Exchange Markets as an Avenue to Foster Economic Development in Africa" notes that whereas the Chicago markets were *demand-driven* and established by its users, the emerging exchanges in Africa have been *donor-driven.*

The author further notes how ambitious it is to establish commodity exchange markets from scratch. There are many interrelated, core institutions that must be established for commodity exchange markets to properly function. These institutions include a market information system, a warehouse receipts system, a system of product grading and certification, a regulatory framework and appropriate legislation, an arbitration mechanism, and producer and trade associations. In addition, a commodity exchange's success relies on other sectors such as banking, insurance, transport, information technology services, and inspections services.

Given the scale of the required institutional development, the author advocates a strong role for government in the formation and coordination of these necessary institutions. Of note, this is the opposite of the historical Chicago experience. But as the author asserts, and as summarized below, the varying fortunes of the Ugandan versus Ethiopian commodity exchanges can be largely explained by the level of government engagement in each project.

Uganda Commodity Exchange

Uganda is a primarily rural country, with the majority of the population living in villages. For many households, selling commodities produced on their farm is their only source of cash income. Therefore improvements in the operations of markets may have the potential to have a positive impact on the lives of the rural poor.

The Uganda Commodity Exchange was established in 1998. The exchange carries out its commodity futures trading and commodity options trading transactions on the basis of an open and free market system. The system was originally funded with a grant from the European Commission of 1.3 million euros. A further 1.13 million euros were given for technical assistance. Unfortunately, many of the original objectives of the scheme have not materialized or have been considerably delayed. Funding for the commodity exchange has now ended, and it is not certain whether the system will receive further funding, as of the writing of the article.

Ethiopian Commodity Exchange

The Ethiopian system developed very differently from the system in Uganda: namely, the Ethiopian system is government-run. The government decided that the new exchange should include the country's most important export commodity, coffee. And rather than leave the trading fraternity to decide whether it would use the new system, the government mandated the use of the exchange by coffee exporters. The major traders and exporters have bought seats on the exchange and have developed a system of dealing with each other to establish prices for various coffee grades. The existing coffee industry infrastructure of warehouses, testing centers and weighing stations has been marshaled in service to the program. The Ethiopian government has also considered expanding the system and including other crops.

Conclusion

Based on Uganda's experience, the author questions whether African commodity exchanges can succeed when the government's role is limited to providing the relevant legal framework and oversight functions (which is the Chicago model.) Instead, the author highlights the relevance of the Ethiopian *government-run* commodity exchange. That said, the author recognizes that the new African exchanges represent something of an experiment, so it is too early to note whether the Ethiopian model will have widespread applicability for other developing countries.

Reference

Till, H., 2016, "Contributing Editor's Collection of Digest Articles," *Global Commodities Applied Research Digest*, Vol. 1, No. 1, Spring.

Keywords

Commodity market development and regulation