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The Downside of 'Financialisation' of **International Commodity Markets**

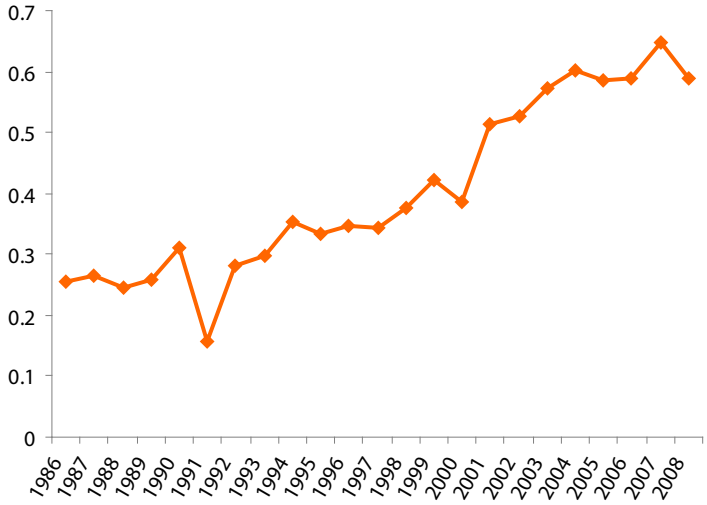
*by Susan Newman, Economics Department, SOAS, and the University of the Witwatersrand, Johannesburg**

The current global financial crisis has revealed that many economies, both developed and developing, have become increasingly 'financialised'. This Development Viewpoint focuses on the 'financialisation' of the international marketing of coffee (the agro-commodity most traded on international exchanges) and the impact on local producers and traders in developing countries.

The term financialisation has been variously defined. In its broadest sense, it can be described as "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies" (Epstein 2005, p. 3).

International coffee markets have become financialised in at least two major respects. Firstly, there has been increased portfolio investment in commodities such as coffee as an asset class. The Figure shows that Futures Contracts on coffee rose to account for about two-thirds of all coffee trading in 2007.

Trading of Coffee Commodity Futures
(% of Total Coffee Trading on the New York Board of Trade, 1986-2008)



Source: Commodities Futures Trading Commission 2009

Initially, futures markets were developed predominantly to allow the effective management of the risks faced by traders of physical commodities such as coffee. However, they have evolved to increasingly reflect the needs of financial investors operating entirely outside of the markets for physical commodities.

Financial investors have increased their share of trading in commodity derivatives throughout the period since the end of the Bretton Woods system in 1973. Also, new large institutional investors, such as hedge funds, have become much more active in such trading. Most traders in futures have no interest, in fact, in dealing with coffee as a physical item: they are constantly trading 'paper coffee' in order to derive profits from price changes.

As a result of these factors, the value of outstanding Over-the-Counter commodity derivatives in June 2007 had risen to over US$ 7.5 trillion, compared with US$ 0.77 trillion in 2002 and US$ 0.44 trillion in 1998 (Bank for International Settlements, 2007).

The second reason that international coffee markets have become financialised is that the firms that deal in physical commodities have increasingly come to resemble financial holding companies, dealing in a wide spectrum of financial services and financial investments. The proportion of the revenues of these firms deriving from such financial activities has been growing relative to the revenues derived directly from the trading of physical commodities.

Moreover, commodity trading companies have increasingly placed 'risk management' at the centre of their core competencies. They can now refer their clients to their in-house research departments and futures brokerages, which are able to cater to both traders of physical commodities and investors seeking to diversify their financial portfolios.

Futures Trading and Coffee Prices

Neoclassical economic theory assumes that where markets are efficient—and futures exchanges are thought to be some of the most efficient—changes in prices should reflect changes in supply and demand conditions. However, recent increases in futures trading on the New York coffee exchange by commodity index funds (such as the Standard & Poor's GSCI and the Dow Jones-AIG Commodity Index) has distorted the relationship between prices and market conditions (Newman 2009).

Consequently, between 2002 and 2007 coffee prices increased at a rate higher than that warranted by changes in supply and demand and became significantly more volatile. The price of the so-called New York coffee 'C' futures contract is now the single most important factor in the determination of the price of coffee.

Such trading of futures has become more influential since the collapse in 1989 of the regime of managed prices based on the International Coffee Agreement (ICA). The liberalisation of the coffee marketing systems in many producing countries, which has been hastened by conditionalities imposed by World Bank Structural Adjustment Programs, has also contributed to financialisation.

With the demise of price stabilisation programs at the international or national level, the World Bank and other donor organisations have

been recently pushing for the widespread use of futures contracts as instruments to manage the risk of price changes. For instance, the World Bank has been actively promoting the use of futures contracts by local coffee producers and traders as a 'market-friendly' tool of risk management. These donor efforts have helped intensify the impact of futures prices on the current market prices of coffee.

Changing Power Relations

Because of the collapse of the ICA and the liberalisation of coffee marketing systems, local producers and traders in coffee-exporting countries are bearing the full brunt of low and increasingly unstable coffee prices. This has been the case whether they are organised into cooperative marketing systems, such as in Tanzania, or work through private marketing channels, such as in Uganda (Newman forthcoming).

The Ugandan producers who market their coffee through private marketing chains are confronted with low prices while the local traders have to shoulder the risks associated with price volatility. In Tanzania, marketing cooperatives are able to spread the risks of price instability across their membership, but such localised arrangements can only marginally mitigate the overall risks. In both cases, international coffee exporters have maintained the positions of power in determining prices since they can hedge their risks through futures trading.

One might assume that national-level collective marketing strategies could improve the share of the world coffee price received by local producers. However, such an approach cannot address the major driver of inequalities in incomes along the whole coffee value chain. This is the uncontested power of international coffee trading companies to derive increasingly larger shares of their revenue from futures and options trading.

Trading in futures contracts involves high costs, not only for purchasing the contracts themselves but also for financing margin calls. Such financing becomes necessary when oscillations in the current price fall outside the 'margin' that is set below the original purchase price by the futures contract.

Because of such expenses, only the largest trading companies have been able to profit from trading futures. They have the financial capacity to fund margin calls and weather any large losses associated with sudden adverse changes in price. Hence, they have accumulated considerable market power. Developing-country export companies find themselves effectively excluded from such profit-making since the risk-management tools available to them are very limited.

Responses to the Current Crisis

There is an urgent need to rein in and regulate the financialisation of coffee markets. The current effort to extend hedging instruments to developing-country producers and traders is certainly not the answer.

One approach could involve separating the process of price determination of the physical commodity from that generated by a futures contract. Such separation has been achieved on a very limited basis for fair-trade and gourmet coffees, which represent small niche markets. Another option would be to revive, in some form, the kind of collective price agreement that was created by the International Coffee Agreement.

However, even if such reforms were successful in helping reduce the impact of speculation on current coffee prices, they would likely achieve little in overcoming the enormous inequalities in power and income that have arisen between large international trading companies and local producers and traders in developing countries. More fundamental reforms would be needed to resolve this problem.

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