Managing risks in highly volatile commodity markets remains one of the major challenges of development, especially for the poorest countries. In 1998, more than 50 developing countries (including many small states) depended on three or fewer leading commodities for more than one half of their export earnings. In many of these countries, commodity production and trade affect the livelihood of millions of people, the government’s fiscal revenue and public expenditure, as well as the country’s trade balance, foreign reserve and creditworthiness. Inability to manage uncertainty makes it difficult for farmers to plan their crops, allocate resources, obtain credit for inputs, and even simply recover costs. It also weakens the ability of governments to maintain a conducive and stable business environment, and to implement policies and programs to assist the poor. Poverty reduction is major objective in addressing the challenge of commodity risk management.

To address these issues, the World Bank has recently convened an International Task Force (ITF) on Commodity Risk Management in Developing Countries to explore new, market-based approaches to help developing countries better manage their vulnerability to commodity price volatility. The ITF brings together a broad representation of international institutions, producer and consumer organizations, and private sector entities. After extensive deliberations and consultations, ITF members reached a consensus on the principles of a possible new market-based approach to bridge the gap between providers of risk management instruments and potential users in developing countries who lack access to these instruments. The ITF further recommends the identification of an international intermediary that would facilitate bridging this market gap.

If implemented, the proposal has considerable potential in promoting development and reducing poverty throughout the developing world, including Heavily Indebted Poor Countries and commodity-dependent small states. It also has the potential to level the playing field, allowing smallscale producers in developing countries to access commodity price insurance available in financial markets. Its success would further demonstrate how market mechanisms, combined with appropriate international support and proper local institutions, can be made to work for the poor.
A. Managing Commodity Risks: A Development Challenge

_Commodity risks as a development challenge._ Managing risks in highly volatile commodity markets remains one of the major challenges of development, especially for the poorest countries. During 1983-1998, prices of many commodities fluctuated from below 50 percent to above 150 percent of their average prices. More than 50 developing countries depend on three or fewer commodities for more than half of their export earnings. In about 20 countries, this dependency exceeds 90 percent. In Africa, commodities account for about three-quarters of merchandise exports. Many developing countries are also vulnerable to price volatility that affects their food security and energy costs. No less than 30 developing countries depend greatly on imports for food and fuels, with such imports representing more than 20 percent of their import bills. In these countries, commodity production and trade affect the livelihood of millions of people, the government’s fiscal revenue and public expenditure, as well as the country’s trade balance, foreign reserve and creditworthiness.

_Heavily Indebted Poor Countries (HIPC)s particularly vulnerable._ All HIPC s are highly dependent on commodities for their livelihood, with commodities representing more than 80 percent of their exports. Moreover, in 1997, 17 HIPC s spent more than 20 percent of their import bills on food and fuels. High dependence on commodities, coupled with high price volatility, results in significant fluctuations in export earnings, which have direct impacts on debt indicators and on countries’ ability to adhere to debt sustainability.

_Commodity Risk Management Critical for Many Small States._ Many small states are highly dependent on production and exports of agricultural commodities (mainly sugar, bananas, timber, coconut oil, vanilla, copra, and fish). For instance, in 1997, the commodity share in the total export value was 98 percent for Gabon, 96 percent for Guinea-Bissau, 93 percent for the Gambia, 69 percent for Namibia, and 61 percent for Trinidad and Tobago. Compounding to the difficulties rooted in the limited opportunities for diversification, phasing-out of preferential trade agreements would increasingly expose both producers (especially smallholders) and government agencies in many of these small states to greater vulnerability to the high price volatilities in the international commodity markets. Yet, most commodity-dependent small states have inadequate access to market-based risk-hedging instruments that would allow them to manage such risks.

_Poverty reduction—a major objective._ Uncertainty due to commodity price fluctuations hampers growth and is associated with increases in poverty. Inability to manage uncertainty makes it difficult for farmers to plan their crops, allocate their resources, obtain credit for inputs, and even simply recover costs. It also weakens the ability of governments to maintain a conducive and stable environment for domestic business and to implement policies and programs to reduce poverty.
B. An International Effort to Explore a Solution

An International Task Force to explore new market-based approaches. Following extensive consultations, the World Bank convened an International Task Force (ITF) on Commodity Risk Management in Developing Countries in early 1999 to explore new market-based approaches to assist developing countries better manage their vulnerability to commodity price fluctuations. Members of the ITF include international institutions (Commonwealth Secretariat has played a significant role in the ITF), producers and consumers organizations, major commodity exchanges, and other private sector entities. In addition, the ITF work is supported by a small group of academics and market experts from around the world.

Recognized market gap. ITF members recognize that current mechanisms created in the 1970s to help developing countries cope with commodity price volatility have achieved very limited success. Meanwhile, markets themselves have created instruments which enable producers and commercial entities reduce the revenue uncertainty that results from volatile commodity prices. Such instruments can effectively provide market-based price insurance. However, entities in developing countries have very poor access to these instruments, and stand to benefit from an international effort to improve such access.

Current action not sufficient. The international community could choose to help bridge the market gap by stepping up technical assistance. However, these efforts have shown to be insufficient. In time, the spontaneous development of markets could be expected to expand private sector risk management offerings. But, as it stands, such market coverage is not available for many poor countries, while for others the associated fees are high. In any case, it is unlikely that market expansion will grow at the rate needed to keep up with increased exposure to global market conditions. Liberalization of commodity markets may accelerate under the next round of WTO negotiations. Lack of access to risk management tools could create pressure to resort to protectionist measures. It is therefore even more pressing to bridge the market gap in risk management.

The proposed new market-based approach. Based on their deliberations and consultations, the ITF has reached a consensus on the need for international intermediation to bridge the gap between providers of risk management instruments and entities in developing countries that lack access to these instruments. ITF members further recommend the creation of an international intermediary to help bridge this gap. The intermediary would focus on facilitation of access to market-based commodity price insurance—price floor for producers (and exporters) and price ceiling for consumers (and importers). It would also provide potential clients with the core services and technical assistance needed to extend the market to them. If implemented, the approach has considerable potential in promoting development, reducing poverty throughout the developing world and expanding opportunities in risk markets.

Leveling the playing field: making markets work for the poor. With liberalization, smallscale producers face the full volatility of international commodity markets, with few means to manage their risk exposure. Local traders now find themselves at a competitive disadvantage to firms with international links that can obtain credit on good terms and hedge their price risk through their parent or affiliate. Improved access to market risk management instruments can contribute to leveling the playing field, allowing smallscale producers and local firms to be better equipped to cope with commodity price risks in global markets.
C. The Proposed Market-based Approach to Commodity Risk Management

*Roles of the proposed intermediary.* The intermediary would facilitate access of smallscale producers to commodity price insurance. It would perform three main functions:

(a) **Provide core services and technical assistance.** The intermediary would provide potential clients with specific core services needed to extend the market to them and ensure that business is transacted in an efficient, fair, and transparent manner. Such services and technical assistance would include dissemination of timely market information, and supporting the development of local transmission mechanisms that could extend price insurance to smallscale producers.

(b) **Provide partial guarantees.** The intermediary will identify and unbundle the risks involved in the provision of price insurance. Participants to the transaction would take on those risks they can deal with most efficiently. In addition, based on sound due-diligence procedures, the intermediary would provide partial guarantees, on a case by case basis, to cover some aspects of these risks, notably the sovereign risk.

(c) **Act as a pass-through.** The intermediary would consider offering directly price insurance, and to the extent possible, hedge its risk position through markets, thereby acting as a pass-through between providers and users of risk management instruments. This role would strictly be limited to exceptional cases where the private sector is unwilling or unable to do so. It would also be limited by the ability of the intermediary to offset the risk it may be exposed to through risk management markets, leaving its own exposure within acceptable ranges of prudential risk management.

*Limitations of the proposed approach.* The proposed approach is not designed to address all aspects of commodity risks or even to cover all commodities relevant to developing countries. It does not attempt to stabilize prices in the market, but will leave market price volatility unaffected. It does not cover all commodities, at least at its early stages, but only those regularly traded in commodity risk markets. And it will not revert the secular commodity price trend, as it would only deal with protection against volatility during a limited time horizon. However, the proposed approach would reduce the uncertainty associated with price volatility, and provide market-based compensation against adverse price movements within such time horizon. Furthermore, the ability to offer commodity risk insurance would expand as new commodity risk markets develop, and more entities participate in such markets.

*Support to test the proposed approach.* During the World Bank Annual Meetings in September 1999, the ITF proposal was presented to a wide audience at a Roundtable discussion which included some 50 experts from international institutions, producer and consumer organizations, commodity exchanges, business leaders, government officials, academics, and market experts from around the world. The topic was taken up again in an Annual Meetings seminar. The panel was made up of Marcus Fedder (moderator), Treasurer of the European Bank for Reconstruction and Development; Clifford Lewis, Senior Vice President of Strategic Planning, Chicago Board of Trade; Richard Kwame Peprah, Minister of Finance, Ghana; and Roberto Rodrigues, President of the International Cooperative Alliance.
proposal received broad support from participants of both events. Speakers stressed the importance of poverty reduction in the proposal, and the crucial role that cooperatives, traders and other institutions acting as local transmission mechanisms, could play in retailing price insurance to smallholders. They urged the ITF to continue its work, and move into testing the approach in a concrete operational context.

D. Moving Forward with Prototype Test Cases

Testing operational feasibility of the approach. In order to test the operational feasibility of the approach, prototype cases would be developed to: (a) gauge the level of potential demand for the proposed instruments and services; (b) assess the feasibility of accessing smallscale producers through local transmission mechanisms (LTMs); and (c) develop the processes and structures necessary for its implementation. The lessons from the test cases will be applied to key operational design aspects including: (a) eligibility criteria, for both potential providers and users of price insurance; (b) business processes and due diligence functions to deliver price insurance; and (c) institutional framework needed to implement the approach (financial, organizational and governance structures).

Development of prototype cases. A few prototype cases (four to six) are being developed, with no financial transactions carried out. These early prototype cases will be very simple so as to best illustrate operational issues and will not involve provision of financial assistance to cover the premium cost for price insurance.2 In parallel, work on the broader analytical and design issues will be conducted, with contributions from experts around the world. Preparatory work will be conducted to explore feasibility, with a full assessment of any risks involved in implementing such cases. Building on this learning experience, subsequent prototype test cases would be progressively more complex, addressing more challenging cases.

Process for developing prototype test cases. The Bank will continue to provide secretariat support to coordinate this work. Prototype test cases will be developed by small multi-disciplinary teams involving Bank Country Departments, experts from the private sector, and relevant international institutions. International Commodity Organizations (ICOs) (e.g., cocoa, coffee, cotton, sugar) will also play a key role. Their relevant experience of local markets and statistical dissemination functions will be most valuable.3 The Common Fund for Commodities (CFC), the umbrella organization, will take a leadership role in coordinating such a collaboration. Furthermore, the ITF Secretariat will actively seek involvement of independent industry experts and practitioners (mainly potential providers of risk management instruments) to guide the work on prototype cases from a business perspective, and advise on the processes to be developed in order to implement the approach. Business links will also be developed with emerging commodity exchanges in developing countries. Finally, a dialogue will be conducted with some NGOs and fair trade organizations, to learn from their experience and draw on their expertise.

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2 More work will be conducted to determine the needs for financial support, to assess development effectiveness, to examine the impact on markets, and to learn from relevant experience in both developed and developing countries.

3 A dialogue is already engaged with ICBs to determine the nature of their participation in the delivery of the ITF proposal, if implemented.
Choice of prototype test cases. The ITF Secretariat has received so far some 50 proposals from government officials, cooperatives, producers’ organizations, international organizations, and market players. The early prototype test cases will be chosen to provide broad coverage of regions, types of LTMs, and types of providers of price insurance. Moreover, selection of cases would be based on the following parameters:

(a) Commodities. Commodities will be chosen among the most relevant to developing countries, traded in international financial markets (i.e., for which liquid markets exist). This universe includes exports of aluminum, cocoa, coffee, copper, corn, cotton, rice, rubber, soybeans, sugar, tin, and wheat; as well as imports of maize, petroleum, rice paddy, soybeans, sugar, and wheat.

(b) Countries. The focus is initially on commodity-dependent countries, vulnerable to large swings in commodity prices, either for their imports or their exports. It is also expected that prototype test cases will involve a number of small states.

(c) Instruments and services. The focus will be on cases with a clear market gap. This requires clarifying the reasons why the private sector does not currently enter into transactions or why the entity in the developing country cannot access available instruments. Provision of the following instruments and services will be explored: (i) core services and technical assistance; (ii) partial risk guarantees for credit enhancement; and, when necessary; (iii) price insurance instruments, notably price floors and ceilings. These instruments would not cover risks related to the physical trade (e.g., quality or actual delivery and handling of the commodity).

Eligibility criteria for users and providers of price insurance. Potential users and providers of price insurance will be subject to eligibility criteria, which will be refined as part of the learning process from prototype test cases. Nevertheless, the following guiding criteria would initially provide a basis for test cases during the first stage:

(a) Users of the price insurance. Local Transmission Mechanisms (LTMs) are expected to act as retailers of the proposed instrument(s) and, as such, to take part in the transaction. They will play a crucial role in aggregating the necessary volumes required for purchasing price insurance from many individual small producers. They will also distribute the funds from the price insurance in the case of a claim, and facilitate the provision of core services and technical assistance to small producers. Prototype cases will focus on LTMs acting on behalf of smallscale producers. Selection criteria will ensure that LTMs:

(i) have the ability to aggregate production and channel benefits of price insurance to smallscale producers;

(ii) have sound and transparent accounting procedures and management capabilities; and

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4 Possible candidates for local transmission mechanisms include large farmers and producer cooperatives; commodity traders, processors and their associations; local banks operating in rural areas; and public entities involved in commodity risk management.
(iii) are willing to be submitted to full auditing procedures by international experts.

(b) **Providers of price insurance.** Several types of firms can offer price insurance to entities in developing countries. Selection criteria will be refined as part of the learning process from test cases. Nevertheless, during the first stage, providers of price insurance will be required to:

(i) be an established credible counterparty to transactions;

(ii) be willing to take part in a competitive bidding process, and adhere to transparency requirements for transactions; and

(iii) be willing to contribute towards the cost of the prototype case either through in-kind contributions (staff time and travel costs), or through assistance in delivering some of the core services (e.g., provision of training to LTM's involved).

**Next steps.** Three stages are envisaged in testing the approach (January to September 2000). Major issues will be addressed as work progresses, with interim reviews at each stage. Work will progress on to the next stage only when and if the results of the preceding stage warrant it. These stages could be broadly described as follows:

(i) The **first stage** involves development of the prototype test cases, with no actual financial transactions being conducted (January-April 2000). Concurrent to this, analysis will be undertaken to address critical analytical issues, including the impact on poverty, use of aid resources, and potential risk exposure.

(ii) Assuming positive results, the **second stage** (May-July 2000) could implement the prototype cases, carrying out actual financial transactions. A Trust Fund Facility (TFF) would be designed for this purpose. Building on this learning experience, subsequent prototype test cases would be progressively more complex, addressing more challenging cases.

(iii) The **third stage** (August-September 2000) could formulate a recommendation on the establishment of more permanent intermediation functions. Based on lessons drawn from implementation of the test cases, along with the conclusions from the analytical and design work, a recommendation may be made on the establishment of more permanent intermediation functions, and on the institutional modalities to carry them out. The roles of the World Bank (if any) would be considered in the framework of a proposal regarding such institutional arrangements.

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5 These include: international commodity traders; investment banks; commodity brokers; insurance companies; and commodity exchanges.