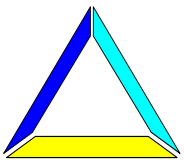
INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING IN UKRAINE
GERMAN ADVISORY GROUP ON ECONOMIC REFORM

Reytarska 8/5-A, 01034 Kyiv, Tel. (+38044) 228-6342, 228-6360, Fax 228-6336
E-mail: institute@ier.kiev.ua, http://www.ier.kiev.ua



S 8

Concept of trade with commodity derivatives of agricultural products and food at the commodity exchange

Comments

I. In the mid- to long-term, commodity derivatives, especially futures, could play a very important role on Ukrainian markets for grain, oilseeds and other agricultural commodities. Of course, much work remains to be done if they are to play this role. It is fundamentally very positive that the Ukrainian Government has made the development of commodity derivative markets a priority.

II. It is also positive that steps are being taken to organise and structure the development of commodity derivative markets in a transparent manner as documented in the above mentioned *Concept*. Derivative markets will only have the desired impact on Ukrainian markets if the users of these markets – private producers, traders and users of commodities both in Ukraine and abroad – choose to make use of them. There is no sense in designing institutions, regulations and derivatives in government circles 'behind closed doors'; the result will not generate the required liquidity. Potential users of commodities derivatives as well as the extensive international experience with more and less successful derivatives in other countries must be drawn into the development process from the start.

III. The role of the government may require more clarification in the *Concept*. There should be no misunderstanding that derivatives markets somehow provide a tool with which the government can regulate markets. If private market participants suspect that this is what the government has in mind, then they will be sure to avoid the derivatives markets like the plague! Derivatives markets can improve the functioning of the market system as a whole by providing market participants with the opportunity to trade risk among each other. However, derivative markets are complex and they can be misused. For this reason these markets need government support in the form of public regulation to ensure that they function as foreseen. A regulatory body must ensure, for example, that no one can 'corner' a market, or that no insider trading takes place. Participants must be sure that this regulation will take place on a completely fair and impartial basis. The purpose of this regulation cannot be to support certain firms of

branches of a sector, or to maintain minimum prices for the underlying commodities etc.

IV. On a related note, the *Concept* could state more explicitly that derivatives markets will only play their full role if government policy on commodities markets is adapted correspondingly. As the *Warenterminbörse* in Hanover has discovered in recent years, the existence of the intervention system for grain in the EU is incompatible with a functioning futures contract for wheat. Similarly, the intervention system for grain recently passed by the Verchovna Rada in its law "*On grain and the grain market in Ukraine*" is incompatible with a functioning Ukrainian futures contract for wheat. (Unless, of course, the intervention system has no real impact on grain markets, for example because it is under-funded; in which case one might ask what is the sense of establishing a 'fictive' system in the first place?). Derivatives markets do not make it impossible for the government to support farmers (for example via direct payments), but they do preclude the use of policy tools designed to influence price determination on the corresponding commodity markets.

V. Under 2. '*Initial conditions…*' in the *Concept*, mention is made of integrated markets. This is a very important issue. Interference by regional authorities in price determination on commodity markets (e.g. restrictions on movements of commodities within Ukraine) would have the effect of increasing the basis risk for potential participants on derivatives markets who are located in effected regions. This would reduce participation on derivatives markets. It could even create a danger of manipulation whereby regional authorities and powerful local traders attempt to influence markets to their personal advantage. As suggested under point IV above, functioning derivatives markets restrict the options available to governments. This includes regional as well as central governments.

VI. I assume that this *Concept* is meant to outline a strategy and not serve as a basis for legal texts. Nevertheless, it includes definitions of a variety of terms and institutions related to commodity derivatives that may be misinterpreted. These definitions are useful in a general sense of clarifying the scope and aims of the *Concept*, but they are too short and sometimes imprecise from a legal point of view. It is not sure exactly what the purpose of these definitions is, and sometimes it may be that they are 'too much' and 'too little' at the same time.

VII. For example, why define 'forward contracts' in this *Concept*? Forward contracts are generally concluded between private legal entities in whatever form is mutually agreeable. Of course, they may be standardised to some extent, if the parties involved contacts find that this is useful. And like any contract, they must be enforceable, which creates a need for government regulation in the form of a functioning legal system etc. But excessive standardisation could reduce their usefulness to market participants.

VIII. Some of the definitions provided in the *Concept* could be misunderstood as imposing unnecessary restrictions. For example, under 3.4. '*Trade participants*', we are told that there "shall be three groups of participants on the commodity derivatives market". While it will be necessary at some point in the future to define who can act as a broker on derivatives markets, there is no real need to define hedgers and speculators. Any individual who wishes to buy or sell derivatives through a broker should be permitted to do so, provided he or she can provide the required financial guarantees. Whether this individual's motives are speculative or based on hedging is irrelevant; in many cases participation on derivatives markets at least implicitly involves a combination of both of these motives.

IX. It is not clear why there is a need for a specific *Concept* for agricultural and food products. In principle there is no difference between a futures contract for wheat and a futures for diesel oil or recycling paper. It might be possible to realise important cost savings and gains in efficiency by unifying all commodities derivatives trade on one exchange. This could help avoid duplication of effort (why establish more than one clearing house, for example?) and it might result in a more stable overall framework (if some derivatives fail to succeed, this could be compensated other more successful derivatives).

X. The development of commodity derivatives is very important for Ukrainian agriculture and the Ukrainian economy as a whole. It would be a great pity if this development were to suffer because of petty rivalries between institutions, regions or political factions in Ukraine. National or sectoral (for example agricultural) pride should not be permitted to stand in the way of finding the best solution, i.e. the solution that is able to provide Ukraine with functioning and stable derivatives markets as soon as possible. If appropriate institutions already exist or are already being created for derivatives markets in areas outside of agriculture (i.e. financial derivatives), then it may make sense to explore the possibility of working together with these institutions. Since derivatives markets are not tools for government regulation or intervention on markets, there is no 'special' relationship between, for example, agricultural policy makers on the one hand, and agricultural derivatives markets on the other.

S.v.C.-T.
July 2002