U.K. COMMODITY MARKETS

Organised markets in primary commodities are an important part of the facilities available in the United Kingdom for the conduct of international trade. Markets in primary commodities are to be found in many countries abroad, some transacting a far greater volume of business than the corresponding markets in the United Kingdom; but these foreign markets are mainly concerned with domestic demand or domestic supply. The distinguishing feature of the U.K. markets is their international character; and in the sphere of international merchanting, that is, buying from one country and selling to another, and in the variety of commodities in which they deal, they are collectively the most important in the world. They have their origins in the history of British exploration and investment overseas and industrialisation at home, and in the consequent growth of the United Kingdom's world-wide trading links.

Post-war revival During the war, many U.K. commodity markets were closed and essential imports became the responsibility of Government Departments, assisted in most cases by private traders in the arrangement of business. Afterwards, the possibility of restoring markets to their former status was early considered, in view of the important contribution which they had previously made both to international trade and to the U.K. balance of payments. The markets required wide facilities for making and receiving payments in sterling and foreign currencies in settlement of contracts with overseas exporters and importers; but the United Kingdom's severe war-time losses of foreign exchange and the bilateral payments arrangements which had in consequence to be negotiated with foreign countries, made it impossible to grant these facilities immediately to all the commodity markets. However, as early as June 1946, a start was made with a trial scheme for the coffee market which had later to be revised. Shortly afterwards other exchange control schemes were introduced which made it possible to reopen the markets for rubber and tin. These two commodities are produced largely within the sterling area. It therefore seemed unlikely that the reserves would suffer serious loss if the markets were allowed free access to supplies, by means of open import licences, or if the exchange control restrictions on merchanting transactions were relaxed to enable merchants to trade freely with buyers and sellers anywhere in the world, and to hold stocks and deal on commodity futures markets abroad. In 1951 a basically similar scheme was introduced for the cocoa market though, as with the amended scheme for coffee, sales to countries outside the sterling area had to be settled in dollars if the commodity had originally been bought for dollars.

These early schemes were drawn up in the context of an inconvertible pound. Subsequent schemes, introduced in the years 1952-54, went a step further in that they applied to commodities produced to a greater extent in countries outside the sterling area. The re-opening of these markets, namely those for lead, sugar, zinc, grain, copper, cotton and copra, was an important part of the policy then being followed of moving gradually towards making sterling convertible. The arrangements made allowed several of these commodities originating in and purchased from dollar area countries to be sold for sterling in other countries outside the sterling area. During this period similar facilities were incorporated in the existing schemes for cocoa and coffee. For cotton and grain, however, which had predominantly to be bought from the dollar area, these so-called dollar/sterling facilities were withheld—in the same way as they had formerly been for cocoa and coffee—until the end of 1958, when non-resident-owned sterling became fully convertible over External Accounts. For a short time in August 1952 U.K. merchants were permitted, for special reasons, to purchase certain commodities from

the dollar area for resale for sterling to countries in the European Payments Union; but these temporary facilities formed no part of the arrangements subsequently made to enable U.K. markets in some of the commodities to be reopened.

The Bank of England's part Exchange control schemes were introduced for twelve commodities in all. (A scheme was also provided for wool, covering only futures transactions, to assist the operation of the London Wool Terminal Market which opened in 1953) The schemes were drawn up and administered by the Bank of England, as agents for H.M. Treasury, working in close co-operation with the appropriate Market Associations. Participation was extended to any U.K. firms which were members of, and recommended by, the appropriate Market Associations. The Associations, in their turn, assumed the responsibility of ensuring that their participating members complied with the arrangements. This system enabled the several hundred firms concerned to conduct their business freely with overseas firms and on foreign markets, provided that they followed the broad trading rules laid down by the schemes, without needing to obtain confirmation that each transaction was permissible before making a contract. Because this freedom was such a valuable advantage it was thought that there would be little risk in making it available to the commodity markets, whose members were subject to the discipline imposed upon them both by their own Associations and by exchange control legislation. This confidence was justified; even in the most trying conditions of the 'cheap sterling' era, when foreign competitors enjoyed advantages which had to be withheld from merchants in this country, the markets adhered loyally to the principles and practices of the U.K. Exchange Control.

The Bank's work in administering the schemes has consisted largely of surveying and aggregating the monthly returns made by each participant. In the early days these returns included details of all inward and outward payments and entailed considerable clerical work in the offices of the firms. Their bankers also were asked to maintain separate accounts for their clients' commodity transactions under the schemes. Later on the returns were simplified, and the convertibility of External Account sterling allowed the schemes' trading rules to be made more straightforward and uniform. In 1960 the separate banking accounts were discontinued.

A feature of the schemes, which has helped to promote the close relations now existing between the Bank and the markets, was the provision for "regular consultation regarding the general position, trading and condition of the Market", to be achieved by frequent liaison meetings between representatives of the Bank and of the Executive Committees of each market. Initially these consultations were in the interest of exchange control, to assist the working of the schemes, to resolve problems arising from them, and to ensure that situations did not develop which might lead to unnecessary expenditure of foreign exchange. Later, with the easing of exchange control restrictions, these discussions have tended to deal far more with general questions of international trade and commodity agreements, movements of prices and kindred subjects; and an understanding of their common interest in these matters has developed on both sides. The regular meetings are held less frequently nowadays, but close relations are kept up by means of frequent personal contacts. Close relations also exist between the Cotton Market and the Bank's branches in Liverpool and Manchester, between the Grain Market and the Liverpool branch, and between the Wool Market and the Leeds branch.

Value of the markets The service which the commodity markets provide to both producers and consumers enables business to be done under accepted rules of trading and conduct, on standard terms of contract covering specified grades of commodity. For U.K. traders and manufacturers it is an advantage to have markets operating in this country where they can be sure of buying their raw materials in their own currency at competitive prices. Because they are international markets, however, they also benefit the economy in two special respects. Firstly, in attracting business from overseas the U.K. markets play an important part in the use of sterling as an international currency. Their existence has undoubtedly made foreign traders more ready to

hold sterling and to settle an important part of their international transactions in it. Secondly, there is the benefit of increased invisible earnings. In addition to the profits and commissions earned by the markets direct, a more significant contribution to the U.K. balance of payments is made by the banking, insurance and shipping services which are employed by commodity traders in the execution of contracts made in the U.K. markets. It is customary for these contracts to be drawn up on c.i.f. terms, in which the charges for insurance and freight to the port of destination are included in the contract price; and it follows that bank credits to finance such transactions undertaken by U.K. merchants, and other related freight and insurance contracts, will tend to be arranged in the United Kingdom. Commodity trading through the U.K. markets thus naturally brings into operation other associated commercial and financial services. Indeed, the commodity markets have been a major influence in London's development as a world centre of commerce and finance.

Forward contracts It may be helpful, before discussing the present position of the markets and some current problems, to outline the broad principles of commodity marketing procedures and particularly the operation of trading in futures.

The general use of the c.i.f. contract has already been mentioned. This is essentially a forward contract, commonly made before the goods to which it relates are shipped from their country of origin. The date on which the contract is entered into may therefore precede the date of delivery and payment by several weeks and sometimes by months. Forward contracting for very distant dates is less common and it is usually possible for consumers of primary commodities to ensure continuity of supply by buying goods to be shipped from the country of origin within three months. The particular type or grade required is defined by the use of internationally recognised standards, without which forward trading on description would not be possible. Market regulations provide for any dispute over the quality of goods delivered to be settled by arbitration, and U.K. arbitration procedures are in general readily accepted by buyers and sellers throughout the world.

Thus the main considerations involved in matching demand with supply are quantity, quality, price, and the date and place of delivery; and business cannot take place between two parties until all these are agreed. A market's ability to equate supply and demand at relatively stable prices varies, of course, with its efficiency and breadth, and is largely governed by the proportion of world trade in the commodity concerned which is channelled through it. Direct trading between governments or government agencies, or between major producing and consuming companies, frequently appears to bypass the markets. But substantial quantities of this trade may be arranged through broker members at negotiated or ruling market prices, sometimes for shipment at regular intervals over a long period. The business of international merchanting, on the other hand, with which the markets are so largely concerned, usually involves smaller quantities and specific delivery dates, and may at times entail splitting up bulk shipments or amalgamating small lots to suit consumers' needs. Even in the broadest market it is unlikely that a producer's selling order could be matched exactly or simultaneously with a consumer's buying order. There is usually an interval of time which has to be bridged if day-to-day trading is to continue, and the function of filling this gap belongs to the merchants or dealers who are prepared to make forward contracts and carry them on their books until maturity, expecting in the meantime to secure complementary contracts enabling them to take and effect delivery on the due date. Until this expectation has been realised or cover in some form has been obtained the forward commodity position in a dealer's books will be unbalanced, either over bought or over sold, and in this situation the dealer is exposed to the uncertainties of price movements.

Futures markets The technique of hedging, or covering, against price risks of this kind, which was first used in the latter part of the last century, effectively enables a dealer to balance his books, if he so wishes, by making further contracts in a futures or terminal market. The first such market in this country developed out of the use of a

section of the Liverpool Cotton Market which dealt in 'future' arrivals. Here importers who had contracted to buy cotton from American shippers for future delivery could immediately sell an equivalent amount of cotton for delivery on a more distant date. Once the actual cotton had arrived in Liverpool and had been sold to a spinner, the importer disposed of his liability to deliver cotton in the futures (arrivals) market by buying back, for the same distant arrival date, the amount of cotton he had previously sold. He thus obtained an insurance against the risk of a fall in price between the time of his original purchase from the American shipper and his ultimate sale to the U.K. spinner. If the price had fallen, he would have a profit on his 'futures' sale to set off against the loss on the actual cotton bought, and vice versa if the price had risen. The enormous growth in these transactions in 'future' arrivals of cotton led the Liverpool market in 1874 to establish a clearing house to facilitate settlement of price differences between firms, payments being made originally in cash but later by means of vouchers. These vouchers were passed through accounts opened by members of the market with a settlement institution called the Cotton Bank, which functioned from 1878 until the outbreak of the last war and was staffed by members of the Bank of England's Liverpool branch.

Although these early hedging transactions in Liverpool were mostly in one direction, being effected by importers wishing to cover their forward purchases of actual cotton, the breadth of the market, which had attracted a considerable speculative interest, ensured that the covering transactions, both the initial sale and the subsequent repurchase, could normally be effected without difficulty. In the modern futures market, although the principles of hedging remain unchanged, trading is done largely between dealer members having different or complementary interests—some, for example, wishing to hedge uncovered forward sales might provide the counterpart for others having opposite commitments. The facilities provided by the futures markets have also been found of considerable value to producers, for example as a means of price insurance for their crops, and to consumers both at home and abroad, many of whom operate as non-members through brokers. Similarly, business is placed in some markets on behalf of foreign merchants, and frequently there are also speculative interests. In consequence many of these markets have grown in breadth and efficiency, and their procedures have become simplified, mechanisation greatly reducing routine work in the clearing houses. Where futures markets enjoy wide support from every kind of trader, the prices quoted, for current or nearest-month delivery, are generally accepted as giving the best indication of true world prices.

The particular purposes for which futures markets are used, the clearing house processes, and many of the technical terms associated with futures trading, all tend to obscure the fact that a futures market contract is a forward commodity contract, involving a definite undertaking to deliver, or to take delivery of, a certain quantity of commodity of a standard grade, at a certain place, on a due date. There are occasions when actual deliveries are made or taken against a futures contract. Because the primary function of futures markets is to provide cover, however, the contractual obligation to make or take delivery is normally discharged by making a further contract, for an identical delivery date and quantity but in the opposite direction. It is in this process of acquiring and relinquishing cover that the finer points of marketing arise.

Dealing techniques

The essential functions of a market—to act as intermediary between producer and consumer, to absorb supply and meet demand, and to ensure that variations in these are reflected in the price quotations—are performed by dealers buying and selling for their own account. The markets work best where there are a good number of dealers competing together, and in these markets the strength of competition may be such that business is done, both with producer and with consumer, at the current market quotation or, in other words, at buying and selling prices with no appreciable 'spread' between them. The dealer's scope for profitable trading then depends largely on intelligent anticipation and careful timing and on his skill in buying the cheapest 'positions' and selling the dearest. He will try to use to his advantage any movement which may occur either in the basic com-

modity price or in other current quotations for various types or dates of delivery, or in futures market prices. For example, he may discover some disparity from the normal price differentials for different delivery positions or qualities, so that in the course of hedging a forward purchase or forward sale an arbitrage transaction can be effected. This depends, first, upon finding a current quotation which seems to offer an advantage over another, so that the cheaper can be bought and the dearer sold, and, secondly, upon there being a further change in differentials later on which will allow the first transactions to be reversed profitably. Because margins are usually small a substantial turnover is needed to make this type of trading remunerative. It takes place, not only through hedging, but on any occasion when distortions of parities or differentials between two forward price quotations appear to have occurred. By this means the whole complex of prices for the various positions and grades in a market and between one market and another for the same commodity is brought into line. The dealer can remain protected against an adverse movement in overall price levels by preserving a balanced position. Except, however, where the market outlook is too uncertain for any view of future price trends to be taken, the dealer will not usually wish to maintain a completely balanced position. It is more likely that throughout the day's trading he will vary the amount of cover he takes according to his interpretation of current news or of specific market factors which may affect prices. The extent of his open position at any moment, that is, the amount by which the total of his stocks, forward purchases and futures purchases differs from the total of his forward sales and futures sales, would depend upon his view of the likely course of prices.

Market positions

The carrying of open or uncovered positions by members of a market is a form of anticipatory trading. It will often lead to an adjustment of the market price and, to the extent that the views of its members coincide, it will move the whole market towards a net long or net short position in conformity with anticipated changes in supply and demand. The overall position of a market is a complex matter because it includes, in addition to the net trading positions of dealer members, contracts made by broker members of the market who, while trading in their own names, place business on behalf of clients at standard rates of commission. Access to a market is thus obtained by non-members, most of whom are likely to be either producers, consumers, or others having a trading interest in the commodity. Some of these non-members may be speculating in commodity futures and a moderate speculative interest of this kind is usually regarded as beneficial because it broadens the market and helps traders to cover price risks which they do not wish to carry. It increases the efficiency of the market and reduces costs. In the more extreme situations, where a price movement looks strong and persistent, it can be embarrassing if outside operators build up large open positions because this can carry the price beyond a sustainable level and produce a vulnerable market. In these circumstances a change in the price trend may lead to panic-trading to avoid losses and cause excessive price fluctuations.

The current trading background

The prolonged decline in prices from their Korean peak, which had for some years been the outstanding feature of world commodity trade, ended, according to most price indicators, in the third quarter of 1962, though a few commodities touched bottom a little earlier or later. Subsequently most commodities have increased in price (rubber, tea and American cotton are exceptions) and trading conditions in most U.K. markets have become more lively.

The recent price recovery has by no means dispelled the anxieties which the long recession in commodity prices caused amongst producers, and which have stimulated renewed efforts by the governments of primary-producing countries to secure safeguards for the future. In consequence commodity problems have attracted world-wide concern, and market practices have been subjected to critical scrutiny and unusual publicity. Members of the markets have been engaged in consultations on these matters, both in their own committees and with Government Departments. Apart from the various plans for stabilising world prices, the moves towards a common agri-

cultural policy by the European Economic Community and the new cereals policy of the United Kingdom (both of which involve, among other things, the imposition of variable import levies) have created unusual problems for certain markets.

A prominent consideration in the discussion of commodity problems is the maintenance of the producer's export income, which depends on the interrelated factors of price and volume. Because the effects of falling prices have not always been offset by increased sales, however, attention tends to be concentrated upon ways of maintaining stable and remunerative prices; and there has been some criticism of the market system on the grounds that it is costly and itself generates price fluctuations. But it remains true that a free market is the most practical means of enabling the relationship between supply and demand to determine prices. A market having adequate hedging facilities may be capable of absorbing a short-term surplus without undue depression of price, but any prolonged or basic disequilibrium in supply and demand is bound to cause a substantial change in values. Sharp price changes, however, will be less liable to occur in a market where the right conditions exist for efficient working; there must be adequate scope for the forecasting of future demand, and there must not be restrictions on supply which prevent merchants from maintaining adequate stocks. Given these conditions, together with the use of an effective terminal market to lessen the risk of loss through price fluctuations, marketing costs will be reduced to a minimum. Frequently these conditions do not exist. For example, uncertainty may be caused by intervention designed to regulate prices, or the diversion of supplies into other channels of distribution may prevent the market from acquiring adequate stocks.

It is widely acknowledged that there should be some restraint on downward price movements as a means of protecting producing countries at times of severe recession. International agreements for sugar and tin have been in force for several years. These have been able to moderate price movements for considerable periods, but at times the attempt to hold prices has failed. In the case of tin, subsequent price movements may have been accentuated by the maintenance for a time of artificial prices which obscured the underlying trend of supply and demand. At present the price provisions of both are inoperative. An agreement for coffee reached last year has undoubtedly helped to produce higher coffee prices. For cocoa, although last year's international conference was unsuccessful, an agreement between producing countries is expected to be put into effect shortly. All these agreements are designed to restrict supplies at certain price levels so as to limit further downward movements, leaving market forces to operate at times of shortage. Exceptionally, the International Tin Agreement also provides for a rise in prices to be restrained by selling tin in the market from time to time from a buffer stock financed by the producing countries; but supplies from the stock were exhausted in October 1963. The long-standing International Wheat Agreement is of a different character, being in the form of an intergovernmental contract which provides certain guarantees on markets and supplies for its producing and consuming members as a whole at prices within an agreed range.

It is interesting that, although these arrangements are all intended to restrict price movement, they have not significantly reduced the amount of business handled by the markets. This is because either they have allowed prices to move within a range wide enough to give scope for trading or they have given way before overwhelming forces of supply or demand. There are other forms of intervention, however, which have had more extensive effects on markets. For example, during 1962 and 1963, when certain major producers were supporting a fixed selling price for copper on the London Metal Exchange, trading there in copper fell to a quarter of its former level. The pricing system used by the Canadian Wheat Board for its sales of wheat and the cotton price support system of the U.S. Government have led to stagnation in the Liverpool Wheat Futures Market and in the cotton futures markets in both Liverpool and the United States. The market for natural rubber, too, though free from any form of direct intervention other than modest disposals from U.K. and U.S. government stocks, has had to contend for many years with the difficulty of predicting the incidence of demand from the

U.S.S.R. and of supply from Indonesia. There have also been the problems posed by growing competition from synthetic rubber.

Restrictions and impediments of various kinds, however, while a hazard to commodity markets, are not necessarily fatal to them. It is the task of market authorities to try to find ways of adjusting market procedure to changing conditions, whether these have arisen from the application of national or international commodity policies or merely from natural changes in the pattern of world trade. Amongst recent modifications are the inclusion for the first time in any U.K. market of a continental delivery point, Rotterdam, for copper and tin contracts on the London Metal Exchange, and provisions for dealing in English barley in the London Coarse Grain Futures Market and in greasy wool in the London Wool Terminal Market.

The outlook

This year's United Nations Conference on Trade and Development is likely to be followed by discussion of further individual commodity schemes for stabilising prices or preventing them from falling to an unduly low level. Changes in tariffs or preferences and further progress towards the harmonisation of prices in the European Common Market may affect commodity trade through the U.K. markets. Growing use of synthetic materials, diversification and increased processing in primary-producing countries, the trend towards larger manufacturing units in consuming countries, the development of trade with the centrally planned economies—all these are bound to affect the markets. In the years ahead, with a growing volume of commodities both natural and synthetic to be marketed, world trade in commodities seems likely to pose increasingly important problems. The U.K. commodity markets, however, have proved their adaptability in changing circumstances and will no doubt continue to provide valuable services, whether on the present lines or, it may be, within the framework of new international marketing arrangements.