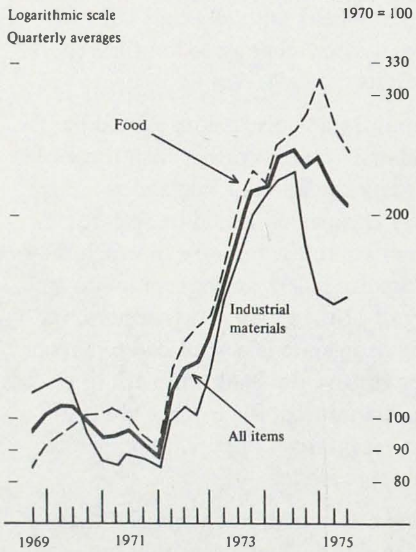
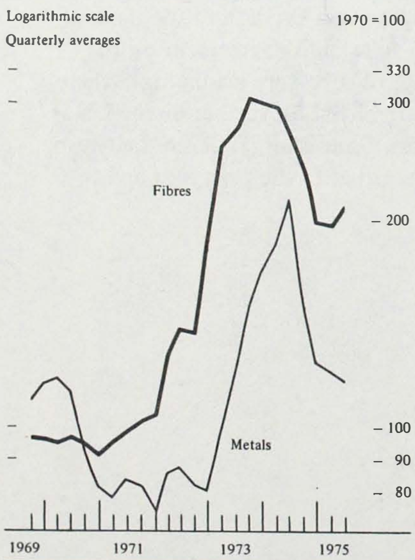
UK commodity markets

The September 1964 and June 1969 issues of the Bulletin *contained articles on post-war developments in the UK commodity markets and the nature of their trading. The present article covers subsequent events, including the extension of official supervision of the markets.*

World commodity prices [a]

The lower chart shows the main sub-groups which make up industrial materials.





[a] *The Economist* world commodity price index (excluding oil) in dollar terms; reproduced with permission.

Prices

The Economist dollar index of world commodity prices (which excludes oil) rose by 170% between mid-1969 and its peak in 1974 (see charts), and although by the summer of 1975 it was appreciably below the peak, it was still over twice as high as at the beginning of the period. A strong and unusually synchronised expansion in the main industrial countries in 1972 and 1973 raised the prices of raw materials to record heights, in both sterling and dollar terms. This followed a period of relatively low prices, when producers had little incentive to create reserve capacity, so the rapid increase in demand soon outstripped supply and prices rose steeply from late 1972 onwards. At the same time, food prices rose even faster, largely because of poor harvests of grains, protein feedstuffs, coffee, sugar and cocoa, but also because of extra demand as real incomes rose sharply.

In early 1974, the delayed effect of restrictive policies adopted by a number of countries and the impact of much dearer oil turned the cyclical slackening of economic growth into the severest recession since the war. Nevertheless, raw material prices held up well into 1974, partly because stocks had been run down, and partly because of fears that shortages of oil might disrupt supplies generally and push up the prices of synthetic products. Food prices as a whole did not begin to fall until later in 1974, when it became clear that a good cereals harvest would allow some rebuilding of stocks, and that high prices were tending to reduce consumption of less essential foodstuffs such as meat, sugar and cocoa.

The reversal in commodity prices, when it came, was sharp, but by mid-1975 the fall appeared to have been checked; demand was still slack, but exporting countries had taken joint action to support the prices of a number of commodities, with some degree of success. In July and August there was some recovery in prices, especially of foodstuffs, owing to the adverse effects of weather on crop prospects. Prices in general are still fairly high in money terms but dearer oil and the rising cost of manufactured goods (to which the high prices of commodities in 1973 and 1974 had contributed) have partly offset the improvement in the terms of trade which commodity producers experienced during the boom.

International commodity agreements

The *Bulletin* articles mentioned above described the setting up and development of international commodity agreements. Of the four agreements existing in 1969, only that for tin is still fully in operation. The International Wheat Agreement came to an end in 1971, when wheat prices, depressed by the existence of large stocks in North America, had fallen below the floor price; it was replaced by a trade convention which imposed no obligations to supply at ceiling prices or to buy at floor prices. In contrast, the economic provisions of the Coffee and Sugar Agreements lapsed when shortages occurred in 1972 and 1973 respectively, because producers and consumers were unable to agree on a higher range of prices.

Even the successive Tin Agreements have had their limitations: they have managed to keep prices above the floor of the range, but have failed to prevent them from rising above the ceiling at times of extreme market pressure. A fifth Tin Agreement was negotiated in June 1975. This does not include obligations on consumer members to contribute to an enlarged buffer stock, but it does emphasise that they are expected to contribute voluntarily.

An International Cocoa Agreement was negotiated in 1972 and came into force a year later, but its provisions have been only partly implemented because market prices have been above the ceiling of the range. A levy of US 1 cent a pound on exports of cocoa is being enforced, and the proceeds will be used to help to finance a buffer stock. As with the Tin, Coffee, Sugar and Wheat Agreements, the administrative headquarters of the Cocoa Agreement have been set up in London.

Despite the difficulties experienced in the operation of commodity agreements, there is a widespread feeling among governments that they are a useful mechanism for stabilising trade, and the general political climate is likely to foster new agreements (see the final section in this article). Agreements covering wheat, sugar, coffee and cocoa are currently under discussion.

Developments in the UK markets

During the last six years, when the volume of world trade in commodities expanded considerably, members of the UK commodity markets retained their pre-eminence as international merchants and brokers. Turnover on the London futures markets, which comes mainly from traders rather than speculators and includes a large element from overseas, has also tended to rise, particularly during 1973 and 1974 when the wide fluctuations in prices greatly increased the need to hedge uncovered commitments.[1]

The international character of the UK markets, which helps to give them their great strength, has been enhanced by a considerable increase in foreign representation in London. This has come about because foreign trading companies and commission houses have set up subsidiaries and branches or have entered into association with UK firms. For example, of the 97 members of the London Metal Exchange, 34 are owned or controlled by foreign companies; and the terminal (futures) market associations have 191 overseas members in sugar, 162 in cocoa, and 82 in coffee. Conversely, UK traders have strengthened their ties abroad. The Federation of Commodity Associations has played a leading role in negotiations with the European Economic Community Commission in Brussels on questions related to commodity trading within the Community, and is now actively seeking to bring in continental members.

The most active futures markets have continued to be those for raw sugar, cocoa, and non-ferrous metals,[2] followed by cereals (EEC wheat and barley), coffee (the Robusta contract) and natural rubber. The table shows the average annual turnover in some of these commodities during 1965–69, and 1970–74. Futures contracts in a number of other commodities were not widely used and some had to be abandoned, but the search continued for improvements to existing contracts and for new contracts to meet trading needs. For instance, in 1975, the Grain and Feed Trade Association introduced a contract in soyabean meal, and the United Terminal Sugar Market Association brought in a special contract which made it possible to hedge in refined sugar at a time when trading on the Paris white sugar market had come to a standstill (see below).

London futures markets: annual average turnover

Thousands of tons

	1965–1969	1970–1974
Sugar	18,072	38,967
Cocoa	2,753	7,413
Copper wirebars[a]	1,470	2,850
Barley	379	1,030
Wheat	120	920
Coffee (Robusta)	279	821

[a] Dealings on the London Metal Exchange are for physical delivery as well as for futures; the two are not recorded separately in the figures for turnover, but futures constitute by far the greater part.

Among other developments, the newly-formed London Rubber Terminal Market Association took over futures trading from the Rubber Trade Association in 1974, revised its method of dealing to conform with that of other markets, and transferred its clearing arrangements to the International Commodities Clearing House (formerly the London Produce Clearing House); the markets operating in Plantation House, Mincing Lane, moved to new premises in Mark Lane;

[1] A description of the use of futures markets was given in the September 1964 *Bulletin*, pages 196–7.

[2] The London Metal Exchange deals in copper, tin, lead, zinc and silver.

and the International Commodities Clearing House, which now guarantees and clears contracts for most of the futures markets, has further developed its computerised system for calculating traders' positions and hence the margin cover due from day to day.[1]

Accession to the European Economic Community, 1973

The commodity markets generally welcomed the United Kingdom's accession to the EEC, though they looked for little or no immediate increase in business as a result, because links with the Continent were already so highly developed.

Accession affected the actual functioning of only two futures markets, in grains and sugar, both of which are covered by the Common Agricultural Policy. The specifications of the London wheat and barley contracts were altered to allow EEC grains to be tendered, and some initial technical difficulties were successfully overcome. In sugar, the problem was more fundamental: the London futures contract is for Commonwealth raw cane sugar, and adequate supplies are required for tendering if the market is to function smoothly. Protocol 17 to the Treaty of Accession provided for imports of such sugar only until the end of February 1975, but continued access was in fact guaranteed under the Lomé Convention.

A number of mainly technical issues have still to be settled: these relate to the harmonisation of company law, fair trading practices, and the treatment for VAT purposes of transactions on futures markets.

Exchange control

The exchange control schemes under which the principal markets operate have required little modification since 1969 apart from extensions to cover additional items. There has been an increase in the number of participants in the schemes, which at present cover cocoa, coffee, cotton, grains and feedstuffs, non-ferrous metals, rubber, sugar, oils, seeds and fats, and wool.

Since June 1972, when exchange control was extended to the overseas sterling area, traders have been free to deal with OSA countries in any currency, thus often avoiding the need to invoice in local currencies for which forward cover was not available. Within the United Kingdom, facilities to settle in foreign currency for goods of non-resident origin were extended from cocoa and coffee to grains, feedstuffs, oils, seeds and fats. More generally, traders have successfully adapted to floating exchange rates.

Towards the end of 1969, the Bank negotiated a voluntary scheme for silver with the London Silver Market and the London Metal Exchange. The purpose of the scheme was to reduce the substantial outlay on stocks of silver bullion which, in the prevailing market conditions, were being held to match forward sales to non-residents. This business was profitable to the United Kingdom but tied up large sums of foreign exchange, and the markets agreed to restrict those stocks which were, in effect, financed from the reserves. In 1972, when market conditions changed, the situation no longer gave concern, and the scheme was suspended.

Invisible earnings

The commodity markets contribute substantially to the United Kingdom's invisible earnings because they handle such a large volume of international trade. Moreover, foreigners use the London futures markets much more than UK residents use foreign futures markets, and taking one year with another there is probably a net inflow under this head also.

[1] The net loss on a trader's outstanding futures contracts caused by adverse price movements.

In order to estimate the markets' invisible earnings, the Bank asked for monthly returns for the year ended May 1975 from many traders in the principal UK international markets and from the International Commodities Clearing House. The returns cover merchanting profit on commodities, (i.e. the profit on goods bought from, and sold to, non-residents); brokers' commissions (for arranging the sale of goods between non-residents); commissions, deposits and 'differences', (i.e. profit or loss), arising from contracts placed by non-residents on the London futures markets, and corresponding items arising from contracts placed by UK residents on foreign futures markets.

The figures have not yet been fully processed, but will be published with a commentary in a subsequent issue of the *Bulletin.* Meanwhile, provisional estimates indicate that the commodity markets contribute about £100 million a year to invisible earnings – a welcome benefit to the balance of payments. The markets also contribute indirectly to our invisible earnings by bringing banking, shipping and insurance business to the City, and by providing services to UK importers and users of futures markets which otherwise would probably have to be sought, and paid for, abroad.

The estimate of £100 million is not, of course, also a measure of firms' profits because allowance must be made for costs incurred in the United Kingdom. Indeed, the net profit margin on the large volume of international trade in commodities which is handled by our traders is small, as it needs to be if our markets are to remain competitive and to continue to flourish.

Observance of contracts

The recent period of volatile prices has prompted a small minority of foreign clients to default on forward contracts (sometimes with the tacit consent of their governments) when it has suited their interest to do so. There have also been a number of apparently unjustified declarations of *force majeure,* either by governments, state trading bodies or private companies. Such breaches of contract have led to numerous arbitration cases, and other cases have been brought with the main object of delaying payment; many have been taken to appeal. UK panels of arbiters have been exceptionally busy, because the UK associations' contracts are used worldwide.

In some instances arbitration awards have been repudiated at a cost to UK traders, who for their part have stood by their contractual obligations. Such adherence to contract emphasises the usefulness in commodity marketing of well-established trading centres whose members' business reputation is beyond doubt. But ultimately trade can flow efficiently only in conditions where all parties respect their obligations.

Financial problems

The markets have had other financial problems in recent years. More working capital was required when commodity prices rose; high interest rates and inflation added to costs; and the larger sums of money required to settle both physical and futures transactions made heavy demands on financial management and on market clearing systems. There were several heavy losses, but in London only one failure of any significance. On the whole, the markets came through a difficult period very well.

Supervision of the markets

Since the United Kingdom's international commodity markets reopened after the war, the Bank have monitored the exchange control concessions given to participants in the commodity schemes and have generally supervised the activities of the markets concerned. The Bank's supervisory powers are based on the exchange control schemes and on the Memoranda of Understanding with the market associations (listed in the appendix).

Briefly, under the original memoranda the associations undertook to maintain and exercise self-regulatory powers in consultation with the Bank – an arrangement implemented by regular, formal meetings with each market, by day-to-day informal contacts, and by monthly exchange control returns showing the position of each trader participating in a scheme. In their general supervision, the Bank were mainly concerned to preserve the financial stability of the futures markets and to avoid undesirable speculation. Mutual confidence has developed between the markets and the Bank and, although there have been occasions when the Bank felt obliged to intervene, the system can be said to have worked well over the years. Nevertheless, the volatility of prices in 1973 and 1974 caused the financial stability of futures markets to be called into question; and the Bank, after reviewing the existing arrangements, called for more frequent and detailed statistics. They also sought to strengthen their liaison with the markets without taking from them their responsibility for self-regulation.

A system of more intensive supervision has now been established, based on new Memoranda of Understanding between the Bank and certain market associations concerned with the operation of exchange control schemes. With the ready assistance of the International Commodities Clearing House, the London Metal Exchange and the Grain and Feed Trade Association, there are now regular consultations on traders' positions. Within the Bank, responsibility for market supervision has been concentrated in the Exchange Control Department. An Adviser in this department now works exclusively on commodity matters; under his direction the Commodity Section of the Commercial Payments Office, drawing on experience gained in monitoring exchange control returns, analyses the additional data provided by the markets and records much more information. As might be expected, its attention tends to be concentrated upon the London Metal Exchange and the more active of the futures markets in Mark Lane, but all the markets are subject to greater statistical analysis. It is now possible to examine records which show the regular pattern of business entered into by the various commodity firms: any sudden variation in volume or change of direction thus becomes apparent and provokes enquiry.

The new system has been in operation for about a year, and the revised methods of supervision have not yet been fully tested. On occasion, however, the new machinery has proved its value. For example, the International Commodities Clearing House satisfactorily coped with difficulties in the cocoa futures market arising from occasional shortages of physical supplies when delivery was due on outstanding contracts; and in July, when reports of a severe frost in Brazil caused coffee prices to fluctuate violently, deposits on futures contracts were increased and additional financial safeguards introduced. Another encouraging feature of this period was that the London Metal Exchange, in consultation with the Bank, examined proposals for bringing their own particular system of financial management more into line with the system used in the other markets.

The Bank will keep the new arrangements under constant review.

Overseas futures markets

Futures markets overseas have also been active, particularly in the United States, where federal supervision of futures trading, exercised since 1936 over markets in domestically produced agricultural commodities, has recently been extended to markets in other products. New legislation has been enacted, and the former supervisory body is being replaced with a five-man Commodity Futures Trade Commission working with a greatly increased staff of several hundred. The Bank are in regular touch with the supervisory authorities in the United States.

The need for sound financial management and supervision has clearly been recognised by the authorities in Paris, where there are three relatively small futures markets. Of these, the white sugar market, where turnover rose sharply during 1974, ran into difficulties late in the year: the Caisse de Liquidation (the French clearing house) failed to ensure the payment of margins by certain continental speculators who were caught with overbought positions when prices fell. The market was closed suddenly on 3rd December and a basis of settlement proposed which would have been greatly to the disadvantage of traders who had made hedging sales in response to the sugar situation in the EEC and elsewhere. Legal action followed and the situation had not been resolved by early September. New rules are being worked out for the Paris markets, which had suffered a severe loss of confidence, and there are proposals for a new clearing house. Meanwhile, as mentioned earlier, facilities for white sugar trading have been provided in London.

The international scene

The maintenance of orderly marketing in physical and futures trade is only one of the problems on the international commodity scene. The developing countries among the primary producers are especially vulnerable to fluctuations in commodity prices, which can cause big swings in export earnings and so in their capacity to import; and the poorest countries, which not only rely on imports of capital goods for industrial development, but are often net importers of commodities, are even more exposed. These difficulties have persisted despite the many years of work on commodity agreements, and despite the existence of special International Monetary Fund facilities.

Developing countries have therefore been urgently seeking new ways of stabilising the prices of their primary products and hence their earnings, and of improving their terms of trade. A practical response has come from the EEC countries which, under the terms of the Lomé Convention, have offered greater access to the products of the forty-six African, Caribbean and Pacific (ACP) countries. The Convention included the Stabex Scheme – a limited arrangement designed to stabilise earnings from certain exports to the EEC, and offering favourable terms. During the past year there have been discussions in UN fora, including the UNCTAD Committee on Commodities, and also in the OECD, the EEC, and among Commonwealth countries. These various discussions are likely to culminate in the fourth conference of UNCTAD in May 1976.

Developments last year included a programme proposed by UNCTAD for a multi-commodity buffer stock, holding up to eighteen commodities and financed by a common fund of $11 billion to be provided by producing and consuming countries, oil-exporting countries and international bodies; and for long-term supply contracts, compensation for falls in export earnings from commodities, and more processing of commodities in the producing countries. The UNCTAD Secretariat recently modified their programme, reducing the number of commodities in the buffer stock to ten and the common fund to $6 billion, with individual commodity organisations retaining more freedom of action. A number of developing countries have also shown a strong interest in a form of indexation whereby the prices of their commodities would be automatically linked to the prices of the manufactured goods which they import.

A UK initiative was launched by the Prime Minister at the meeting of Commonwealth Heads of Government in Jamaica last May. Briefly, the United Kingdom sought general agreement on a number of principles, in particular a recognition that producers and consumers were interdependent. Practical measures proposed included better exchanges of information on prospective supply and demand; the development of producer/consumer associations; the encouragement of agreements to promote the orderly conduct and development of trade by whatever means were most suited to individual commodities; international agreements to stabilise prices within an accepted range; and the establishment of a scheme to stabilise export earnings of developing producers.

A wide range of interests and attitudes exists, but there is common ground between the developing and the developed countries, and the task is to build on this common ground and reconcile the differences. This will not be easy: there is no single solution which can be applied uniformly across the diverse field of commodities or which can meet the different needs of all developing countries. But success in moderating fluctuations in commodity prices and the earnings of developing countries would make a valuable contribution to economic co-operation between the industrialised nations and the Third World.

Appendix

The following list of associations relates to the UK commodity markets mentioned in the article. There are many other market associations in the United Kingdom.

Commodity	Associations	Futures market associations
Cocoa	Cocoa Association of London Ltd	London Cocoa Terminal Market Association
Coffee	Coffee Trade Federation	Coffee Terminal Market Association of London
Cotton	Liverpool Cotton Association Ltd	
Grains and feeding-stuffs	Grain & Feed Trade Association Ltd	GAFTA Soya Bean Meal Futures Association; London Grain Futures and Clearing House
Non-ferrous metals	London Metal Exchange	London Metal Exchange
Rubber	Rubber Trade Association of London	London Rubber Terminal Market Association
Sugar	Sugar Association of London	United Terminal Sugar Market Association
Vegetable oils and oil seeds, animal fats and marine oils	Federation of Oils, Seeds and Fats Associations Ltd	London Vegetable Oil Terminal Market Association
Wool	British Wool Confederation	London Wool Terminal Market Association