Invisible earnings of the UK commodity markets

It was reported in an article in the September 1975 issue of the *Bulletin* (page 246) that in May 1974 the Bank, with the support of the Federation of Commodity Associations, had undertaken a survey into the contribution of the commodity markets to the United Kingdom's invisible earnings. The survey was designed to provide an up-to-date estimate of earnings from the large physical trade in commodities between foreign countries which is handled by UK firms, and also to show the effects on the balance of payments of futures transactions (in which not only commodity firms, but other UK residents participate). This article gives the results of the survey for the period from June 1974 to May 1976. The co-operation of the many firms which took part in it is much appreciated.

For the purpose of the survey, 'physical trade' covers firms' activities as brokers (i.e. matching sellers with buyers) or as agents, for which they earn a commission, or as merchants (i.e. themselves buying and selling, usually for forward delivery), on which they seek a profit. To conform with balance of payments accounting conventions, earnings from physical trade include changes in the volume and market price of stocks which merchants hold abroad for resale.

Operations in commodity futures markets serve primarily to insure against price risks. Merchants, producers and consumers buy and sell futures contracts to offset uncovered commitments in the physical commodity so that, if prices change, gains (or losses) in one match losses (or gains) in the other. Gains and losses on futures transactions are known as 'differences'. Invisible earnings from UK futures markets consist of the commissions received from overseas residents when they buy and sell contracts, and the net differences which UK residents collectively receive from, or pay to, the overseas residents who use those markets. Similarly, on overseas futures markets UK residents pay commissions and pay or receive differences.

The survey concentrated mainly on the commodity market associations with which the Bank have close connexions through exchange control. The commodities covered [1] account for the greater part of UK firms' turnover in, and earnings from, physical trade between foreign countries in all commodities and effectively for all futures transactions. Firms accounting for virtually the whole of the trade in question submitted returns relating to the year ended May 1975. A number (the 'selected firms') agreed to provide returns for a further period in order to give an indication of how earnings vary: their figures for June 1975–May 1976 make it possible to estimate the range within which total earnings for that year probably lay.

The scope of the survey and the types of transaction covered are described in the appendix. This article does not consider all the ways in which the activities of commodity traders directly affect the balance of payments; nor does it consider the indirect costs and benefits of the use of sterling to finance third-country trade.

Summary of results

The results of the survey are set out in the tables. Table A, which relates to all respondents, shows reported earnings in the year to May 1975 from three groups of commodities (foods, fibres and other industrial raw materials), together with an estimated range of total earnings for the following year. Table B gives figures for selected firms for both years. For some commodities, stocks held abroad for resale

[1] Foods: cocoa, coffee, feedstuffs, grains, oils, seeds and fats, sugar.
Fibres: cotton, jute, sisal and allied fibres, wool.
Other industrial raw materials: copper, lead, silver, tin, zinc (all reported by members of the London Metal Exchange), rubber.

changed considerably during the two years, and earnings from physical trade are shown before and after adjusting for changes in the value of these stocks (see below and the appendix); the total column includes the stock adjustment.[1]

For 1974/75, earnings from physical trade after stock adjustment (where the margin of error is greatest, in both the reported figures and the stock adjustment) and the inflow from all futures transactions are each estimated at over £90 million, thus providing a total benefit to the United Kingdom of some £180 million. For 1975/76, the figures for selected firms indicate that total earnings were rather larger, probably within the range of £200–250 million. Large fluctuations are to be expected; in particular, there might well be a net outflow from 'differences' in some years.

Earnings from physical trade

To produce figures which conform to balance of payments definitions raises considerable problems for reporting firms (see appendix), and earnings from physical trade cannot be estimated at all accurately.

The importance of changes in stocks has already been mentioned: metals were particularly affected, because in times of surplus the London Metal Exchange is an important financing medium for stocks, which built up rapidly after the middle of 1974. In both years of the survey, the figures reported by members of the Exchange had been sharply reduced by payments for additions to stocks abroad. The offsetting adjustment was itself reduced by a fall in prices in 1974/75, but increased by a rise in prices in 1975/76. The effects of stock changes in other commodities were relatively unimportant in 1974/75, but became more pronounced in the following year, when large positive adjustments were made to reported earnings from trade in foods and fibres. In 1975/76, much of the adjustment was to allow for price increases stemming from sterling's depreciation. The following general comments are based on the adjusted figures and on information provided by traders.

In 1974/75, the effects of the world recession and falling prices were partly offset by other factors – in particular, earnings from sugar and metals benefited from forward sales made earlier at higher prices. The principal earners were (among foods) sugar, followed by cocoa and, elsewhere, metals.

The recession continued in the early part of the second year under review, but economic activity began to recover from the third quarter of 1975, and the prices of a number of industrial raw materials turned up. Among foods, price movements varied widely, with coffee and cocoa rising sharply but sugar tending to fall on balance. The available evidence suggests that earnings from physical trade were larger than in the previous year. Results appear to have varied from commodity to commodity, but earnings were reported to be higher in coffee, animal feedstuffs and metals.

The information about physical trade suggests that margins from brokerage and agency business are typically ½% of the value of the goods, and from merchanting usually between 1% and 3%, though they can be higher. In merchanting, virtually all purchases, and most sales, are for cash against documents; but in some cases the overseas buyer himself will have refinanced his purchase with a London bank. The earnings figures exclude the cost of any credit granted over and above the merchant's normal terms of cash against documents, but they cover finance for the basic period of a few days during which merchants are awaiting payment. Other expenses also have to be met, and the earnings figures are not therefore a measure of net profits to the traders.

[1] Not all increases in the value of stocks are realised, because of forward sales made at lower prices; the converse would also be true.

Commissions earned on UK futures markets

Turnover was fairly heavy on some of the main UK futures markets during the first year of the survey, when prices changed rapidly. Commissions (including premiums on 'options' – see appendix) earned from overseas residents totalled £14 million, mostly from cocoa, metals and sugar. In the second year, a decline in commissions from the placing of futures contracts seems to have been outweighed by much larger receipts of premiums for options in cocoa, coffee and sugar.

Commissions on the placing of contracts are usually between ⅛% and ½% of value. Premiums for options vary widely according to market conditions.

'Differences' on UK futures markets

'Differences' (i.e. gains and losses) on futures contracts placed on UK markets produced a net inflow of some £95 million in the first year of the survey. The largest inflow came from sugar: early in the year overseas residents had net long positions (i.e. purchase contracts), and the liquidation of these positions led to large outflows from the United Kingdom up to the time of peak prices in November 1974, but to even greater inflows in later months as prices fell. A moderate outflow was reported for cocoa. The London Metal Exchange reported a large inflow, mainly in the first few months, because of the liquidation of long positions taken up by overseas residents near the time of peak prices earlier in 1974.

During the second year, when changes in many prices were smaller, the total inflow into the United Kingdom apparently declined. Small outflows were reported for several commodities, but foods as a whole appear to have generated a further sizable inflow.

'Differences' (and commissions) on overseas futures markets

UK operations on overseas futures markets are fairly small compared with overseas residents' operations on UK markets and are estimated to have produced an outflow in 1974/75 of £20 million for foods as a group, and of £16 million for all commodities taken together. During the second year the net movement was negligible.

Conclusion

The results of the survey confirm that operations in commodity markets have made a substantial contribution to the United Kingdom's invisible earnings. The amount of the contribution may, however, vary widely from year to year, e.g. the large inflow from 'differences' on futures contracts, such as occurred in 1974/75, should not be regarded as typical. But a sizable net income may be expected regularly from physical trade and from commissions for the placing of futures contracts.

Appendix

The method of the survey

Coverage

Two hundred and twenty commodity firms, including almost all the important members of the principal markets, agreed to submit monthly returns of invisible earnings from physical trade and from futures transactions during the year beginning June 1974. The International Commodities Clearing House (see below) also agreed to co-operate. The commodities covered are listed in the footnote to page 34. Some information was obtained on other commodities, but not enough to warrant inclusion in the results.

Towards the end of the year covered by the survey, forty-six firms reporting the largest figures, together with the International Commodities Clearing House, agreed to submit returns for a further period. The coverage varied from over ten firms for commodities showing large earnings to one or two for the less important commodities.

Earnings from physical trade

This entry was designed to cover physical trade between foreign countries and to include commissions on brokerage and agency business, together with profit from merchanting. The London Metal Exchange conducts business in 'warrants' representing title to metal in warehouses (mostly on the Continent), and members reported such business as well as ordinary physical trade. Firms were asked to exclude the following elements:

(i) payments and receipts in respect of goods which were imported into, or exported from, the United Kingdom;
(ii) insurance and freight when goods were bought f.o.b. and sold c.i.f.;
(iii) expenditure on promoting business overseas, such as travel, costs of representation etc;
(iv) profits of branches and subsidiaries abroad.

It proved difficult for many firms to calculate earnings defined in this way, because their accounting systems had been designed to provide different information. Particular problems arose over the inclusion of payments for imports and for goods whose ultimate destination was uncertain; over transactions in which there was more than one UK intermediary; and over settlements by a UK resident on behalf of an overseas party. Also, certain items reported within receipts, such as charges for processing arranged by the merchant, were not part of earnings from physical trade in commodities. In most of the cases which attracted notice, a reasonably satisfactory method of reporting was established, but it was not possible to consult all firms or always to revise earlier figures accurately, and some misclassification was no doubt undetected.

When the survey was being prepared, it was seen to be impracticable to ask firms to allow for changes in credit or in stocks temporarily held abroad for resale, in order to make the figures correspond more closely to the definition of invisible earnings. Although a few instances of changes in length of credit and rather more of changes in the volume of credit were reported, such information did not allow adequate adjustments to be made on this score.

However, for most commodities broad adjustments could be made for changes in stocks held overseas, by using returns supplied to the Bank for exchange control purposes. These adjustments follow general balance of payments accounting conventions. For example, a payment to an overseas resident by a trader for stocks held abroad should have no net effect on invisible earnings: the reported figures, however, would show an outflow, so an adjustment is made, based on the estimated addition to the value of stocks held abroad. This adjustment must have a counterpart in an opposite entry in the capital account of the balance of payments, representing the notional outward investment implicit in an increase in current assets overseas. A rise in the value of stocks solely on account of price is also represented as an invisible earning matched by outward investment. The converse applies when stock values fall. These adjustments are subject to considerable margins of error because the exact volume of stocks and the correct average prices are not known. However, such errors will tend to balance out in successive periods.

Transactions on futures markets

Transactions on these markets comprise the buying and selling of futures contracts (for delivery up to many months ahead), essentially to cover price risks ('hedging'), but also for other purposes connected with trade; there is usually an element of speculation as well. Contracts have to be placed through members of the futures market concerned, who charge a commission to clients. (In the UK markets, most members also engage in physical trade.) The contracts are normally terminated before maturity, with the holder receiving any profits or paying any losses (known as 'differences') arising from price movements.

All domestic and overseas residents can use the UK futures markets, all of which were covered by the survey: cocoa, coffee, grains (wheat and barley), metals (the London Metal Exchange), rubber, soyabean meal, sugar, vegetable oils and wool. Certain overseas transactions on those UK markets which have clearing arrangements with the International Commodities Clearing House (i.e. all except the London Metal Exchange and the grains markets) were reported by the Clearing House. This was because overseas members of the Clearing House can have contracts registered in their own names instead of in the names of the firms through which they deal; and in such cases, commissions and differences are settled direct with the Clearing House.

Commodity firms and other UK residents with a trading interest in commodities make use – subject to exchange control regulations – of the overseas futures markets (mainly those in the United States), but much less than overseas residents use UK markets.

Commissions earned on UK futures markets

On UK futures markets, commission on the placing of contracts is a fixed sum for some commodities, but for others is calculated as a percentage. In the survey, this item included premiums paid for 'options' (i.e. the right to take up futures contracts at a fixed price during a given period ahead). Amounts were reported net of sharing of commissions with overseas residents.

Differences on UK futures markets

These were usually reported net at the termination of contracts, even though money might have passed earlier as prices changed.

Commissions and 'differences' on overseas futures markets

This is a combined total of payments and receipts by UK residents in respect of their transactions on overseas futures markets. Commissions were not considered important enough to justify a separate heading in the returns.

Commodities: invisible earnings, June 1974–May 1976

(– indicates an outflow from the United Kingdom)

£ millions

	UK firms' earnings from physical trade: Excluding changes in value of stocks held abroad	UK firms' earnings from physical trade: Including changes in value of stocks held abroad	Overseas residents' operations on UK futures markets: Commissions paid to UK residents	Overseas residents' operations on UK futures markets: Flow of 'differences'	UK residents' operations on overseas futures markets	Total (columns 2 to 5)
Table A	*1*	*2*	*3*	*4*	*5*	*6*
All reporting firms						
June 1974–May 1975						
Food	49	43	8	55	–20	86
Fibres	18	16	–	–	3	19
Other industrial raw materials	–12	32	6	39	2	79
Total	55	91	14	94	–16	184
June 1975–May 1976						
Total						200–250[a]
Table B						
Selected firms						
June 1974–May 1976						
Foods:						
1st year	52	49	7	48	–20	84
2nd year	51	68	11	21	–	100
Fibres:						
1st year	15	13	–	–	2	15
2nd year	9	17	–	–	– 1	16
Other industrial raw materials:						
1st year	– 5	28	5	32	1	66
2nd year	11	69	3	3	1	76
Total						
1st year	62	90	13	80	–17	166
2nd year	71	154	15	25	–	193

– nil or less than £500,000.

[a] Estimate derived from figures of selected firms (see Table B). Includes an allowance of +£100 million for changes in the value of stocks held abroad for resale.