IMPROVING EFFICIENCY IN THE COCOA MARKET

My name is Guy Sneyers and I will elaborate on ways and means to improve market efficiency in the cocoa sector. I make this presentation on behalf of the Common Fund for Commodities (CFC) and its Acting Managing Director. I would like to thank to thank the Government of Côte d'Ivoire and in particular the Embassy of Côte d'Ivoire in The Netherlands for inviting CFC to this event and ICCO for their efforts in organizing this event. I have always worked for development institutions starting with the United Nations Development Programme in 1980 followed by a long assignment in the Food and Agriculture Organization of the UN and since 6 years I work on commodity development in CFC. As the name indicates we deal with commodities, mainly agricultural commodities but also some base metals. Cocoa is one of the most important commodities we deal with, to the extent that since 1993 to date we have committed over 16 million US dollars for cocoa projects in our programme.

CFC is a development Organization which has subscribed to two major goals agreed upon by the International Community in the form of the Millennium Development Goals. These goals are to alleviate poverty and ensure food security for the world by 2015. In the framework of the CFC approach, we support these goals by promoting equitable gains from production and trade of commodities in today's global markets. Most of my presentation will elaborate on the market efficiency problems of the African cocoa sector. There two main reasons for this prominent place given to the African cocoa sector:

- Africa produces 71% of the world cocoa production followed by Asia (15%) and Latin America (14%);

- 13 out of 17 CFC cocoa projects were committed to cocoa development in Africa. I believe that the situation is similar in other development institutions.

Our aim in alleviating poverty is to help poor people to increase their income by providing seed money, sharing knowledge, building capacity and forging partnerships in the public and private sectors. In the cocoa sector CFC together with the ICCO promotes best practices available to date that could be upscaled and disseminated to help the lives of millions of cocoa farmers and workers.

On the supply side the cocoa sector is characterized by the small holdings. According to ICCO about 95% of the cocoa farmers are smallholder farmers. CFC believes that these smallholder farmers could be transformed into efficient commercial entrepreneurs if the current growth in demand for sustainable cocoa is maintained and if the cocoa supply chain is rationalized. On the demand side, the sector is characterized by the buyers, typically large scale international food or confectionary industry concerns. We believe that these private sector concerns accumulated considerable experience to play an important role in the cocoa economy and increasingly these concerns also invest into cocoa farming and share the profits with the rural communities. As a matter of fact we are convinced that the interests of poor cocoa farmers can be strengthened by cooperating with big business and investing in interventions of mutual benefit. The work for profit principle is inherent in every private sector undertaking be it farming, processing or trading. We are aware that these smallholder-industry exchanges can take numerous forms including outgrower production systems, contract farming, joint ventures with shared capital, social credits, credit guarantees, reimbursable interest free loans, loans etc.

It should be mentioned that all the credit instruments I just mentioned were always available as project financing instruments in the Fund but in practice grant funded projects took a more predominant role in CFC projects. CFC decided to change the course and provide a larger share of its financial support in the form of loans and other innovative debt and equity instruments. These instruments include loans, “returnable grants” (a zero interest loan to be repaid over a pre-determined period), equity, quasi equity, lines of credit and guarantees. The basis for this change of course is a strong determination to promote a more commercial, demand driven approach for CFC projects. Ultimately this will lead a more commercially sustainable enterprise based approach for commodity development interventions. We are convinced that this type of interventions can considerably improve the efficiency of the cocoa sector. If successful, the industry can further expand these interventions under Public Private sector Partnerships.

What are the challenges for the cocoa markets? In the first instance we see the structural problems in the sector which can be attributed to major supply side production constraints. I will elaborate on these later. On the structural side we recently observed considerable supply surpluses due primarily to favourable weather conditions in the major producing countries. However today analysts predict that production trend is declining and the gap between supply and demand will increase in future years. It is believed that the cocoa sector has entered a period of structural deficit. This may present a challenge to the sustainability of the entire industry.

The production constraints affecting the cocoa economy and creating the structural deficit are multifold and I will give some specifics along with possible solutions:

- As mentioned before cocoa is a smallholder crop. 95% of the cocoa produced in the world originates from small unorganized farmers mostly living below the poverty threshold. The solution is to increase organization of the farmers into effective producer associations established to get more bargaining power in the cocoa supply chain;
- The cocoa sector suffers from chronic under-investment. Commercial banks perceive investment into smallholder cocoa production to be highly risk prone. As a result, farmers lack access to affordable credit. The Government has better access to funds due to its ability to levy general taxes in most African villages or export taxes specifically for coffee and cocoa. It should invest some of these tax revenues in the cocoa sector and/or community development. The efficient use of this revenue should be supervised by the producer associations, the main exporters, the commercial banks and the Government;
- Due to ageing farmers, ageing trees and the lack of sustainable farming practices, stagnating yields and low productivity, cocoa production declines. The number of farmers engaged in cocoa production also dwindles due to the rural exodus to large African cities. The next generation of cocoa farmers abandoned cocoa production and only the old generation remains. The solution could be public private partnerships to invest in premium price quality cocoa and social community investments to ensure better living standards for the cocoa producer communities;
- Some farmers shift from cocoa to other commodities such as rubber and palm oil. Perhaps this can be avoided if cocoa farmers would get more competitive prices for their produce. Rubber and palm oil are also facing a situation of supply deficit but perhaps react to this situation in a

more flexible manner by stimulating production and investment in new plantations. Rubber and palm tree farmers were encouraged to be more efficient. In the cocoa sector these incentives either do not exist or if they exist, they are not very effective;

- In most countries, cocoa lacks market information dissemination and transparency for the benefit of the producers. In some countries Government led Cocoa Boards try to collect reliable information but generally the quality of the information remains poor. This weak link in the supply chain could be partially resolved by efficient price risk management systems/products (warehouse receipt credits, crop insurance etc);
- In most countries there is a lack of social standards in the form of child labour rules, gender issues and occupational health and hazard regulations. The absence of these standards mainly affects the cocoa producers but it is important that the consumers also address these constraints by agreeing on certification standards with the producers. In return of a guaranteed supply by the producers of certified total quality cocoa, meeting economic, social and environmentally criteria for cocoa, the consumers are commited to pay premium prices for the quality cocoa produced under the scheme.

All these factors which I just mentioned distort effective supply response to changing demand. The resulting inefficient cocoa market further presents a challenge to the sustainability of cocoa industry if the eventuality of long-term supply deficit in the cocoa sector is not addressed. I have tried to mention some solutions to address these constraints. The problems and the solutions were already known since quite some time, hence this chapter is not to be considered rocket science. One further factor which I have not mentioned so far is the problem of market volatility closely related to an increasing financialization of agricultural commodities. Some observers use words with negative connotations such as speculation to describe this problem which has also affected the cocoa sector. Solutions are not easy to identify and evidence is not conclusive on how futures market instruments impact on the physical markets in the short and long term. The problem was recognized by the international community and placed on the agenda of meetings such as the G-20 summit in Mexico, the United Nations and several other fora.

In December 2011, the General Assembly of the United Nations adopted a resolution calling for a high-level thematic debate on the issues of commodity market volatility. The Common Fund for Commodities was invited to participate and contribute to the debate, and, through its network of private sector commodity actors, facilitated the participation of the commodity finance sector. In 2012 CFC has helped a group of five private banks in setting up a public-private initiative (PPI) on commodity market volatility. It was agreed that, in principle, considerable scope existed for banks' involvement in supporting international measures in support of poor people affected by commodity market volatility. Banks have the instruments and experience necessary to make financial resources available for investment into physical commodity production capacity. Investment remains the only sustainable way to address the fundamental physical causes of global volatility in commodity markets.

The PPI participants could not agree on the interpretation of financialization of commodity markets. The debate on financialization is often context dependent (for instance the rising prices in food and oil crops) and not relevant for an objective, politically balanced debate. Moreover price volatility should not be confused with general price levels. Evidence from statistical analysis of market data contradicts some of the popular perceptions by revealing that the current volatility in commodity markets is not extremely high, but historically low. This development is surprising given extreme physical shocks experienced in a number of key commodity markets including cocoa. Futures markets are by their nature financial, therefore the subject of the debate is not the penetration of financial capital in commodity markets "*per se*" but the externalities involved in the process. There are also instances of extreme volatility in non-financialized commodity markets which demonstrate that financialization is not the only explanation for volatility.

The debate in the PPI demonstrates that the issue of the commodity market volatility has become a global issue. The CFC suggests that vulnerable countries need to develop their capacity to deal with globalized markets and this should be supported through public-private partnerships. The development of this capacity primarily requires investment in knowledge, skills and broad financial and physical infrastructure. Practical actions should address:

- **<u>Cocoa market information</u>**. As mentioned before the cocoa market is not transparent for the producers. This can only improve by initiating large scale market information dissemination activities. The open question is: who should collect information and manage such a Market Information Services (MIS) system. The smallholder farmers badly need this information to mitigate price risks. The demand side has an in built interest to keep price information secret. The producing country Governments have cocoa development organizations which are already collecting statistics relating to production, trade and prices but the quality of the information is poor and quite often they have not disseminated this information to their producers. At the global level ICCO disseminates statistics but how much of this information is useful for smallholder cocoa producers. For wheat, maize, rice and soybeans the G-20 has set up an Agricultural Market Information System (AMIS) in FAO to collect information and monitor these markets. AMIS is not available for other commodities.

- **Cocoa risk management**. Affordable and locally feasible hedging instruments should be made available to developing countries. This includes the experience of CFC and some other agencies in terms of providing such instruments to primary producers. However can also be observed that the economics of most crop insurance schemes in developed countries required government subsidies of around 75%, which demonstrated the practical difficulties in building effective pure market based insurance schemes for commodity risk management.
- **Training in the use of appropriate financial instruments for cocoa production and value addition**. This includes education and capacity building for effective use of financial instruments at the primary producer level.

This concludes my presentation on the constraints hampering the efficiency of the cocoa market. I have tried to provide some solutions to address these constraints. The production constraints need to be addressed as a matter of priority since they affect the sustainability of the entire African cocoa economy. The cocoa sector is also affected by the issue of market volatility which needs to be recognized as a problem by the international community. CFC is addressing both issues through its projects and through interventions in the international policy bodies. Project implementation and interventions on market volatility are not the exclusive prerogative of either the private sector or the public sector. The solutions to address issues of cocoa market efficiency should be developed as Public Private sector Partnerships.