

The Demand for Price Risk management in Cotton¹

Joe C.B. Kabissa

Director General, Tanzania Cotton Lint and Seed Board

Tanzania is still heavily dependent on primary commodities for its economic growth. However, its contribution of such commodities to the world market is rather small. Tanzania is thus a price taker. With regard to cotton, there are supply - side constraints as well, as reflected by extremely low yields obtainable per ha. Consequently price shocks at the world market level may have far reaching economic and political consequences given this heavy dependency on commodities.

In the past, the government intervened through marketing boards in order to mitigate adverse effects associated with cotton price shocks. This burden, however, has now been shifted directly onto traders and farmers following the recent market reforms. Smallholders on one hand have not only lost guaranteed fixed prices but are now becoming increasingly exposed to uncertain price movements. Traders, on the other hand, most of who have only recently become involved in cotton trade, are mere novices who prefer to sell on a spot rather than on the futures market. Thus they are unable to achieve price protection.

During the 2004/05 marketing season, something unique happened which may serve to illustrate why both smallholders and traders need price protection against price shocks. Last October, cotton prices on the world market rose to about 79 cents per pound following a shortfall in production in China as a result of adverse weather. A reign of high prices which ensued thereafter prompted a handful of ginneries in Tanzania to sell some of their bales ahead of time. However, the majority did not do so and instead decided to wait in anticipation that prices would continue to rise. Unfortunately, at the start of the buying season in late June 2004, prices had fallen to levels not different from last year in June. These traders are thus unable to pass onto farmers the benefits they would have gained had they sold their cotton ahead of time.

Farmers on the other hand, have also been treated to a shock. Since the 1999/00 season, they have been selling their seed cotton at a price equal to

¹ Presented at the EU-Africa Cotton Forum, Session 5, Paris, 5-6 July, 2004

or greater than a floor price set jointly by the cotton board and traders just prior to announcement of the start of the buying season. Often times, farm gate prices have tended to rise steeply above the floor price due to stiff price competition amongst cotton traders. This has tended to occur because for the past four seasons, there has been a mismatch between supply and demand of cotton in Tanzania. These seasons have further been characterized by farm gate prices never falling below the floor price but going up instead. As a result, farmers have as a rule, resorted to selling their cotton much later than necessary in order to lock in on high prices that are achievable towards the end of the buying season.

What is going to happen this season is that given the projected falling of prices on the world market, farm gate prices will for the first time drop to levels below the floor price. This is going to happen when Tanzania is bracing up for a record output in post reform era. What is yet to be known is how farmers will react to this dramatic turn of events given that over the past five years they have been selling their cotton at increasing prices.

The need for price protection

In Tanzania, cotton is grown in two major contrasting areas, designated the western and eastern cotton growing areas respectively. In the former area, cotton is the only source of employment and cash. In both cotton growing areas, the decision on whether to grow cotton or not is dependent on prices paid to cotton relative to competing crops. Because of uncertainty as to the price farmers will receive after harvest, most farmers often tend to intercrop cotton with competing crops. It is to be noted though that, the need to reduce their exposure to fluctuations in the world market prices in order to better their income remains an overriding concern. Seasonal cotton price fluctuations have thus had a direct bearing on how much cotton is sown on an annual basis. In the past, farmer's organizations provided some protection but this service has almost disappeared following the liberalization of markets. Farmers no longer have this protection.

Cotton traders on the other tend to be wary of the risk associated with price shocks happening between the time of buying cotton from farmers and that of selling their lint to mills or cotton merchants. The scenario explained earlier on clearly illustrates the difficulties of buying on the spot market in an era of rapidly changing world prices.

Because of price risks involved, lending institutions now offer conditions to cotton traders prior to providing the financing for their operations. This is increasingly been done by most banks and in particular, CRDB, Exim and Standard Chartered as they also want to protect their own portfolio as exemplified by increased utilization of services offered by collateral firms. The need for secure lending is further reflected by increased demands from banks for proof of having sold forward (e.g. showing a sales contract) prior to their accessing financing from export credit guarantee schemes. This aspect of bank requirements for traders to opt for price protection is being pursued for all major commodities in Tanzania.

The future

Because traders who benefit from the use of price risk instruments by protecting their profits and securing financing may be expected to pass on some of the benefits to farmers, enhanced use of such tools is needed. This is a big task which would require sensitization, education and promotion. In this regard, the Cotton Board after noting increased rates of defaulting on contracts in recent years invited the Vice President of the Liverpool Cotton Association to come to Tanzania and conduct a seminar for cotton traders on aspects of good trading practices. But traders need to be introduced to the software and hardware of derivative markets. In this regard assistance from the EU and the World Bank is urgently needed.