

# ***REVIEW OF COMMODITY TRADING AND CHALLENGES TO VIABLE DERIVATIVES CONTRACTS IN TURKEY***

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# Aim of this study

- This study deals with
- the role of commodity exchanges in agricultural marketing in Turkey and
- its importance in transition to futures markets and
- licensed warehousing practices together with discussions on existing problems and suggestions for solution.

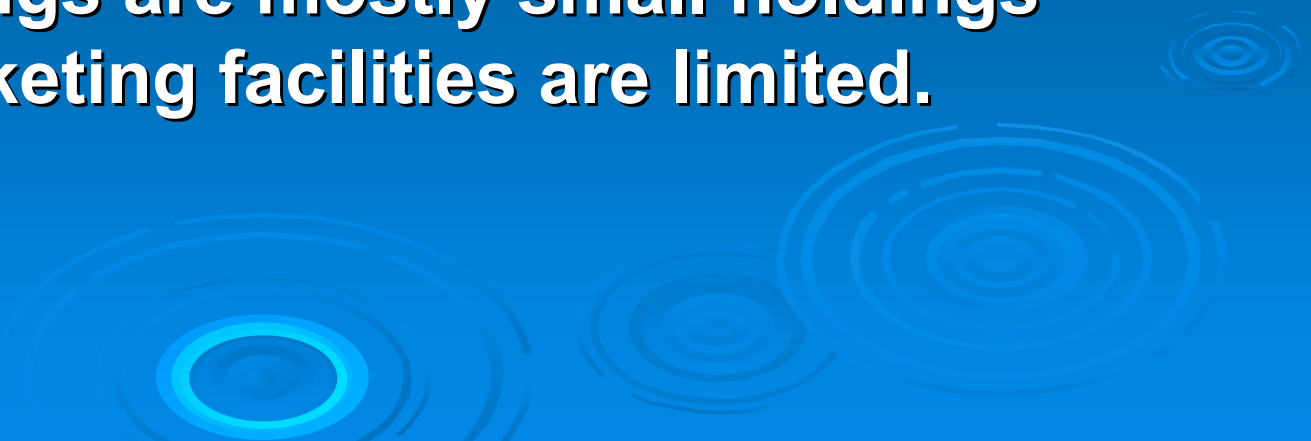
# Outline

- Structure of Turkish Agriculture
  - Agricultural marketing system in Turkey
  - Role of commodity exchanges in agricultural marketing system
  - Derivatives exchange and derivatives market
  - Licensed warehousing
  - Conclusions and suggestions for development of the sector
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# Structure of Turkish Agriculture

- **The farm holdings in Turkey consist of small family holdings,**
- **Agricultural activities are carried out by farmers and family members,**
- **The average land size of the farm holdings is small (6 ha) and their lands are considerably fragmented.**

# Structure of Turkish Agriculture

- **Farm holdings' need for operating capital is huge.**
  - **Conventional production is widely performed on the farms.**
  - **Input use and agricultural technology level is insufficient and factor efficiency is low.**
  - **Farm holdings are mostly small holdings whose marketing facilities are limited.**
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# Agricultural Marketing System in Turkey

- The marketing rate of agricultural products in Turkey varies from crop to crop.
- Agricultural crops generally reach to the consumer through various marketing channels.
- There are numbers of commission agents, traders, wholesalers, retails, exporters in these marketing channels.



# Agricultural Marketing System in Turkey

- Commodity exchanges play an important role in the marketing of such agricultural products as cereals, legumes, dry fruits and nuts, cotton, sunflower and live animals.
- About 20% of the supply of agricultural goods is transacted in commodity exchanges.
- Wheat and cotton lead the list of transacted goods.

# Commodity exchanges

- **Commodity exchanges are establishments of corporate identity established to engage in the trade of goods including setting, registering and announcing prices in line with the provisions of the Law no. 5174 .**

# **Agricultural Marketing System: Prices**

- **Since agriculture is climate-dependent as a sector, prices maintain a certain level during harvest seasons, but then rise until the next harvest.**
- **In goods that can be stored these price fluctuations may be contained through to a limited extent whereas in others no such opportunity exists.**

# Agricultural Marketing System: Prices

- State interference in the formation of prices of agricultural goods prevents pricing in free market conditions. Thus prices remain above world prices.
- In recent years radical measures were taken:
- Agricultural products covered by state purchase scheme were limited to cereals and hazel nut.
- The practice of financing supporting agencies directly or indirectly by the Central Bank was abandoned.

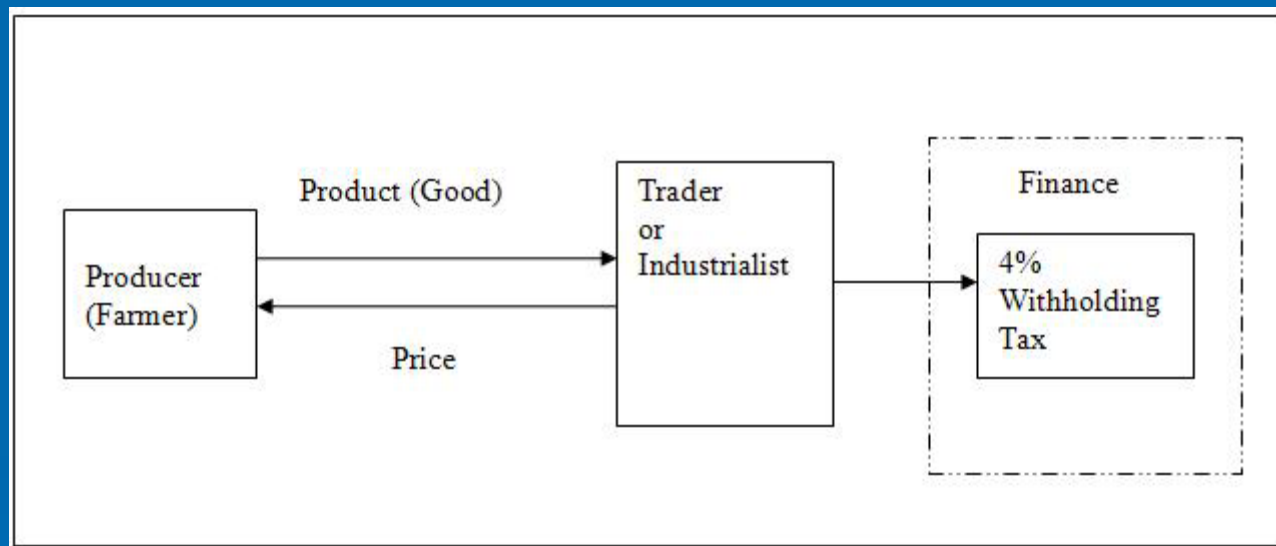
# Commodity Exchanges

- The “Project on the Promotion of Commodity Exchanges” was launched in 1999 in order to rearrange existing exchanges in cooperation with the FAO and World Bank and to create specialized commodity exchanges.
- Wheat and cotton were selected as pilot crops. Project on the Promotion of Commodity Exchanges was completed in 2003.
- The project covered the local commodity exchanges of Konya, Eskişehir, Polatlı and Edirne for wheat and İzmir, Adana and Şanlıurfa exchanges for cotton.

# Agricultural Goods: Possible Trade Channels

- **When agricultural goods are traded without any transaction in commodity exchanges, a withdrawing tax of 4% is payable to the Ministry of Finance. These are cases when traders buy goods directly from farmers.**

# Trade out of commodity exchange



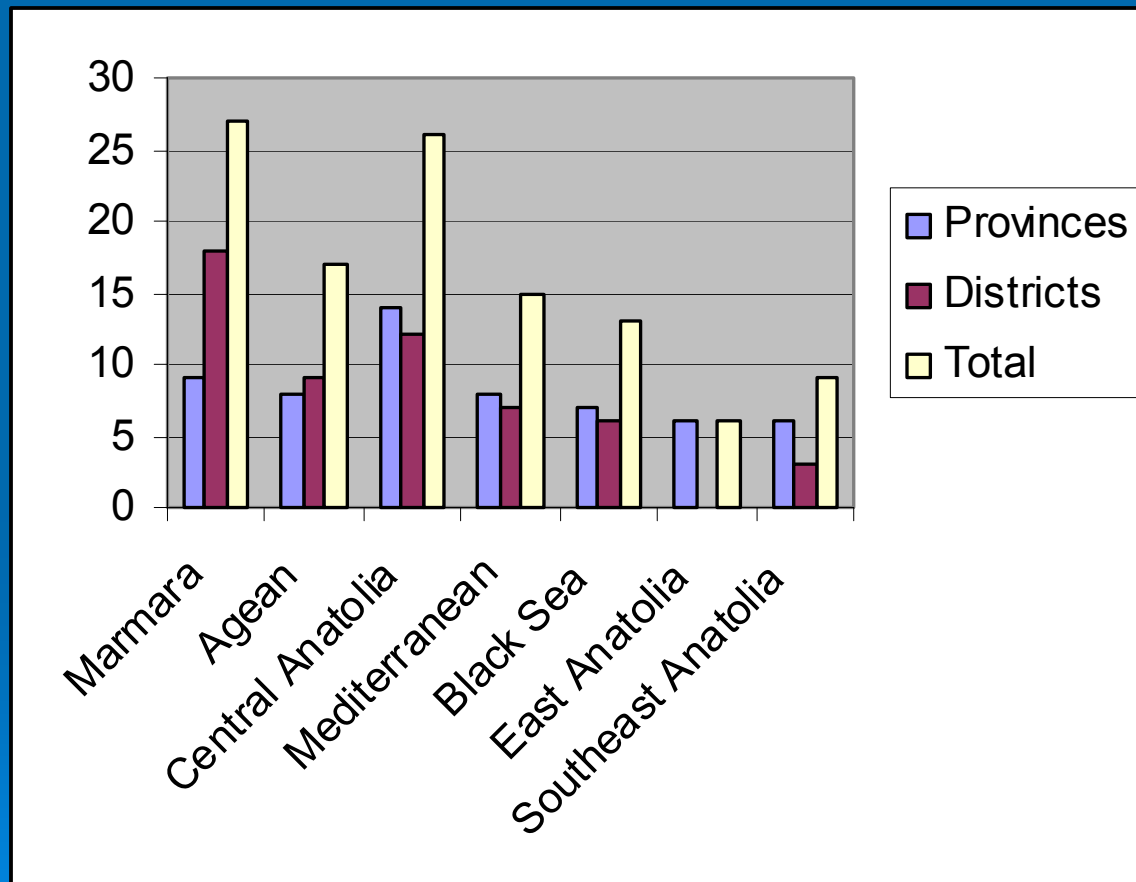
# Commodity Exchanges

- Under article 46 of the Law no. 5174, goods that go through transaction in commodity exchange have to be registered.
- A given commodity exchange charges a registration fee of 0.01 to 0.03% of the amount specified in invoice.

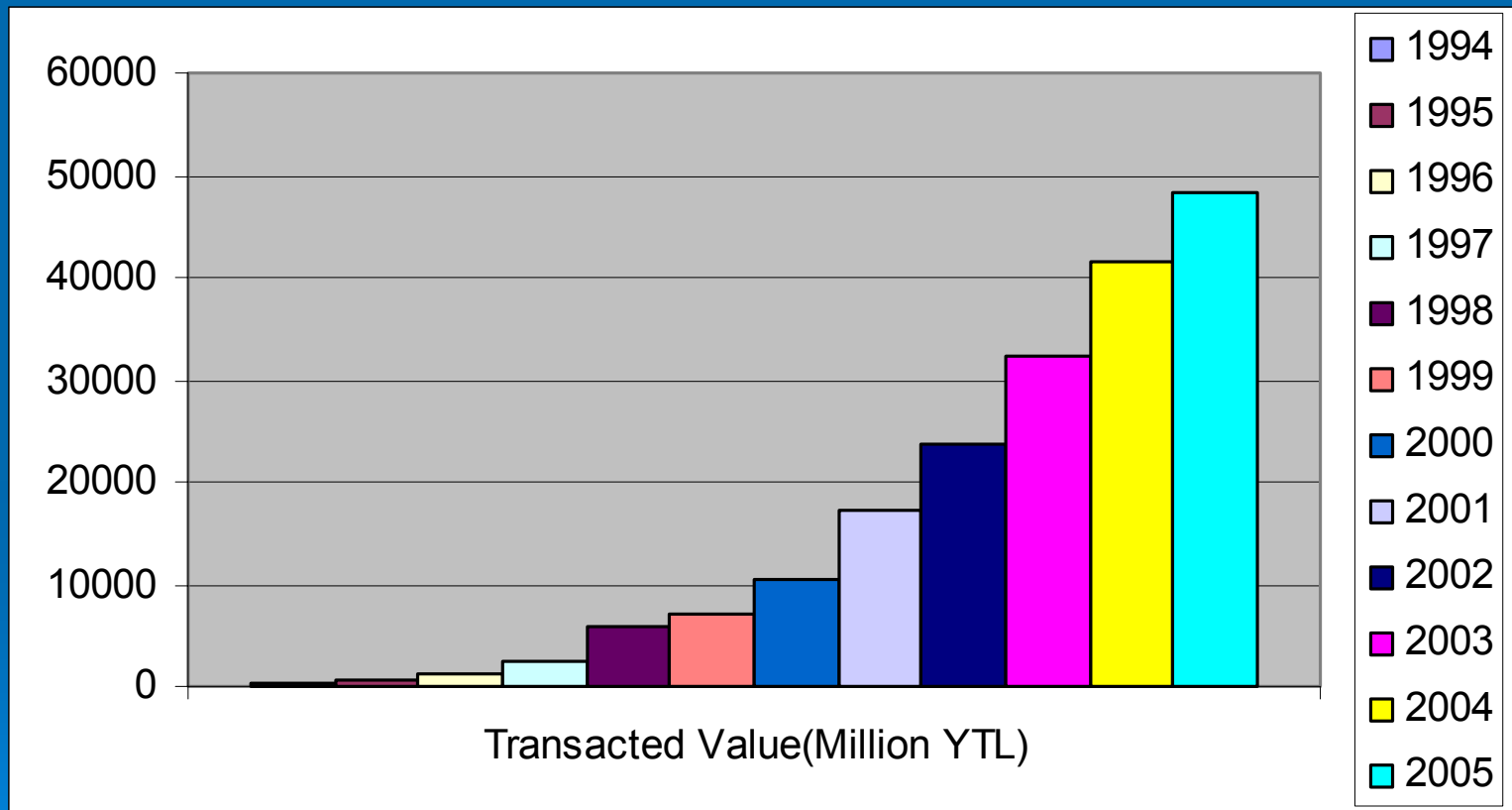
# Commodity Exchanges

- **Of 113 commodity exchanges presently active in Turkey at present, many are engaged only in this registration procedure.**
- **Significant amount of tax loss occurs since 80% of goods bypass commodity exchanges and registration.**

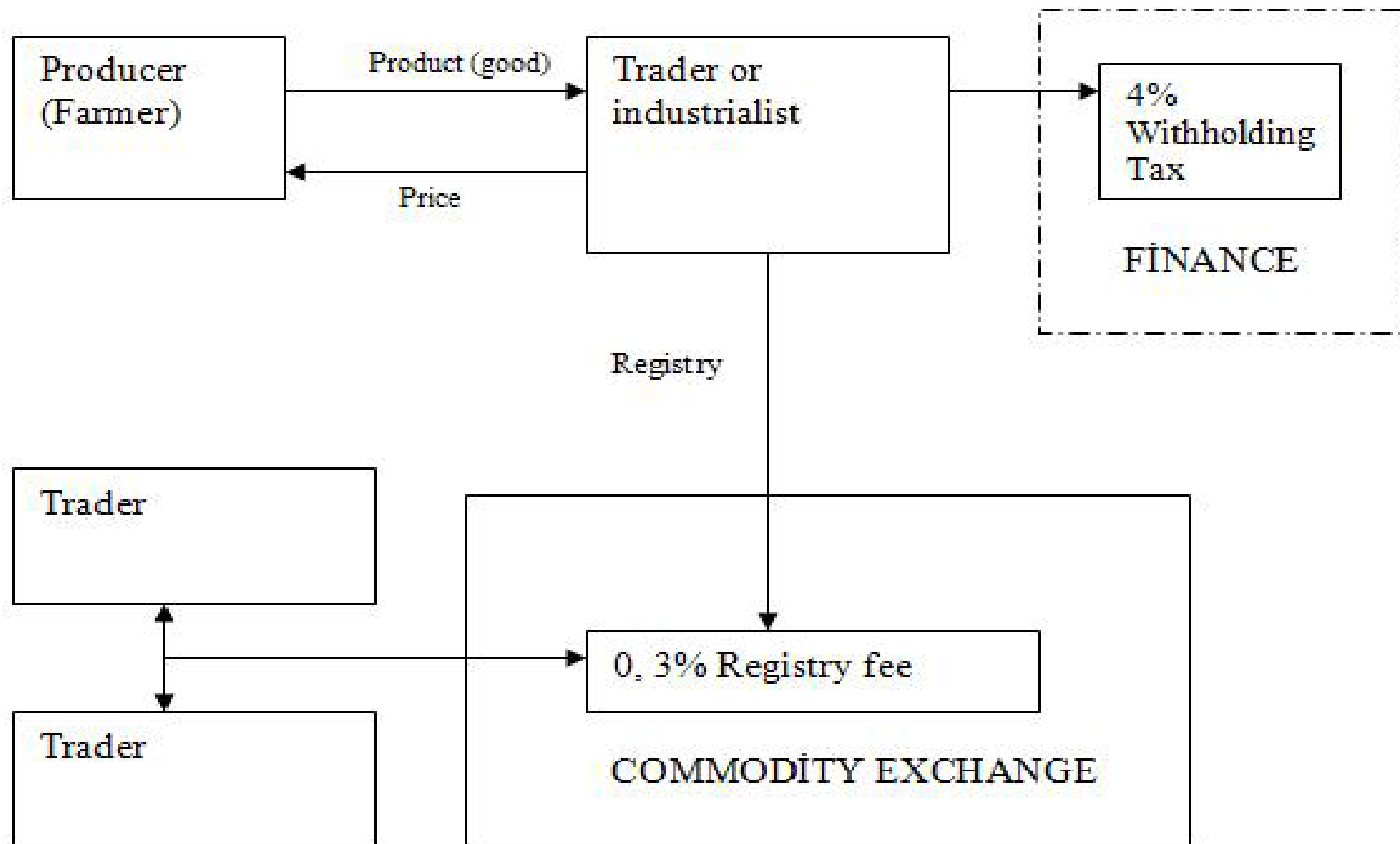
# Distribution of Commodity Exchanges by Regions



# Transacted Value of Commodity Exchanges



# Registration is made in Commodity Exchange



# Commodity Exchanges

- In commodity exchanges where there is sales hall, traders/industrialists examine samples provided by providers, offer a price and prices are set this way.

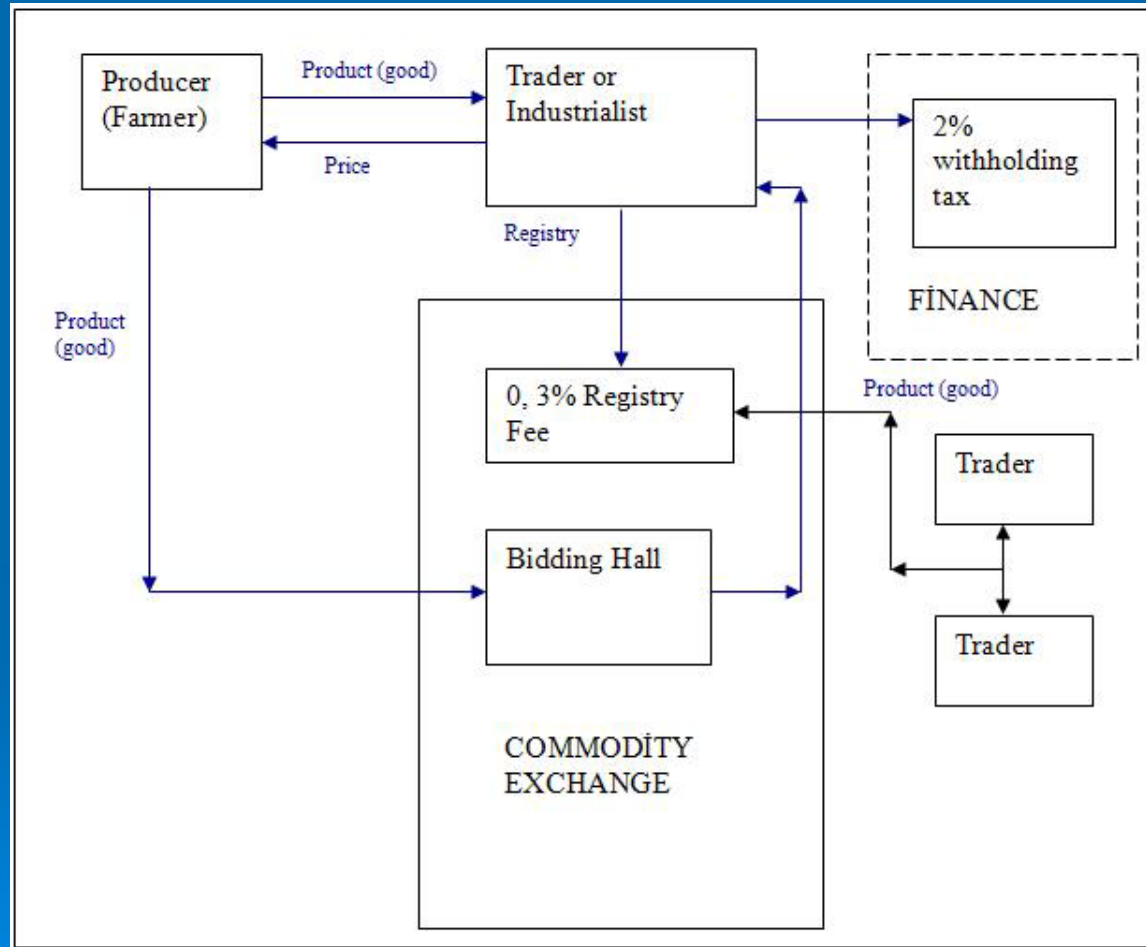
# Commodity Exchanges

- **In this system, samples taken from producers are exhibited to trades ready in the hall; then products are sold to the highest bidder and registered.**

# Advantages of the system:

- **Price is set as a result of competition by more than one buyer,**
- **Producers can make estimations about the worth of their goods by looking at sales figures,**

# Case where Open Transactions are made in Commodity Exchange



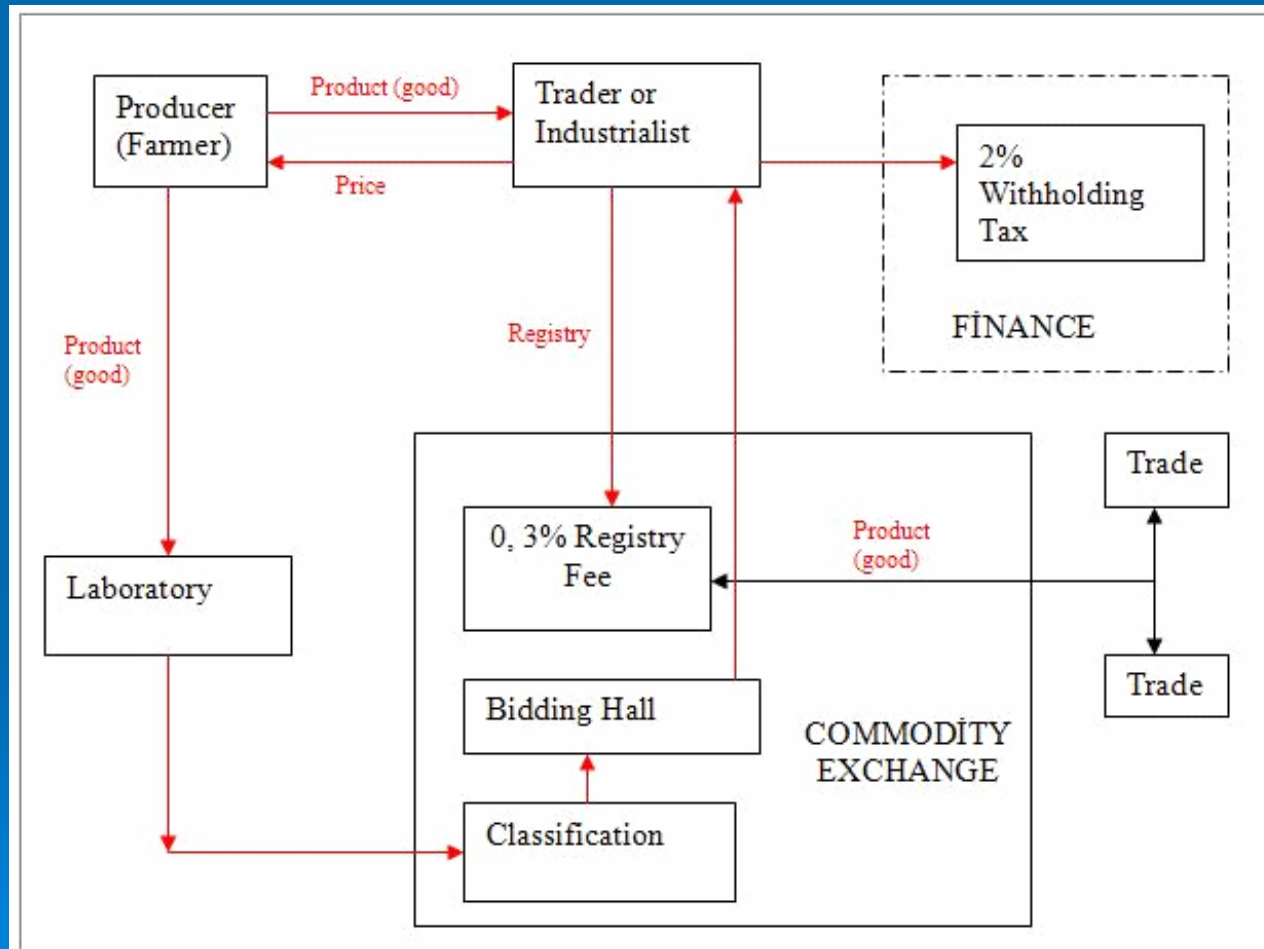
# Commodity exchanges: advantages

- No tax loss is incurred since traders cannot hide the profit margin which remains between buying and selling prices,
- Goods can be classified by type (i.e., hard, semi-hard in wheat),
- Commodity exchanges are functional in making transactions registered.

# Commodity Exchanges

- **The commodity exchanges of Polatlı and Edirne who invested in laboratories with financial assistance they received under the project for Promoting Commodity**
- **Exchanges are able to present products to open trade after having them tested in laboratories for their characteristics .**

# Quality Analyses Conducted by Commodity Exchange Labs



# Derivatives Exchange and Derivatives Market

- Derivatives exchange was established in order to compensate for imbalances in supply and demand and price risks associated with agricultural crops, and add a temporal dimension to transactions in addition to classical spot transactions.

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# Derivatives Exchange

- Upon the amendment made on the Capital Market Law, no. 2499 in accordance with Capital Market Law, no. 4487, the regulatory framework has made it possible to establish a derivatives exchange in İzmir, Turkey.
- Such legal framework permits Turkish Derivatives Exchange (TURKDEX) to design and develop markets where derivative contracts of assets, liabilities and indicators are traded in a competitive and secure environment. [


# Derivatives Exchange

- TURKDEX, started its operation right after the company was registered in Registry of Commerce. This registration was officially announced through the Gazette of Registry of Commerce, dated July 4, 2001.

# Share holders of TURKDEX

- The Union of Chambers of Commerce, Industry, Maritime Trade and Commodity Exchanges of Turkey
- Izmir Mercantile Exchange,
- Istanbul Stock Exchange (ISE),
- Is Investment Securities,
- Kocbank,
- Vakif Investment Securities,
- Garantibank,
- Akbank,
- Industrial Development Bank of Turkey,
- ISE Settlement and Custody Bank,
- The Association of Capital Market Intermediary Institutions of Turkey.

# Derivatives Exchange

- The priorities of Turkdex are as follows:
  - protection of investors,
  - transparency in executions,
  - integration with international markets
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# Derivatives Exchange

- Since we are specifically interested in the commodity component of the TURKDEX which is only in its infancy in Turkey, we are going to deal with cotton and wheat futures below.

# TurkDEX-Aegeancotton Futures

- Cotton is one the major agricultural products of Turkey. Farmers, cotton traders and all the other people who buy or sell cotton or its derivatives face the cotton price risk.
- With the introduction of the cotton future contract, these people have the chance to hedge this risk effectively and be able to make longer future plans.

# TurkDEX-Anatolian Red Wheat Futures

- Wheat producers and people who use the wheat as raw material will be able to know the wheat prices much before the harvest time and be able to make longer future plans.

# Current problems of derivatives exchange in Turkey

- In the TURKDEX, while there is high number of foreign exchange contracts, commodity contracts unfortunately had almost no transaction since the initiation of the market

# Current problems of derivatives exchange in Turkey

There are many reasons that can explain this situation in the TURKDEX:

## **Education:**

Educational achievement is indeed one of the primary reasons. The problem is related to both sides: If farmers remain uneducated they will not sell their goods in the TURKDEX; if consumers are uneducated they will not buy from the TURKDEX or engage in hedging.

# Education

- Steps to be taken include educating both producers and consumers and starting small-scale transactions at the beginning to demonstrate the benefits of such exchange to both parties.

# Current problems of derivatives exchange in Turkey

- **Price setting:** Agricultural crops price should be formed in free market. The sector of agriculture should be closed to price-related interventions and prices should emerge as a result of internal dynamics without intervention as it is the case in other sectors.

# delivery

- **Delivery:** In contracts, one party commits to deliver and the other to receive the delivery. Here, some problems may arise as a result of specific reasons (i.e. unfavourable weather conditions, drought, unexpectedly bad yield, etc.) where goods cannot be delivered or received.

# Delivery

- Considering past examples in physical commodity trade, waiving is a frequent and serious problem concerning both parties.
- The question is: Can impossibility of waiving in TURKDEX transactions be one of the reasons for the absence of such transactions?

# Warehousing

- In TURKDEX, the minimum amount specified for a wheat contract is 5 tons. This minimum is kept low in order to attract small investors.

Yet, this convenience did not prove effective in increasing the volume of transactions.

- In our opinion, it will take some time for such transactions to be a serious component of TURKDEX. For example, the problem of warehousing has not been solved yet.

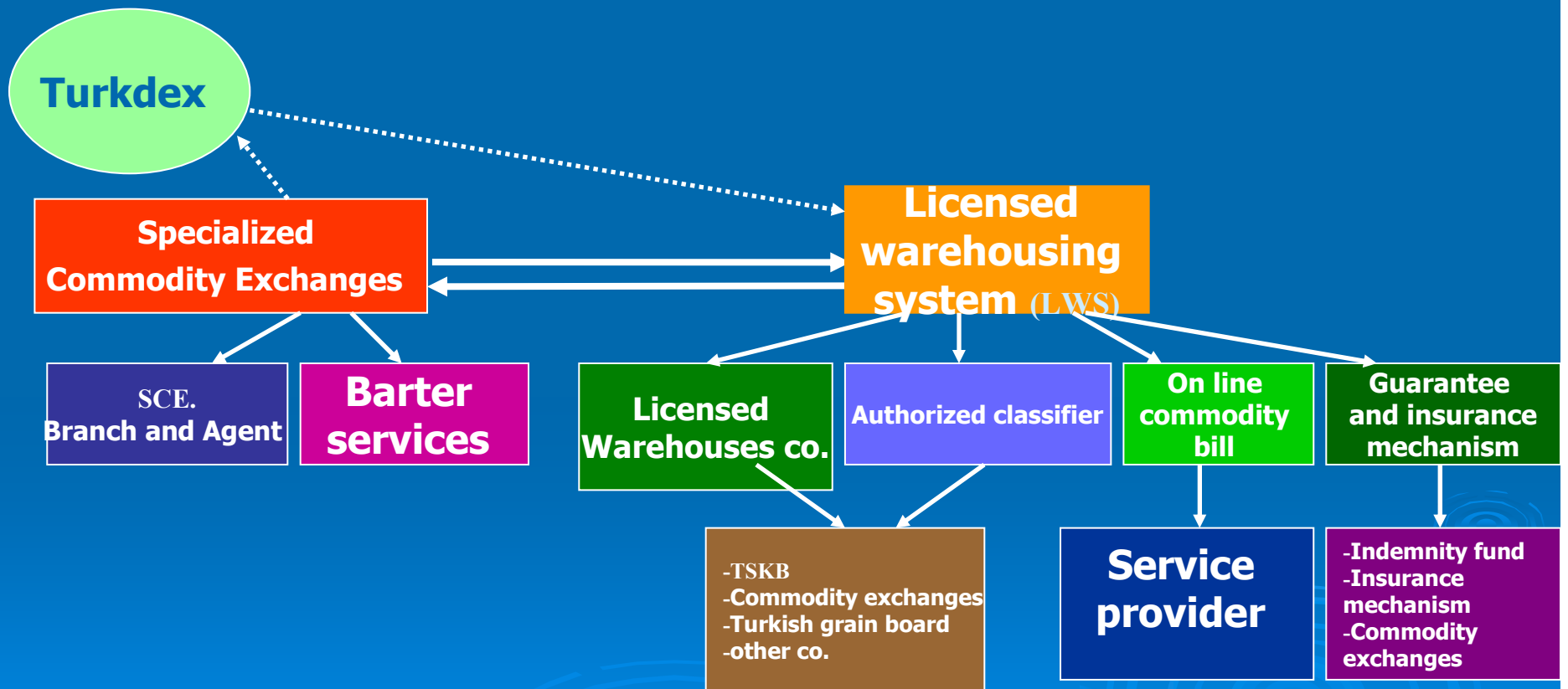
# Licensed Warehouse: Legal status

- Under the project for “Development of Commodity Exchanges” (1999-2003) preliminary work for a system of licensed warehousing had already been conducted.
- Legislative framework for the establishment of specialized commodity exchanges in the status of joint stock Company, much stronger than presently active 113 commodity exchanges, is ready.
- With the contribution of the Ministry of Finance, legislative arrangements have taken place including the Law no. 5174 on TOBB Chambers and Commodity Exchanges and Law no 5300 on Licensed Warehousing in Agricultural Goods as well as 8 associated Regulations.

## **The system has two major instruments:**

- **Agricultural good**
- **Authorised classifier**

## Elements of licensed warehousing system



# Licensed Warehouse

- The new system will contribute to the solution of possible marketing problems that may emerge as public institutions such as TMO, unions and state monopolies cease to engage in purchases,
- The cost of purchasing and storing incurred by the State will be reduced at least in some goods as a start,

# Licensed Warehouse

- When quality specifications and standards are set on more objective terms, high quality goods will enjoy higher prices, thus encouraging producers to comply with such standards,

# Licensed Warehouse

- Emerging warehousing and laboratory testing system will create new lines of employment in the sectors of banking and insurance.

# Suggestions for development of the sector:

## Production:

- In Turkey farmers grow without taking account of quality standards and sell their crops at market prices.
- Cost of inputs is quite important in overall costs of production.
- instead of certified seed, which is an additional cost item, farmers prefer to use cheaper seeds.

# Suggestions for development of the sector:

- Since prices of agricultural goods will be determined on the basis of quality criteria in licensed warehousing system, it is of utmost importance to inform farmers on this issue..

# Suggestions for development of the sector:

## Marketing:

- Farmers generally have no bargaining power vis-à-vis buyers. They don't have much choice but accept prices offered by intermediaries in the marketing chain.
- Especially in the process of EU accession organisation of farmers in various forms is important.

# Suggestions for development of the sector:

- **Storing:** For an effectively working system of licensed warehousing, such components as:
- licensed warehouse,
- laboratory authorised for classification,
- commodity exchange and
- central registry need to be considered together
- these components need to be introduced simultaneously and work in a coordinated and integrated manner.

# Suggestions for development of the sector:

- **Derivatives exchange:** There is need for the introduction of legal and economic infrastructure so as to increase the volume of transactions in the commodity component of derivatives exchange (TURKDEX) in the context of futures exchange and setting future prices in advance.

# Suggestions for development of the sector:

- The spectrum of crops which is presently limited to cotton and wheat should be gradually enlarged so as to cover other important crops including hazel nut, corn, barley and even sunflower. Of course, all these require the absence of any state intervention including assignment of floor and sales prices.