Commodity Risks and Impact on Government Budgets: Parallels with the Practice of Public Debt Management?

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Agenda

The context - new interest in commodity risk management

Government-level commodity risk management problems

Institutional requirements and challenges

Discussion
Market perspective:
- Rising demand for food & energy will continue to create volatility in the market
- For energy, prices have somewhat retreated from ‘08/09 highs
- Investment banks are going back to basics - increasing efforts to market hedging solutions to sovereigns

Country perspective
- Food/fuel crisis of ‘08 impacted many countries & led to renewed interest in commodity risk management
- Countries are not only concerned about price volatility but also supply uncertainty (particularly for food)
- Not an easy time to predict budgetary requirements for support to agriculture / energy sector
- Not an easy time to manage/sustain price support mechanisms

Questions: Would hedging against price shocks help?
Points to Consider

• Impact of commodity price volatility on the government budget can be:
  • Direct or indirect
  • Different for importers and exporters

• Commodity prices often affect the cost of supporting price stabilization / subsidy mechanisms which:
  • Are unpredictable, creating budget uncertainty which is detrimental to longer term planning and investment (public and private)
  • Carry a high opportunity cost, since resources are deflected from investments with longer term benefit

• Although there are no financial instruments that can mitigate the impact of longer term trends, short-term price volatility can be managed with market tools

• Hedging against price shocks is more affordable than hedging against smaller variations in price

• The market for risk management is growing, but the playing field can be uneven if government capacity to understand and use hedging tools is low
Importance of Risk Assessment – Where is the Government’s Exposure?

**Policy Risks**
- Subsidies
- Stabilization funds
- Safety nets
- Investment plans
- Tax Revenues

**Commercial risks**
- Price Risk
- Supply Risk
- Delivery Risk
- Credit & Financing Risk

**Diagram**
- Government
  - External Market
  - Consumers
  - Internal market
A few countries have attempted e.g. Mexico, Panama but...

- Lack of awareness about specific nature of exposure
- Lack of a legal framework authorizing the government to hedge
- Lack of an institution/organization/department with the mandate to implement the hedge
- Lack of technical expertise / capacity
- Lack of focus on the problem when prices are favorable; lack of resources when prices are not
- Political economy considerations around decision-making and reputational risk
- Negative stories created by inappropriate strategies in the past
Institutional Requirements for Commodity Hedging are similar to Public Debt Management

Requires:

• Careful and comprehensive risk assessment
• Transparency, good governance, and sound decision-making
• An institutional framework including legal & regulatory guidelines
• Understanding of the policy framework associated with the risk
• Careful use of market instruments to manage risk with
  • Solid understanding of the instruments
  • Clear statement of the objectives of the hedging strategy
  • Cost-benefit analysis
  • Capacity building
  • Communication with stakeholders
• An organizational framework that establishes
  • Transaction support processes
  • Accounting and taxation policies
  • Oversight, supervision, and reporting
Conclusions & Questions for Discussion

• Should contingent liabilities have contingent financing strategies?
• Can / should market tools be used as a source of contingent financing?
• How are governments looking at and managing this exposure now?
• Are public debt management offices involved?
  • If so, how?
  • If not, who?
• Are there capacity challenges? If so, how are they being addressed?
• How can the World Bank help?
Back-Up Slides on Advisory Services
Commodity Advisory Services

Step 1: Needs assessment
• Evaluates the current state of existing processes and procedures
• Suggests areas where external expertise can build government capacity and add value to implementation of risk management programs

Step 2: In-depth technical advisory engagement
• Support is customized to meet the specific needs and timing of the client
Objective: To assess specific risks and evaluate institutional issues that can affect implementation

Specific activities can include:
• Analyzing the supply chain and market issues
• Analyzing the existing policy framework
• Defining the objectives of a hedging strategy
• Assessing legal and regulatory infrastructure
• General review of commodity hedging products
• Review of other institutional issues that would impact implementation, including governance issues related to decision-making and technical capacity

Timing: 3 to 6 weeks
**Objective:** To provide technical support to the government for implementation of a risk management strategy.

**Specific activities can include:**

- Comprehensive risk assessment
- Development of a comprehensive commodity risk management framework
- Assistance to revise policy and institutional frameworks
- Technical analysis to simulate country-specific impact of price movements
- Technical support to design a framework and governance process for selecting hedging strategies
- Education for stakeholders and policy-makers
- Technical capacity building for ministry staff
- Technical support for any required changes in legal, and regulatory infrastructures
- Technical advice related to structuring and executing transactions with the market
- Market execution on behalf of the client

**Timing:** Dependent on client needs; combination of field work and long distance support.