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

A new context for commodity risk management

- 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?

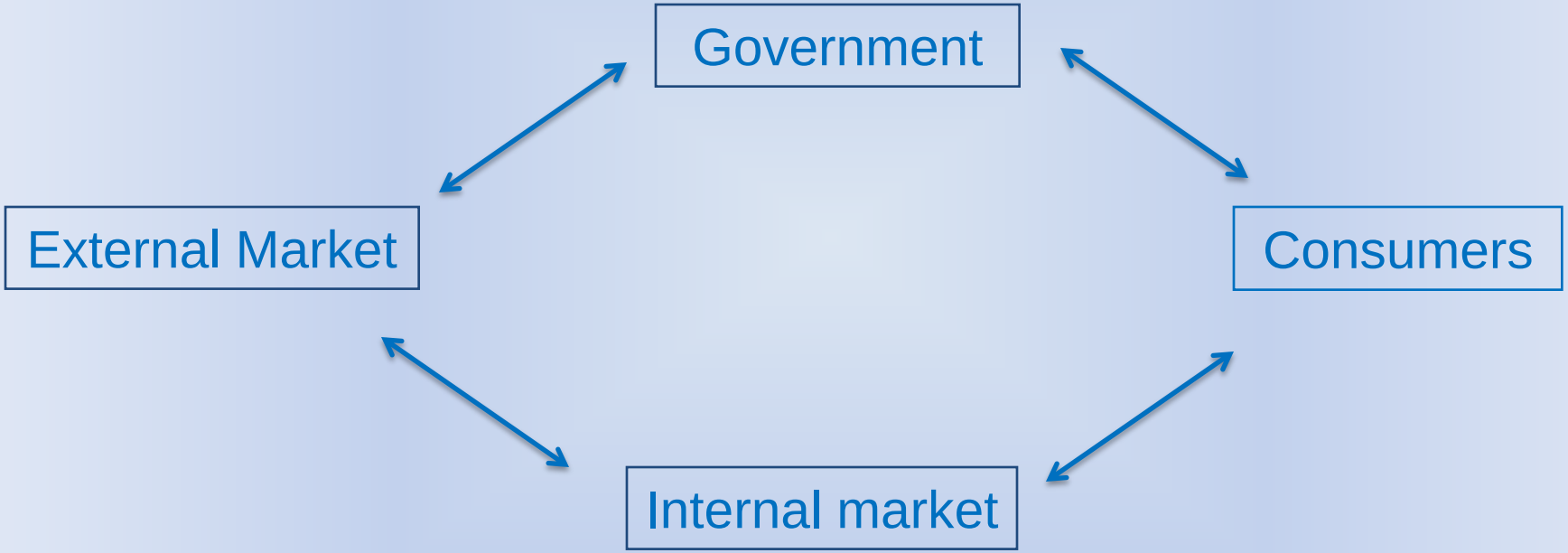
Points to Consider

- 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

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Challenges remain for Implementation of Commodity Risk Management

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

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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

Needs Assessment

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

In-Depth Technical Advisory Engagement

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.