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Forward Contracts: A Market Based Alternative to Government Intervention in Agriculture Marketing in Sri Lanka

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Abstract

Two main objectives of government intervention in agricultural marketing are to stabilize food prices and to ensure that farmers receive remunerative prices for their produce. Since early 1970s, successive governments in Sri Lanka have intervened in agricultural marketing by offering guaranteed prices to farmers for selected food crops. Although the guaranteed price scheme has been in operation for over three decades, it has failed to produce expected results for various reasons. As a market-based alternative to government intervention in agricultural marketing, the Central Bank of Sri Lanka introduced forward contracts under the *Govi Sahanaya* scheme in 1999. This paper examines the forward contract scheme and reviews its performance. Although it is still in its infancy, the *Govi Sahanaya* scheme has generated encouraging results. The paper recommends that this program be taken seriously by policy makers and be given state patronage to increase farmer participation.

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1. Introduction

Seasonality in food crop production results in wide fluctuations in food commodity prices during the cropping season. As low prices during the harvesting period and high prices during the lean period unfavuorably affect both producers and consumers, stabilizing them would benefit both. Farm-gate prices often become so low during the harvesting period that a large number of farmers find it difficult to even recover the cost of production. This often results in defaults in loan repayment and, in some instances, some farmers being forced out of business. Small farmers are particularly vulnerable to wide price fluctuations because low prices during the harvesting period make farming unprofitable and unviable. A large variation in commodity prices within the season makes it difficult for farmers to decide on what crops to grow during the next season. Also, it discourages farmers from applying the right dosage of fertilizers and agro chemicals, adopting new technologies, and undertaking new investment. Low prices during the season also mean low incomes to farmers, which limit their access to credit from formal financial institutions at reasonable interest rates. All these factors result in low investment, hence, low productivity and low growth in the domestic agricultural sector.[1]

In order to ensure that farmers receive remunerative prices for their produce during the harvesting period, governments often intervene in the commodity market by offering guaranteed prices for farm produce. Although the guaranteed price scheme has been in operation in Sri Lanka for a long time, it never produced satisfactory results.[2] As an alternative to the government intervention in agricultural marketing, the Central Bank of Sri Lanka introduced forward contracts under the *Govi Sahanaya* scheme in 1999. At present, paddy, chillies, big onion, gingelly, maize, vegetables, medicinal plants, and several other crops are covered under the scheme. This scheme operates in many districts.

The objective of this paper is to examine the *Govi Sahanaya* scheme and review its performance. In Section 2, a brief survey of various instruments used for hedging commodity price risks is presented. Although these price risk management instruments are mostly used in developed countries, it will be of great importance to know how they work. Section 3 briefly discusses the history of government intervention in agricultural marketing

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[1]The domestic agricultural sector includes rice, other field crops (grains other than rice, oil seeds, pulses, and root crops), fruits, vegetables, and sugar.
[2]Section 3 provides a detailed discussion on the guaranteed price scheme.

in Sri Lanka. Section 4 presents the conceptual framework of forward contracts under the *Govi Sahanaya* scheme and the progress it has made to date. The role of institutions is discussed in Section 5. Section 6 concludes the paper.

2. Commodity Price Risk Management[3]

Commodity price risk management instruments have been designed to assist producers, consumers, traders, and processors to protect themselves from uncertain adverse price movements and, in some instances, to secure short-term funds for investment. As direct trade deals between producers and consumers have increased in importance over the recent past, commodity producers and consumers have become more exposed to coping with commodity price risks themselves. This is particularly true in developed countries. In developing countries, on the other hand, commodity producers run great risks of not being able to recover even the costs of production due to depressed commodity prices during the harvesting period. Commodity producers are not the only ones that suffer from adverse price movements. Traders who buy commodities before reselling face the risk of being unable to cover the purchasing costs. Commodity processors face price risks in respect of inputs and outputs as their margins depend upon variations in the two prices. All these mean that final consumers have to pay higher-than-expected prices for the commodities they purchase. Furthermore, there are price risks associated with carrying inventories by exporters, importers, and other traders.

Commodity price risk management instruments are available as standardized or tailor-made contracts. While standardized contracts are usually traded on organized commodity exchanges, tailor-made contracts are traded directly between two market participants. In what follows, various price risk management instruments and market places where they are traded are discussed.

2.1 Market Places

2.1.1 Commodity Exchanges

Commodity exchanges are financial market places or exchange floors where commodity contracts are traded with the objective of *transferring* exposure to commodity price risks. Organized commodity exchanges have existed for over a century. The world's most active

[3]This section draws upon *A Survey of Commodity Risk Management Instruments* (UNCTAD/COM/15/Rev. 2), April 1998.

commodity exchanges are located in developed countries. They include the Chicago Board of Trade (CBOT), New York Mercantile Exchange (NYMEX), and Coffee, Sugar, and Cocoa Exchange (CSCE) in the USA; London Metal Exchange (LME), International Petroleum Exchange (IPE), and London International Financial Futures and Options Exchange (LIFFE) in the UK; Marche a Terme International de France (MATIF) in France; and several exchanges in Japan. The most popular commodity exchanges located in developing countries are the Singapore International Monetary Exchange (SIMEX) in Singapore; Kuala Lumpur Commodity Exchange (KLCE) in Malaysia; Bolsa de Mercadorias & Futuros (BM&F) in Brazil; Buenos Aires Grain Exchange in Argentina; and many commodity exchanges in China and India.

Most commodity exchanges that were started recently conduct electronic trading with terminals located throughout the country. In some cases, terminals in other countries are also linked to the central exchange. Contracts are standardized with a specific quantity, specific quality, and specific delivery time and procedures. Contract price is the only variable left for negotiation between contract buyers and sellers. Standardization of contracts makes negotiation of contract specifics unnecessary. On commodity exchanges, hedgers, *i.e.,* buyers and sellers, can easily find a counterpart because of the presence of speculators and other hedgers who like to take an opposite position. Speculators are market participants who make profits from their perceived correct anticipation of future price movements. They have nothing to do with the physical transaction of commodities.

Each commodity exchange has a central body or a clearing-house, which acts as the counterpart to all transactions guaranteeing that there is no counterpart risk for those who enter into contracts. Trading on an organized commodity exchange is conducted through (1) open outcry system, (2) balancing method (a system whereby offer and demand are matched by an auctioneer), (3) electronic trading through the use of a computer network, or (4) market-maker system (a system where market makers and clearing members are linked through a computerized trading network).

2.1.2 Over-the-counter Market

Forward contracts and swaps are traded through the over-the-counter (OTC) market. In the OTC market, direct interaction between buyers and sellers takes place with the help of an intermediary. Usually, a bank, a trading house, or a brokerage firm plays the role of the intermediary. Since contracts traded at the OTC market are tailor-made to the needs of clients, once a contract is agreed upon it is difficult to reverse it. Moreover, as intermediaries are reluctant to give price quotes to unknown people, the OTC markets are not transparent.

2.2 Commodity Price Risk Management Instruments

2.2.1 Forward Contracts

Forward contracts are OTC contracts that facilitate planning and marketing by allowing traders lock in forward prices and securing a processing margin. In a forward contract, the buyer agrees to take delivery and the seller agrees to make delivery of a specified quantity of a commodity of choice at an agreed future date at an agreed price. In a forward contract, unlike in a futures contract, physical delivery and the actual payment take place at the maturity of the contract. If the prevailing market price is greater than the contract price, the buyer will make a profit at the expense of the seller. If, on the other hand, the market price is lower than the contract price, the seller will make a profit at the expense of the buyer. In a forward contract, the seller hedges the risk of holding the commodity while the buyer hedges the risk of the need to acquire it at a future date. This is known as "forward cover." In an organized forward market, this involves simultaneous execution of an offsetting transaction. For example, if a trader holds a certain commodity, he can insure against a possible decrease in the price of that commodity by selling the same quantity in the forward market at the prevailing forward price. At maturity of the contract, the trader sells the commodity at the specified price, and hence, avoids the risk of a price decline. There are two basic characteristics of forward contracts. First, exchange of cash does not take place when the contract is signed. Second, since there is an inherent risk of default (seller not delivering the commodity or buyer not paying the agreed price), the successful execution of a forward contract entirely depends upon the reputation of the two parties entering the agreement.[4]

[4]Advantages of forward contracts are: (1) forward contracts are tailor-made to the needs of buyers and sellers, (2) forward contracts ensure physical market for the commodities produced, and (3) forward contracts enable contracting parties to obtain production or pre-export finance. Disadvantages of forward contracts are: (1) once entered into a contract it is difficult to reverse it, (2) lack of transparency in price formation, (3) no possibility of profiting from favourable spot market developments, and (4) major counterpart risk involved as transactions are not guaranteed by a clearing house.

2.2.2 Futures Contracts

Futures contracts are another vehicle to hedge commodity price risks and are traded on organized commodity exchanges. They allow traders to lock in the value of inventories, finance part of storage costs, and secure a processing margin. In a futures contract, like in a forward contract, the buyer and the seller enter into a legally binding agreement whereby the seller agrees to make delivery of a certain quantity of a specified commodity at an agreed price at a future date. The buyer agrees to take delivery. However, unlike in a forward contract, physical delivery does not usually take place in a futures contract at its maturity. Although the contract stipulates making and taking physical delivery of the commodity, the usual practice is to offset the initial contract on or before its maturity by executing an equal but opposite transaction. For example, a farmer who would want to hedge by selling a futures contract at the time of planting the crop will purchase an identical futures contract with each cancelling the other out. This is known as "closing out" the position. When the producer makes the physical sale he will receive the prevailing market price. If the market price is lower than the price on the futures contract, the loss on the physical market is compensated by the higher price on the futures contract. If, on the other hand, the market price is greater than the price on the futures contract, the gain on the physical market will be offset by the loss on the purchase of the "closing out" contract. All transactions on futures contracts are made through the central body (the clearing-house), which automatically assumes the position of counterpart to both sides of the transaction.[5]

2.2. 3 Options

Options are another risk management instrument traded on organized commodity exchanges. They are used to obtain protection against unfavourable price movements while retaining the possibility of profiting from favourable price movements. Unlike in forward or future contracts, options do not lock in prices. An option gives the owner the right to buy

[5] Futures contracts differ from forward contracts in many respects: (1) futures contracts are traded on organized exchanges through clearing houses while most forward contracts are traded in the OTC market, (2) there is no need to negotiate contract specifications in futures contracts as terms on the quantity, grade, and delivery are standardized, (3) there is little or no counterpart risk involved in futures contracts as all transactions are guaranteed by the clearing house, (4) initial position of a futures contract can easily be reversed, and (5) physical delivery is not implied in a futures contract. Disadvantages of futures contracts are: (1) requirement of initial cash transfer for margin payments and daily settlements to adjust margins to adverse price movements freezes working capital, (2) there is no possibility of profiting from favourable spot market developments, and (3) there can be a significant difference between the spot price and the contract price.

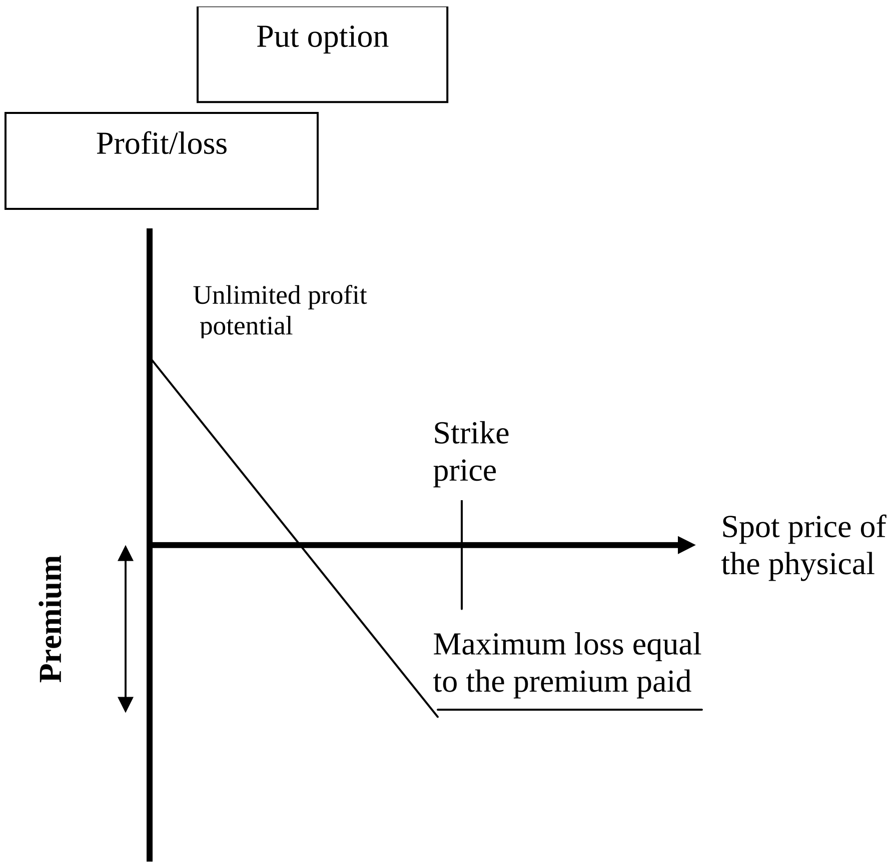
or sell a certain quantity of a commodity of interest at a pre-arranged price on or before a specified date. The pre-arranged price is also known as the "strike price." The buyer or the seller of the option pays a price called "premium" to the counterpart or the clearing-house when purchasing the option.

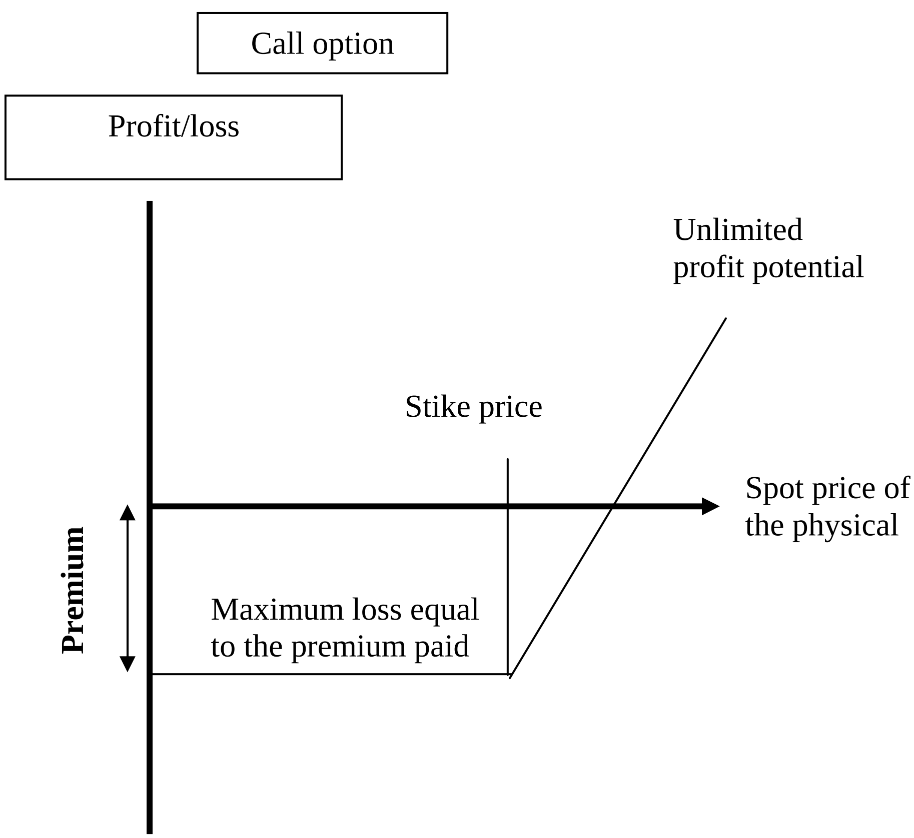
There are two options: "call option" and "put option." Figure 1 depicts the pricing mechanism of the two options. The call option gives protection to consumers and processors who think that the market price would increase in the future. The call option will give the trader the right (but it will not oblige him) to purchase the commodity at the strike price enabling him to profit if and when the market price is greater than the strike price. The premium is the maximum the trader would lose in case the market price goes below the strike price. The put option, on the other hand, particularly benefits producers who think that the market price of their produce would decline. The put option will give the buyer the right to sell the commodity of interest at the strike price. If and when the market price goes below the strike price, the option buyer can sell the commodity at the strike price.

Options differ from forward and futures contracts in several ways. First, the buyer of an option must pay the premium when the option is purchased. Second, in the case of futures contracts, if the hedger is unable to find cash within the specified time period the contract will be automatically cancelled. There are no such risks in option trading. Third, if the operation is not executed through the clearing-house, the seller of an option does not face a credit risk by the counterpart. However, the buyer of an option does face a credit risk if the operation is not carried out through the clearing-house. This is because in executing his option, the buyer depends on the seller's fulfillment of his commitment.[6]

[6]Three advantages of options are: (1) they are available at central exchanges in standard form, (2) there are no "funding risks" as the cost of protection is known beforehand, and (3) option holders can profit from favourable price movements. Disadvantages of options include: (1) premiums can be expensive, (2) selling options can be risky, and (3) margin calls must be paid by option sellers.

Figure 1: An Example of Futures Options



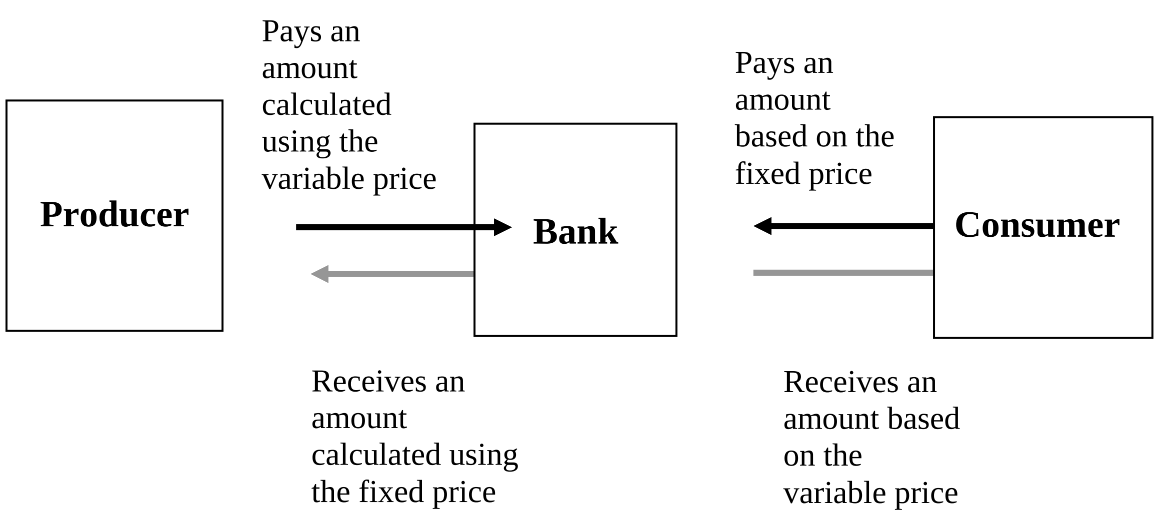


2.2.4 Commodity Swaps

A swap is a medium to long-term price risk management instrument traded on the OTC market. A swap is a purely financial arrangement where delivery of the commodity does not take place. With swaps, producers can fix or lock in the price they will receive while consumers can lock in the price they will pay. An intermediary such as a bank or trading company facilitates swaps between producers and consumers. The mechanism of a swap arrangement involving a producer, consumer, and bank is illustrated in Figure 2.

If the reference price, which is also known as the variable price or the market price, is greater than the fixed price, the producer will pay the bank an amount equal to the difference between the reference price and the fixed price. This difference is known as the intermediary. In this case, the bank will pay the consumer the intermediary. If, on the other hand, the fixed price is greater than the reference price, the bank will pay the producer the intermediary and the consumer will pay the bank the intermediary. Swaps are popular among lenders and investors as they provide security for their cash flows. Being a purely financial transaction, a swap allows the producer and the consumer to hedge price risk without

Figure 2: An Example of a Swap Agreement Involving a Producer, Consumer and Bank



directly effecting production, distribution, and procurement. In other words, swaps allow producers and consumers to alter their production and consumption patterns according to the changing market needs while providing an effective way to hedge price risks.

World swap market is dominated by the interest rate and currency swaps. The commodity swap market is still very small. The petroleum swap market is the most liquid with a large number of intermediaries making price offers. Commodity swaps are negotiated mainly for metals and coal. Wheat, paper pulp, orange juice, coffee, and sugar are the only agricultural commodities for which swaps are negotiated in the world commodity market. The existence of liquid and well functioning futures and forward markets is the main reason why swaps are not a popular instrument for hedging price risk even in developed countries.[7]

3. Government Intervention in Agricultural Marketing in Sri Lanka

3.1 Role of PMB, Co-ops and CWE

Farmers in Sri Lanka have two options regarding marketing of their produce–government institutions and private traders. Since early 1970s, two government institutions, the Paddy Marketing Board (PMB), which was established in 1971, and the Multi-purpose Co-operative Societies (Co-ops) were charged with purchasing a variety of agricultural commodities at designated prices (floor prices).[8] The objectives of establishing the PMB were twofold: (1) to ensure a guaranteed price for paddy, and (2) to supply rice to consumers at "reasonable" prices. The PMB was originally responsible for procurement, storage, and milling of paddy. During mid 1970s, the PMB was the most responsible single procurement agency for paddy. It annually purchased nearly 50 per cent of the country's paddy production. However, with the growth of private sector millers since 1977, the role of the PMB gradually diminished over the years. In 1996, the PMB purchased only one metric ton of paddy (Central Bank of Sri Lanka, *Annual Report* 1997). The PMB halted its operations in 1997 and was finally closed down in 2000. Although Co-ops too played an active role in the purchase of paddy during the early 1970s, they lost the state patronage gradually during the post-1977 period as consequence of the introduction of liberalization policies in 1977. Even though Co-ops are

[7]Advantages of commodity swaps include: (1) swaps are tailor-made medium to long-term hedging instruments attractive to lenders and investors, (2) there is no margin calls, and (3) counterpart is known to both producers and consumers. Disadvantages of swaps are: (1) high transaction costs, (2) positions are difficult to reverse, (3) it is difficult to assess the fixed price, (4) as there is no clearing-house involved there is counterpart risk, and (5) there is no possibility to benefit from favourable price movements.

[8]Officials in the Ministry of Agriculture determine the floor price for a commodity as the amount that provides a reasonable return to farmers for their farm produce.

still involved in the purchase of agricultural commodities, the government has only a limited clout over their operations.

The Cooperative Wholesale Establishment (CWE) is the only state trading enterprise in the country today dealing with agricultural commodities. The main role of the CWE is to stabilize food prices by importing food commodities when the domestic production fails to meet the domestic demand. Ensuring food security by maintaining buffer stocks is another important role of the CWE. When the PMB and the Co-ops were actively involved in the purchase of agricultural commodities, the CWE too purchased farm produce, except paddy, in small quantities. Since the PMB halted its operations in 1996, the government has often relegated the CWE with the responsibility of purchasing farm produce, particularly paddy, at guaranteed prices. More often than not, the CWE has incurred huge losses in these operations.[9]

3.2 Why Didn't the Guaranteed Price Scheme Work?

Average farm-gate prices were often below guaranteed prices irrespective of the market of the PMB and the Co-ops. The failure of the market intervention program in Sri Lanka jeopardized, to some extent, the achievement of the goal of agricultural diversification. Private marketing agents were preferred despite lower prices because they provided certain economic services the PMB and the Co-ops never provided to farmers. The inability of the PMB and the Co-ops to provide these services undermined their goal of increasing market competitiveness. Their usefulness to farmers was diminished and maintenance of guaranteed prices during surplus periods failed to materialize.

The failure of the guaranteed price scheme can be attributed to several reasons. First, unlike the PMB and the Co-ops, private marketing agents collect farm produce at farm-gate, thereby saving farmers transportation charges. Second, private traders pay at the time of purchase and they pay in cash. On the contrary, the PMB and the Co-ops often delayed payments due to financial constraints. Spot cash payments provide farmers with much needed liquidity and eliminate the transaction cost of cashing a cheque. Third, private traders accept sub-standard produce at discounted prices. The PMB and the Co-ops, on the other hand, only accepted farm produce of certain quality at a certain price. Farmers were

[9]For a detailed description on the role of the PMB and the CWE in agricultural marketing, see Epaarachchi, *et al* (2002).

therefore reluctant to transport their produce to the PMB and the Co-ops due to the risk that it would be rejected. Fourth, most private traders provide credit to farmers in cash, in kind, or both. Farmers' preference for private marketing agents over the state institutions is an indication that the economic value of the services provided by private traders should have been at least equal to, if not greater than, the difference between the average farm-gate price and the guaranteed price (Gleason and Weliwita, 1991).

The relationship between farmers and private traders extends beyond seller and buyer. Private traders assume the role of creditors, input suppliers, transporters, a source of market information, and reliable purchasers of agricultural produce. This relationship is of significant economic value to farmers as they are unable to supply themselves with many of these services and there is no government program that attend to their varied needs.

In the absence of forward contracting or a futures market, farmers in Sri Lanka have no marketing options to manage price risks. Their inability to tolerate price risks is compounded by low levels of cash assets, which leads to a scenario in which farmers are compelled, for economic reasons, to sell their produce when prices are low, that is as soon as the crop is harvested. This scenario is exactly what the guaranteed price scheme was designed to prevent. The alternative is to provide farmers themselves with mechanisms to manage marketing or price risks, which will reduce reliance on government market intervention.

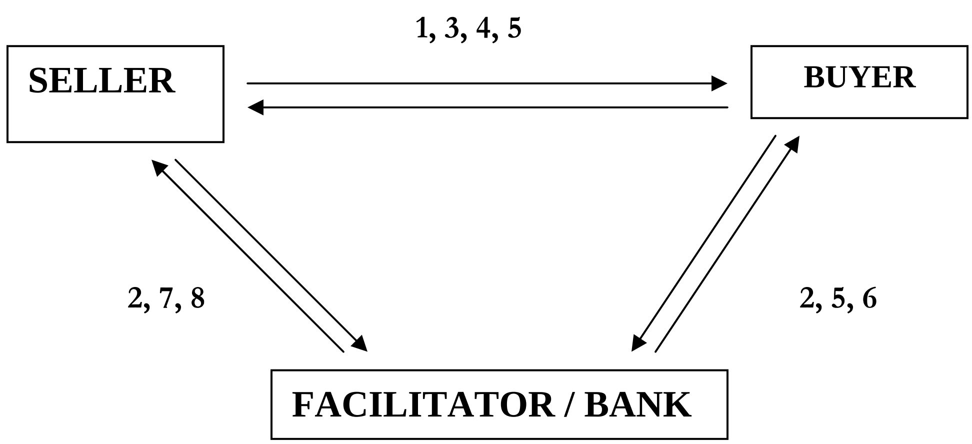
4. Forward Contracts Scheme in Sri Lanka

The Central Bank of Sri Lanka under the *Govi Sahanaya* scheme introduced commodity forward contracts in 1999. A forward contract is a legally binding agreement between a buyer and a seller whereby the buyer agrees to buy an agreed quantity of a commodity of specified quality at a predetermined price at a future date and the seller agrees to deliver that quantity. In this agreement, the seller is guaranteed a certain price for his produce while the buyer is guaranteed an assured supply of a quality product. Although the Central Bank introduced this agreement on a formal basis only recently, this type of marketing arrangements have existed in Sri Lanka for a long time on an informal basis.[10]The legal

[10]Marketing arrangements between the Ceylon Tobacco Company, which is a monopsony, and tobacco growers and buyers and sellers of certain perennial crops, particularly of minor export crops, are two good examples.

standing of forward contracts originates from the Sale of Goods Ordinance No.11 of 1896. This Ordinance describes forward sales as a "contract of sale of goods whereby the seller agrees to transfer the property in goods to the buyer on a future date for a monetary consideration" (Central Bank of Sri Lanka, 1999).

4.1 Schematic Representation of a Forward Contract



1. Buyer and seller sign a contract. The facilitator certifies the signatures. A copy of the contract is given to the buyer, seller, and facilitator each (see Appendix 2, Annex 1).
2. Seller can use the contract, if necessary, as collateral to obtain a cultivation loan from the bank. Buyer too can obtain a loan from the bank for storing or processing of purchased produce.
3. Seller asks the buyer to pay through the bank.
4. Seller delivers goods to the buyer.
5. Buyer issues a Goods Received Note (GRN) to the seller upon delivery of goods (see Appendix 2, Annex 2). Buyer informs the bank.
6. Buyer remits payment to the bank.
7. Seller forwards the GRN to the bank.
8. After recovering loan outstanding, the bank pays the balance to the seller.

4.2 Determination of the Contract Price

In a forward contract, the seller is guaranteed a remunerative price for his produce while the buyer is assured of the supply of a quality product. A facilitator, usually a bank, helps in bringing a buyer and a seller together and in determining the contract price.[11] The most important element in a forward contract is the contract price. The contract price is determined based on the cost of production, the cost of production and the retail price both, or the border price of the commodity of concern. Choice of the most appropriate method depends upon the commodity itself and various other factors such as the variation of farm-gate prices and retail prices. These three methods are described below.

A. Based on Cost of Production

In most cases, cost of production is used as the basis of the contract price. The Department of Agriculture annually publishes cost of production data for food crops for various districts. It publishes two series of cost of production figures: (1) the cost of production of inputs excluding family labour, and (2) the cost of production of inputs that include the imputed value of family labour. As the contract price must be based on the true cost of production, cost of production that includes the value of family labour is used in determining the contract price. Usually, the contract price is 150 per cent of the true cost of production. This will guarantee the farmer a 50 per cent margin over his cost of production.

B. Based on Retail Price and Cost of Production

In many cases, retail food prices fluctuate widely within the cropping season as a result of the volatility in farm-gate prices. However, in some cases, the volatility in retail prices does not closely correspond with the variation in farm-gate prices and the cost of production. In this case, the contract price calculated based on the cost of production would not be a remunerative price to the producer. Tomato is a case in point. For example, the annual average cost of production of a kilo of tomato in the Matale district in 1998 was about Rs. 6. However, the retail price of tomato was as high as Rs. 60/Kg during the lean period. A contract price of Rs.9/Kg, which would be the contract price if it were calculated based on the cost of production method, would not have been attractive to the producer at all. In this case, the average between the retail price and the cost of production could be used as the basis of the contract price.

[11] Role of the facilitator is discussed in Section 5.

C. Based on World Market Price

The third method used for computing the contract price is the use of the *c.i.f.* price. As some imported food commodities are cheaper and better in quality than the local produce, processors in particular prefer to import them even though they are available in sufficient quantities locally. Maize is a case in point. In this case, the *c.i.f.* price is used as the contract price.

4.3 Advantages of a Forward Contract

There are many advantages of a forward contract to all three parties involved. These are briefly discussed below.

A. Advantages to the Seller

A forward contract will assure the seller a market and a price for his produce even before the cultivation season begins. This will enable him to undertake his production in a planned environment. Guaranteed market and price will be a great incentive for the producer to undertake new investment and use improved technology in the production process.

Seller can obtain a cultivation loan from the bank using the forward contract as collateral. This is a main advantage to farmers, farm companies, and village level commodity assemblers who have little or no access to credit from formal credit sources due to lack of collateral.

B. Advantages to the Buyer

A forward contract will assure the buyer a stable supply of goods with the required quality at an agreed price. This will reduce cost of storage and risk of investment.

A forward contract will make it easier for the buyer to obtain bank loans to pay the seller since the contract is sufficient evidence for the existence of a market for goods purchased for re-sale or use as raw materials for manufactured products.

C. Advantages to the Facilitator

- The main benefit to the facilitator is the commission fee it gets for the services it provides. The seller and the buyer share the commission fee, which is normally 1-2 per cent of the contract value.

- Another advantage to the bank is that forward contracts guarantee loan recovery. The bank recovers loans outstanding before it pays to the seller what the buyer remits as sales proceeds.

- The bank's role of bringing buyers and sellers together will enable it to expand its customer base.

4. 4 Progress of the *Govi Sahanaya* Scheme

Table 1 presents the performance of the forward contract scheme since its inception in 1999. A total of 6239 contracts were signed during the 1999-2001 period. The value of these contracts is Rs. 228.3 million. It is encouraging to note that among all the banks involved, the Seylan Bank, which is the only private bank to be involved in the scheme, had signed the highest number of contracts. Although many crops are covered under the scheme, paddy, maize, and big onion accounted for more than 75 per cent of the total number of contracts. A detailed breakdown is provided in Appendix 1.

Table 1
Number and Value of Forward Contracts

Facilitator	Progress			
	Contracts signed by December 31, 2000		Contracts signed by August 20, 2001	
	No	Value (Rs. Million)	No.	Value (Rs. Million)
Ruhuna Development Bank	779	48	1,100	62
Rajarata Development Bank	497	9.6	758	17
Kandurata Development Bank	208	4.9	947	12
Uva Development Bank	19	1	247	10.5
Wayamba Development Bank	62	2.9	62	2.9
Sabaragamuwa Development Bank	143	2.5	320	7
Seylan Bank	1191	56.8	1720	84
People's Bank	319	4.4	319	4.4
Bank of Ceylon	87	2	170	12
Co-op Rural Banks	194	2.7	227	3.5
Uva Provincial Council	41	4.9	217	7
Isuru Project	7	1	27	2
NGOs (Sarvodaya SEEDS)	30	1	125	4
Total	3577	141.7	6239	228.3

Source: Rural Credit Division, Central Bank of Sri Lanka.

5. Role of Institutions

5.1 Role of the Facilitator (Banks)

A facilitator can be any organization that has the capacity to help a buyer and a seller enter into a forward contract and to facilitate/regulate the trading activities of the parties to the agreement. These include all record keeping functions related to the contract such as the registration of the contract and the cancellation of the contract once all transactions have been completed. The facilitator also plays the vital role of promoting confidence and a workable relationship between the buyer and the seller. If and when a dispute arises between the buyer and the seller, the facilitator will attempt as best as it can to settle the dispute amicably. The facilitator constantly monitors different stages of the contract to ensure that the buyer and the seller are fulfilling their contractual obligations. Given the nature of the role the facilitator plays, banks are best equipped to provide the services of the facilitator. As a matter of fact, only banks have been involved so far in functioning as the facilitator under the *Govi Sahanaya* scheme. The facilitator charges a commission in the range of 1 to 2 per cent of the value of the contract for the services it provides. This ensures that the facilitator can function on a self-sustaining basis as the commission covers its costs of operations and a margin of profit.

5.2 Role of the Government

The Ministry of Agriculture, whose mandate is to increase the production and improve the marketing of farm produce, can and must play a pivotal role in promoting forward contracts. The most important element in this exercise is to create awareness among farmers, traders, and processors that forward contracts are an effective vehicle for managing commodity price risks. The Department of Agriculture can effectively use its TV and radio programs and the extension services to get the word across to farming and trading communities.

The Thirteenth Amendment to the Constitution has empowered Provincial Councils to undertake necessary steps to develop agriculture, fisheries, and livestock resources in provinces. The amendment empowers Provincial Councils to implement any program or programs to improve agricultural marketing. The Uva Provincial Council has already helped individual farmers and farm organizations to sign a large number of forward contracts under the *Uva Initiative*. Under this initiative, farmers and farmer organizations have already signed forward contracts with exporters for exporting vegetables, flowers, fruits, and cereals.

5.3 Role of Farmer Companies and Farmer Organizations

Many farmer companies have already been established under the auspices of the Ministry of Agriculture. These farmer companies can enter into forward contracts with private traders and processors for the sale of their produce. Several farmer companies have already signed forward contracts with private traders for various crops. Farmer organizations also can play an important role in this regard. In Sri Lanka, the role of farmer organizations is limited mainly to helping farmers obtain inputs and, in certain instances, assist farmers in irrigation and water management practices and disseminating information on other agricultural practices. Farmer organizations rarely involve themselves in commodity marketing. Forward contracts are an excellent opportunity for farmer organizations to assist fellow farmers by organizing forward contracts with large-scale traders and processors.

6. Summary and Concluding Remarks

High volatility in food commodity prices due to seasonality in food crop production unfavourably affects both consumers and producers. Low farm-gate prices during the harvesting period make farming unprofitable and unviable. Governments often intervene in agricultural marketing by offering guaranteed prices to ensure that farmers receive remunerative prices for their produce. Although the guaranteed price scheme in Sri Lanka has been in operation for over three decades, it never lived up to its expectations for various reasons. Implementation of the guaranteed price scheme is justifiable, on theoretical grounds, because farmers in Sri Lanka do not have any viable marketing options such as forward contracting or futures markets for managing commodity price risks.

As a market-based alternative to state intervention in agricultural marketing, the Central Bank of Sri Lanka introduced forward contracts under the *Govi Sahanaya* scheme in 1999. The scheme covers many crops and operates in many districts. This paper examines the *Govi Sahanaya* scheme and reviews its performance. Although it is still in its infancy, the scheme has generated encouraging results. Market-based alternatives such as forward contracting and futures markets are the only alternative to state intervention in agricultural marketing. The paper strongly recommends that this program be taken seriously by policy makers and be given state patronage to increase farmer participation.

Appendix 1

Table A-1
Forward Contracts Signed by June 30, 2001

Facilitator	District	No. of Agreements	Value (Rs.Million)	Remarks
1.Rural Development Bank (RDB)Matara	Hambantota, Matara	1100	62.0	800 paddy and 30 gingelly
2. RDB-Anuradhapura	Anuradhapura	534	11.5	300 gingelly and 234 other crops
3. Peoples Bank-Anuradhapura	Anuradhapura	319	4.4	Paddy
4. Cooperative Rural Bank- Anuradhapura	Anuradhpura	227	3.5	Maize
5. RDB-Matale	Matale	320	6.0	
6. Bank of Ceylon-Matale	Matale	121	10.0	84 big onion and 37 vegetable
7. Sarvodhaya- Matale	Matale	125	4.0	Big onion
8. Uva Development Bank	Badulla, Moneragala	205	8.0	19 paddy, 30 gingelly and 156 maize
9. Uva Initiative	Badulla	217	7.0	
	Kurunegala, Puttalam	62	2.9	
	Ratnapura	143	2.5	Mixed crops
10. Isuru Project-Central Bank	Puttalam	27	2.0	Ayurvedic medicine
11. Seylan Bank (Island wide)	Monaragala, Hambantota, Polonnaruwa, Anuradhapura	1600	69.0	Moneragala 400 maize, 1200 paddy

Source: Rural Credit Division, Central Bank of Sri Lanka.

Table A-2
Forward Contracts Signed under Various Crops by August 20, 2001

Facilitator	Crop					
	Paddy	**Maize**	**Gingelly**	**Big Onion**	**Other Crops***	**Total**
1. Ruhuna Dev. Bank/Regional Office, Matara	956	0	144	0	0	1100
2. Rajarata Dev. Bank/ Regional Office, Anuradhapura	87	147	290	167	67	758
3. Kandurata Dev. Bank/ Regional Office, Matale	208	0	0	739	0	947
4. Uva Development Bank	19	173	55	0	0	247
5. Wayamba Dev. Bank	0	0	62	0	0	62
6. Sabaragamuwa Dev. Bank	0	0	130	0	190	320
7. Seylan Bank	1100	608	0	12	0	1720
8. Peoples' Bank	0	47	272	0	0	319
9. Bank of Ceylon	0	0	0	102	68	170
10.Co- op Societies	33	194	0	0	0	227
11.Uva Initiative	0	0	0	0	217	217
12.Isuru Project	0	0	0	0	27	27
13.NGOs	0	0	0	125	0	125
TOTAL	**2403**	**1169**	**953**	**1145**	**569**	**6239**

Note: * Soya, Passion Fruits, Tea Leaves, Mushrooms.
Source: Rural Credit Division, Central Bank of Sri Lanka

Table A-3
Forward Contracts - Maize

District	Facilitator	Maha 1999/2000				Maha 2000/01				Yala 2001			
		1	2	3	4	1	2	3	4	1	2	3	4
Anuradhapura	RDB	61	50	2.2	9	86	40	1.8	10				
Monaragala	UDB	50	50	0.7	9	59	59	2.3	10				
Badulla	UDB	21	21	0.3	9					43	30	0.9	15
Monaragala	Seylan Bank					608	600	12.0	10				
Anuradhapura	PB					47	38	1.0	10				
Anuradhapura	Co-op					194	170	2.1	10				

Note: 1 = Number of Agreements signed, 2 = Number of Agreements performed, 3 = Value of Contracts (Rs. Million), 4 = Contract Price Rs/Kg.
Source: Rural Credit Division, Central Bank of Sri Lanka

Table A-4
Forward Contracts - Big Onion

Area/District	Facilitator	Yala / 2001			
		1	2	3	4
Anuradhapura	RDB	167		36.0	24
Matale	KDB	739		90.0	24
Polonnaruwa	RDB	50		8.0	24
Polonnaruwa	Seylan Bank	12		6.0	24
Matale	BOC	102		20.0	24

Note: 1 = Number of Agreements signed, 2 = Number of Agreements performed,
3 = Value of the Contracts (Rs. Million), 4 = Contract Price (Rs/Kg).
Source: Rural Credit Division, Central Bank of Sri Lanka

A-5

Forward Contracts - Paddy

District	Facilitator	Yala 1999				Maha 1999/2000				Yala 2000				Maha 2000 / 01				Yala 2001			
		1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
Hambantota	RDB	181	181	8.2	12	398	373	36	12	240	198	11	13	137	137	4.5	13	240	198	11	13
Anuradhapura	RDB	-	-	-	-	-	-	-	-	-	-	-	-	87	80	2.4	12	-	-	-	-
Badulla	UDB	-	-	-	-	-	-	-	-	-	-	-	-	19	19	1.0	12	-	-	-	-
Polonnaruwa	SB	-	-	-	-	-	-	-	-	110	110	4.0	12	590	590	42	12	110	110	4.0	12
Kandy	KDB	165	91	2.9	13	-	-	-	-	-	-	-		80	80	8.0	13	-	-	-	-
Anuradhapura	Co-op	-	-	-	-	-	-	-	-	-	-	-	-	33	33	0.6	12	-	-	-	-

Note: 1 = Number of Agreements signed, 2 = Number of Agreements performed, 3 = Value of the Contracts (Rs. Million), 4 = Contract Price (Rs/Kg).
RBD = Ruhunu Development Bank, UDB = Uva Development Bank, SB = Sabaragamuwa Development Bank, KDB = Kandurata Development Bank.
Source: Rural Credit Division, Central Bank of Sri Lanka

[redacted]

Annex 1

Appendix 2

Copy	1 - Buyer 2 - Seller 3 - Facilitator

FORWARD SALES CONTRACT
Between Buyer and Seller
(Under the Sale of Goods Ordinance No. 11 of 1896)

<table>
<tr><td>1. CONTRACT NUMBER PRODUCT AND DATE</td><td>(a) Contract Number</td><td>(b) Product</td><td>(c) Contract Date
(DD) (MM) (YY)</td><td>(d) Place</td></tr>
<tr><td>2. GRADE / SPECIFICATION & PACKAGING</td><td colspan="4">(See page 3 for description)</td></tr>
<tr><td rowspan="2">3. PARTIES ENTERING INTO CONTRACT</td><td>(a) BUYER</td><td colspan="3">NAME (IN FULL) :
ADDRESS :
COMPANY REG. NO:……………. N.I.C.NO. :…………….</td></tr>
<tr><td>(b) SELLER</td><td colspan="3">NAME (IN FULL) :
ADDRESS :
COMPANY REG. NO.:………….. N.I.C.NO. :……………..</td></tr>
<tr><td>4. VOLUME & PRICE</td><td colspan="2">(a) Kilograms Nett</td><td colspan="2">(b) Unit Price per kg. bag
Rs. Cts.</td></tr>
</table>

Continued …

<table>
<tr><td>5. VALUE</td><td colspan="3">(a) In number
.
Rs. Cts</td><td>(b) In words
______________ .
____
Rupees</td></tr>
<tr><td>6. DELIVERY</td><td colspan="3">(a) Place</td><td>(b) Before (DD) (MM) (YY)</td></tr>
<tr><td>7. MODE OF PAYMENT</td><td colspan="4">By cash or a banker's pay order on acceptance of goods by the Buyer. The acceptance is confirmed by the issue of an endorsed goods receipt note to the Seller.</td></tr>
<tr><td colspan="4">8. VALIDATION</td><td rowspan="5">SEAL/
FRANK</td></tr>
<tr><td>Signature - Buyer</td><td colspan="2">Signature - Seller</td><td>Signature – Facilitator</td></tr>
<tr><td>Date</td><td colspan="2">Date</td><td>Name</td></tr>
<tr><td>Place</td><td colspan="2">Place</td><td>Date</td></tr>
<tr><td></td><td colspan="2"></td><td>Place</td></tr>
</table>

Annexure forms a part of this document to describe the commodity specification, packaging and amendments.

Annex 2

GOODS RECEIVED NOTE

Contact Number

Date DD MM YY

Copy 1 - Buyer
2 - Seller
3 - Facilitator

1. BUYER	Name (In Full) Address Company Reg. No./NIC No.		
2. SELLER	Name (In Full) Address Company Reg. No./NIC No.		
3. COMMODITY, GRADE & PACKAGING	(a) Product	(b) Grade	(c) Packaging
4. GOODS ACCEPTED	(a) Volume Kilograms Net (b) Value Rs. Cts.		
5. GOODS REJECTED	(a) Volume Kilograms Net		

<table>
<tr><td></td><td colspan="2">(b) Remarks</td></tr>
<tr><td>6. DELIVERY</td><td colspan="2">(a) Period
From DD MM YY
To DD MM YY
(b) Place ______</td></tr>
<tr><td>7. PAYMENT
INSTRUCTIONS
OF THE SELLER</td><td colspan="2"></td></tr>
<tr><td colspan="2">8. VALIDATION

Signature - Buyer / Date - / Place -
Signature - Seller / Date - / Place -
Signature - Facilitator / Name - / Date - / Place -</td><td>SEAL/
FRANK</td></tr>
<tr><td colspan="2">9. FOR OFFICIAL USE</td><td></td></tr>
</table>

Standard Characteristics for pepper - Grade 2
And Packing Details in Forward Sales Contract No. ☐

Quality Specification	Esdianeous matter 1.5 per cent maximum by mass. Mouldy berries 2 per cent by mass. Light berries Broken pepper corns and skins 10 per cent maximum by mass. Pin heads 1 per cent by mass. Moisture 14 per cent by mass.
Packagings specification	Packed in 50 kg. Jute-hessian bags. Each bag shall be marked legibly and indelibly or a label attached with the information of name of the product, nett weight, type. Grade, contract number and the name and address of the Seller.

Note : The commodity gradings are as per specifications of the Sri Lanka Standard Institution (SLSI). In formulating the specifications consideration has been given to provisions under the Sri Lanka Food Act No. 26 of 1980.

Amendments to Forward Sale Contract No. ☐ (permissible within the by-laws of ………………………….) during the period of validity of the contract.

Date	Description of Amendments	Signature of		
		Buyer	Seller	Facilitator

1. **Period the Agreement Coming in to Force**

The agreement shall be in force during the period commencing on the contract date specified in item 1 and expires on the delivery date specified in item 6 in the contract document provided however, that any rights obligations arising from this contract after the said period of validity shall be enforceable notwithstanding the expiry of the period of validity of this contract.

2. **Delivery at Buyer's Warehouse**

Delivery shall be effected by Seller/Buyer to the place specified in item 6.

The Buyer shall provide labour at Buyer's expense for carriage from Seller's transport vehicle and shall accept delivery and will be required to keep the Warehouse open for such delivery at all normal working hours defined to be from 9 a.m. - 2 p.m. during the delivery period of ten working days prior to date specified in item 6.

The Buyer shall, upon delivery of the consignment, issue a receipt stating date, identification and weight of the goods delivered. When part delivery is made each such delivery shall be acknowledged by an issue of receipt stating date, identification and weight. On completing the delivery of the entire consignment as per contract agreement, the Buyer should confirm its receipt by issuing a duly certified Goods Received Note.

3. **Quality & Packing**

Quality shall be defined in item 2 and described in page 3.

All objections to quality shall be made by the Buyer to the Seller, his Agent or Broker immediately on delivery but not later than two working days from the date of delivery and failing amicable settlement of the objections regarding quality, the parties may have recourse to the facilitator for resolution or to a technically competent independent authority.

The consignment should be packed according to specifications in item 2 of this document.

4. **Weight**

The weight of the commodity to be delivered shall be as specified in the contract as per item 4. Where there is any variation from such weight of more than 2%, the Buyer shall have the right to refuse acceptance of any excess or claim delivery of any deficiency. Any variation in weight shall be noted on the "goods received note" at the time of delivery by the Buyer or the Seller or their representative.

Variations whether within the aforementioned 2%, (or at Buyer’s option of more than 2%) shall be adjusted immediately at the contract price, by reimbursement to the Buyer by the Seller for any deficiency or by additional payment to the Seller by the Buyer for any excess, as the case may be.

The weight of the commodity delivered shall be established at the place of delivery as specified in the contract. Scales, weights, labour and all facilities for weighing the commodity shall be provided by the Buyer at his expense since delivery is made at Buyer’s Warehouse or a Warehouse designated by the Buyer.

If the Buyer or the Seller or their representative demands the right to check the accuracy of the weighing scale provided, test weights stamped and scaled by the relevant local authority shall be made available to the Buyer on demand.

5. **Payment**

The Buyer shall pay to the Seller immediately on receipt by cash or within 14 days of delivery of consignment as per arrangements stipulated in item 7. In the event this contract document is lodged with a bank by the Seller as security for advances granted and either the Seller or the Bank intimate such fact to the Buyer in writing, the Buyer shall pay the amount due on the contract directly to the Bank and such payment shall discharge the Buyer from liability to pay the Seller under the contract. The Buyer hereby undertakes to pay the full proceeds of the contract direct to that bank. The seller shall give notice in writing to the Buyer, the Bank/Financial Institution and the Facilitator of such arrangements.

6. **Sub Contracting**

The Seller may sub contract the fulfillment of Seller’s obligation under the contract with the prior consent (in writing) of the Buyer, subject to the guidelines issued by the facilitator.

7. **Force Majeure**

In the event of war, invasion, act of foreign enemy, hostilities (whether war has been declared or not) civil war, rebellion, revolution, insurrection or military usurp of power, the

Seller shall be relieved of liabilities incurred under the contract wherever and to the extent which the fulfillment of such obligation is frustrated, prevented or impeded as a consequence of any such event or by any statute rules, regulations, orders or requisitions issued by any government, department or other duly constituted authority or from strikes, lockouts, break down of plant or any other causes (whether or not of a like nature) beyond the Seller's or Buyer's control as the case may be.

8. **Default**

In the event the Buyer defaults from purchasing the consignment or from payment as per agreement without due notice or reason, the Seller shall be entitled to claim loss and damages and the Buyer shall be liable to such claim made by the Seller for not fulfilling the terms and conditions of this agreement.

9. **Facilitator**

The approved facilitators are Banks and other credit institutions who have agreed to provide credit under this scheme.

10. **Arbitration**

In transactions exceeding a value of Rs.500,000, the parties so desire may go for arbitration under the Arbitration Act. The decision of such arbitrator shall be final, binding and conclusive on the parties hereto and enforceable through any court having jurisdiction over the matter. Before resorting to arbitration, disputes can be referred to the facilitator for mediation.

11. **Amendments**

The above terms and conditions may be amended by a written agreement signed by the Buyer and Seller. The amendments, dated and signed by the Buyer, Seller and the Facilitator shall be recorded in Annexure 2. Amendments to the price and quality is not permitted under the terms and conditions of this contract.

Signature………………………. Signature…………………
(Buyer) (Seller)

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