

A BUSINESS MODEL FOR PARTICIPATION BY THE GRAIN MARKETING BOARD IN THE PROPOSED WAREHOUSE RECEIPTS SYSTEM IN ZIMBABWE:

AN EXPLORATORY REVIEW



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1.0 Introduction and background

In September 2020, government of Zimbabwe and private sector embarked on a pilot project for the Warehouse Receipts System (WRS) in Zimbabwe. The pilot was to serve as a precursor to the establishment of the Zimbabwe Mercantile Exchange (ZMX). Towards this goal, the Warehouse Receipt Act (Chapter 18:25) of 2007 was operationalised in April 2021 through the Statutory Instrument No. 224 of 2020. The ZMX was officially launched on 19th August 2021 and is set to commence trading.

Furthermore, a digital software, which can be linked to ZMX, has been installed and operationalised and has also been integrated with the systems at selected banks. A module for use by the Office of the Registrar of Warehouses has also been put in place. Despite restrictions imposed by the Government to control the spread of COVID-19, some awareness campaigns and capacity building activities have been undertaken, targeting key actors including commercial farmers and farmer groups, trader associations, warehouse operators, mobile phone network service providers, bank financial institutions, and transporters. Relevant public regulatory bodies such as the Reserve Bank of Zimbabwe (RBZ) were also targeted in the course of these actions.

Some storage facilities owned by TSL Limited have been certified by the Registrar to be used for storage and issuance of warehouse receipts (WRs) under the WRS. Two additional other private storage services providers, the Origen PLC and the Export Trading Group, have expressed interest in being certified as warehouse operators but are yet to submit applications to the Office of the Registrar. The Grain Marketing Board (GMB) has also expressed interest in applying for 12 of its storage sites to be certified under the WRS. Some of these GMB storage facilities have already been inspected by the Registrar and approval is pending.

As the single largest storage operator in the country, the GMB is likely to emerge as the lead actor in offering storage services to individuals, groups and firms under the WRS. However, its strategic role in grain marketing as well as in the implementation of the Government's national food security policy, may create potential policy-related stumbling blocks which may slow down or even impeded the development of the WRS as well as ZMX. This review paper, therefore, explores the business model which GMB can adopt in order to meet objectives such as being a highly competitive service provider, taking into account the fact that some private warehouse operators have or are considering applying to be certified under the WRS. In addition, the model should ensure that provision of warehousing and ancillary services is financially viable and not a drain on corporate or government resources. It should also help to minimise policy-related uncertainty, which has been the bane of similar projects in many African countries.

2.0 Basic Warehouse Receipting Concepts and models

2.1 Generic description of WRS

Coulter and Onumah (2002)¹ describe WRS as involving the issuing of WRs as evidence that specified commodities of stated quantity and quality have been deposited at particular locations by named depositors. The WRs may be issued to individual farmers, farmers' groups, traders, exporters, processors or any individual/corporate body. The receipts may be paper-based or electronic, but no

¹ Coulter J.P and G.E. Onumah (2002) "The role of warehouse receipt systems in enhanced commodity marketing and rural livelihoods in Africa", Food Policy, Vol. 27, No. 4 (2002).

matter the form, they represent a legally-binding obligation by the issuing warehouse operator to hold a commodity by way of safe custody.

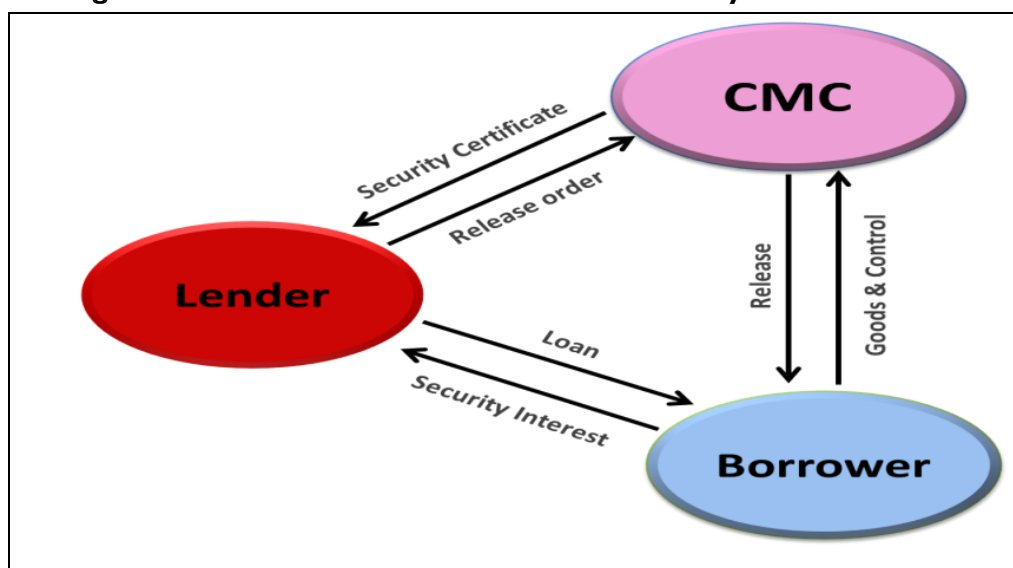
This implies that the issuer is liable to deliver the goods on demand and has to make good any loss (e.g. through theft or damage by fire) but does not retain legal or beneficial interest in it. For this reason, in the event of liquidation of the issuing company their creditors cannot seek recourse to the underlying stored commodities since legal title remains with the depositor or *bona fide* holder of the receipt. Recourse is limited only to the issuer's lien covering outstanding storage costs.

The most critical feature of a WRS is that the issuer guarantees to deliver the underlying commodity upon presentation of the receipts. It is this guarantee which makes it possible for the holder of a WR to sell the commodity through transferring it to a buyer. It is also the credibility of this guarantee which makes WRS acceptable to financial institutions as collateral for loans – a function which led to WRS being more commonly referred to as inventory credit systems.

2.2 Common WRS models in Africa:

The first form of WRS which emerged in African countries following liberalisation of agricultural marketing systems involved custody of stocks by collateral management companies (CMCs), who were mainly international inspection companies, the pioneers being Société Générale de Surveillance (SGS). The CMCs set up tripartite *collateral management agreements* (CMAs) involving a specific bank, a specific borrower and the collateral manager as illustrated in Figure 1.

Figure 1: Basic structure of CMA-based inventory finance



Source: N. Budd (2014)².

The system is structured for individual borrowers who hold stocks exclusively in one facility or site and are charged fees, which can be quite high, on per facility/site basis. Most actors in commodity value chains are excluded from access and, usually, only large-scale importers, exporters and processing companies are able to take advantage of this system. Furthermore, as noted by Onumah (2012)³, the

² Budd N. (2014) "Inventory finance", Presentation at Workshop at Ulaanbaatar, December 15, 2014.

³ Onumah G.E. (2012) "Warehouse Receipts and Securitisation in Agricultural Finance to Promote Lending to Smallholder Farmers in Africa: Benefits, Legal & Regulatory Issues", *Uniform Law Review*, Vol. 17, 2012-1/2 pp.351-367.

WRs issued under are not transferable and so cannot be used to facilitate trade either directly between different parties or through an exchange. Its main purpose is to facilitate inventory financing.

In contrast, there is a WRS model which exclusively targets smallholder farmers, storing their commodities in small-size warehouses with capacity of 50-100 tonnes. The warehouses are usually run by farmers' organisations or cooperatives and access is mainly to their members. It is quite common in Francophone West African countries where it is referred to as *Warrantage*. Under this system, the participating farmers deposit commodities (usually cereal grains) in a warehouse and obtain a WR which they deliver to microfinance institutions (MFIs) as security for loans of up to 70% of the market value of the stored commodity. When the crop is sold, payment is made to the MFI. In general, smallholder farmers benefited through ensuring the availability of food at household levels during the "lean or hunger" season. However, the WRs issued are non-transferable, implying that in most cases this WRS model cannot support formal trade in agricultural commodities as is the case with the CMA model discussed above.

2.3 A regulated WRS will suit the Zimbabwe context

The regulated WRS model, which has been promoted in some African countries and is the one being adopted in Zimbabwe, mirrors the model in the US in terms of the key building blocks. The main distinguishing features include: the involvement of an **independent regulator** which is responsible for licensing/certifying operators as custodians of warehoused stocks; storage by **multiple depositors** in a single storage facility or site; and issuance of **transferable WRs** – making it possible to underpin trading by exchanges. The building blocks include the following:

- a. A network of licensed/certified warehouses/silos and operators.
- b. Licensing/certification requirements which are applied in selecting providers of storage services under the WRS. The licensing/certification requirements include operators having:
 - Adequate capital;
 - Suitable storage infrastructure (owned or leased under terms which are at least co-terminus with duration of the licence or certificate);
 - Properly assized/calibrated weighing scales and grading, sampling equipment;
 - Well-trained staff; and
 - Insurance against fire, theft/burglary and other perils as well as performance bonds to cover for in-store losses due to management lapses or fraud etc.
- c. Regulatory body which strictly applies these licensing/certification requirements as well as other the legislative framework, regulations and industry best practices needed to minimise in-store losses. This body is required regulate issuance of standardised warehouse receipts in order to minimise the risk of fraud. Furthermore, it exercises oversight over the operations of the licensed/certified operators through carrying out regular on-site and off-site examination of their activities in order to minimise the risk of non-delivery of stored goods upon presentation of a WR.
 - The Regulatory body can be a government agency (as in the US, Tanzania and Uganda) or non-public (e.g. the commodity exchange as is the case in South Africa, Ethiopia and Zambia).
- d. Supporting institutional infrastructure including the following:
 - Reliable market information systems to keep market players well-informed;

- Trade-friendly quality standards set with the aim of ensuring storability and tradability of the stored commodities; and
 - Enabling policies.
- e. Financial institutions willing to lend against the receipted commodities as well as depositors and buyers eager to trade using the receipts.

2.3.1 Cases of successful regulated WRS model in Africa

The regulated WRS has been most successful in **South Africa**, where it underpins trading by the Agricultural Division of the JSE Securities, which started off as the South Africa Futures Exchange (SAFEX), taken over by the Johannesburg Stock Exchange (JSE) in 2001. It was however called a Silo Certificate System (SCS) because storage occurred mainly in grain silos. The exchange registered the grain storage/trading companies and their storage facilities, applying minimum capital and other standards it set. Collateral managers were engaged by the exchange to monitor stocks and storage management on its behalf but not as issuers of the silo certificates as in the case of the model described in Section 2.2 above.

According to Sturgess (2017)⁴, the SCS helped to assure delivery against traded contracts, thereby boosting not only trade on the exchange floor but also facilitating trade in the grains value chains because the grains could be collateralised in highly secure and trusted facilities. It is noteworthy that South Africa's success was due not only to having a network of well-capitalised and professionally-run storage facilities and a well-developed banking industry, which was quick to seize the new financing opportunities that emerged, but also the fact that the post-apartheid Government of South Africa maintained pro-market agricultural trade policies and avoided interventions which distort markets.

The **Ethiopia** Commodity Exchange (ECX), which was launched in 2007, has become the leading spot exchange in Africa. It trades commodities with market value of about US\$ 1.3 billion per annum, predominantly export crop such as coffee and sesame⁵. It is also reported to have significantly improved government revenue generation by offering a transparent platform for tracking volumes of commodities exported through formal channels. It also generates gross revenue which is about 1.5 times its operating costs, implying that its operation is financially sustainable. Its commodity trading function is linked to a network of warehouses which are licensed by the ECX.

Tanzania began piloting a regulated WRS in the late 1990s and it has been most successful for export crops such as coffee and cashew. The Tanzania Warehouse Receipts Regulatory Board (TWRRB) has licensed over 60 privately-run warehouses with total storage capacity of about 260,000 tonnes. Its functions are based on warehouse receipts legislation and regulations adopted by the Board. The bulk of the commodities receipted by volume are cashew (62%) and coffee (32%) and depositors are able to attract significant inventory finance, estimated at over US\$200 million per year. The Tanzania Mercantile Exchange (TMX) was launched in April 2020 on the foundation of the country's regulated WRS and is already showing considerable potential.

⁴ Sturgess C. (2017) "Understanding the JSE's Commodity Derivatives price risk management tools", Presentation at Southern Africa Grains Network, 15th May 2017.

⁵ Source: PARM (2016) "Ethiopia Agricultural Risk Assessment", Platform for Agricultural Risk Management (PARM), IFAD, Rome 2016.

2.3.2 Why the regulated WRS suits Zimbabwe

The recent launch of the ZMX is one reason why the regulated WRS suits the market development needs of Zimbabwe. The three cases briefly discussed above show the importance of a regulated WRS in the functioning of commodity exchanges. In contrast, there is evidence from across Africa showing that commodity exchanges which have been promoted without supportive delivery systems structured on a credible WRS have struggled to take off or gain traction. This certainly is one reason why the success of ZMX and the WRS option adopted in Zimbabwe are intertwined.

Another reason why the regulated WRS is a good option for the country is that a significant proportion of agricultural producers are smallholders for whom the CMA model is unsuitable, in part because of the high cost. The inventory credit or Warrant age model may be accessible to them but it still does not open access to the large formal market in, for example, grains markets to them. The regulated WRS makes formal storage, marketing and finance accessible to the smallholders whilst also allowing for participation by medium and large-scale actors. One benefit of the latter is the likelihood of both the WRS and ZMX being financially sustainable over short-to-medium term time frame.

A third reason for recommending this model is because it is aligned with the policy goal of scaling down government's involvement in food grain marketing without losing control. It is possible for Government to channel its grain procurement and sales to major processors through ZMX. That can be done only when the WRS is embedded in the ZMX ecosystem.

2.4 Anticipated services/benefits from regulated WRS in Zimbabwe

Like their counterparts in many developing countries, the marketing strategies adopted by smallholder farmers in Zimbabwe does not maximise their profits but is often dictated by other factors. Top among these is the pressure to sell the bulk of their output at harvest in order to meet consumption needs at harvest and to repay loans taken for production. Their farm income is often reduced as a of opaque practices in the informal marketing system – standard weights may not apply and/or scales may be adjusted. Furthermore, even if quality premiums are available in the market, they rarely benefit.

Successful development of the WRS can help in transforming this situation by providing alternative marketing options and access to finance at pre and postharvest.

2.4.1 Enabling smallholder farmers to adopt better marketing strategies

One option the WRS will offer is the ability of depositors to delay sale and benefit from normal intra-seasonal price increase. This is because it will be possible to borrow against the stored grains for purposes of repaying production loans and to meet pressing household needs. The main challenge for farmers opting for this is price risk, usually occurring as a result of policy interventions which create market uncertainty.

Evidence from Tanzania, Uganda and Burkina Faso suggests that even if farmers have the option of taking inventory finance some of them to not take it. For such farmers, the preference is to be able sell a fraction of their output soon after harvest and store the rest in facilities which are managed by professionals and therefore reduce postharvest losses. By so doing, farmers households have more food grain available for consumption and/or sale. This option will be available under the WRS.

2.4.2 Enabling smallholders to participate in exchange trading

Selling through the exchange makes it possible for farmers to gain from directly selling to end-users such as processors or exporters and also to enjoy premiums offered for the quality commodities which are traded. The exchange, when it matures beyond spot trading, will offer futures and options contracts which make it possible for market actors to hedge against price risk. Such participants will largely include those who are using the WRS.

2.4.3 Creating opportunities of low-cost inputs credit

Zambia has successfully piloted a WRS-based inputs finance scheme which can be replicated in Zimbabwe. The scheme involves direct sale of inputs on credit by major distributors rather than relying on bank finance. Stored commodities are still used as collateral and can only be sold with the permission of the inputs distributor. The contract can be set up at the time of harvest but sale and payments is delayed until late in the season. Bypassing banks in financing inputs substantially reduces the cost of borrowing.

3.0 Warehouse Receipt System Business Model for Storage Operator

Following from discussions in the preceding sections, the role and business model to be adopted by GMB is explored in this section. Three alternative models are considered and these are discussed below.

3.1 Business Model I: Maintaining the current operating model

GMB currently operates as a vertically-integrated entity performing the following statutorily-defined functions, among others:

- a. **Grain procurement** including setting producer prices through an administrative process, which sometimes focuses on projected production costs rather than market fundamentals. Under this system, deliveries by producers constitutes a sale and is mandated by statute. In such a situation, if producer prices are above market prices, producers have incentives to oversupply to GMB as has happened in the Zambian market in recent years. The consequence is that GMB is likely to be selling below cost, undermining its long-term viability and/or making it more dependent on the public purse.
- b. **Storage** occurs primarily on behalf of GMB, and it is unlikely that Government/GMB will consider alternative storage service providers resident in Zimbabwe even if they are more efficient and/or charge lower fees. Hence, losses arising out of laxity in failure to comply requisite professional standards and practices tend to be absorbed centrally. In some jurisdictions, this has encouraged practices by staff which increase the level of in-store losses.

Examples include intake of poor quality commodities and storage management practices which increased risk of quality deterioration.

- c. **Grain marketing** decisions tend to be administrative and allocations and prices tend to be influenced by considerations other than market fundamentals. This may lead to crowding the private sector out of the grain marketing chain. For instance, loss of competitiveness in grain procurement will drive large-scale processing companies to be dependent on Government for supplies rather than structuring their own, cost-efficient systems.

Detailed cost/benefit assessment of the model will show that it is not sustainable and alternatives need to be explored. In particular, cost of storage services will be taken as part of overall operational costs and discourage evaluation of the cost-effectiveness of internally-sourcing this service. Opening up that space to external competitive pressures is likely to drive improvements which will be to the benefit of GMB and Government as whole.

3.2 Business Model 2: Leasing designated GMB sites to private operators

As Zambia started piloting a regulated WRS in 2000, one of the first steps taken by the Government was to allow the Food Reserve Agency (FRA) to lease storage facilities to qualified operators. The leases were to run for about five years and the operators were required, as part of the tenancy terms, to use the allocated facilities only for grain storage. The economic rentals charged were set at levels which allowed for proper maintenance of the designated facilities, but also took account of the need for the private operators to run financially viable storage operations which will incentivise them to invest in increasing available storage capacity in the country. A competitive tendering process was used to transparently select parties to whom the facilities would be rented.

The result is that some of the pioneer warehouse operators who took advantage of this scheme have ended up as foundation members of the network of warehouse operators who are currently certified by the Zambia Agricultural Commodity Exchange (ZAMACE). They invested in new storage infrastructure and through that attracted foreign investment in the same industry, especially from the major South African grain trading companies. As a result, available storage capacity has more than doubled at the national level since 2000. The bulk of the increase came from the private sector, which has overtaken government in terms of storage capacity owned. The implication is that, measures which allow the private storage industry to flourish can trigger growth in the supply of commodity storage space without huge public investments.

This option can be adopted by Zimbabwe, meaning that GMB will designate some storage sites for leasing to private operators willing to participate in the WRS and incorporated into the ZMX ecosystem. Details of the terms and conditions which will guide such an action can be worked out later.

It has to be noted however that leasing public storage facilities will not be sufficient to drive growth in the industry if demand for services is not fostered by required trade policy actions. For instance, in recent years, the FRA in Zambia has totally dominated grain trading, setting above-market producer prices for grains such as maize. The stocks it procures are also stored in its own facilities, including open-air storage. The private sector has therefore be unable to compete in storage service delivery and even less so in grain trading. Not only have they been unable to compete on grain pricing but also the uncertainty created as a result of government interventions stifled private trading.

Hence, if Zimbabwe is to go for this option, then there should be certainty that trade-friendly policy actions will be implemented by the Government.

3.3 Business Model 3: GMB provides autonomous storage services

Under this model, GMB retains ownership of all the storage sites but designates those which will form part of the WRS as autonomous operating sites under the GMB as a holding company. The designated sites will offer storage services to GMB, the Government and other actors including private depositors (e.g. farmers, traders and processors). They have to be run as separate cost centres, which have to be financially/commercially viable and tasked with covering operating costs whilst aiming in the medium-term to generate net revenues which will fund regular maintenance and capacity expansion. In principle, this objective is to be achieved whilst competing with private service providers.

The GMB headquarters will be responsible for their licensing/certification, including paying for requisite insurance cover and other start-up costs for participating in the WRS. In addition, it will provide guidelines for setting fees for storage and other ancillary services such as drying, cleaning and sorting if required by actors in their catchment area. Most crucially, and to avoid breaches of regulatory conditions which can lead to fines or loss of license/certification, the headquarters need to set up an internal oversight department which will carry out regular on and off-site examination of the designated facilities in order to ensure compliance with relevant legislation, regulations and best industry practices.

3.3.1 GMB procurement functions under this model

With grain storage service being independently provided, GMB will be required to procure grains from smallholders and other producers by means of buying the WRs representing the underlying stocks. If the stocks are from “contracted sources”, then the purchase will involve transfer of the WR to GMB rather than the physical grains. If not, then GMB will procure through the ZMX, but can stipulate if so required by policy, that the grains it buys should have been sourced from smallholders. Since trade contracts issued by the exchange will be backed by WRs, traceability can be assured.

Since GMB becomes *bon fide* owners of the grains procured, it can pledge the stocks to financing banks. Standard Chartered in South Africa financed grain stocks on behalf of the Government of

Zambia in 2010 and, in principle, other local and international financial institutions such as the IFC have shown interest in providing financing in this form. The liquidity which will be created will address the problem of delays in paying farmers who sell to GMB and ease the pressures these households face.

It will also allow other producers to store in GMB facilities and either access inventory finance or trade through ZMX as previously occurred when farmers sold grains stored by GMB through the defunct Zimbabwe Commodity Exchange (ZIMACE).

3.3.2 Grain marketing by GMB versus relief supplies

As noted above, grain allocation and pricing by GMB is through an administrative process which may be rewarding commercial processors without necessarily easing the effects of price shocks on consumers. Grain marketing can become more transparent if channelled through the ZMX. This does not preclude direct sales to specifically-designated small-scale millers who may be servicing a targeted group of poor consumers.

3.3.3 GMB role in moderating adverse price movements

A major concern among policymakers is the possible loss of control when there is considerable shift to the market. However, this model allows for interventions in the market to address short-term gluts which may disincentivise producers and/or price spikes which adversely affect consumer wellbeing. GMB can, through its bidding process at the ZMX, provide a buffer against steep price falls which may occur during the peak of the harvest when there is a bumper harvest.

On the other hand, when prices begin to spike normal levels, it should be possible for GMB to increase its sales into the commercial market, thereby triggering lower prices. The key here is that, for as long as GMB and Government are committed to this approach, private traders will often adjust to market information, in a manner that minimises the risks of either a collapse of producer prices due to short-term oversupply or crisis-causing price hikes. The Government of South Africa has, since 1996 not intervened directly in the grain markets but access to reliable market information and certainty in the policy environment has enabled the private traders to continue to supply grains into the regional markets even when there is a domestic shortfall. This is because they are able to respond to any potential domestic deficits through gap-filling imports.

The type of policy levers mentioned here are akin to Open Market Operations (OMO) by the reserve or central banks. It allows policymakers to influence money supply and interest rates indirectly, that is, without administratively fixing interest rates.

4.0 Conclusions and recommendations

In this review we have shown that though three different types of WRS exist in Africa, the most appropriate for Zimbabwe is the regulated WRS. This is because it is accessible to actors of different size, ranging from smallholder farmers (usually as groups) to large-scale enterprises in agricultural value chains, including aggregators, wholesale traders, exporters, importers and processors. It can also support the recently launched ZMX, improving its prospects of becoming one of the few successful exchanges in Africa. This because, under the regulated WRS, transferrable WRs can be issued which can be used to back trade contracts and guarantee delivery. It is the inability to guarantee delivery which has undermined the development of the most exchanges promoted in Africa since the early 1990s.

It is also evident that the Zimbabwe has the basic physical and institutional infrastructure to make the regulated WRS in the country. Some reforms will, however, be needed, including in the policy environment and also the type of business model which GMB will adopt. In Section 3 of this overview document, we have briefly set out three business models. The first involves maintaining the status quo where GMB vertically integrates the key functions of grain procurement, storage and sales. It has been argued that this model is likely to reinforce perceptions about market risks and therefore, at the minimum, slow down the development of the exchange.

A second model discussed maintains the GMB core operations but creates space for private sector warehouse services provision by leasing designated sites to private operators. Though this may allow for new entrants and, through competitive pressures, improve the quality of storage service delivery, most of the factors which cause market uncertainty are likely to remain.

The third business model involves GMB restructuring its operations in order to provide storage services as an autonomous commercial function, independent of its grain procurement, marketing and other policy-related functions. The sites designated for this operation will be made autonomous and operate in competition with private service providers in a manner which guarantees delivery of receipted commodities. The Board's grain procurement and marketing functions are also to be aligned to the development of the exchange. That will mean using market levers rather than administrative interventions to achieve policy objectives.

It is recommended that Business Model 3 is given consideration by GMB. If it is seen as the way forward, then further work is needed on the following issues:

- a. Details of a restructuring plan for GMB, including details on the investment required and expected returns to the investment; the financial returns to users of the storage services

including smallholder producers; and the potential fiscal benefits to Government as the scope and cost of its involvement in the grain marketing system changes.

- b. Training and capacity building plans for managers and staff of the designated sites in warehouse management and reporting protocols under the WRS. This form of training will also benefit private service providers and may be extended to them as a public good in support of Government's market development agenda, though full or partial cost recovery is also possible. Similarly, GMB head office personnel who will be responsible for oversight of the operations of those sites will require capacity building which will not be limited to training but also include the preparation of relevant manuals e.g. inspection manuals.
- c. Training will also be needed by GMB personnel who have to monitor market developments in order to advise appropriate policy responses using market levers.
- d. Related to the above, a review of existing grain market information systems and submission of specific recommendations which will keep market actors and policymakers better informed.
- e. A promotional plan focusing not only advertising the services to be provided by the storage arm of GMB but also how it can be accessed by smallholders and other actors.
- f. The above may require outlining a plan for constructing aggregation centres which will make it possible for smallholders to bulk their produce, ensure compliance with quality standards and avoid costly rejection of stocks delivered to the designated warehouses.