

**Informal hearings of civil society on financing for development
(UN Headquarters, Conference Room 3, 22 March 2004)**

Commodities as a Development Issue

Discussion paper by Irfan ul Haque*

The Monterrey Consensus highlights the need to mitigate the consequences of low and volatile revenues from commodity exports. As noted by the UN Secretary-General in his first report on the "Implementation of and follow-up to commitments and agreements made at the International Conference on Financing for Development", as many as 38 developing countries are dependent on a single commodity for more than 50 per cent of their export income, while 48 countries depend on only two. Price fluctuations have not diminished and the price levels of some important commodities have fallen to historically lowest levels.

In discussing the "commodity problem", it is important to dispel the notion of "gloom and doom" that has come to be associated with commodity markets. The fact is that commodities, even under depressed market conditions, continue to provide comfortable earnings to traders, processors, and other intermediaries in the value chain from primary production to final consumption. There are also a number of commodities that have benefited from significant technological advances in productivity, quality improvement, and product-use, and enjoy good prospects for further technological growth. There may have been "a sort of conspiracy of silence" on the commodity issue (as President Chirac put it), but it enabled the industrial countries to give huge subsidies to agriculture competing directly with the supplies from developing countries. One cannot even say that the industrial world lacks interest in commodities, considering the prominence the issue assumes the moment there is the prospect of supply shortage or when the welfare of domestic firms is at stake (the battle over bananas between the EU and US a few years ago was nothing but that).

In short, the commodity problem is quintessentially a developing country problem, reflecting developing countries' vulnerability to adverse market developments and their inability to take advantage of technological improvements. Other actors in the market – traders, processors, consumers, even industrial country primary producers – remain distant from the developing countries' distress.

There are basically three aspects of commodity markets that have an impact on primary producers' welfare, viz., wide fluctuations in primary prices and incomes, the long-term declining trend in prices, and the declining share of primary producers in the value chain.¹ The position of commodity producers has generally worsened in recent years, just as the belief in public action and institutions to deal with the commodity problem has considerably weakened under the neoliberal ideology. In particular, there is little support today for a revival of

¹ "Value chain" refers to value addition as a commodity moves and gets processed from its original source (farm or a mine) before reaching the final consumer.

* This paper was prepared on the initiative of the Friedrich Ebert Foundation and the Washington-based New Rules for Global finance Coalition.

international commodity agreements or reestablishment of state marketing bodies, which once helped to regulate commodity markets.

Following a UN General Assembly resolution, UNCTAD called a meeting of a group of “Eminent Persons” on 22-23 September 2003 in Geneva to address the commodity issue. This note attempts to provide the context and highlight some of the recommendations of this expert group (of which I was a member) as they relate to the three above-mentioned areas of concern. The full report has been produced as an UNCTAD official document (TD/B/50/11, dated 30 September 2003).

Price and earnings instability

In dealing with the issue of volatile markets, the measures designed to stabilize producers’ income should be distinguished from the issue of price stability. The EU’s STABEX was an example of a scheme designed to provide compensation, on an ex-poste basis, for unforeseen export earnings shortfalls to a number of African, Caribbean, and Pacific (ACP) countries. The IMF’s Compensatory Financing Scheme (CFS) was also designed to provide short-term balance of payment support to countries facing adverse terms of trade shocks. Neither of the two schemes, however, is currently operative. STABEX was abandoned when the last Lomé Convention was negotiated, although thought is being given to its revival in some form. The main reason why the CFS has been little used over the years is that the financing under the scheme is contingent on the country concerned being able to satisfy the IMF as to the temporary nature of the price fall, a condition that primary producers have found difficult to fulfill. Funds are not available if the price fall is seen as following a secular trend.

The Eminent Persons’ Report (EPR), in urging the revival of CFS, underscored the need for ex-ante mechanisms, i.e., linking automatic payouts to specific occurrences, and eliminating conditionalities associated with the IMF’s conventional support. (#12)

With respect to stabilizing prices, there has been some interest in the so-called “market-based risk management” instruments, which attempt to take advantage of options trading. The EPR noted that although this was not a panacea, “market-based tools for providing ... security exist for a number of commodities.” (#25) But several things need to be considered. First, the use of options and hedges as protection against price uncertainty, like any insurance, has a cost, which is directly proportional to the risks involved. To state the obvious, these instruments, like conventional hedges, simply offer protection against price uncertainty; they do not deal with the volatility itself. Secondly, options trading require rigorous regulation and supervision to prevent abuse, which may not be feasible in a typical low-income commodity-dependent economy. Finally, individual producers may not have sufficient means or the expertise to purchase hedging instruments. The EPR, however, urged that “efforts to create the capacity to manage commodity price instability should become a part of all rural development schemes ...” (#26)

Price maintenance

Price stabilization and maintenance are closely related issues, for they both turn fundamentally on producers’ ability to regulate their supplies. In fact, the conventional measures

for stabilizing prices – buffer stocks or hedges – would be easier and economical to implement if prices displayed a generally rising rather than a falling trend. Primary products suffer from long periods when price remains below long run costs, causing hardship to producers and fiscal difficulties for governments. When faced with similar problems, the industrial countries, despite strong neoliberal ideology, have shown a remarkable degree of pragmatism, offering protection as well as financial aid to agriculture or ailing industry, justifying it on grounds of hardship to some domestic group or unfairness of other countries' actions.

Primary producing countries can take a leaf from this experience: if arrangements to regulate production or exports of surplus commodities are not possible under an international agreement, producers could come together with the aim to curtail supplies and improve market conditions. Such cooperation is also needed for strengthening their bargaining position vis-à-vis transnational corporations engaged in trade in commodities in question. The EPR notes: "Where appropriate or feasible, [supply reducing measures] may include producer-consumer schemes, joint measures by producers only, and national measures." (#17)

There have been a number of past examples of producers' alliance, most well known being the OPEC (the Organization of Petroleum Exporting Countries). Others have included coffee, tin, and natural rubber. Under US leadership, a cartel-like action was also tried in aluminum, a manufactured product, in the early 1990s, to withstand the threat of supplies from the former Soviet Union disrupting the market. The experience of these alliances indicates that, for their success, there are at least two prior conditions that must be fulfilled or at least substantially fulfilled. The first condition is that all major producers share a common interest and vision in controlling production or exports so that a collective action has sufficient support. The problem arises when the costs of the action are borne by the alliance members, but the benefits of higher price are shared by all producers. This problem of free ride can more easily be tackled if there are only a few producers of the commodity in question.

Secondly, a price level completely divorced from market forces can only be maintained for a very limited time period. The bigger the difference between the price that the alliance members want and the free market price, the more difficult it becomes to maintain the target price. The payoff on cheating is directly proportional to this difference and under pressure an alliance risks its breakdown. There is also the consideration that higher the target price, more likely would it be for non-alliance sources of supplies to emerge. Notwithstanding the difficulties in forming producers' alliance, there are a few commodities where such a step may be feasible.

If the price cannot be maintained at a sufficiently remunerative level, the producers must diversify out of commodity production. Commodity markets, however, do not function according to the textbook model. The actual experience shows that low prices tend only to accentuate producers' dependence on the commodity in question since there are few feasible alternatives. Trade liberalization and exchange rate depreciation (which were the key components of the structural adjustment programs) actually made matters worse by discouraging the rise of new industries, which require protection and government support. The EPR recognized this problem and made several recommendations to build up local capacities and

capabilities. (#18 and #19) It also lent support to the Commonwealth Secretariat's proposal for the creation of an International Export Diversification Fund. (#27-#29)

Enhancing value added

As a product moves from the farmgate or mine to the port for export and then on to the final consumer, it goes through both a process of handling (i.e., grading of output, packaging, domestic transport, paperwork, trade finance, etc.) and actual physical processing. The question arises, how various steps along the value chain are controlled and coordinated, especially when the crossing of national boundaries is involved. In particular, the question arises as to how improvements in productive efficiency get shared between producers of primary products in developing countries and final consumers in industrial countries. In a number of cases (notably, cocoa and coffee), producers have been hit hard by the depressed prices, but this has had little impact on the price of the finished product. This means that primary producers have faced price declines without the benefit of increased demand that would have followed if the final product price had also fallen. Thus, from the perspective of economic advancement, the distribution of value added between primary producing, developing countries and the consuming, industrial countries has become an even more important issue than the level and instability of the price.

The distribution of value added and the appropriation of profit at each stage of the chain depend basically on the market structure, the rules governing commercial transactions, and the corporate relationships that develop at each level. In the case of agricultural commodities, in addition, ecology, specific processing requirements (including phytosanitary considerations), and the ease of mechanization, storability, and transport all play a role in structuring transnational commercial relationships. If atomistic competition prevailed (i.e., all sellers and buyers were so insignificant that they could not individually influence the market price) and if the bargaining power was not dependent on agents' economic status, the market could be relied upon to settle the question of who gets what at different stages. However, in the case of primary commodities, that is far from being the case, and is one reason why globalization and market liberalization are viewed with suspicion by those who have little control over how markets function.

The ability to improve a producer's position in the value chain is obviously closely related to its ability to diversify. The EPR did not make a specific recommendation in this regard but noted: "The place of primary producers in the value chain is an important issue to consider in the case of commodity-based development and diversification. Improved competitiveness and successful diversification are principal avenues for strengthening this place so that a greater part of the value added is retained in the country". (#40)

Before concluding this short paper, it is necessary to underscore another class of problems that some primary producers face, i.e., the distress caused as a result of the subsidies given by the industrial countries to producers of agriculture crops, most notably cotton, that directly compete with their exports. This was considered a very important issue in the EPR, which recommended devising modalities for the payment of compensation to the distressed countries. (#7)

Report of the Meeting of Eminent Persons on Commodity Issues**Recommendations in the order as mentioned in the text above**

#12 *Compensatory finance has an important potential role in insulating developing countries from the worst effects of international price volatility, and indeed in reducing volatility. In order to be effective, such financing has to meet the following requirements:*

- *Operation on the basis of ex-ante rather than ex-post mechanisms (in other words, clearly linking automatic pay-outs to specific occurrences);*
- *Ease of access, in terms of technical requirements;*
- *Absence of conditionalities for receiving the finance – it should be sufficient that the country itself carries no evident blame for the specific commodity-linked loss that it suffered;*
- *The inclusion of a pass-through mechanism to actual producers and consumers.*

#25 *Much of the burden of commodity price volatility is now borne directly by producers (with particularly severe effects on the poorest of them). Negative effects are also felt by processors, traders and consumers in developing countries. Producers in particular would benefit strongly from better price risk management – the increased likelihood of not receiving less than a certain price for their products. While not a panacea and requiring proper conditions for use, market-based tools for providing such security exist for a number of commodities.*

#26 *The international community should play a more proactive role in this area. We feel that, with some urgency, efforts to create the capacity to manage commodity price instability should become a part of all rural development schemes, along with the various efforts to plan and prioritize development assistance (in particular, the Poverty Reduction Strategies as formulated under the aegis of UNDP and the World Bank, and the Integrated Framework for Trade-Related Technical Assistance for the Least Developed Countries set up in the context of WTO). Donor institutions should provide more support to implement programmes in this area.*

17 *In the short term, however, measures to reduce the supplies put on the market may be necessary. Where appropriate or feasible, these may include producer-consumer schemes, joint measures by producers only, and national-level measures. In this connection, we recognize the “free-rider” problem and the operational difficulties with supply management schemes. Producer countries that face a situation of oversupply are also encouraged to take national measures – an example is Malaysia’s use of a cess on palm oil production imposed in times of high prices, which is used in times of low prices to subsidize the use of palm oil in a non-traditional way, namely for electricity generation – as well as measures in cooperation with others that can address their predicament. Relevant institutions could be approached to organize meetings to examine the experiences in this area. Countries that are not party to such schemes should agree to apply a favourable interpretation of GATT Articles XI, XX and XXXVI, as well as other relevant articles of GATT and WTO Agreements, and to forego using competition policy measures against such schemes. Developed countries should eliminate subsidies, where feasible, to contribute to reducing oversupply.*

#18 Many commodity-dependent developing countries do not have the capacity to benefit from potential market openings. Support for strengthening supply capacity in the commodity sector should be made an integral part of international assistance to commodity-dependent countries. This should include policy-level support to design and implement strategies, policies and measures for commodity-based development and diversification, the improvement of domestic research and development capacities, as well as support for the organization of small-scale producers to achieve better integration into international supply chains. Encouraging and strengthening organization of small-scale producers, processors and traders of commodities with a view to enhancing their capacities for technology absorption and for marketing of their product is important. We emphasize the importance of assistance aimed at enabling small producer to meet quality and traceability requirements, as well as market exigencies reflected in the specifications of importing firms.

#19 We recognize that capacity building has many different facets and that different entities such as international organizations, private companies, particularly TNCs, business associations, NGOs and the Governments of developed and developing countries have their specific insights and competences. A holistic approach with consistency and complementarity, and based on a spirit of partnership among all the relevant actors, has a better chance of making a positive impact than a piecemeal approach. We call for an organization such as UNCTAD to be entrusted with the task of convening the different entities mentioned above so that needs of commodity-dependent countries in terms of capacity building are examined, an integrated coherent programme of capacity building is designed, its implementation followed up, and a division of labour as well as commitments are secured. The implementation of such a programme “in the field” would call for country-level arrangements, possibly led by international organizations with country presence. Donor organizations are invited to support these capacity-building activities financially.

#27 Ultimately, in order to drastically reduce poverty, countries need to fully utilize opportunities to diversify their productive capacity (within the commodity sector, including through value addition, and outside the sector). Having access to markets is a necessary condition, but not a sufficient one: they need to develop new supply capacity. The recommendations above should help in this respect. But the ability of countries to move away from excessive dependence on a few commodities would be much strengthened if, for their efforts, they had access to an “International Diversification Fund”. This could be linked to an existing institution, such as the Common Fund for Commodities.

#28 We urge the international community to have a new look at such a Fund, and in particular, consider a new mode of financing it. This would be justified given the long-term decline in the terms of trade for commodity exports from developing countries, which implies a real resource transfer to consuming countries.

#40 The place of primary producers in the value chain is an important issue to consider in the case of commodity-based development and diversification. Improved competitiveness and successful diversification are principal avenues for strengthening this place so that a greater part of the value added is retained in the country. It was generally agreed that horizontal, vertical and geographic diversification is an integral part of the development process in commodity-dependent developing countries and that only a very small number of countries have been successful in basing economic development on the commodity sector, particularly the export of raw commodities, alone. Improved stability of prices will contribute to facilitating the diversification process by reducing risks to producers and allowing them to invest in diversification. It was also emphasized that diversification ultimately has to be the result of decisions taken on the level of individual producers. Diversification policies should enable them to make informed choices. Support or diversification, whether by Governments or by international agencies, should take into account both current and prospective world market conditions and avoid the risk of fallacy of composition. Diversification

recommendations should not be based on static comparative advantages, but on dynamic considerations. Diversification is not, however, an end in itself, but an element of development strategies. Competitive commodity producers should not have to diversify out of commodity production just because of market distortions such as those introduced by subsidies.

#7 Meanwhile, however, there is need for action to compensate developing country farmers for the losses that they suffer as a result of current developed country policies. In line with the proposal by four African countries at the WTO Ministerial Meeting at Cancun, we call for an early elimination of subsidies provided in developed countries to cotton and for the compensation of the loss of earnings due to the supplies of cotton subject to subsidies. We call upon the international community to prioritize research on the modalities for such a compensation mechanism, working with expert organizations such as UNCTAD. We also call for further work on the appropriateness of extending the model of the “cotton initiative” to other relevant commodities.

Questions related to the paper

- Wouldn't it be more appropriate to consider the terms of trade as a measure instead of absolute price levels in the discussion on commodities as they better reflect purchasing power of exporting countries?
- What scope of action does the WTO Committee on Trade and Development have with regard to the long-term price decline of primary commodities? Is the WTO Committee an appropriate institution to tackle the "commodity problem" and would special and different treatment be an adequate instrument to respond to it.?
- What are some examples of commodity agreements that have been successful in the past and why did they go out of business?
- What are the shortcomings of the IMF's Compensatory Financing Scheme? How would you design a mechanism to address the commodity price falls that are the result of a secular trend?
- You have made several recommendations. What would your ideal, comprehensive package look like? When would you apply which policy tool? What would you rank as the top priorities?
- The Eminent Persons Report has made a number of recommendations but has not identified a specific institution that could be entrusted to monitor progress or carry them out. Do you feel that an institution is needed? If so, which existing institution could undertake the task?
- You have not mentioned "fair trade" products such as coffee and chocolate. Are these useful tools? Should the UN and all of its agencies insist only on the promotion of "fair trade commodities"? How much difference would it make?
- Wouldn't it be important to integrate a gender perspective in the commodity discussion to be able to elaborate adequate policy recommendations, if we take into account that women "constitute 70% of the agriculture work-force, produce 80% of food crops, and that 75% remain active in production, processing, packaging, labeling, and sales in most developing and least developed countries?"
- How do you evaluate the environmentalists' approach of charging the full price for goods that would cover all major "externalities" (pollution, non-renewable products, violation of labor standards) as a response to the problem of low prices for primary commodities?