INTRODUCTION

1. This paper aims to set out a commonly agreed framework for addressing the various problems associated with commodity production.[1] In particular it focuses on "soft" agricultural commodities identified for coverage under the UNCTAD Integrated Programme for Commodities, which tend to be produced in developing countries and consumed in developed ones. This paper covers the development perspectives, as well as the interests of domestic industries and consumers. These commodities display certain defining characteristics:

- They are often produced in rural areas;
- They often involve a number of small producers;
- They are primary products, as opposed to manufactures, and involve minimal levels of processing within the producer country; and
- They use 'low-tech' methods of production relative to manufactures.

2. The 'commodity problem' is often described as declining terms of trade (commodity prices rising less rapidly than those of manufactures) and export instability (fluctuations in prices and earnings). These problems are exacerbated in many countries by an overdependence on a few commodities. Several factors contribute to these problems:

- Increased competition through the expansion of commodity production in developing countries;
- Erosion of preferential margins for traditional suppliers leading to reduced barriers to new market entrants - many traditional commodity-producing nations have seen their share of a particular commodity market lost to other nations[2];
- Reduced demand: Primary resources are used increasingly less (as a percentage) in developed country production;
- Downward pressure of world agricultural prices as well as the "dumping" and subsidy activities of various industrialized nations.

3. In addition, there remains concern about the low priority being accorded to the agricultural sector in some poverty strategies, and the consequent impact on levels of investment (e.g. in rural infrastructure). There is also a growing perception that, post-liberalisation of domestic commodity markets, there has been an increase in the proportion of the international commodity trade earnings, which accrue to market participants located outside the producing country. The significant decline in commodity processing that has taken place in the least developed countries has merely served to heighten these concerns.[3] Some commentators have also begun to question the future of small-scale producers in relation to their capacity to meet social standards and other market requirements (including the WTO agreement on sanitary and phytosanitary measures).

4. At the same time many developing countries are, increasingly, having to contend with serious challenges such as high inflation and rapidly devaluing currencies, environmental pressures, as well as major public health challenges (HIV/AIDs, malaria). While some countries have succeeded in reducing their dependence on primary agricultural commodities, for many the age-old 'commodity problem' remains as pervasive as ever.

5. However, the global political and economic landscape has changed considerably since the UNCTAD Integrated Programme for Commodities was finally negotiated in the 1970s, leading to the creation of the Common Fund for Commodities. Direct market intervention arrangements (e.g. buffer stocks, export quotas etc.) and the economic provisions that once graced most International Commodity Agreements (ICAs) have

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[1] This paper reflects broad inter-departmental agreement on a variety of issues related to soft commodities. It is based on contributions from DFID, DTI, DEFRA, FCO and HMT.

[2] The Windward Island share of the UK banana market has fallen from 27% in 1996 to 18% in 2000 in spite of preferential market access arrangements (PROMAR Report, 2001). The emergence of Indonesia (cocoa), Vietnam (coffee) have also altered the structure of the market in those commodities.

[3] UNCTAD (2002).The Least Developed Countries Report, 2002: Escaping the Poverty Trap, p.147

increasingly been seen as inappropriate in modern markets. Moreover, WTO Agreements have established a new set of rules governing the international trade in agricultural goods and services.

6. Donor policies and priorities have also changed, as have views on the appropriate role to be played by the State. Poverty reduction has emerged as the overarching objective of most international donor agencies. There is also increased emphasis on channelling funding at the sector level or through the government budget in support of well defined, nationally owned, poverty reduction strategies as set out in a Poverty Reduction Strategy Paper (PRSP). Regarding the perceived role of the State, there has been a shift away from direct involvement in service delivery (e.g. commodity marketing, input supply, credit provision etc.) towards an emphasis on creating an enabling legal, political, social and economic environment.

THE IMPORTANCE OF A COHERENT APPROACH

7. There are several reasons for setting out a coherent approach in a commodity policy paper:

DEVELOPMENT PERSPECTIVE

8. Statistics for developing countries reveal commodity dependence as a pervasive feature. It was estimated in 1995 that at least half the countries in sub-Saharan Africa and Latin America relied on commodities for over 50 percent of their exports, with some countries relying particularly on one, two or three commodities. Over 57 percent of the export earnings of Uganda, 80 percent of Burundi and 68 percent of Ethiopia come from coffee. . And this should be contrasted with the experience of East Asian economies who have changed the pattern of their economies by diversify successfully into manufacturing.

9. The dependence on commodity production is particularly acute in Africa, as exemplified in the case of the beverage commodities – tea, coffee and cocoa. These crops are of considerable economic importance and contribute more than 15% of export earnings to ten countries in Africa. For nine of these countries, beverage commodities make up over 20% of export earnings and for three, more than 40%.

10. This commodity dependence is undoubtedly a development problem. It contributes to, or reinforces, development-related problems such as low incomes and food insecurity, poor education and health; low savings and investment; environmentally unsustainable practices; persistent fiscal deficits; balance of payments problems; and scarce foreign exchange. A proper understanding of the role of commodities in the livelihoods of the poor is central to progress in poverty reduction. Decision makers, whether operating at national or international level, must recognise this if the prospect of rising incomes and investment in developing countries is to be realised and if the Millenium Development Goals are to be achieved.

UK INTERESTS

11. The UK has strong political and economic ties to many developing countries (for example through our membership of the Commonwealth) for which trade in soft commodities is not only an important source of foreign exchange but also an integral part of the livelihood of a significant proportion of their populations. Invariably, the poorest countries are those exhibiting the greatest commodity dependence. The UK's commitments to promoting development, the elimination of poverty and the pursuit of policies that create sustainable livelihoods for poor people are clearly spelled out in the two White Papers published in 1997 and 2000 respectively. The correlation between commodity dependence and poverty means that we cannot ignore commodities in our development strategy. Increased global prosperity and protecting the most vulnerable and ensuring they benefit from the process of globalisation are explicit objectives of the UK government.

12. The UK also has an important and direct interest in the proper functioning of commodity markets. Our historical ties and preferential trade arrangements mean that we are a major importer and consumer of some primary agricultural commodities. For example, the UK imports teas from approximately 30 different countries and consumes 150,000 tonnes of tea per year; this amounts to 13% of international trade in tea. The UK imports 740,000 tonnes of banana per year with a retail value of £660 million, which is 15.4% of the EU banana market. Commodities also contribute significantly to the mercantile and financial life of London.

Numerous agents associated with the commodity trade, such as traders and insurers, are closely linked to London International Financial Futures Exchange (LIFFE).

EU INTERESTS

13. Until recently, International Commodity Agreements (ICAs), such as the cocoa, coffee and jute agreements, were negotiated between individual producer and consumer countries. International Commodity Bodies (ICBs) were established to manage these Agreements. Under this arrangement, signatories to the Agreements were able to contribute, subject to agreed rules and procedures, to the affairs of the relevant ICB.

14. EU Member States' participation in ICBs is changing as the EU itself evolves, and as the ICAs or other commodity agreements are themselves renegotiated. For example, with effect from October 2002, the European Commission has assumed sole competence on behalf of all the Member States of the European Union on matters regarding the operation of the International Coffee Agreement. The International Jute Study Group is already a Community competence; similar arrangements have been proposed for other commodities, including cocoa, in future. Where the legal basis for sole competency has been established, the European Commission assumes lead responsibility for negotiations, based on a Community Position agreed in advance by the Member States, and in accordance with the so-called Helsinki Principles (see Annex 3). Important administrative arrangements (e.g. payment of subscriptions to the ICBs) are also transferred to the Commission. The Working Party on Commodities (known as PROBA, from the French - Produits de Base) continues to serve as the principal forum for negotiation of the Community Position.

15. With such arrangements in place it has become even more imperative for the UK to present a co-ordinated position to guide debate in PROBA and other EU meetings, and for the EU as a whole to co-ordinate effectively. Whether an ICB operates under the exclusive Community competence, or with full Member State participation, will determine how influential the UK position will be, and how that influence can be exerted. Adequate preparation in advance (in Brussels) of meetings of International Commodity Bodies or other negotiations in respect to commodities not covered under the Common Agricultural Policy (CAP), is therefore particularly important to safeguard UK objectives and interests. Agreement between the Member States and the Commission on how to co-ordinate and prepare for meetings of the ICBs will have to be closely monitored and adhered to.

16. The Department for Trade and Industry (DTI) has overall policy lead on UK commodity matters and is responsible for co-ordinating with other relevant parts of Whitehall including the Department for International Development (DFID), the Foreign and Commonwealth Office (FCO), HM Treasury (HMT), Department for Food and Environment (DEFRA) and the Food Standards Agency (FSA).

PRINCIPLES AND OBJECTIVES

17. In 1999 it became increasingly clear that the EU's collective involvement in the ICBs had become somewhat disjointed and that despite our significant interests, as reflected in our voting rights and subscriptions to the ICBs, we were punching below our weight. At the Initiative of the then Finnish Presidency of the EU, representatives from the EU Member States met in Helsinki in October 1999 to consider future guidelines for a coherent EU commodity policy. The Commission and the Member States agreed a set of principles commonly referred to as the Helsinki Principles, which cover some of the institutional aspects of the ICBs with a focus on increased efficiency and private sector participation. It was a first step in identifying the common issues that needed to be pursued in order to ensure a more effective participation in the ICBs.

18. In summary, the key principles governing UK commodity policy are as follows:

- Coherence between EU commodity policy and other policies – including EC development policy
- Avoiding market-distorting intervention at both domestic and international level, including movement towards the lowering, and eventual elimination, of all tariff and non-tariff barriers to trade (including quotas, tariff escalation and other restraints);
- Non-discrimination in commodity markets including freedom of all relevant stakeholders to participate in, or contribute to, local, national and international deliberations that affect the trade in a particular commodity or group of commodities;
- Fair practice in regard to all aspects of commodity production, marketing and trade including, but not limited to, sourcing and other contractual arrangements, employment and other conditions;
- Good value for consumers encompassing food safety standards in accordance with internationally agreed or other equivalent procedures

19. UK Objectives can therefore be stated as:

- To ensure European Community commodity policy is both compatible and coherent with UK policies, including development policy, and to improve the functioning of Community co-ordination efforts at international negotiations or deliberations on commodity matters;
- To ensure that the Common Fund for Commodities, all international commodity bodies and agreements, including successor arrangements, operate as efficiently and as effectively as possible in accordance with clearly defined corporate plans and strategies, as set out in the Helsinki Principles;
- To encourage the liberalisation of commodity markets, for the benefit of all market participants, including EU companies and consumers;
- To reduce the negative social, political and economic impacts on developing countries, particularly on the livelihoods of the poorest, arising from commodity dependence.

ISSUES CONTRIBUTING TO THE COMMODITY PROBLEM

20. This section summarises the key issues contributing to the commodity problem and further analysis is provided in Annex 1

LONG TERM PRICE DECLINE

21. Evidence indicates that, over time, the price of primary commodities declines relative to manufactures. This is often explained by: i) uneven market structures where developed country manufacturers command large rents versus zero profit competition in developing country primary goods; and ii) higher income elasticity of demand for industrial goods relative to primary goods. In addition to this, the prices of most primary agricultural commodities have declined in real terms. The particular characteristics of primary agricultural commodities (low income and price elasticities) that is reflected in sluggish demand and regular periods of increased competition leading to global oversupply have probably led to this long-term decline in prices.

22. This decline is likely to continue for various reasons. On the supply side technological improvements, leading to rapid increases in productivity, increased competition, reduced protection of markets, the expansion of regional trading associations and individual producers mistaking temporary price rises for permanent will all contribute to an expansion of production. On the demand side, technology developments, which further displace primary commodities as inputs and consumption items, and slower population growth will act to depress demand growth; on the other hand rising stocks encourage manufacturers to ride out high commodity prices thus depressing world prices.

23. In common with all agricultural raw material producers, commodity dependent countries are capturing less and less of the value of their markets relative to downstream processors, wholesalers and retailers. This is mostly due to the evolution of the demand in developed countries with a persistent increasing preference for more processed food For many, declining foreign exchange earnings (vital for food imports, agricultural inputs[4] and other essential capital good requirements) are reflected in a continuous cycle of low investment, low savings and low productivity. Debt sustainability then becomes a major issue. Meanwhile, domestic market liberalisation in developing countries has removed the cloak of security once provided by state managed entities to producers of commodities destined for export and donors and the International Financial Institutions (IFI's) have been blamed for accentuating the problem of declining prices through their support for various recovery efforts (e.g. re-establishment of plantations) following catastrophic events such as war.

SHORT TERM PRICE VOLATILITY

24. In addition to the long-term decline, the prices of most internationally traded commodities are also subject to a high degree of volatility in the short-term. This volatility can be traced to a number of factors: i) lag between production decisions and delivery to the market (this is particularly the case for tree crops such as coffee and cocoa) ii) consumer demand for commodities changes little if the price rises or falls, whilst supply of many commodities is often dependent on the weather; iii) supply is also unresponsive to price in the short term so that shifts in demand have a large impact on price.

25. Large price volatility and unpredictability has implications at both the microeconomic and macroeconomic level. Fluctuating prices have a direct impact on the income received by small producers. At a national level, price volatility can significantly impede macroeconomic stability, economic growth and poverty reduction.

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[4] It is estimated that, in three years, Ethiopia, lost almost US$167 million in export revenues as a result of the slump in coffee prices (UN Office for, Integrated Regional Information Network (IRIN), 23 January 2002.

26. Sharp falls in prices also threaten the ability of the Heavily Indebted Poor Countries (HIPC) initiative to offer a robust exit from unsustainable debt. If prices fall after the required level of debt relief has been pledged (at decision point), that level of debt relief will be insufficient by the time the country exits the process (at completion point). The rules of the initiative are sufficiently flexible to allow additional debt relief at completion point (topping up) to those countries affected by exogenous shocks, although international commitment is needed to ensure there is sufficient financing available for this.

27. Governments in commodity-producing countries have attempted in the past to stabilise commodity prices by various means. The most common form of price stabilisation policy has taken the form of buffer stock intervention by a central authority that maintained commodity prices at a particular level by buying up any excess supply, and releasing stocks whenever the market tightened. Such interventions did help prevent large temporary shocks from affecting producers' investment decisions. However, they were unsuccessful because they relied on administratively set prices; they were not designed to address the issue of declining terms of trade; and they tended to shift risk from individual producers to the national Government (and therefore to the general population).

28. International efforts at stabilising commodity prices have been similarly unsuccessful. Efforts to control supply in order to support the price are difficult to enforce, particularly for agricultural commodities where artificially high prices merely encourage new producers to enter the market. Even for minerals, fixed prices encourage consumers to seek alternative products.

29. The potential of private or government entities to manage price risk through commercial risk management instruments has long been recognised as a means to achieve greater price security and to enhance access to credit[5]. But it is also recognised that, if used imprudently, they are potentially dangerous[6]. The World Bank as well as the Common Fund for Commodities is currently exploring the potential of such instruments for small-scale producers on a pilot basis.

30. Mechanisms to manage price risk can be distinguished from those to manage quantity i.e. crop risk. Whilst the use of market-based financial risk management instruments by farmers is common in the US, it remains unclear whether farmers in developing countries will be able to afford the premiums in the absence of subsidy. Indeed, insurance markets for agricultural commodities are particularly difficult to create due to the large moral hazard and systemic risks inherent to crop insurance. Even in the US where it is heavily subsidised, coverage is still considered unsatisfactory and premia often considered too high by farmers wishing to better manage their risk.

OVERDEPENDENCE ON COMMODITIES

31. As previously noted, statistics for developing countries reveal commodity dependence as a pervasive feature. Almost all the countries in Africa for example depend on primary commodities for over 50% of their export earnings. Reducing dependence on commodities by diversifying into different types of exports appears to be the best way to reduce vulnerability to negative price impacts in the long run. Broadly speaking, there are two diversification routes available to producers seeking to reduce their dependence on commodities: a) vertical diversification – measures that seek to capture a higher proportion of the value chain (i.e. to move the producer up

[5] Article 68 of the Cotonou Agreement also provides for European Community support for market based insurance schemes designed for ACP states seeking to protect themselves against the risk of fluctuations in export earnings.
[6] UNCTAD (1994)

the value chain) and b) horizontal diversification – investment in alternative crops or products including non-agricultural products.

32. However, tariff peaks and tariff escalation are a major obstacle to the development of a processing capability in the country of origin. The European Union's 'Everything But Arms' initiative and preferential access arrangements established under the Lomé Convention have gone some way to address these barriers, but more remains to be done. Another major impediment to the development of a modern processing capability remains poor infrastructure and the lack of an effective investment-enabling environment. At the same time, the investment levels required to penetrate retail outlets in consuming countries are significant on account of high marketing costs (including advertising and storage).

33. Horizontal diversification (e.g. into other crops, or products and services destined for the local or export trade) presents a different set of challenges. The significant investment associated with tree crops makes producers reluctant to destroy (e.g. scrubbing) these to move into other crops or sectors.[7] Adapting to new marketing systems frequently involves competition against already established players, including producers in developed countries who benefit from generous subsidies as well as deliberately protectionist tariffs and other trade barriers. In addition, the banking systems and capital markets are severely underdeveloped in many commodity-exporting countries, particularly those in sub-Saharan Africa. This missing market makes it difficult for producers who wish to diversify to raise the capital necessary to finance investment in new sectors. Finally, the institutional structure of the ICBs, each with a narrow focus on a single commodity, does not help promote horizontal diversification.

34. Despite a number of initiatives the reluctance of foreign firms to invest in many of the poorest countries is well known. In some circumstances this is due to uncertainties caused by political and economic instability. Small producers also experience difficulties in gaining access to capital for investment. The WTO has begun work to establish a multilateral framework of rules governing international investment, with the objective of securing a stable and predictable climate for investment worldwide.

35. Those countries that have successfully diversified away from dependence on primary commodity production and into more stable income earners (e.g. manufactures) were primarily in Asia and Latin America. They did so by promoting long-term economic transformation, rather than as a result of domestic export-targeted measures or external preferential trading schemes. High investment and savings were important in the development of supply capacity and public investment in infrastructure and education played a key role. It may therefore prove hard for poor countries in Africa to follow these examples. Nonetheless, the experience of these countries highlights the importance of including diversification away from commodity dependence as a long-term objective of development strategies such as the PRSP.

MARKET PLAYERS

36. It is sometimes argued that commodity prices are determined by a small band of multinational companies (MNCs) with the power to force prices down in order to increase their margins. However, as discussed above, the long term decline in prices can be attributed to the characteristics of commodities markets rather than price manipulation by MNCs. In the long run, factors such as technology, climate and demography are likely to have a far stronger effect on the price level. In the short-run, the degree of competition depends on the characteristics of each commodity market, even though some of the same MNCs are likely to be involved in the trade of a number of international commodities.

37. Although the concentration of MNCs is unquestionable, there is no substantive evidence of abuse of market power. Yet the suspicion persists, and commodity-producing countries are not well placed to investigate claims or take action against anti-competitive practices, which affect them but occur in other jurisdictions. The

[7] Indeed, in some countries (e.g. Kenya) the law prohibited the destruction of coffee trees.

inclusion of a competition agreement within the WTO as a result of the Doha Round would strengthen the framework to support competitive markets

38. At the other end of the supply chain, most commodities are produced on estates or on smallholder farms or plots. There is growing interest in the conditions (especially social and environmental) under which sourcing of commodities takes place and there now exist a number of international programmes (e.g. the ILO International Programme for the Elimination of Child Labour) designed to provide governments and the international community with valuable lessons for tackling the worst forms of child labour wherever it takes place. However, on smallholder farms, employment terms and conditions are informal, largely set by local custom and practice and are more difficult to monitor and implement. Moreover, as the costs of compliance with social and other ethical codes are usually borne by the producer, corporate social standards may be inappropriate and a potential liability to the livelihood prospects of independent smallholder producers (who are simultaneously entrepreneurs, employers and labourers).

FOOD AND REGULATORY STANDARDS

39. There is increasing consumer concern in the EU about the safety and quality of food. Labelling and traceability from origin requirements are expected to become more stringent. At the same time there has been a significant growth in the markets for organic produce. Certain commodity production systems have traditionally been singled out for their heavy usage of pesticides and other external inputs (e.g. cotton, bananas). But there may be other commodity production methods which could qualify as organic.

40. Many producers and local institutions in developing countries lack the human, technical and financial resources to meet the growing number of voluntary or other food safety standards imposed by private sector operators in developed countries and which frequently exceed internationally agreed standards based on scientific evidence. Effort is needed to ensure that precautionary measures, whether or not based on theoretical risk, do not detract from the importance of scientific evidence. And technical assistance is necessary to help producers comply with internationally agreed standards and where appropriate qualify for organic status.

INTERNATIONAL COMMODITY BODIES

41. Early attempts to address the commodity problem centred on international action pursued through the activities of a number of international commodity bodies (ICBs). This resulted in the establishment of various International Commodity Agreements (ICAs) and Compensatory Financing Schemes. As discussed above the objectives were usually to plan and regulate the system of prices, or, to insulate consumers and producers from market fluctuations through price controls or subsidies. However, these schemes that attempted to separate domestic commodity prices from international prices were unable to deliver the main objectives of price stabilisation or earnings stabilisation owing to the market complexities arising from frequent supply shifts and changing demand conditions..

42. Despite their shortcomings, the commodity organisations can still provide the main forum in which the developed countries can engage with the developing on issues of mutual importance. Some of the producer countries hold them in high regard because of this. The need for dialogue between producers and consumers is crucially important. The International Study Group (ISG) approach to commodity organisations, as set out in the Helsinki Principles, seems to hold out the most likely prospect of fostering such a dialogue.

43. Discussion of the future of ICBs has tended to avoid institutional reform. However, for a number of organisations, bureaucratic operating procedures have hampered their ability to provide solutions. Ideas recently proposed for the reform of the Cocoa Organisation included: a five year strategic plan; simplification and streamlining of decision making structures; increased public accountability; stricter financial control; and a transparent and open procedure for electing the executive director.

44. The Common Fund for Commodities (CFC) was set up to fund buffer stocks from its First Account. But, this Account was never called upon, and instead its work now focuses on activities and projects funded from the Second Account (research, development, technical assistance, diversification). Most of the objectives of the Common Fund remain valid - the achievement of stable conditions in commodity trade, the diversification of production, improvement of the real income of Developing Countries, of market access, competitiveness, market structure and marketing. In part it already provides a ready-made structure for addressing common commodity problems, through its involvement in the selection and financing of projects from all of the International Commodity Bodies (including the ICAs and the ISGs).

POSSIBLE ACTION POINTS

General

45. Before we can address the substance of the Commodity Problem, we must ensure that we have the institutional resources to do so. We should urge the Commission to allocate sufficient human resources to the units dealing with the ICBs. Presently for example, there is only one full-time policy maker responsible for coffee, cocoa, jute and tropical timber. As the move towards exclusive Community competence continues, the administrative burdens on the Commission will increase.

46. It is also important that we identify the market and policy failures affecting the commodities markets and do not promote intervention that might add to the current distortions, such as the past policy of buffer stocks. For example, from the previous section, the following market failures can be identified:

- Information failures:
    - Growers and international organisations have difficulties in identifying short-term price fluctuations from long-term trends and tend to over-estimate future prices.
    - Low technology transfer and lack of information on best practice necessary to maintain international competitiveness.
    - Lack of know-how on diversification and risk management.
    - Lack of know-how on tariffs and non-tariffs barriers.
- Access to capital
    - Many small producers have no access to banking, and investment is hindered by typically very high interest rates.
- Market power
    - Commodity producers are much more fragmented than wholesalers and processors, and the buyer power of the latter probably means that the burden of cost increases in the supply chain fall disproportionately on small suppliers.

47. The CAP, poor governance and bad investment climate are on the other hand, prime examples of policy failures.

48. The following list of possible action points reflects our thinking on how we could address these market failures and reduce the impact of the Commodity Problem.

LONG-TERM PRICE DECLINE

- Support for realistic diversification strategies for commodity dependent countries (both diversification out of commodities and also up the value chain). These should become a part of the PRSP design process. Includes long-term development goals such as fostering a good investment climate and good governance

- Povision of know how and opportunity to diversify out of commodities (agricultural extension services, adult literacy etc)
- Increase knowledge and bargaining power of producers e.g rural radio for price information, cooperatives and larger farms, and rural roads to provide access to local markets

SHORT-TERM PRICE VOLATILITY

- Subsidise micro-credit schemes and access to rural savings, so that surplus from the good years can be carried over
- Examine how it should be in their own commercial interests for businesses to agree to longer-term contracts with producers to smooth out fluctuations (rather than being viewed as an aspect of Corporate Social Responsibility)
- Analyse existing obstacles to the use of market based instruments for risk management
- evaluate World Bank and CFC pilot on price risk management for small scale producers (p9)
- Effective use of the STABEX successor in EU aid policy
- (HIPC) Continue to push for full financing of topping up at completion point to account for shortfalls in exports resulting from the fall in commodity prices.

OVERDEPENDENCE ON COMMODITIES

- We should use our influence in the various ICBs and in the CFC to ensure that a significant and increased proportion of the finance allocated to projects is earmarked for diversification.
- Diversification strategies should be well founded by taking into account the comparative advantage of Commodity Dependent Countries and changes in trade preferences – possibly needing a greater focus on services
- Expanding trade opportunities for commodity-dependent countries; cutting tariffs and reducing the negative impact of the CAP - .
- Develop financial markets
- Support the inclusion of an investment agreement in the Doha Development Round

FOOD AND REGULATORY STANDARDS

- Focussing technical assistance to ensure that commodity dependent countries are able to meet the standards and thus access markets for their goods.

MARKET PLAYERS

- Encourage establishment of cooperatives to increase producers bargaining power
- Support the inclusion of a competition agreement in the Doha Development Round agenda

INTERNATIONAL COMMODITY BODIES

- .Ensure effective coordination between the Member States and the Commission to prepare for meetings of the ICBs.
- Reform of ICBs – involving all stakeholders with an emphasis on information sharing and market analysis including the promotion of horizontal diversification where appropriate –further reform ideas in annex 1.
- We should press for review of the operating objectives and implementation plans of the ICBs, and continue efforts to streamline the operation of the ICBs, including the decision making processes and project implementation
- Ensure greater emphasis in work programmes on sustainable outcomes rather than operational (ie project) outputs.
- Strengthen the role of the CFC so that it ensures the spread of best practice between the projects of the different International Commodities Agreements.

ETHICAL TRADE AND FAIR TRADE

49. It is important to make a distinction between ethical trade and fair trade.[8] Ethical Trade tends to be concerned with the *conditions of production*, whilst Fair Trade tends to highlight the *price paid to the producer*. Nonetheless, many fair trade organisations are at the forefront of efforts to highlight the presence of exploitative practices and to promote greater corporate social responsibility. Fairly traded commodities represent a small share of the global trade in commodities[9]. While it remains to be seen whether they can secure a significant share of the conventional market for any particular commodity [10], there are questions in any case about the long-term effectiveness of such a solution being operated on a large scale. However, their role in raising consumer awareness and in putting pressure on conventional supply chains to take account of ethical issues is politically very important in working towards a trading system which is fair for all.

50. Fair trade organisations have created a parallel marketing chain, facilitated through distinctive labelling (e.g. Fairtrade Mark), which allows consumer to pay a premium which supports producers and their communities directly. a One implication of this approach is that the rules and practices governing conventional international trade, particularly for tropical agricultural commodities, are in some way 'unfair'. This has created tension with other market players who do not regard their own practices as 'unfair' in who dispute where any unfairness lies[11] (Morton 2002). The few studies in this area have been inconclusive or have relied on anecdotal evidence.

51. Those sceptical of the value of fair trade arrangements regard them as a voluntary tax or charitable contribution paid by developed country consumers ,]. They question thepotential for helping a large number of poor producers in this way because of the correspondingly large number of consumers required to contribute. Proponents argue that a 'living' price, above the cost of production, is the only sustainable long-term strategy for consuming countries. They also point to the positive impact of the community projects funded by such schemes, even though they may be small in relative terms.

52. Both sides have a point. However, any move away from the voluntary nature of fair trade arrangements risks a consumer backlash. Any administered system would also face the practical challenge of determining an appropriate "fair" price. Finally, such a scheme would require counter-measures to ensure that the "fair" price did not encourage marginal producers to move into the commodity, exacerbating the problem further and reducing the effectiveness of initiatives to promote diversification.

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[8] See briefing paper produced for DFID by the NRET Need proper reference

[9] Fairtrade bananas currently account for about 2% of the UK market (Promar). Similarly, Fairtrade coffee accounts for 1.0 to 1.5% of global trade in coffee (Westlake, 2002)

[10] Even in the Netherlands where there has been a great deal of publicity, 97% of consumers still do not purchase fair trade coffee. It has also been reported that in the UK purchases rose steeply for the duration of Fairtrade fortnight, only to return to normal levels.

[11] According to Westlake (2002), the ICO has found no evidence that retail coffee prices are increased at times of world shortage but are not reduced at times of surplus. Need full reference

ANNEX 1: COMMODITY PROBLEM ISSUES

1. COMMODITY PRICES IN THE LONG TERM

DECLINING PRICES RELATIVE TO MANUFACTURES

1. The starting point for any discussion on non-oil commodity prices is the Prebisch & Singer (1950) hypothesis. This posits that in the long run, the price of primary commodities, relative to manufactures, declines. Using data for the period 1870-1945 they found that the terms of trade of developing country exporters had deteriorated at a rate of between 0.5 – 0.7% per year. The hypothesis implies that the international trade environment for developing countries worsens over time, if they depend on primary commodities. Most research since has supported the Prebisch & Singer hypothesis.

2. Economists have attempted to explain the Prebisch & Singer hypothesis through: i) asymmetric market structures consisting of oligopolistic rents in (developed country) manufactures versus zero profit competition in (developing country) primary goods; and ii) higher income elasticity of demand for industrial goods relative to primary goods.

DECLINING ABSOLUTE PRICES

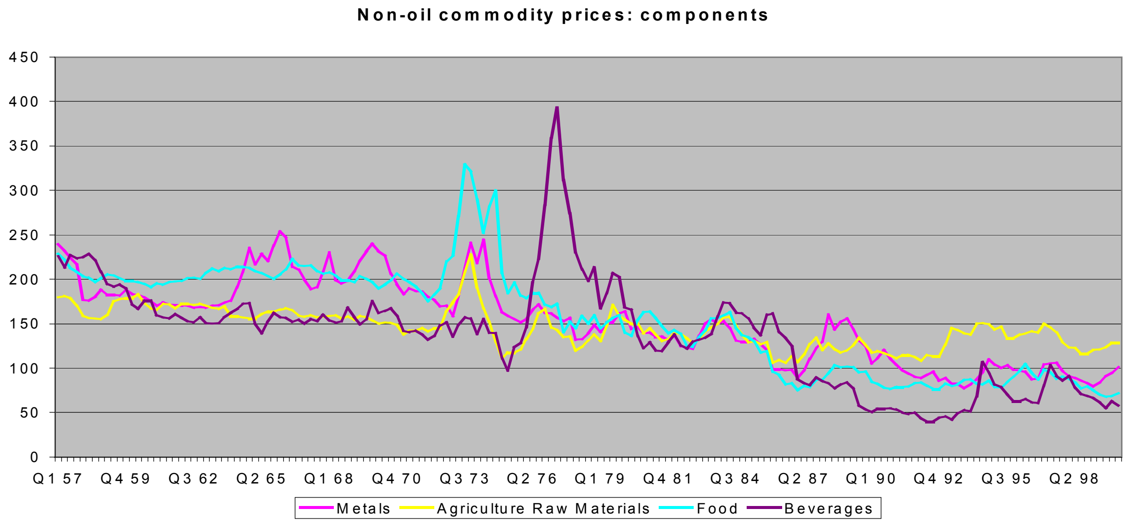
3. The prices of most primary agricultural commodities have declined in real terms. The graph below shows clearly how the prices of all non-oil commodities have behaved since the late 50s; there has been an overall fall in real commodity prices, except for a brief period of commodity power (1973-1979), which put control of supply in the hands of developing country exporters. It is important to note that a decomposition of the non-oil aggregate index into its 4 main subgroups - metals, agricultural raw materials, food and beverages – demonstrates that the fall in real commodity prices is a phenomenon that has affected the entire non-oil primary sector.

4. In a number of cases, the development of substitutes has been the cause. For example, cheap synthetic fibres can be used as substitutes for cotton in the textile industry. Other reasons include declining intensity of natural resource use in developed country GDP; improvements in commodity production techniques; and new producers entering the market.

5. However, Deaton & Laroque (1992) amongst others have found that aggregate commodity prices follow a random path (where the best predictor of tomorrow's value is today's value). The implication of this is that it is hard to attribute the decline in real prices to a consistent and predictable trend. Rather, it would appear that the fall in prices has been due to a series of random shocks that were more negative than positive. IMF studies[12] indicate that the negative net effect of these random shocks on aggregate commodity prices is due to two particular features of commodity prices. Firstly, on average, price slumps tend to last twice as long as price booms (63 months as opposed to 37 months between 1957 and 1999). Secondly, prices typically fall further in slumps than they rebound in subsequent booms. This unequal pattern of rising and falling prices creates additional problems for commodity producing countries, as policy cannot be formed on the assumption that upswings and downswings in prices will counterbalance each other over time. Over time, the particular characteristics of primary agricultural commodities (low income and price elasticities) that is reflected in sluggish demand and regular periods of increased competition leading to global oversupply have led to this long-term decline in prices.

[12] IMF (May 2000) *World Economic Outlook*. Washington DC. IMF

Figure 1[13]



COMMODITY PRICE PROSPECTS FOR THE FUTURE

6. Predicting the future path of non-oil commodity prices is obviously subject to much uncertainty, but if there is no change to the way these markets operate the historical decline may continue into the next decades for the following reasons[14]:

7. On the supply side:

- **Technological improvements** can be expected to continue increasing supply and lowering costs, as considerable research is devoted to techniques for agriculture and for mineral extraction. For instance, intensification of coffee production and relocation out of frost-prone growing areas in Brazil have improved productivity and increased coffee yields. Technological improvements are also aided by increased diffusion of information and growing techniques;

- **Increased competition and reduced protection of markets**, especially in previously highly protected markets, are likely to lead to increased supplies and greater price competition from suppliers. The emergence of major new producer countries, such as Vietnam, which has increased its level of coffee exports by 900% over the last decade, has contributed to depressed prices;

- **Expansions of regional trading associations** (e.g. EU, NAFTA, MERCOSUR, ASEAN) are likely to occur, which will break down tariffs and trading barriers thus reducing the prices of traded commodities (at least within the blocs);

- **Despite better information, individual producers are still likely to mistake temporary price rises for permanent ones leading to overcapacity**. When prices are high, existing producers will expand production and new producers will continue to enter the market, leading to excess supply. However, even though prices will drop, transmission is not instantaneous. For example, with crop commodities it requires several years before newly sown areas will produce viable crops, which will create a lag between higher prices and increased supply. Equally, as prices fall, farmers will not instantly cut back on supply due to the investment they have made in their crop.

[13] The price series are deflated by world prices of manufactures exports (Index, 1990=100).
[14] For the purposes of this paper our forecast horizon is 20 years. As a result we can ignore for the time being the upward effect of potential future resource constraints on prices.

8. On the demand side:

- **Technology developments,** in some cases the development of new man-made materials are likely to further displace primary commodities as inputs and consumption items in the 21st century;

- **Slower population growth** will act to depress demand growth[15]. The World Bank forecast global population growth to slow from 1.4% during the 1990s to 1.1% in the first decade of the 21st century and 0.9% in the second. In the newly industrialized countries of East Asia (where commodity demand has grown most rapidly in recent years) population growth will be even slower. To some extent rising world income growth will offset this. But since many commodities have relatively low-income elasticities, faster growth is unlikely to be price supportive in the long run.

- **Rising stocks,** oversupply of many commodities has led not only to falling prices, but also to rising stocks. High levels of reserves encourage manufacturers to ride out high commodity prices, which further depresses world prices.

- **Rising demand for more highly-processed food** lengthens the market chain, weakening market signals and allowing the downstream sector to capture an increasing share of the added value of the commodities traded.

CONSEQUENCES

9. Commodity developing countries are capturing less and less of the value of their markets relative to downstream processors, wholesalers and retailers. For many, declining foreign exchange earnings (vital for food imports, agricultural inputs[16] and other essential capital good requirements) are reflected in a continuous cycle of low investment, low savings and low productivity. Where export growth rates begin to lag behind interest rates on external debt, debt sustainability becomes a major issue with important implications for the effectiveness of international debt relief efforts such as the HIPIC initiative.

10. Domestic market liberalisation in developing countries has removed the cloak of security once provided by state managed entities to producers of commodities destined for export (e.g. pan-territorial guaranteed producer prices). At the international level, the collapse of international supply management arrangements has generally been accompanied by a reduction in commodity prices. In spite of benefits to some producers (prices as a higher % of f.o.b.), there is a growing acceptance that producers of primary agricultural commodities are simply receiving a 'larger share of a diminishing slice'.

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[15] Potentially, this is quite a complex factor – acting both on demand and supply. If population growth in developed countries slows relative to developing countries, not only might demand growth slow, but potential supply will rise. However, in this respect, the availability of other inputs (e.g. land) will be important too.

[16] It is estimated that, in three years, Ethiopia, lost almost US$167 million in export revenues as a result of the slump in coffee prices (UN Office for, Integrated Regional Information Network (IRIN), 23 January 2002.

11. Donors and the International Financial Institutions (IFI's) have been blamed for accentuating the problem of declining prices through their support for various recovery efforts (e.g. re-establishment of plantations) following catastrophic events such as war. Other support provided to support research efforts designed to improve productivity (e.g. higher yielding varieties) or designed to counter the threat posed by pest or disease has also attracted criticism in certain quarters. There is no evidence however to suggest that this criticism has directly contributed to the declines in ODA to agriculture as reported by certain UN Agencies[17].

[17] According to IFAD (2001), the real value of net aid disbursed to agriculture in the late 1990s was only 35% of its level in the late 1980s, Rural Poverty Report 2001, The Challenge of Ending Rural Poverty p. 41.

2. SHORT TERM PRICE VOLATILITY

VOLATILITY

12. In addition to the long-term decline, the prices of most internationally traded commodities are also subject to a high degree of volatility in the short-term. This volatility can be traced to a number of factors:

- Demand for most commodities is relatively price-inelastic, that is, consumer demand for commodities changes little if the price rises or falls, whilst supply of many commodities is often dependent on the weather. The two combined cause supply variability to have a large effect on price. For example, frost in Brazil can greatly reduce the world's supply of coffee, but the price has to increase by a large margin to bring the fairly unresponsive demand into equilibrium with the smaller supply.
- Supply is also often very inelastic, or unresponsive to price, in the short term (e.g. the commodity may be perishable, inventory costs are high or production takes considerable time) so that shifts in demand have a large impact on price.

13. Moreover, several studies have found that the volatility of primary commodity prices increased sharply following the collapse of the Bretton Woods system in the early 1970s and has remained high[18].

CONSEQUENCES

14. Large price volatility and unpredictability has implications at both the microeconomic and macroeconomic level. Because large sections of the population are dependent on commodities for their livelihoods, fluctuations in commodity prices have a disproportionate impact on the welfare of entire communities. Fluctuating prices not only create unemployment uncertainty but also lead to increased risk aversion. This is manifest in reduced household consumption and reduced farm level investment. Limited investment in new technology (e.g. pest abatement technologies), labour (e.g. maintenance) or capital (e.g. new perennial crops) serves to further reduce competitiveness thereby distracting rural investment.

15. Fluctuating prices have a direct impact on the income received by small producers. Low prices translate into low earnings, which have significant consequences for household food security as well as challenges to maintaining the asset base (e.g. human and natural capital). With limited opportunity for 'smoothing out' earnings shortfalls from savings or other means (e.g. insurance policies), the poor are particularly vulnerable to destitution arising from a single, sharp fall in prices. At the same time, price instability seriously reduces the creditworthiness of producers in terms of concerns about debt repayment.

16. At a national level, price volatility can significantly impede macroeconomic stability, economic growth and poverty reduction. For HIPCs, most of whom are commodity dependent countries, price volatility and uncertainty make it difficult to achieve debt sustainability and the macroeconomic stabilisation needed for a successful structural adjustment program.

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[18] Maizels (1994), *World Development 22(11)*; Reinhart & Wickham (1994), *IMF Staff Papers 41(2).*

STOCKS AND PRICE STABILISATION

17. Governments in commodity-producing countries have attempted in the past to stabilise commodity prices by various means. The most common form of price stabilisation policy has taken the form of buffer stock intervention by a central authority that maintained commodity prices at a particular level by buying up any excess supply, and releasing stocks whenever the market tightened. The benefits of such policies can be expected to be greater the more volatile the price environment. Such interventions may also help prevent large temporary shocks from affecting producers' investment decisions, and causing more permanent changes in supply. However, they tended to suffer from at least three fundamental problems.

- Most schemes require some concept of a long-run equilibrium price in order to iron out fluctuations around this 'norm'. It has proved impossible to establish such a price with any accuracy due to difficulties in distinguishing permanent from temporary price shocks. Many schemes determined prices administratively; that is, they were based on political considerations and failed to reflect market fundamentals, which required large resource transfers in years of low prices. With limited access to credit and unmanaged risk exposure, these programmes were difficult to maintain in the face of consecutive years of low prices.
- Moreover, in addition to concerns about their overall cost-effectiveness; they are not designed to address the issue of declining terms of trade. Attempts to stabilise in real terms prices paid to producers over a long period are therefore bound to be unsustainable.
- Price stabilisation schemes shift risk from individual producers to the national Government (and therefore to the general population). Producers therefore have no incentive to seek private forms of smoothing income. Moreover, it is not clear that the social benefits of stabilisation schemes outweigh the social costs.

18. Consequently, commodity boards have been abolished in most countries. They acted as a tax on producers in years of high world prices and a drain on government resources in years of low world prices. While governments have used various instruments to insulate producers against price changes, they have not been successful in protecting the economy as a whole. Commodity price booms have tended to be accompanied by increased public investment in projects selected by non-economic criteria (Varangis *et al*, 1995). Spending increases in boom times have not been matched by spending falls when prices drop (IMF, 1994). No attempts have been made to replace the boards with other price stabilisation schemes.

19. International efforts at stabilising commodity prices have been similarly unsuccessful. Efforts to control supply in order to support the price are difficult to enforce, particularly for agricultural commodities where artificially high prices merely encourage new producers to enter the market. Even for minerals, fixed prices encourage consumers to seek alternative products.

20. Even if there were a credible commitment by governments in commodity dependent countries (CDCs) to spread the effects of commodity price fluctuations, finance on international markets may be hard to come by. Many CDCs already have high and unsustainable levels of debt so that borrowing when prices are low would be difficult. Low commodity prices are also likely to coincide with balance of payments problems, damaging the country's creditworthiness. In addition, public policy in this area would still need to develop some accurate concept of the price 'norm', which as stated above has not so far been successfully determined.

INTERNATIONAL COMPENSATORY FINANCING

21. Both the IMF and the EU formerly operated schemes (Compensatory Financing Facility and STABEX[19] respectively) that made financial transfers to national governments in compensation for shortfalls in export earnings owing to fluctuations in the price or supply of commodities.

22. The IMF established the Compensatory Financing Facility (CFF) in the 1960s to assist countries experiencing either a sudden shortfall in export earnings or an increase in the cost of cereal imports caused by fluctuating world commodity prices. From 1988, this was called the Compensatory and Contingency Financing Facility (CCFF),

[19] Coffee, cocoa and cotton dominated STABEX transfers

although the contingency element has now been eliminated. The financial terms are a length of typically 12–18 months, whilst repayment is normally expected within 2¼–4 years unless an extension is approved. CFF loans carry no surcharge. It was hoped that this instrument could, potentially, play a major role in alleviating the effects of price shocks and their destabilizing impact on incomes. Pakistan (1998) and Azerbaijan (1999) used this type of assistance after weather-induced shocks to the cotton harvest led to temporary shortfalls in export earnings. The success of the programme does depend on the ability of the IMF to distinguish between temporary and permanent shocks. However, in practice the CCFF levies heavier interest rates than the Poverty Reduction and Growth Facility, which may be a more appropriate instrument for the poorest developing countries.

23. STABEX started life under the Lomé I convention (1975-79), basically as an export earning stabilisation scheme. The link between STABEX and commodities was in the triggering function; a loss in export earnings relative to a four-year trend activated an automatic compensation for the exporting government to use as it saw fit. With time, stricter conditions concerning the use of funds were introduced. Increasingly the EC required the ACP beneficiaries to reinvest STABEX payments in the sectors and activities, which had been the cause of export instability. This aggravated the commodity dependence problem.[20] Several criticisms have been levelled against STABEX:

- Limited scope – STABEX did not cover minerals, products covered by the CAP and manufactured goods (with some exceptions such as cocoa and coffee products). This could lead to excessive export of products covered
- A few countries benefited over-proportionally from the scheme (Cote d'Ivoire, Senegal and Cameroon)
- Lack of resources – the scheme had funding difficulties in the 80s and early 90s
- Timing – although it is the fastest disbursing instrument in the EU's aid portfolio, compensation payments were typically made 12 months to four years after the shortfall

24. Despite these shortcomings, STABEX proved valuable to the beneficiary countries. The successor arrangement to STABEX under the new, as yet un-ratified, EU-ACP Partnership Agreement (Cotonou) contains a provision for declines in export earnings from all sources (i.e. not from a single commodity as was the case under STABEX). The link with commodity prices is therefore weaker than under STABEX. The agreement applies only to the ACP countries (excluding South Africa) as signatories of the new Convention.

Market Based Instruments: Derivatives And Insurance

25. The potential of private or government entities to manage price risk through commercial risk management instruments has long been recognised as a means to achieve greater price security and to enhance access to credit[21]. But it is also recognised that, if used imprudently, they are potentially dangerous[22]. The World Bank as well as the Common Fund for Commodities are currently exploring the potential of such instruments for small-scale producers on a pilot basis.

26. **Derivatives:** Although most major commodity producers are in the developing world, prices for their goods are set by interactions in organized commodity exchanges in world financial centres. These exchanges and financial institutions have created various market instruments for managing risk. Here, buyers and sellers can hedge their price risks and others can take positions on future price changes. The instruments, such as futures, options, swaps and commodity-linked notes are intended to make revenues more predictable and reallocate risk between private traders and producers, rather than transferring it to governments. However, these sophisticated risk management mechanisms are not readily accessible to those at the beginning of the trade chain, typically the small producer, and unlike compensatory financing do not offer external support to stabilise national income.

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[20] Page and Hewitt (2001), *World Commodity Prices: Still a Problem for Developing Countries?* ODI Special Report 2001

[21] Article 68 of the Cotonou Agreement also provides for European Community support for market based insurance schemes designed for ACP states seeking to protect themselves against the risk of fluctuations in export earnings.

[22] UNCTAD (1994)

27. **Insurance:** In 1999, the World Bank with the assistance of UNCTAD convened an International Task Force (ITF) to assist developing countries in better managing their risk to commodity price volatility. The ITF consists of a wide range of stakeholders from the commodity sector: international institutions, producers' and consumers' groups, commodity exchanges, commodity trading firms, and private sector entities. It is exploring the potential of market-based commodity price risk management, in its simplest form, a type of price insurance that will serve to mitigate exposure of producers in developing countries to price shocks and the negative effects of price volatility. In addition to these feasibility studies, the ITF is implementing risk management instruments in El Salvador, Tanzania, Thailand and Mongolia. The ITF's aims are (i) to develop mechanisms to reduce the price uncertainty faced by poor producers and consumers, and particularly, smallholders, (ii) to increase the capacity of local organisations to access commodity risk management markets and transmit the benefits of this use to poor producers or consumers, and (iii) thereby to improve the incomes of, in particular, medium- and small-scale farmers. Insurance could potentially play a role in countries that do not have the required structure for the instruments discussed above, and official schemes might be able to offer some of the services previously provided by marketing boards, such as price dissemination, market information and training.

28. Whilst the use of market-based financial risk management instruments by farmers is common in the US, it remains unclear whether farmers in developing countries will be able to afford the premiums in the absence of subsidy. There are also other obstacles to the use of market based risk management, which need to be tackled. These include:

- Poorly articulated demand for risk management tools by producers; and a lack of consideration of the positive externalities associated with risk management, such as poverty reduction and increased effectiveness of aid
- Country risk considerations, including institutional weakness, regulatory restrictions on securitisation and financial market deficiencies;
- Barriers to market entry such as high training and technical assistance costs, which will not be captured by a market initiator;
- Cost: many of these schemes are untried in a developing market context and the ITF's estimation of financial needs may be optimistic. It is not yet clear that promoting insurance is a better use of aid than reducing commodity dependence;
- Key requirements include the presence of strong intermediaries (cooperatives, banks or other) as well as a robust domestic regulatory framework.
- Unattractive product for insurance providers due to high levels of moral hazard and systemic risk inherent to crop insurance policies.

A more realistic approach might be to encourage the use of longer-term (several year) contracts between producers and buyers (e.g. as Starbucks have experimented). This would not solve the problem of declining prices, but would provide a measure of stability that would allow producers to plan several years ahead, thus avoiding some of the negative consequences of price volatility.

3. OVERDEPENDENCE ON COMMODITIES

COMPARATIVE ADVANTAGE AND OVERDEPENDENCE

29. Statistics for developing countries reveal commodity dependence as a pervasive feature. Almost all the countries in Africa depend on primary commodities for over 50% of their export earnings; primary commodities account for 45% of sub-Saharan exports (ODI, 2001). Over 57 percent of the export earnings of Uganda, 80 percent of Burundi and 68 percent of Ethiopia come from coffee, whilst Burkina Faso (63%) and Mali (84%) rely heavily on cotton (UNCTAD, 2001). Table 1 gives an indication of the commodity dependence in three regions and the relative failure of Africa to diversify exports away from primary commodities.

Table 1: Primary Non-Oil Commodity Exports as a Percentage of Total Exports

	1980	**1990**	**1995**
Latin America and the Caribbean	84.1%	67.5%	50.1%
Asia	75.5%	35.1%	24.2%
Africa	91.4%	84.1%	80.3%

Source: UNCTAD (1999)DFID

30. Viewed from the local or household perspective, the contribution of commodities to the livelihoods of rural dwellers becomes even more apparent:

- Between 25 percent and 30% of all rural households in Bangladesh are directly involved in jute related activities (FAO, 1998)
- The tea industry directly affects the livelihoods of three million Kenyans (Kitching, 2002)
- An estimated 700,000 households are involved in coffee production, and around 15 million people, around a quarter of the population are dependent on coffee for their livelihoods in Ethiopia (Greenhalgh, 2002)
- An estimated 3.6 million workers involved in cocoa production in Cote D'Ivoire (cited in Kotecha, 2002)
- In Swaziland some 16,000 people are directly employed in the sugar industry, corresponding to about 15% of formal sector employment. About 80,000 are dependents of those employed in the sugar industry (ref. CFC publication 2001)
- The banana industry in Costa Rica employs 40,00 directly and a further 100,000 indirectly (Kaplinsky,)

31. Even with such statistics it is easy to underestimate the importance of commodities to the social fabric of many local communities that extends beyond the employment and incomes it provides. Most commodities undergo some minimum level of processing prior to export. This typically takes place off-farm (e.g. in mills) and generates a whole range of resource flows as well as social services (health, housing etc.) to producers, employees and their dependents that frequently go unrecorded[23]. There are also broader linkages between commodity production and the more formalised industrial (including manufacturing, pharmaceutical) and service sectors (e.g. banking and finance, transport and haulage). Levies, taxation and other royalties from commodity production represent an important source of local and national government revenue.

[23] This does not include the resource flows that derive from other commodity related activities including food packaging (e.g. banana leaves), soap making (e.g. cocoa ash) and household fuel (e.g. cotton-stalks).

DIVERSIFICATION

32. Reducing dependence on commodities by diversifying into different types of exports appears to be the best way to reduce vulnerability to negative price impacts in the long run. Broadly speaking, there are two diversification routes available to producers seeking to reduce their dependence on commodities: a) vertical diversification – measures that seek to capture a higher proportion of the value chain (i.e. to move the producer up the value chain) and b) horizontal diversification – investment in alternative crops or products including non-agricultural products.

33. **Vertical diversification:** A number of options to move up the value chain exist which may be explored either in tandem or in isolation. One option is to seek to shorten the marketing chain by limiting the number of intermediaries between the producer and the consumer[24] in order to reduce the size of the rents that accrue to these economic agents. This requires a significant degree of collaboration and organisational capability amongst producers in the producing country. Another option is to pursue a product differentiation strategy (e.g. branding) designed to secure a premium price for the producer and/or secure greater bargaining power vis-à-vis retailers or other intermediaries on account of certain unique product characteristics – physical (e.g. size), quality, social, environmental sustainability (e.g. organic) etc. This strategy requires a significant degree of consumer sophistication and is only appropriate to certain market segments (e.g. certain types of arabica coffee rather than robusta). Supplying these 'niche' markets requires a minimum degree of institutional capacity and it requires careful assessment as to whether the additional investment required to attract a premium is justifiable. A third alternative is for producers, or other local entrepreneurs, to seek to undertake more of the processing or other physical transformation activities that are currently undertaken in the consuming country e.g. packaging, blending, etc.

34. Tariff peaks and tariff escalation are a major obstacle to the development of a processing capability in the country of origin. The European Union's 'Everything But Arms' initiative and preferential access arrangements established under the Lomé Convention have gone some way to address these barriers, but more remains to be done. For example the impact of border measures remains pervasive in protected agricultural sectors, of which sugar is the most extreme example. Tariff peaks and tariff escalation are being addressed in the context of the WTO round of trade liberalisation negotiations. But non-tariff barriers, such as product, safety and environmental standards, still pose obstacles, which weigh more heavily on developing than developed country producers (see below).

35. A major impediment to the development of a modern processing capability remains poor infrastructure and the lack of an effective investment-enabling environment. At the same time, the investment levels required to penetrate retail outlets in consuming countries are significant on account of high marketing costs (including advertising and storage). Diversification through direct acquisition of market intermediaries in consuming nations (e.g. Tata purchase of Tetley) remains a rare exception and is likely to remain the case for some time to come. For certain commodities, the capital-intensive nature of processing may discourage labour abundant and capital poor countries from adding value (the second stage of cloth manufacture is much more capital intensive than the first or final stages). In other areas, the obstacle comes from the economics of the industry e.g. coffee companies appear to want their roasting and processing plants near their final retail market since, in that way, they can blend coffee from a variety of developing countries and in addition, they have sunk costs in this processing plants.

36. **Horizontal diversification** (e.g. into other crops, or products and services destined for the local or export trade) presents a different set of challenges. The significant investment associated with tree crops makes producers reluctant to destroy (e.g. scrubbing) these to move into other crops or sectors.[25] Agro-ecological constraints can also be significant, particularly in the case of hillside production systems. The challenges (especially knowledge) of adapting to new marketing systems (e.g. high value horticultural produce) frequently involves competition against already established players, including producers in developed countries who not only benefit from generous subsidies as well as deliberately protectionist tariffs and bureaucratic practices (e.g. seasonal tariffs).

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[24] For example, strategy pursued by Costa Rican exporters to by-pass the main (MNC) buyers.

[25] Indeed, in some countries (e.g. Kenya) the law prohibited the destruction of coffee trees.

37. Foreign direct investment in the primary sector of developing countries remains very low[26] as private (local and international) banks continue to be wary of lending to the agricultural sector. Those with access to credit to finance their operations are invariably the large multinational conglomerates whilst domestic operators increasingly find it hard to raise the necessary working capital or to secure access to trade facilitation instruments.

38. A number of initiatives have emerged to improve the investment climate in developing countries. For example, MIGA provides public insurance to promote investment in developing countries by offering protection to investors and financial instruments from non-commercial risks. At the same time a number of producer countries have pursued legal and other reform measures designed to attract more foreign investors. A proposal for the re-establishment[27] of an international diversification fund (to finance various national level programmes designed to alternative crops and products as well as to expand consumption in producer countries) has also been mooted. However, addressing major local and national governance issues (including corruption and political instability) probably remains the most important, and formidable, challenge to a successful diversification strategy.[28]

39. The WTO has begun work to establish a multilateral framework of rules governing international investment, with the objective of securing a stable and predictable climate for investment worldwide. Negotiations should address the issues of access to investment opportunities and non-discrimination, protection of investment, and stable and transparent business climate.

40. Those countries that have successfully diversified away from dependence on primary commodity production and into more stable income earners (e.g. manufactures) did so by promoting long-term economic transformation, rather than as a result of domestic export-targeted measures or external preferential trading schemes. High investment and savings were important in the development of supply capacity, and public investment in infrastructure and education also played a key role.[29] These countries were primarily in Asia and Latin America. However, world conditions have changed and it may prove hard for poor countries in Africa to follow these examples. Nonetheless, the experience of these countries highlights the importance of including diversification away from commodity dependence as a long-term objective of development strategies such as the PRSP.

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[26] 5% of FDI in 1997 , Quoted in DFID Plans – Halving world poverty by 2015. Taken from UNCTAD (1999) World Trade Report

[27] A Coffee Diversification Fund, financed from levies paid by exporting members, together with contributions from some consuming member countries, was operated under the 1968 International Coffee Agreement.

[28] Paul Collier has argued that high transaction costs in Africa mean that the continent has a comparative advantage in activities with few transactions (e.g. primary commodity production). Services also have relatively low transaction costs and hence might represent a viable diversification route. Paul Collier (2002), *Primary Commodity Dependence and Africa's Future.* World Bank.

[29] Page and Hewitt (2001)

4. MARKET PLAYERS

MARKET CONCENTRATION

41. It is sometimes argued that commodity prices are determined by a small band of multinational companies (MNCs) with the power to force prices down in order to increase their margins. Several empirical studies have shown the existence of market power in most commodity markets. A study on grain (NRI, 1996) found that it was in the interests of MNCs to manipulate commodity prices in the short-run. In the long-run, however, other factors such as technology, climate and demography were likely to have a far stronger effect on the price level. Even in the short-run, the study found that competition between the large grain traders was aggressive. Whether these conclusions can be carried over to other commodities is open to question. It seems likely that the long-term decline in commodity prices is due to factors other than price manipulation by MNCs. In the short-run, the degree of competition depends on the characteristics of each commodity market, even though the same MNCs are likely to be involved in most international commodity trade.

42. Commodity producing countries are not well placed to take action against anti-competitive practices, which affect them but occur in other jurisdictions. Some countries do yet have a domestic competition law or regulatory body. All would benefit from some form of formal cooperation as an integral part of free trade agreements, for example on the lines of the agreement between the EC and South Africa, as well as informal cooperation with other competition authorities.

43. The WTO has also begun work on a multilateral competition framework. Commodity producing countries and their competition authorities could benefit from the advantages while not being tied to more traditional, resource-intensive bilateral cooperation. A WTO agreement would apply to anti-competitive practices having an impact on international trade. This could take in hard-core cartels, cross-border abuses of a dominant position affecting trade, and anti-competitive practices with a market foreclosure effect. Technical assistance to boost the human and institutional framework of developing country competition law implementation and enforcement is a clear requirement and is being coordinated by the WTO and international institutions.

SMALL PRODUCERS AND ESTATES

44. Most commodities are produced on estates or on smallholder farms or plots. There is growing interest in the conditions (especially social and environmental) under which sourcing of commodities takes place. Indeed, there has been much media hype surrounding abusive forms of child labour much of which has been exaggerated. Notwithstanding, there is increasing concern about labour conditions and there now exist a number of international programmes (e.g. the ILO International Programme for the Elimination of Child Labour) designed to provide governments and the international community with valuable lessons for tackling the worst forms of child labour wherever it takes place.

45. On smallholder farmers, employment terms and conditions are informal, largely set by local custom and practice and are more difficult to monitor and implement.

46. The record of estates and larger plantations is mixed and there are a number of well-documented cases of exploitation. At the same time, there are many examples[30] of estates, particularly in Africa, that attach considerable importance to the welfare of their employees and their dependents. Awareness of the need to demonstrate greater levels of corporate social responsibility has led to the development of various social codes relevant to an entire industry or commodity sector. These codes not only relate to treatment of employees and their direct dependents but also extend to procurement policies[31], particularly where this involves smallholder producers. Assessment of compliance with codes is normally done according to certain established procedures and guidelines

47. By highlighting exploitative practices operating in certain commodity producing countries, NGOs[32] have been prime movers for change. With the growing influence of the retailers in the UK, pressurised by greater consumer sensitivity to ethical issues, there are signs that an increasing number

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[30] of (e.g. Brooke Bond Kenya Ltd.

[31] For example, in the tea

[32] Examples include Banana Link, the Ethical Trading Initiative

of other market intermediaries are beginning to shift their attention from a previously narrow focus on issues primarily centred on environmental sustainability.

48. The degree to which ethical considerations (e.g. sourcing arrangements) are explored appears to be influenced by the complexity and level of integration of the commodity chain. Commodities such as cocoa and cotton generally have more complex chains or weakly integrated chains. On the other hand the commodity chains for banana and tea are less complex or better integrated. Where the value chain is long and involves a plethora of intermediaries between the producer and the consumer there appear to be fewer incentives for change.

49. On the whole the costs of compliance with social and other ethical codes are usually borne by the producer. Auditing costs escalate considerably where supply chains involve producers who are dispersed over a wide geographical area. Whilst it is recognised that many export-orientated sectors tend to be better regulated and have higher standards, those with the capacity to bear the costs are typically the large estates and plantations. This is not the case for independent smallholder producers (who are simultaneously entrepreneurs, employers and labourers) and for whom corporate social standards may be inappropriate and, most importantly, could be a potential liability to their livelihood prospects. With other compliance requirements also assuming greater significance (e.g. traceability) it is perhaps not surprising that some commentators are beginning to question the viability of smallholder producers.

50. Low prices make it harder for even the most generous employer and there is a difficult balance to be struck between improving employment conditions and setting standards which discourage employment and may lead to the transfer of production to larger, more capital intensive (i.e. highly mechanised) concerns, and even to other countries. This has particular ramifications for those who advocate the adoption of a living wage over and above what the local labour market can support

5. INTERNATIONAL COMMODITY BODIES

BACKGROUND

51. In 1976 the UNCTAD Integrated Programme for Commodities (IPC), brought together 18 commodities of major interest to developing countries. Negotiations were also launched on a new financial instrument - the Common Fund for Commodities (CFC) - to support market intervention with the purchase of buffer stocks. The negotiations were concluded in 1980, and the CFC formally came into being in 1988, after the ratification process.

52. Early attempts to address the commodity problem centred on international action pursued through the activities of a number of international commodity bodies (ICBs). This resulted in the establishment of various International Commodity Agreements (ICAs) and Compensatory Financing Schemes. Concern about the volatile prices of commodities led to frequent market interventions by national governments. As discussed above the objectives were usually to plan and regulate the system of prices, or, to insulate consumers and producers from market fluctuations through price controls or subsidies. Although the ICAs had to incorporate the interests of *both* consumers and producers, the later IPC, comprising ten core commodities, had as an explicit objective to raise the price of commodities.

53. However, these schemes that attempted to separate domestic commodity prices from international prices were unable to deliver the main objectives of price stabilisation or earnings stabilisation owing to the market complexities arising from frequent supply shifts, changing demand conditions as well as fluctuating prices. All the ICAs have now abandoned formal market intervention measures. Previous attempts to intervene had tested the resolve of the member countries to the extreme, forcing some to withdraw entirely from the organisations. Whatever market failures exist in commodities, these were not resolved by the buffer stock-type agreement, which kept prices high for consumers and provided

mixed incentives to producers. For example, the failure of Brazil and other producers to keep to their coffee export quotas was one of the factors that led to their abolition in 1989.

54. However, despite the difficulties, the commodity organisations can still provide a useful forum in which the developed countries can engage with the developing on issues of mutual importance. Some of the producer countries hold them in high regard because of this. In the case of Jute, the seat of the Council is in Bangladesh – currently the only Least Developed Country to host an ICB (the ICCO is due to move to Abidjan in the Ivory Coast from 1 January 2003). The political importance of its location should not be overlooked. One of the elements of the Study Group on Lead and Zinc for example which is considered beneficial is the fact that the meetings alternate between developed and developing countries.

55. The need for dialogue between producers and consumers is crucially important. Regardless of the types of agreement which cover commodities, the problems still remain, often more acutely than previously. Consequently, we should continue to support an international study group (ISG) approach to commodity organisations, as this seems the most successful element of existing arrangements, though perhaps their traditional role would need to be enhanced.

REFORM OF INTERNATIONAL COMMODITY BODIES

56. Discussion of the future of ICBs has tended to avoid institutional reform. However, for a number of organisations, bureaucratic operating procedures have hampered their ability to provide solutions. Problems include:

- an over-complex Committee structure with bureaucratic formalities;
- poor organisation and chairing of meetings. (It should not be necessary, for example, for the organisations to meet for a whole week at a time unless there are exceptional circumstances, e.g. renegotiation of the Agreement);
- insufficient scrutiny and accountability of Executive Directors (ED). They must systematically consult members about important policy and financial matters;
- lack of public accountability, e.g. to the trade, producers and consumers. (Ideas for improvement include the establishment or improvement of internet sites to publicise activities);

57. The costs of running ICBs are high, but vary considerably, and some of course are clearly more efficient than others. Taking cocoa as an example, ideas recently proposed by the UK and Germany to other consumer colleagues for reform of the Organisation included:

- a five year strategic plan, prepared by the ED, for delivering objectives including targets for reducing running costs;
- simplification and streamlining of decision making structures, in particular by reducing the number of committees and making the Council the main forum for discussions on policy matters;
- increased public accountability, for example through news releases detailing discussions in Council and the establishment of internet sites;
- stricter financial control to encourage members to make timely contributions and to avoid the accumulation of arrears;
- a review of staff and other resources needed to deliver objectives, possibly by independent consultants. This would in particular need to look at the grading of the ED;

- a transparent and open procedure for electing the ED based on merit, taking account of best business practice, e.g. advertising. The post should not go automatically to the largest producer or most influential country.

58. However, reform is not easy and invariably runs up against entrenched interests. For example, even though both the coffee and cocoa organisations have recently renegotiated their agreements and even though neither now contain economic clauses they have still retained their bureaucratic committee structure and formalities. In some cases, producers attach great importance to these organisations and oppose reform; attempts to bring about change are seen as detracting from the power and credibility of the organisation and, by extension, producers.

Common Fund for Commodities

59. The CFC was set up to fund buffer stocks from its First Account. Given the changes in the world (mainly market liberalisation) in the decade that it took the CFC to come into being, this Account was never called upon, and instead its work now focuses on activities and projects funded from the Second Account (research, development, technical assistance, diversification). While we should not suggest recreating the old Integrated Programme by suggesting that the CFC co-ordinate the activities of the Commodity Organisations, it does have an evolving role based on implementation of the Five Year Action Plan, and evaluation and dissemination of results. It may also have a genuine supporting role in technical assistance to address the full range of supply/market problems and spreading best practice, and advocacy.

60. Most of the objectives of the Common Fund remain valid - the achievement of stable conditions in commodity trade, the diversification of production, improvement of the real income of Developing Countries, of market access, competitiveness, market structure and marketing. There is also a general feeling that the CFC is beginning to be a more interesting player than previously. However, it still needs to prove itself and test the robustness of its Five Year Action Plan, and to put in place and implement a successor plan that delivers tangible results on the ground. In part it already provides a ready-made structure for addressing common commodity problems, through its involvement in the selection and financing of projects from all of the International Commodity Bodies (including the ICAs and the ISGs). The possibility of using its unique position to ensure the spread of best practice between projects from the different ICAs in areas of common concern should be further explored. The European Commission should be encouraged to look at this issue further. Best use of the existing resources of the CFC could ensure that we do not create additional layers of bureaucracy when trying to encourage better coherence between the organisations, and also minimise the duplication of effort that might occur without such coherence.

ANNEX 2: ECONOMIC THEORIES ON COMMODITY PRICES

STANDARD THEORETICAL FRAMEWORK

The standard theoretical framework for analysing commodity price movements is to assess the demand and supply conditions in particular commodity markets, for both the short and longer terms.

In the short term, demand in many commodity markets is relatively stable, dependent on global world economic conditions. Furthermore, as discussed above demand is often regarded as price "inelastic". The supply schedule is considered unstable and prone to fluctuations, typically caused by changes in harvest strength, e.g. due to weather changes. The combination of stable, price inelastic demand, and unstable supply can drive fluctuations in commodity prices over the short term.

In the longer term, demand is more price responsive (more "elastic) as time allows greater scope for substitution and for the development of new technologies, which permit a greater or lesser use of the commodity in question. Supply price elasticity is also greater in the long term, as restrictions ease on capacity, and on the ability to adjust production. Long-term prices can be viewed as being more stable with quantities adjusting more to changes in market factors. However, this long run equilibrium price may not be static - the model allows it to be subject to long term pressures, upward or downward.

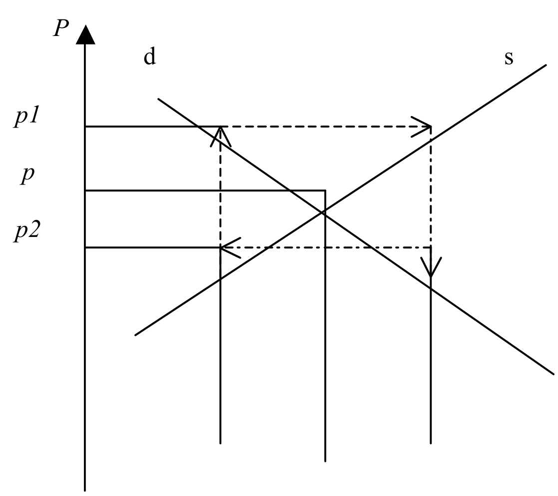
Other analytical Frameworks

THE COBWEB THEORY

The theoretical framework described above assumes that the market is always in equilibrium. Price volatility is merely a result of supply and demand conditions in the short run.

An alternative formulation, using the same standard demand and supply framework, leads to the conclusion that price volatility is a result of inbuilt market *disequilibrium.* Three conditions are needed to generate this result:

- There is a time lag before an intended expansion in production is actually available for sale in the market. This is obviously the case for some crop commodities, such as coffee, where trees can take several years to mature sufficiently to start producing.
- The decision by producers to change production is based essentially on the current market price, rather than the expected price when the commodity reaches the market.
- There are many producers, all behaving independently. This is true for many crop commodities.



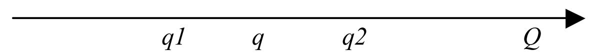


Figure 2

The diagram above illustrates the workings of the Cobweb theory. For a given commodity, the equilibrium price and quantity are *p* and *q* respectively. That is, at price *p,* producers supply exactly the amount (*q*) of commodity that consumers want to buy. A shock to supply, e.g. a poor harvest, would have the effect of reducing it to *q1*. Because demand is now greater than supply, the price rises to *p1* in the first period. Producers, seeing the higher price, *p1,* would make the decision to increase supply to *q2* (or perhaps new producers enter the market to take advantage of the higher price). However, this increased (over)supply will not enter the market until period 2 (because of the time lag), and when it does producers will be forced to drop their price to *p2* in order to clear the market. At this lower price, producers will cut back supply to below the equilibrium quantity. And so on and so forth… The price would oscillate around the equilibrium, *p*, but never actually be at that level. Indeed, price elasticities of demand and supply could be such that disturbances from equilibrium would have lasting destabilising effects.

Both of the above frameworks might be applicable to differing degrees for different commodity markets. They account for some of the features of commodity markets that we observe, e.g. volatility, whilst special cases of the cobweb theory can help account for persistence of shocks.

STORAGE MODELS

However, the above theories do not fully account for all short run movements we observe. This has led to further theoretical work, which has elaborated on the standard demand and supply framework by introducing the role that storage of commodities plays in commodity markets.

Storage models can usefully account for some of the price volatility apparent in commodity markets. For instance, if a commodity can be stored for a long time it may not make sense to sell it even if the price is high, particularly if the seller has some degree of market power. By withholding supplies from the market, the supplier may be able to drive the price higher still and then sell it. In this way, we can consider the commodity as a financial asset that the holder can trade when they believe the price has reached its peak (the oil market appears to behave in this way with suppliers driving prices up). Similarly, if a manufacturer can build up reserves of a commodity, they may be able to ride out periods of high prices thus driving the world price artificially low (it has been suggested that coffee roasters use stocks in this way to keep the world coffee price low).

ANNEX 3

The Helsinki Principles

The Commission and the Member States have agreed that the following principles should be reflected in the strategy for future commodity co-operation and in the specific mandates for future commodity negotiations:

- direct market intervention mechanisms should be avoided;
- the positive experience of the international study groups should be reflected in the future co-operation;
- however, future forms of co-operation should be decided on a case by case basis;
- there should be a minimum share of production and consumption represented to guarantee the effectiveness of the intergovernmental co-operation;
- the private sector should be given a more important role within the framework of co-operation;
- the structures and decision making procedures (including excessive administrative practices and requirements) should be streamlined.