UNITED NATIONS

TD

United Nations Conference on Trade and Development

Distr.
GENERAL

TD/B/COM.1/82
7 February 2007

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Trade in Goods and Services, and Commodities
Eleventh session
Geneva, 19–23 March 2007

COMMODITIES AND DEVELOPMENT

Background note by the UNCTAD secretariat[*]

Executive summary

This background note focuses on selected areas of commodity policy that pose challenges for the international community and where UNCTAD is in a position to make a contribution to the policy debate and to implementation.

In 2005, developing countries' share of global GDP at purchasing power parities surpassed that of developed countries. Commodity commerce and the commodity economy itself, particularly its most dynamic elements, are increasingly influenced by developing country actors. The system of rules and institutions governing this commerce was designed by developed country actors with their own needs in mind. A major task for the international community in the years ahead is to facilitate the necessary institutional changes.

Existing systems for compensatory finance are not working as they ought to. UNCTAD is carrying out a review of those systems, aiming to evaluate their effectiveness and generate detailed ideas for changes. In the context of commodity market fluctuations, the international community also needs to urgently address the particular requirements of oil-importing countries.

There is a need for mechanisms and resources that allow developing country interests to influence the procedure for setting standards, and for technical assistance to enable developing country producers to meet standards. UNCTAD supports developing countries in their efforts to have their interests taken into account in the standard-setting process, including through cooperation with the private sector, and has put in place an ambitious capacity-building programme in this area.

The proliferation of sustainability labels, such as fair-trade and organic labels, poses particular problems for developing country producers. UNCTAD is attempting to address those problems in cooperation with stakeholders within the context of the Sustainable Commodity Initiative.

UNCTAD will continue and strengthen its work in the area of energy, trade and sustainable development. The focus will be on developing countries' critical areas of need, such as fostering policy dialogue; providing a forum for discussing price volatility; supporting developing countries' policymaking processes regarding energy security; helping developing countries to fully exploit opportunities arising from renewable energy sources; assisting energy-exporting developing countries in formulating policies for the development-oriented use of windfall gains; improving local content; emphasizing the importance of a level playing field in the area of production and trade of biofuels, including the need to reduce trade barriers and phase out trade-distorting subsidies; and addressing issues of governance and transparency.

[*] This document was submitted on the above-mentioned date as a result of processing delays.

GE.07-50200

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I. INTRODUCTION

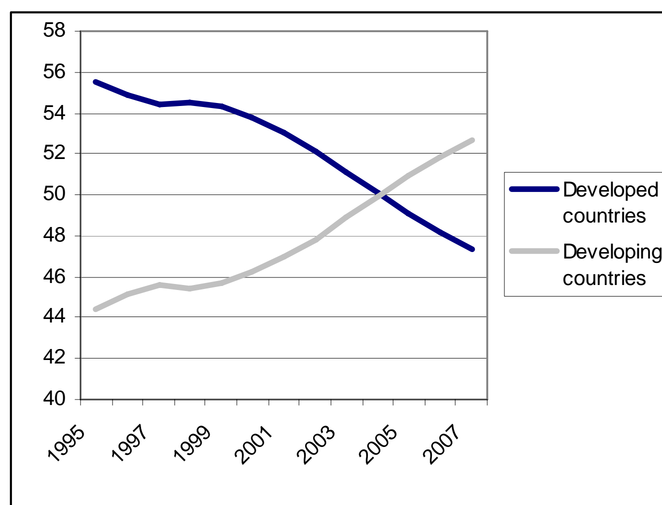
1. UNCTAD's work on commodities covers a wide area and includes many diverse activities. The present note focuses on selected areas of commodity policy that pose challenges for the international community and where UNCTAD is in a position to make a contribution to the policy debate and to implementation. Those areas are (i) the income effects of commodity market instability, (ii) standards and market requirements for commodities, and (iii) energy, and they are discussed in chapters III to V of the this note. First, however, chapter II attempts to provide an overview of important current trends in international commodity markets.

II. COMMODITY MARKET TRENDS

A. The emerging dominance by the South

2. In 2005, developing countries' share of global GDP at purchasing power parities surpassed that of developed countries for the first time (see figure 1).[†]

Figure 1. Shares of world GDP at purchasing power parities (percentages)



Source: IMF, http://www.imf.org/external/data.htm.

3. This development is particularly significant for the world commodity economy. Developing countries use more commodities per unit of GDP than developed countries (even when GDP is calculated at purchasing power parities). The continuation of the present situation, with faster economic growth in developing countries, would therefore be expected to stimulate commodity demand. The fastest-growing and largest developing economies — China and India — are going through a phase of growth in which commodity demand increases particularly rapidly. This has contributed to the rapid increase in world demand for most commodities in the past few years. One of the results is that trade among developing countries is growing as a share of total commodities trade. Table 1 shows developments over

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[†] The use of purchasing power parities is important in this context because it assigns proper weight to that part of developing country commodity production that is not internationally traded.

the five-year period 2000–2004. There is every reason to believe that the share of South–South trade will continue to grow rapidly.

Table 1. South–South commodity trade (including fuels) by regions, 2000 and 2004

Region	Share of commodity exports to developing countries, % of total		Share of commodity imports from developing countries, % of total	
	2000	2004	2000	2004
Africa	28	31	33	38
America	23	26	28	32
Asia	44	48	51	55
All developing countries	39	44	45	50

Source: Calculations by the UNCTAD secretariat on the basis of Comtrade data.

4. With the continuation of current trends, developing country actors will assume greater importance in commodity commerce and the commodity economy itself, particularly its most dynamic elements. However, the system of rules and institutions governing this commerce was designed by developed country actors with their own needs in mind. A major task for the international community in the years ahead is to facilitate the necessary institutional changes that reflect the growing importance of developing countries in the global commodity economy, including through the design of policies and the building of capacity.

B. Medium- and long-term price trends

5. The rapid growth in commodity demand has naturally affected prices, and as figure 2 shows, price indices of all commodity groups have risen over the past few years.

6. However, the boom in commodity prices since the beginning of the new millennium has been mainly driven by increases in the prices of *minerals, ores and metals* as well as of *crude oil,* which rose by 41 per cent and 27 per cent per year respectively between 2003 and 2006. The minerals and metals price index reached record levels in 2006 (about 240 per cent of the average in 2000–2005). These prices have led mining companies to launch the largest move towards concentration ever observed in this industry in terms of size and of number of deals. The trend is towards the creation of mining groups with diversified interests in various minerals, with the objective of reducing price risk.[‡]

7. The index for all groups has shown an annual growth rate of 20 per cent between 2003 and 2006, compared with +2 per cent between 1994 and 1997, the previous peak of the index. However, although the level of the price indices for *food* and *agricultural raw materials* is higher in 2006 than it was on average between 1994 and 1997, the average level during the period from 2003 to 2006 was below the one from 1994 to 1997 (see table 2). The average food price index for 2006 was 20 per cent higher than in 2005. The index for agricultural raw material prices was mainly driven by the rubber market. Even if the trend seems to have changed in the second half, rubber prices remain very high (about 40 per cent above their 2005 level). The price rise can be explained by the combined effect of booming demand from China and rising oil prices, which have made synthetic rubber less competitive.

8. For *tropical beverages*, the fall in prices from 1997 to 2002 had been so strong (-50 per cent) that the boom in prices since 2003 (+41 per cent) has not allowed the index to

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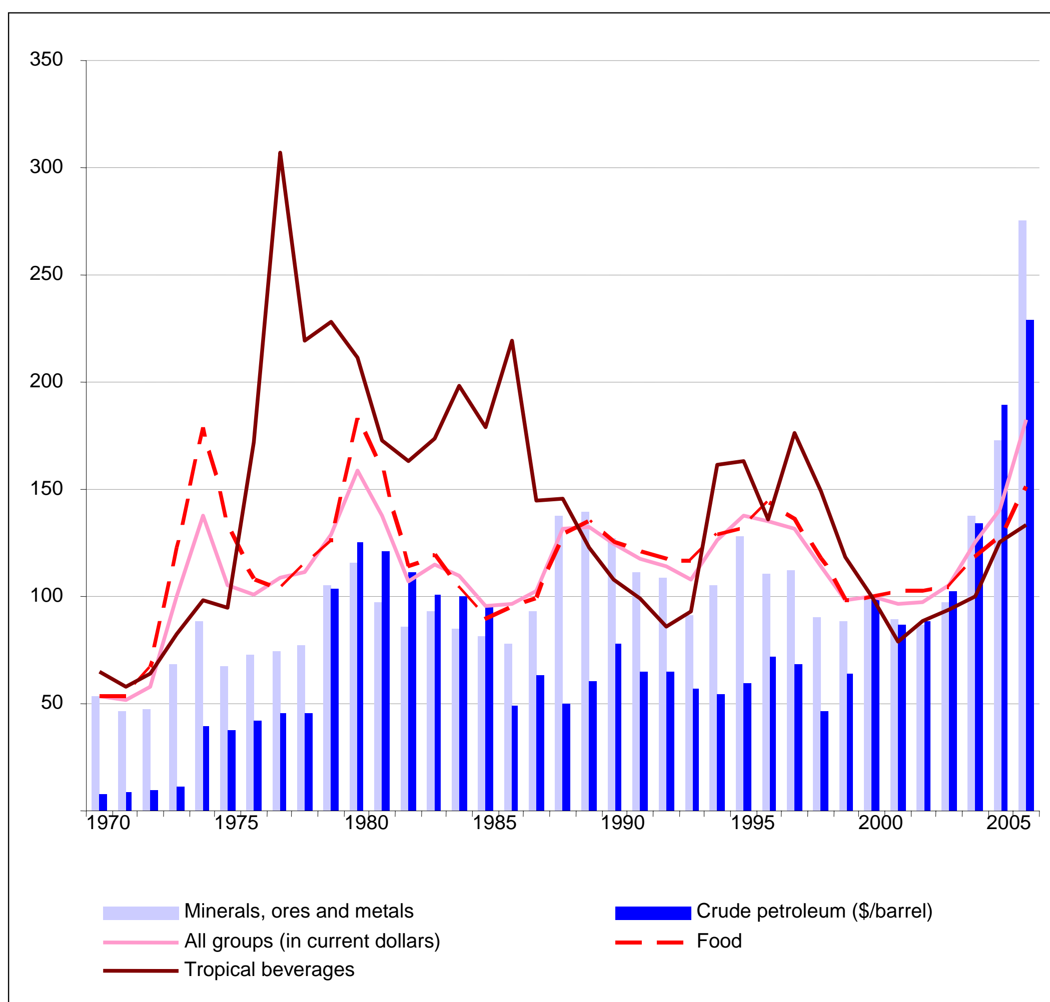
[‡] See United Nations, *World Economic Situation and Prospects 2007*, for a discussion of this trend.

recover its previous level. Recently, there have been large variations within the group, with Robusta coffee prices recording massive increases, and prices for Arabica coffees tending to fall.

9. While robust growth rates in developing countries were the main factor responsible for recent commodity price increases, intense speculation activity added significantly to those increases. Unlike in earlier periods, speculative activity was mainly undertaken by actors with no stake in the commodity sector and investing in commodity-based indices. In June 2006, half of the €200 billion invested in commodities worldwide were placed in commodity indices.

Figure 2. Commodity price indices 1970–2005 (2000 = 100, current dollars)



Source: UNCTAD — INFOCOMM, from Commodity Price Statistics database.
* Year 2006: Average of the first 11 months of the year (January–October inclusive).

Table 2. Evolution of commodity indices, 1994–2006

	Average prices			Average annual growth rate (%)			Prices
	1994–1997	1998–2002	2003–2006	1994–1997	1998–2002	2003–2006	2006
All groups (in current	132.73	101.27	138.38	2.0	-4.0	20.0	182.1
Food	135.50	104.15	125.22	2.0	-3.0	13.0	151.0
Trop. beverages	159.37	107.15	113.09	5.0	-11.0	12.0	132.4
Agr. raw materials	136.04	98.94	130.54	-1.0	-3.0	11.0	154.1
Minerals, ores and metals	114.00	91.15	170.25	3.0	-1.0	41.0	272.9
Crude petroleum	63.76	77.14	157.78	8.0	21.0	27.0	205.8

Source: UNCTAD — INFOCOMM, from Commodity Price Statistics database.

10. The effects on terms of trade of the commodity price increases have differed among developing countries, depending on the composition of their exports and imports. Three main groups of countries can be identified:[§]

11. *First group: Developing countries mainly exporting oil and mining products.* This group has mainly benefited from commodity price increases. For oil-exporting countries, for example, the extra revenues from exports have been equivalent to about 6.7 percentage points of their GDP. For countries exporting mining products, the gain has been smaller but still significant, with windfall revenues equal to about 3 percentage points of GDP between 2003 and 2005.

12. *Second group: Developing countries mainly exporting manufactures and importing raw materials.* Unlike the first group, these countries, which include most East and South Asian economies, have mostly lost out on the increase in raw material prices. Their relative loss of income was about 1 per cent of their GDP per year between 2003 and 2005.

13. *Third group: Developing countries exporting agricultural products.* For these countries, the change in terms of trade mainly depended on the prices of the commodities that they exported and the share of oil in their total imports. In 2005, for instance, terms of trade for coffee exporters tended to improve, whereas those for cotton or soybeans exporters deteriorated.

14. Although the prospects for continued rapid growth in developing Asia constitute a positive element for commodity prices, the structural reasons underlying the historically declining real price trend — ease of entry, standardized products and relatively transparent markets that make it difficult for sellers to appropriate productivity gains — still prevail and their influence is likely to be felt when capacity catches up with the Asian-led demand growth. Moreover, in spite of the increases, real commodity prices are still lower than they were at the height of the previous two oil price shocks. Accordingly, the present price boom is unlikely to constitute a break with the long-term declining trend of real commodity prices. That being said, developing countries as well as the international community as a whole should seize this opportunity to address urgent development challenges and to undertake programmes to share benefits with disadvantaged segments of society and small producers.

[§] See UNCTAD, *Trade and Development Report 2006*, pp. 26–27.

This would increase commodity-dependent countries' prospects of being able to embark on a sustainable growth path.

III. DEALING WITH THE INCOME EFFECTS OF COMMODITY MARKET INSTABILITY

A. The rationale for compensatory finance

15. The economies of about 80 developing countries are highly dependent on commodities. Thus they are the first to be concerned by volatility in volumes and prices which results in large fluctuations of their export income. Variability impacts on income stability, economic growth, inflation and competitiveness. Developing countries are highly vulnerable to commodity price shocks not only because of their great dependence with respect to export earnings from a few commodities but also because of their limited capacity to resist shocks.

16. Table 3 sets out price instability indices for a number of commodities. Cocoa, coffee and cotton show two to four times greater price variability than do all food products. Price instability, of course, translates into income instability.

Table 3. Instability index for selected commodities, 2001–2003

	All commodities	All food	Cocoa	Coffee	Cotton	Crude oil
Instability index	5.1	4.0	16.6	8.1	14.5	10.5

Source: UNCTAD Handbook of Statistics 2006.

17. Compensatory schemes are normally designed to help producers of exports goods to resist shocks. The large increases in oil prices in recent years has highlighted the need for compensatory schemes to also address income effects arising from variations in costs of crucial imports.

B. Examples of international compensatory schemes

1. Compensatory Financing Facility of the IMF/Compensatory and Contingency Financial Facility

18. The Compensatory Financing Facility (CFF) was created by the IMF in 1963. Its main purpose is to provide assistance to member countries experiencing balance-of-payments difficulties due to temporary export shortfalls beyond their control. The fall in export earnings, which defines the amount of credit, is measured by comparing observed earnings with a reference value, defined as the geometrical average of export earnings over a five-year period centred on the shortfall year and including two years of projected exports. The access is limited since lending from the CFF cannot exceed 45 per cent of the member's quota. Depending on the member's record of past cooperation and expectations of future cooperation, limits range from 10 per cent to 45 per cent of quota. For instance, in 1999 Algeria and the former Yugoslav Republic of Macedonia benefited from the Contingency Financial Facility (CCFF) under 20 per cent of their quota. Algeria received SDRs 223.5 (million) with a quota of SDRs 1,254.7 (million) and the former Yugoslav Republic of Macedonia SDRs 13.8 (million) with a quota of SDRs 68.9 (million) under the Eleventh

Review Quotas.[**] The loans should be repaid by the beneficiary country as soon as its export income is above the average value.

19. The CFF was incorporated in 1988 into the CCFF. Only countries with structural adjustment programmes were eligible for CCFF credits. The CCFF has traditionally been a major avenue for borrowings from the IMF — annual drawings under it averaged just under one fifth (17.5 per cent) of total credit extended by the IMF during 1963–1998.[††]

20. The facility was revised again in 2000 to simplify the structure of access limits and to add the condition that the financial support had to be accompanied by economic adjustment. The facility has not been used since.

21. Several analyses have criticized the slowness of payments: often compensation arrived only when countries were no longer experiencing difficulties. In the period 1982–1992 most drawings were made by large commodity exporters: India, Argentina, Brazil and the Philippines accounted for over 40 per cent of total drawings, while African countries accounted for only 4 per cent (one drawing by Côte d'Ivoire). Because of the facility's non-concessional nature, member countries have preferred to use other schemes where possible, including the ones described in the next section.

2. Stabex and Sysmin

22. Two compensatory schemes were introduced by the European Commission in the Lomé Convention in 1975. Their main goal was to compensate shortfalls in export earnings through an automatic transfer.

23. Stabex was used for agricultural exports and, unlike the CFF, it was directed specifically towards the commodity sector that incurred the loss of revenue. All agricultural commodities were included except sugar and meat. The transfer was made automatically if the decline in export revenue was due to exogenous factors and if the product accounted for a significant part of the country's total export income. The amount to be transferred was calculated by the difference between observed values and reference values calculated for the product. The payment was made to the Government, which was expected to spend it in the sector concerned or in a way that would benefit producers in that sector. There was no obligation to reimburse. Sysmin functioned like Stabex but was intended for the mining sector.

24. Major obstacles for the schemes were the lack of financial resources (especially during the commodity crisis of the 1980s–1990s) and the time lag in transferring the payment. Another problem was that few countries benefited. Indeed, "under Lomé I, II and III, three products, namely coffee, groundnuts and cocoa received 60 per cent of all Stabex transfers".[‡‡] Five countries (Cameroon, Côte d'Ivoire, Ethiopia, Senegal and Sudan) received half of the transfers.

25. From 1980 to 2000 Sysmin transferred ECU 1,752 million ($2.27 billion) and Stabex ECU 5,150 million ($6.67 billion) to the ACP countries. By way of comparison, world export value for iron ore was approximately $10 billion and for cocoa about $3 billion in 2000.

[**] http://imf.org/

[††] Cashin P., Liang H. and McDermott C. J. Do commodity price shocks last too long for stabilization schemes to work? *Finance & Development*, September 1999.

[‡‡] Koehler G. The future of STABEX. Libreville, Gabon, 6–7 November 1997.

Under the successive Lomé Conventions, control was increasingly exerted over the use of these funds, so that disbursement lags increased and automaticity declined.[§§] The two mechanisms were abolished in 2000 and replaced by Flex.

3. Flex

26. The failure of the two previous schemes resulted in the adoption of a new compensatory fund, Flex, which began operation in 2000. Its main objective is to assist ACP Governments that are facing loss of income due to short-term fluctuations of total export earnings. It is regarded as budgetary support to finance government spending on development programmes. The main difference from the other schemes concerns eligibility criteria:

- 10 per cent (2 per cent for LDCs) loss of export earnings from all goods exported or from the total of agricultural or mining products exports (if above 40 per cent of total export revenues) relative to the last three years; and
- 10 per cent worsening in the public deficit for the year in question or foreseen for the following year**.**

27. Both criteria have to be met, and because of difficulties in meeting the second criterion only six countries out of 51 were eligible to benefit from Flex. In 2004 the European Commission decided to extend and simplify the use of this instrument. The second eligibility criterion, relating to the public deficit, was abolished and the special clause concerning the 2 per cent loss for LDCs was extended to landlocked and island countries. Studies showed that if the new criteria had been introduced from the beginning, the ACP countries would have received €255 million instead of €35.65 million.[***]

28. Nevertheless, despite the above-mentioned modifications, the effectiveness of the scheme is still questioned. Payments do not reach the relevant sector (unlike in the case of Stabex) or the producers. The scheme is also subject to the same administrative delays as the other three mechanisms. The European Council supports a review of Flex to reduce the delay.

4. Elements of a more effective and user-friendly compensatory scheme

29. An effective compensatory scheme should meet the following requirements:

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

[§§] Combes J.-L. and Guillaumont P. Commodity price volatility, vulnerability and development. *Development Policy Review,* 2002, 20 (1): 25–39.
[***] http:/ec.europa.eu/trade/issues/global/development/pr120204_fr.htm
[†††] UNCTAD. Report of the Meeting of Eminent Persons on Commodity Issues. TD/B/50/11, 30 September 2003.

30. Moreover, transfers that are not refundable are preferable because, otherwise, countries with large prior debt burdens might be excluded. Finally, a good institutional framework in the beneficiary country is necessary for the system to be effective. In many countries, Governments face difficulties in distributing funds to small producers.

C. An attempt to estimate the cost of compensatory schemes

31. Compensatory financing schemes are designed to compensate loss of income earnings resulting from price shocks. They can also be used to compensate increases in the prices of imports of essential goods such as oil, which can affect the whole economy of the importing country.

32. Table 4 shows the compensation for loss of income in connection with coffee exports in Kenya. Exports decreased until 2002 before increasing again. A compensatory fund would have intervened from 1997 to 2004 for a total of $580 million. This might have helped to keep farmers operating, and they would have been in a position to benefit from better prices already in 2000. In this case, one can assume that exports would have been higher already in 2000, and this would have probably limited the loss of income in the following years and thus the amounts to be compensated.

Table 4. Hypothetical payments to compensate for variations in Kenyan coffee exports

Years	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Exports in $ million	291	287	289	212	171	154	95	35	90	93
5-year moving average of exports in $ million	176	206	232	264	268	250	223	184	133	109
Amount to be compensated in $ million	-114	-81	-57	52	96	97	127	149	43	16

Source: UNCTAD secretariat calculations based on Comtrade data (import volumes) and the *UNCTAD Commodity Price Bulletin* (prices).

33. Table 5 shows the payments that would have been necessary in order to allow LDCs to maintain their imports of crude oil at a level corresponding to the average of the preceding five years. The cost of the import volume to be compensated is calculated with the aid of a price reference.

Table 5. Hypothetical payments to compensate for variations in LDC crude oil imports

Years	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Imports in 000 tonnes	2 323	3 540	3 310	3 711	2 028	2 035	2 029	3 758	3 113	1 134	1 167
5-year moving average of imports in 000 tonnes	2 474	2 115	2 424	2 553	2 694	2 982	2 925	2 623	2 712	2 593	2 414
Quantity to be compensated in 000 tonnes	151	-1 424	-885	-1 159	666	947	896	-1 135	-401	1 458	1 247
Price, value in $/barrel[‡‡‡]	16.91	20.42	19.19	13.08	18.14	28.22	24.46	24.95	28.90	37.76	53.37
Estimated amount to be compensated in $ million	18	-208	-121	-108	86	191	156	-202	-83	393	475

Source: UNCTAD secretariat calculations based on Comtrade data (import volumes) and the *UNCTAD Commodity Price Bulletin* (prices).

[‡‡‡] The crude oil price results from the average of FOB UK Brent, FOB USA Gulf WTI and FOB DUBAI Dubai.

34. A compensatory mechanism would have disbursed $433 million from 1999 to 2001. The 2004 and 2005 price increases would have resulted in a compensatory payment of $868 million for all LDCs. Such a payment would have helped LDCs to maintain their crude oil imports, thus preventing energy security crises and increased indebtedness.

35. An example of a regionally based scheme targeting oil import costs is the Petrocaribe scheme. Petrocaribe is a regional oil alliance between Venezuela and the countries of the Caribbean Community (CARICOM), concluded in 2005.[§§§] Under the Petrocaribe system, countries buy oil at market prices, but have to pay only a part thereof, while the remainder can be paid through a 25-year financing agreement at an interest rate of 1 per cent. Venezuela provides from 5 to 50 per cent financing for oil imports from Venezuela, depending on the oil price. Countries can pay part of their bill in other products such as sugar, bananas or services.

36. Petróleos de Venezuela S.A. (PDVSA), Venezuela's State oil firm, created an affiliate — PDV Caribe — to implement this initiative, which "aims to foster integration of this geopolitical bloc through a plan for the national use of energy".[****] Venezuela has agreed to supply 185,700 barrels of oil per day to the region.

37. Another element of the alliance is the ALBA (Bolivarian Alternative for Latin America and the Caribbean)–Caribbean Fund, which will provide development grants to less developed Petrocaribe members. This fund is financed by contributions from its member States, with Venezuela already having given $50 million.

38. After a year only five members have been able to implement this initiative. Most of the members do not have the appropriate infrastructure (distribution, storage, terminals) that would allow them to benefit from it. In addition, since some of the existing infrastructure belongs to private companies, the procedures for financing upgrading will take time.

39. If Petrocaribe were implemented at 100 per cent, the total oil import cost of the countries concerned would be $2.26 billion a year, at an oil price of $50 per barrel. Venezuela would finance $965 million a year.[††††]

IV. STANDARDS AND MARKET REQUIREMENTS

A. "Mainstream" standards

40. Globalization has created new trade opportunities, but also major challenges, for developing country producers. Supermarket chains have developed logistics systems that make it easier to source products from those producers. However, supermarkets prefer to use their own procurement systems based on contractual arrangements with specialized wholesalers and/or farmers that can meet the high standards they demand. Therefore, small farmers, who find it difficult to comply with the exigencies of supermarkets, risk being marginalized. More generally, actors in developing countries face problems in complying with quality standards because of inferior technology, insufficient information, weak

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[§§§] Fourteen of the 16 members of CARICOM are parties to the agreement: Antigua and Barbuda, the Bahamas, Belize, Cuba, Dominica, the Dominican Republic, Grenada, Guyana, Haiti, Jamaica, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, and Suriname.

[****] Extracted from the statement by Mr. Rodriguez, Foreign Minister of Venezuela, at the summit in Puerto La Cruz, 29 June 2005.

[††††] http://www.caribbeannetnews.com/cgi-script/csArticles/articles/000029/002953-p.htm

institutional arrangements, and high transport and handling costs that are the result of weak infrastructure.

41. It is important to note that standards address a wide range of issues, including health and safety, quality management, labour conditions and environmental aspects. They are designed by a diverse set of institutions, whose interests differ considerably. Some are concerned with defending or advancing commercial interests. Others are driven by wider concerns such as protecting the vulnerable (consumers, the environment, etc). However, while enterprises in developing countries are expected to comply with global standards, they or their Governments have little to say in the setting of these standards. Accordingly, there is a need to ensure that developing countries are given an opportunity to influence the standard-setting procedure so that standards take into account the capabilities of developing country producers. In a resolution adopted at its 61st session, the United Nations General Assembly reaffirmed "that developing countries should play an increasing role in the formulation of, inter alia, safety, environment and health standards, and [it] recognizes the need to facilitate the increased and meaningful participation of developing countries in the work of relevant international standard-setting organizations". It went on to encourage "the private sector, in the context of corporate responsibility and accountability as well as responsible business practices, to enable developing countries to put in place measures that are appropriate and necessary for meeting market requirements and standards, inter alia, quality control standards, and invites the relevant intergovernmental organizations to establish procedures for elaborating product and process standards that take into account the interests and capabilities of developing countries".[‡‡‡‡]

42. The need to build capacity in developing countries to deal with standards is clear, with respect to both the capacity of producers and exporters to comply with standard requirements and the capacity of government to provide, or support the provision of, the necessary supporting services, including testing and certification facilities.

43. UNCTAD is carrying out technical assistance projects in the area of standards compliance in selected countries in Africa as well as in Pacific island countries. The projects are expected to improve the capacity of producers' associations and export associations to comply with sanitary and phytosanitary standards and agri-food safety standards in order to facilitate exports.

B. Sustainability labels

44. The rapid growth of sustainability programmes and labels over the past 20 years, and their sudden expansion into mainstream markets, have had a significant and increasing impact on commodity supply chains and in particular on the situation of small producers. These voluntary approaches began as a response to perceived social injustice, environmental degradation and economic inequity. The programmes, in general, have been based on the concept that the market could be used to correct inequalities by providing financial incentives to producers through access to higher-value markets. The corollary to this argument was the belief that government and regulatory approaches to addressing those issues were too limited or ineffectual. As a result, those programmes have developed independently, with this allowing for flexibility and dynamism for responding to market developments, but also leading to uncoordinated and uncontrolled growth.

[‡‡‡‡] Text of draft resolution A/C.2/61/L.56, 4 December 2006 (at the time of writing, the document reference number of the final resolution was not yet available).

45. The direct market benefits of the programmes have been impressive, with several of them achieving consistent price premiums and exponential growth in volumes traded. Both Fair Trade and Organic certified products have expanded in volume traded by, on average, 20 per cent over the past five years and price premiums have been relatively consistent. In addition, numerous reports have indicated growing consumer demand for products produced and traded in an environmentally, economically and socially responsible manner. Also, a series of direct and indirect benefits have been presented as intrinsically deriving from compliance with sustainability standards. Such benefits include increase in net return through more rational input use and resource management; conservation of soil, water and biodiversity through the adoption of best management practice; improved productivity and worker satisfaction through improved living and work conditions; enhanced organizational structures; and establishment of long-term commercial relationships.

46. However, in order to implement those programmes and to reap the benefits they can offer, a comprehensive network of support structures had to be created; and this was made significantly more difficult by the removal of national-level support services as a result of trade liberalization policies. The services required for compliance with a particular programme include direct technical assistance to producers for the implementation of standards and compliance with certification requirements; support related to organizational and business capacity-building; facilitating access to or provision of affordable trade financing; establishment of direct market linkages with "specialty" buyers and retailers; and, where possible, influencing international and national policy in recognition and support of these programmes. Although many of these sustainability programmes strive for the costs of those services to be internalized within the programme's fee structure, the majority still rely heavily on public and private support. Studies conducted by UNCTAD and the International Institute for Sustainable Development (IISD) have found that without these services, producers and in particular small producers find it extremely difficult or impossible to enter the programmes.

47. When the programmes were limited to a small percentage of producers and producer groups, it was possible to provide those services and to obtain higher prices in specialty niche markets. However, in recent years the success of the programmes, coupled with increased consumer demand for sustainable products, has brought certified products into conventional retail distribution channels and mainstream actors have begun their own sustainability programmes. Therefore, what previously represented 3 to 6 per cent of market share is now attempting to address the other 94 to 97 per cent of the market. Because of these developments, additional pressure has been placed on actors along the supply chain. The movement into mainstream markets puts downward pressure on price premiums as supplies increase and larger retail chains demand ever lower prices from suppliers. Furthermore, the rapid expansion of these programmes limits the provision of comprehensive support services, with the result that producers are required to meet standards independently and bear the transaction costs associated with compliance and certification. Several of the established programmes, in recognition of this situation, are expanding their support services through core programmes financed by technical assistance funds, although the long-term viability of such a funding system is uncertain.

48. The development of mainstream sustainability standards programmes has also given rise to serious questions concerning the establishment of standards and implementation programmes that can address the variety of production regions and socio-economic realities. Furthermore, programmes need to be transparent, inclusive and not dominated by top-down

approaches, and able to be efficiently disseminated and credibly verified in the field. The need for support to producers in adopting and implementing those standards is enormous. Addressing developments in a way that will allow the benefits provided by sustainability programmes to be realized in the mainstream markets will require substantial commitment and effort. It is particularly important to avoid creating barriers to market entry for small producers.

49. In response to this situation, UNCTAD and IISD launched in 2004 the Sustainable Commodity Initiative (SCI), a multi-stakeholder platform to identify gaps and provide support for creating sustainable supply chains. The coffee sector was chosen as a flagship sector given its history and predominance in sustainability labelling. Task forces were established to identify priority areas for intervention and concrete activities. Four focus areas were identified: implementation, financing, information exchange and policy development. Under implementation, priority was given to understanding the costs and benefits of implementing sustainability programmes. The Committee for Sustainability Assessment (COSA) project was created to develop global assessment tools for measuring those costs and benefits, which can serve as decision-making tools for producers, policymakers and other stakeholders in the sector. The methodology is now tested in five countries and full project implementation is planned for 2007. Under financing, emphasis has been placed on enhancing trade finance for small and medium-sized enterprises. An association, the Financing Alliance for Sustainable Trade (FAST), was set up by some of the key international institutions providing trade finance to producers in sustainability programmes. The association's objective is to increase producers' access to affordable finance, and it will be launched in early 2007. Regarding information exchange, a comprehensive capacity-building strategy is being developed in four thematic areas: best management practices, financial literacy/risk management, internal control systems/traceability and market information/marketing. The curriculum will be developed jointly by international and national organizations and presented directly to producer organizations and local counterparts. This is a pilot project for the coffee sector which can be adapted to other commodities. In the area of policy development, the SCI has worked closely with the International Coffee Organization on the development of these projects and on discussions related to incorporating sustainability aspects into the renegotiation of the International Coffee Agreement.

50. The work of the SCI can provide a valuable example to commodity sectors regarding the development of a multi-stakeholder approach for identifying priority problems and areas of intervention, and the development of concrete activities for addressing those crucial issues.

V. ENERGY

A. The changing global energy economy

51. The past few years have witnessed a dramatic rise in oil prices, which can be mainly attributed to the lack of spare capacity at a time when demand increased at a higher rate than expected. Political instability, weather damage to wells and refineries, and perceived risks to supplies provided additional reasons needed for a speculative surge in prices.

52. After growing at an average rate of 1.54 per cent a year during the period 1992–2002, world oil demand increased by 1.93 per cent in 2003 and 3.7 per cent in 2004. In the space of three years, world oil requirements grew by a total of 6.5 per cent. Developing regions,

particularly China, but also West Asian and Latin American countries, have accounted for a large share of the increase in demand.

53. Forecasts, including those of the International Energy Agency (IEA) and the United States Department of Energy (DoE), point to an increase of nearly 50 per cent in world oil consumption over the next 25 years. There is an increasing likelihood of oil prices remaining substantially above the past long-term trend for a considerable time. Furthermore, it appears prudent to assume that large price fluctuations will remain a feature of the market.[§§§§]

54. Meanwhile, approximately 1.6 billion people in developing countries do not have electricity. To achieve the Millennium Development Goals, this number should decrease to less than 1 billion by 2015 (IEA, *World Energy Outlook 2006*). The corresponding increase in electricity generation will require massive investments in energy resources and infrastructure, including alternative sources of energy.

55. These developments pose major adjustment challenges for many developing countries, but they also offer opportunities.

56. For oil-exporting countries the most urgent need is to prevent the influx of export revenues from leading to real exchange rate appreciation and loss of competitiveness in non-oil sectors. Over the longer term, those countries need to channel oil revenues to investments in infrastructure development and human capital, inter alia through a strengthening of basic services such as health and education, while taking into account the economy's absorption capacity.

57. Developing countries that are oil importers face a strain on their balance of payments, with the degree of seriousness depending on whether they export other commodities and have benefited from the general commodity price increase. Many of these countries will look for ways of spreading the costs of higher oil prices over a longer period of time. While compensatory financing schemes would be well suited to assisting countries with this task, in practice they have been little used. Section III discusses possibilities of adapting such schemes to the needs of developing countries. Over the longer term, financial and risk management instruments could make a substantial contribution to lessening adjustment costs. However, systems for using such instruments need to be in place well before oil price increases occur.

58. UNCTAD has long experience of work in the area of finance and risk management. Its advice to Governments on risk management is particularly pertinent in this era of high and fluctuating oil prices. It has produced training manuals covering the use of financial instruments and the implementation of control systems to prevent abuse and losses, and has organized training on understanding hedging opportunities and choosing appropriate hedging instruments.

B. Diversification of energy sources: Biofuels

59. The prospect of higher oil prices, together with the now generally accepted need to limit fossil fuel consumption in order to combat climate change, has driven countries and institutions to explore alternative energy sources, especially renewable and climate-friendly ones.

[§§§§] See UNCTAD, Adjusting to recent changes in the energy sector: Challenges and opportunities. TD/B/COM.1/EM.31/2.

60. Biofuels are probably the most attractive alternative for developing countries and offer a promising diversification strategy. Developing country farmers generally find it difficult to diversify into new crops because of lack of experience and, above all, because such diversification carries with it major risks. Diversification into biofuel feedstocks, however, can be a low-risk strategy for farmers, since demand is likely to be more stable than for most other crops. Risks are also lower because some biofuel crops such as sugar cane have "dual uses". If the biofuel market is slow, farmers can carry out arbitrage between that market and the traditional food product market. Moreover, the reallocation of land to energy crops would result in higher prices of traditional agricultural products, both products with "dual use" because of increased overall demand, and products with which biofuel production would compete for land. This would result in resource transfers to rural areas in developing countries.

61. Biofuels production can provide positive development impacts beyond the cultivation of feedstocks. It leads to higher employment in the agricultural sector, raising demand for non-agricultural goods and providing a base for rural economic diversification. In addition, the sugar and maize experience in Brazil and the United States indicates that the infrastructure for the transformation of feedstock into biofuels is likely to be located close to where the feedstock is grown. The improvement of infrastructure would benefit rural areas and the marketing of other rural products.

62. Biofuels production in some developing countries, particularly Africa, is still in its infancy. Investment in infrastructure, technology and research is needed to gear production to the needs of small farmers, whether for local-scale or agro-processing purposes. Africa will need to find viable sources of funding to develop this sector. To address this need, UNCTAD and the ECOWAS Bank for Investment and Development have pooled efforts to promote the financing of biofuels and jatropha plantations in Africa, with special emphasis on the Clean Development Mechanism of the Kyoto Protocol. Under this initiative, a fund will be set up to finance agricultural and industrial production of biofuels. The fund will seek to promote investment in the biofuel supply chain and includes a window for financing research and development as well as capacity-building.

63. While biofuel's potential advantages for developing countries, from the point of view of energy diversification and rural development, are evident, success in producing biofuels for export may be more difficult to achieve. For small developing countries, the role of international trade in developing industrial-scale biofuel production is critical, since their domestic markets for biofuels are small. Accordingly, these countries will need to have access to foreign markets in order to develop biofuels production. However, the expansion of trade in biofuels faces several obstacles. Tariffs on biofuels are significant, and the development of international trade is held back by the existence of domestic subsidies, particularly in developed countries.[*****] While incentives may be necessary in order to achieve the expansion in biofuel use that is desired for environmental reasons, such incentives can easily be designed so as to be neutral between imported and domestically produced biofuels. Present fuel quality standards may also constitute obstacles to trade expansion, but, more seriously, there is a risk that recent initiatives to ensure the environmental and social sustainability of biofuels production through the introduction of certification procedures may be exploited for protectionist purposes.

[*****] For an overview of barriers to trade in biofuels, see UNCTAD, Challenges and opportunities for developing countries in producing biofuels. UNCTAD/DITC/COM/2006/15, November 2006.

C. Implications of high oil prices for Africa: Challenges and opportunities

64. Africa is rapidly becoming more important as an oil- and gas-producing region. During the period 1990–2005, oil production rose from 9.9 to 11.2 per cent of world production. Gas production increased from 66.5 GM3/year (billion cubic metres per year) in 1990 to 150 GM3/year in 2005. Oil reserves have risen by as much as 59 per cent, compared with 15 per cent worldwide, and Africa is now estimated to possess 10 per cent of world reserves.

65. While Africa produces about 3.5 times as much oil as it consumes,[†††††] the higher oil prices have had a severe impact on the many oil-deficit African countries. Twenty-eight countries in the region spend more than 10 per cent of their total import bill on oil. A doubling or tripling of the price has a very serious impact on their balances of payments. As seen in table 4 in chapter III, the recent oil price increases led to a reduction in oil import volumes by more than two thirds in LDCs, most of which are in Africa.

66. Regional cooperation is of crucial importance to African countries, both oil exporters and importers, in addressing the challenges resulting from the changes in the energy economy. Of particular importance to both categories of countries is the need to improve the functioning of regional and national markets for oil and processed products. Many oil refineries in Africa operate below capacity and the markets for products are often characterized by distortions, some of which are caused by small market size and others of which result from government policies. Regional cooperation in areas such as technical standards and procurement can make a major contribution to efficiency. Reorganizing the procurement of small-volume imports of petroleum products into bulk procurement, and the distribution of these imports over subregions, will generate economies of scale. Sharing storage infrastructures also offers savings.

67. Regional cooperation can also be extended to cover the effective management of oil revenues generated by the producing countries in order to meet the region's development needs. In this context, the present discussion on the possibility of producing countries offering financing facilities to importing countries is of particular interest.

68. UNCTAD contributes to cooperation on energy issues in Africa, most importantly through its annual Africa Oil and Gas Trade and Finance Conference, which this year will take place in Nairobi (Kenya). These conferences have been institutionalized as a platform for creating backward and forward linkages between the energy and finance sectors. They bring together all stakeholders to debate and share experiences on issues such as finance, risk management, technology development, energy mix, corporate social responsibility, governance and local content. The latter is of particular importance as part of measures to increase the contribution of the oil and gas sector to economic development. At present, the involvement of local enterprises as suppliers to the industry is very modest, and few linkages exist to ensure spillovers into the economy. A greater contribution requires proactive policy intervention and long-term strategies within the context of public–private partnerships, as well as adequate financing.

[†††††] 2005 BP Statistics, http://www.bp.com/sectiongenericarticle.do?categoryId=9010942&contentId=7021565.

D. Cooperation and dialogue

69. In addition to regional cooperation, cooperation and dialogue between consumers and producers, including at the global level, are important. Increasing South–South trade will necessitate enhanced cooperation between oil exporters, newly industrialized countries that are oil net importers, and the most vulnerable groups in the South. UNCTAD can act as facilitator for discussions among groups of countries, including by providing a forum for discussing price volatility, assessing supply and demand trends, and building consensus.

70. Other vehicles for enhancing cooperation would be the initiation of a global oil policy dialogue to reconcile the diverse needs and capacities of individual countries. Such a dialogue could focus on initiatives such as the establishment of a two-tier price system more favourable to poor countries. The oil fund initiative of the African Energy Commission can be considered to be an element of such a system, especially since it offers a compensatory scheme.

VI. POLICY ISSUES AND THE ROLE OF UNCTAD

71. With respect to ***trends in world commodity markets***, the review in the present report has highlighted the fact that the bulk of commodity commerce and the commodity economy itself, particularly its most dynamic elements, are increasingly influenced by developing countries. At the same time, the system of rules and institutions governing this commerce has been designed by developed country actors with their needs in mind. A major task for the international community in the years ahead is to facilitate the necessary institutional changes that reflect the growing importance of developing countries in the global commodity economy, including through the design of global policies and the building of capacity.

72. Concerning the ***income effects of commodity market instability***, it has been noted on several occasions that existing systems for compensatory finance are not working as they ought to. This is best illustrated by the fact that they have been very seldom used by the countries for which they were designed. UNCTAD is carrying out a broad review of these systems, supported by a grant from the Government of Finland, aiming to evaluate their effectiveness and generate detailed ideas for changes. As regards the specific problem of oil-importing countries, there is a need for the international community to urgently address this issue, and since oil price volatility seems to be increasing, it may recur at relatively frequent intervals, which means that ad hoc measures are unlikely to be sufficient. UNCTAD can play a role in the design of any new facilities that may be deemed necessary.

73. As regards ***standards and market requirements***, two conclusions emerge clearly from any debate about the role of standards with regard to the competitiveness of developing country producers. First, there is a need for mechanisms and resources that allow developing country interests to influence the procedure for setting standards in both the public and the private sector. Second, developing country producers, processors and institutions need large amounts of technical assistance in order to meet standards and benefit fully from the expansion of world commodity demand. UNCTAD is working on ways to strengthen developing country interests in the standard-setting process, including through cooperation with the private sector. It also has an ambitious technical assistance programme aimed at enabling developing country producers to comply with both public and private sector standards.

74. Sustainability labels, such as fair-trade and organic labels, form a separate, rapidly growing subset of standards. The proliferation of such standards, together with rapid growth in the share of the market influenced by them, poses particular problems for developing country producers. UNCTAD is attempting to address these problems in cooperation with a broad collective of stakeholders within the context of the *Sustainable Commodity Initiative,* in a way that attempts to ensure that developing country interests are given proper weight.

75. UNCTAD will continue and will strengthen its work in the area of ***energy***. Research and analysis, intergovernmental work and capacity-building activities will focus on some of the critical areas of need of developing countries, including LDCs and Africa, such as:

- Monitoring and analysing the trade and development implications of the changing energy economy and national and international energy policies, including the impact on economic growth and poverty reduction; export competitiveness; sectoral impacts; trade barriers; development and transfer of technology; access to energy services; and the role of competition policy issues;

- Fostering policy dialogue focusing on energy security, sustainable development and poverty reduction in developing countries;

- Facilitating debate among groups of countries, including by providing a forum for discussing price volatility, assessing supply and demand trends, and building consensus and partnership between interested parties;

- Supporting developing countries' policy-making processes relating to energy security, and enhancing the role of the energy sector in achieving sustainable development and poverty reduction;

- Helping developing countries to fully exploit opportunities arising from renewable energy sources such as biofuels, wind and solar energy. These alternative energy sources can help increase rural incomes in developing countries, improve income security through diversification, raise the quality of life in rural areas through access to affordable energy, and contribute to a development path that is less carbon-intensive;

- Highlighting issues facing energy-importing developing countries, including improvement and better use of compensatory finance facilities, as well as regional cooperation such as producer–consumer cooperation, including South–South and North–South cooperation, on reducing the impact of oil price fluctuations;

- Assisting energy-exporting developing countries in formulating policies and strategies for development-oriented use of windfall gains by those countries so as to capture the positive effects of high prices and make them sustainable. Some important issues that need to be addressed include critical investments in energy and related sectors, improving local content and better linkages with local industries, especially SMEs, and efficient energy product markets;

- Emphasizing the importance of a level playing field in the area of production and trade of biofuels, including the need to reduce and eliminate trade barriers and phase out trade-distorting subsidies. Investors in prospective biofuels export facilities in

developing countries need to be assured that markets are going to be open and that there will be scope for large exports, allowing them to exploit economies of scale;

- Addressing governance and transparency issues, and seeking to enhance the capacity of developing countries to implement non-distorting policies.

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