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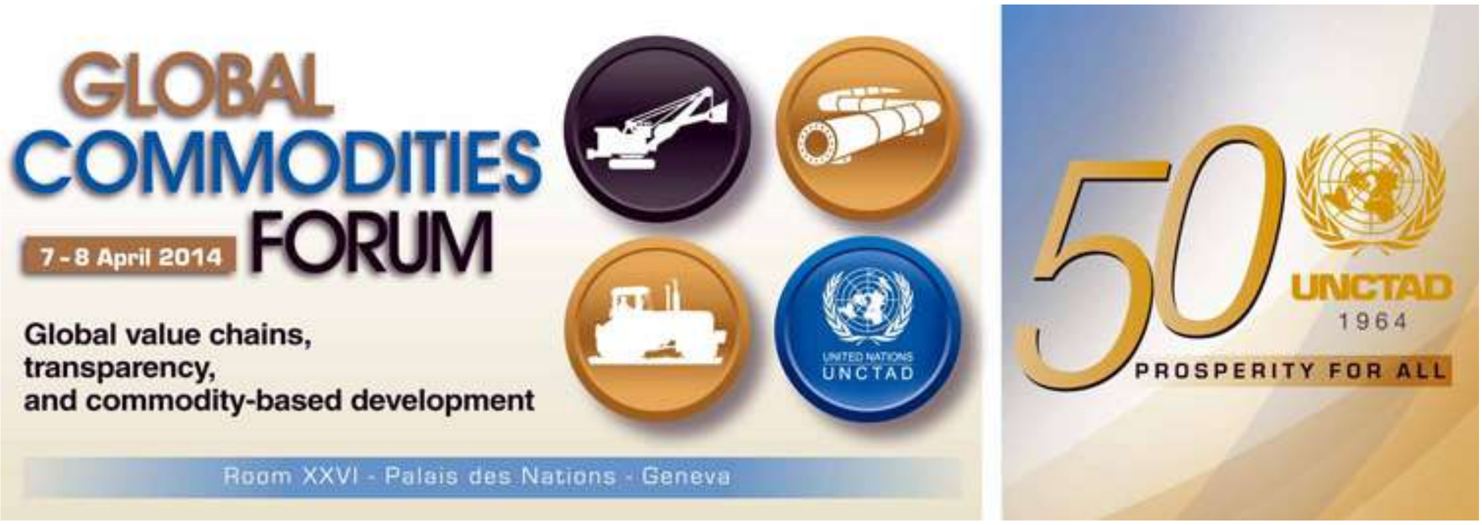

BACKGROUND NOTE

(unedited version)

UNITED NATIONS
UNCTAD

New York and Geneva, 2014

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THROUGH THE LENS OF GLOBAL VALUE CHAINS

In previous years, the Global Commodities Forum (GCF) has debated perennial problems faced by commodity-dependent developing countries (CDDC),[1] such as: the gains they draw from trading their commodities; the investments required to improve their gains; and the policies and institutions necessary to convert those gains into durable improvements in the quality of life of their citizens.

At the 2014 Forum, participants will examine the commodities problems through the lens of global value chains (GVC). The GVC concept is not new: authors in academia began to develop it in the 1990s, as a framework by which to understand the political economy of the globalization phenomenon.

Early authors such as Gereffi (1994) described the concept of "global commodity chains," in which transnational corporations (TNC) from Northern economies explicitly coordinated global production and distribution systems, composed of a disintegrated chain of activities that are outsourced to independent firms in low-cost Southern economies. To understand decisions made within these "global commodity chains," early theories focused on the exchange of goods between parties, and on the pivot points in the organizational structures of the chains.

As transportation and communication technologies improved, TNCs were increasingly able to disaggregate productive activities, to the point that the links of their supply chains were no longer articulated on the exchange of intermediate goods, but on tasks and business functions (Gereffi 2013). Adjusting to this level of detail, the "global commodity chains" theory transitioned into "global value chains," a framework that tracks the value added to an eventual end product, instead of tracking the physical flow of its intermediate goods.

The GVC concept's original focus on transactions and organizational pivot points has remained useful in discussions about trade policy and export competitiveness. For example, the Organisation for Economic Co-operation and Development (OECD 2013) employs the GVC concept to frame its argument that developing countries improve their position in the world economy by liberalizing their trade and investment policies, and by installing infrastructure, institutions and programmes that boost the competitiveness of local firms.

Theorists have continued to extend the applications of the global value chains concept beyond its original instrumentalist focus. In terms of outcomes, this includes studying the impacts of GVCs on non-economic development outcomes, such as: health, environment, social welfare, labour standards, and innovation. In terms of stakeholders, GVC theory has widened its vision, from countries and firms, to include workers, farmers, consumers and entrepreneurs (Lee 2010).

Several authors have examined the mechanisms by which GVC participants, either firms or countries, upgrade their position on the chain, either by improving the quality and efficiency of their existing activities, or by competing for higher value-added

[1] A commodity-dependent developing country relies on commodity exports for 60% or more of its export earnings.

activities. A discussion of the many upgrading strategies is beyond the scope of this background note, but a common theme in the literature is that TNCs no longer seek only the jurisdiction with the lowest labour cost, but also the ones that afford them the greatest flexibility.

In many cases, this has evolved from outsourcing individual activities, but retaining the overall coordination; to outsourcing sequences of activities, including their coordination, to turnkey suppliers. This evolving outsourcing model changes the competitive landscape for firms in developing countries, who must propose innovative service packages, invest in a wider range of training, and compete asymmetrically with firms offering different nontraditional packages (Humphrey and Schmitz 2001; Gibbon 2003; Kaplinsky and Morris 2008).

From a critical perspective, theorists have used GVC theory to challenge several orthodox beliefs in the development field. For example, Kaplinsky and Morris (2008) see the current wave of globalization, not as a simplistic outward flow of opportunities from the bloc of wealthy Northern economies, to the developing South; but as a dynamic, multipolar political economy in which countries compete to create and retain rents. Among Southern economies, China and India have, in general, proven strongest at securing the most attractive entry points into GVCs, as well as positioning themselves for upgrading opportunities. In this situation, the authors propose, other developing countries may actually see fewer opportunities to participate in capacity-building activities.

Indeed, Gibbon and Ponte (2005) argued that GVC success stories among African countries did not involve upgrading to more advanced and remunerative activities that serve niche markets, but rather "trading down" to simple, labour-intensive activities that serve mass markets.

Banga's (2013) findings seem to underline the concentrated distribution of value-added. Using OECD-WTO Trade in Value Added (TiVA) data, she estimates that: OECD countries capture 67% of value created in GVCs; the BRICS economies[2] and a handful of economies from East and Southeast Asia capture 25%; leaving the remaining 100+ developing countries to divide among them the balance of 8% of value-added in GVCs.

Moreover, Banga (2013) proposes that, due to the phenomenon of re-exportation, simple participation in GVCs does not guarantee a net improvement in domestic value-added, even for economies traditionally identified as models of export-led growth. For example, Germany and South Korea are significant participants in GVCs and have a rising ratio of exports-to-GDP, but have a falling share of domestic value added in their exports. In other words, the growth in their export value-added has come mainly from importing intermediate goods produced elsewhere. By contrast, China has grown the share of domestic value-added in its exports, despite exports falling as a share of the country's GDP.

Even when a developing country succeeds in entering a GVC and hosting a certain set of value-added activities within its borders, not all of that value is retained in the domestic economy. For example, UNCTAD (2013a, 149–151) estimates that, of the total value of an average developing country's exports:

[2] BRICS: Brazil, Russia, India, China and South Africa

- Foreign value added, in the form of imported inputs, captures 25%;
- Domestic firms capture 40-50% directly;
- Affiliates of foreign firms capture 25-35%, of which:
    - The local economy, in the form of wages and other expenditures, retains 15-20%; and
    - Earnings of 10-15% are shared between domestic and foreign shareholders.

Altogether, this means that foreign firms capture an average of 30-33% of export value added in developing countries; with the domestic economy retaining the balance of 67-70%.

The collation of value-added trade data remains very new, but it simply confirms an existing consensus in the literature: simple participation in GVCs is insufficient. As a minimum, it provides small, short-term returns. But without investments in human capital and in infrastructure, there are few opportunities for industrial development (UNIDO 2008). And such investment and planning requires political cooperation among local producers, lead firms and government, for example: to attract investment capital; to implement training and certification programmes; and to ensure shared responsibility for investments and political compromises (Humphrey and Schmitz 2000).

Even the trade-oriented discourse about GVCs has evolved from solely focusing on eliminating trade barriers, to demanding the equitable distribution of benefits from GVCs. The OECD, WTO and UNCTAD (2013) co-authored a report calling for governments to embed their GVC-related strategies in their industrial and development policies. Moreover, the three institutions recommend flanking these plans with a suite of environmental, social and governance policies that channel eventual GVC participation towards equitable, durable impacts.[3] They also recommend policies to help SMEs and entrepreneurs, so as to deepen the participation in GVCs beyond just lead firms.

Although global value chains are a useful and increasingly robust conceptual tool, there remain engaging new paths for researchers and policy makers to elaborate. Specifically, to fulfill its implied end-to-end perspective, the GVC concept requires, for example: a functional extension to include waste and pollution outputs, along with their associated disposal and recycling services; and a firm-level extension to include providers of logistics services and of information and communication technology (ICT) products and services.

PARTICIPATION OF COMMODITY-DEPEDENDENT DEVELOPING COUNTRIES IN GLOBAL VALUE CHAINS

Many commodity-dependent developing countries (CDDCs) export their resources with little or no value added to them. As a result, the overall participation of CDDCs in GVCs is low, and their share of total value-added is small (Banga 2013).

[3] The report gives the example of UNCTAD's Investment Policy Framework, which is available at: http://investmentpolicyhub.unctad.org

As for their export markets, Kaplinsky and Farooki (2011) anticipate that, in the immediate future, many OECD governments will seek to reduce their trade deficits, and thus reduce their commodities imports. Meanwhile, inhabitants in China and India will continue to flock to the cities for work, sustaining the demand growth in those two countries for a wide variety of commodities required to feed and house the workers, and to fuel the resulting economic activity.

In addition to demand growth, "standards arbitrage" will also motivate CDDCs to export to China and India. Standards regimes in OECD countries are typically stricter than those in China or India.

Demand growth and more accessible standards regimes in China and India will balance stagnant demand from OECD economies, and thus invite CDDCs to export more of their commodities to Asia. Although this rebalancing of economic growth towards China and India will not necessarily involve a commensurate increase in those two countries' share of total value-added, it will induce other, more subtle shifts.

Different from OECD countries, China and India often compete with other developing countries for lower value-added activities. Therefore commodities trade from CDDCs to China and India will boost South-South trade, but will likely restrict the exporting country's upgrading opportunities within the value chain.

This restriction on upgrading opportunities will be compounded by the different profile of end products demanded by Chinese and Indian consumers. On average, they consume cheaper, less differentiated products than consumers in OECD countries, limiting the value-added opportunities for countries seeking to supply the Chinese and Indian consumer markets (Kaplinsky and Farooki 2011).

GOVERNANCE IS THE KEY

Early GVC theory focused on transactions and organizational pivot points, and therefore on firm-level governance, where governance refers to the non-market forces that shape outcomes. Later theorists expanded the GVC framework to encompass other facets of production and trade, and to include the participation of other actors, thereby raising its governance to a public, albeit informal, level.

Nevertheless, although the GVC discourse has begun to address, conceptually, the difficult questions of equity and so-called "externalities"[4] from GVCs, the informal governance of the chains is weak on these questions, as is the wider international political and legal system. As a result, GVCs are often prone to "capture" by a small number of powerful firms. These firms use their dominant position, and sometimes collude so as not to compete with one another, thereby to dictate transaction terms and capture a disproportionate share of value-added. This rent-seeking behaviour is predicated on power, not on productivity or innovation, and it crowds out opportunities and incentives for less powerful firms to enter the GVC and upgrade their position (Fitter and Kaplinksy 2001).

[4] Pollution, workplace health and safety, and food price volatility, are examples of externalities in commodities value chains.

Faced with the capture of GVCs by powerful firms under an informal, firm-level system of governance, Gereffi foresees the following possibility:

> One potential outcome of the current situation is that public governance will be called upon to play a stronger role in supplementing and reinforcing corporate codes of conduct, product certifications, process standards and other voluntary, non-governmental types of private governance that have proliferated in the last two decades, and that multi-stakeholder initiatives involving both public and private actors will arise to deal with collective action problems. (Gereffi 2013, 21)

Political conditions affect the balance between public and private governance of GVCs: between, for example, rules legislated into national law and enforced by dedicated state regulators; alongside self-regulatory measures adopted by firms. Although the GVC literature has focused mainly on firm-level governance of the chain, it is ubiquitous in practice that both public and private actors contribute to governance.

According to Gereffi at al. (2005), the practicality of governance interventions - whether public policy interventions or corporate strategy - depends on three factors:

1) the capabilities of actual and potential suppliers to fulfill the requirements of the transaction;
2) the complexity of information and knowledge transfer; and
3) the extent to which this information can be codified for efficient transmission between parties.

According to the last two of these factors, related to the complexity, availability and transmission of information, the commodities sector is traditionally information-poor. This lack of transparency contributes to a lesser scale and frequency of governance interventions in the commodities sector than in other more strictly governed sectors, such as, for example, the financial or commercial aviation sectors. As mentioned earlier, the commodities sector faces an increasing concern about the equity and externalities of its social outcomes, outcomes that are poorly addressed by the sector's traditionally informal and opaque governance architecture.

For participants at the 2014 Global Commodities Forum then, the governance challenge of ensuring more equitable outcomes in the commodities sector constitutes the link from the first day of the programme, devoted to global value chains, to its second day, devoted to transparency.

A RENEWED FOCUS ON TRANSPARENCY

The transparency of governance in the commodities sector has attracted renewed attention since the 2008 financial crisis. Transparency remained a central theme as the attention of regulatory reformers followed financial flows out from the banking sector at the centre of the crisis, to the interconnected derivatives[5,6] and extractives sectors.

[5] Source: European Union, 2013. Directive 2013/34/EU. Available at: http://eur-lex.europa.eu [Accessed 16 December 2013].

By way of the extractive sector, the effects from a recent wave of disclosure legislation will flow through the rest of the commodities value chain. In the USA, Section 1504 of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires extractive companies ("engaged in the commercial development of oil, natural gas, or minerals") to disclose to the Securities and Exchange Commission (SEC) all payments to governments.[7] The European Union (EU) passed similar disclosure legislation in 2012, binding on the same sectors as the US legislation, as well as forestry.[8] Both the US and EU rules require companies to report payments by country and by project.

After the passage of the US and EU rules, legislators in other countries with important extractive sectors announced their intention to comply. Norway passed a reporting guideline that came into force on 1 January 2014.[9] The Canadian[10] and British[11] governments each announced their intention to legislate comparable rules in 2014; and the EU's Nordic member countries[12] announced their intention to transpose the new EU directive into their national laws.[13]

The reform movement now looks set to turn its attention to the commodity trading sector. In the USA, Section 619 of the Dodd-Frank Act, the so-called Volcker Rule, will come into force on 1 April 2014, restricting banks' proprietary trading of, among other things, forward contracts for physical commodities.[14] Although the Volcker Rule applies only to financial institutions, it will likely reduce liquidity and raise capital costs in commodity markets, as well as restrict speculative trading by non-banks.

In Switzerland, the parliament passed a non-binding postulate in 2013 that calls for a law requiring the disclosure of payments to governments by companies in the commodities sector. The postulate emphasizes that the law should apply to the entire value chain: from the miners who extract the minerals, to the traders sell them to markets abroad.[15]

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[6] Monetary Authority of Singapore, 2012. Proposed Regulation of OTC Derivatives. Available at: http://www.mas.gov.sg [Accessed 16 December 2013].

[7] Source: U.S. Securities and Exchange Commission. Dodd-Frank Spotlight - Specialized Corporate Disclosure. Available at: http://www.sec.gov [Accessed 16 December 2013].

[8] European Union, 2013. Directive 2013/34/EU. Available at: http://eur-lex.europa.eu [Accessed 16 December 2013].

[9] Publish What You Pay, 2013. Recommendation from the Standing Committee on Finance and Economic Affairs (translated from the Norwegian). Available at: http://pwyp.no [Accessed 8 January 2014].

[10] McCarthy, Shawn, 2012. Miners urge new rules, more transparency. *The Globe and Mail*, 6 September. Available at: http://www.theglobeandmail.com [Accessed 8 January 2014].

[11] UK Government, 2013. Natural resource transparency: ensuring natural resources and extractive revenues are used for public benefit, in: National Action Plan 2013 to 2015. Available at: https://www.gov.uk [Accessed 8 January 2014].

[12] The EU's three Nordic countries are: Denmark, Finland and Sweden.

[13] The US White House, 2013. Joint Statement by Kingdom of Denmark, Republic of Finland, Republic of Iceland, Kingdom of Norway, Kingdom of Sweden, and the United States of America. Available at: http://www.whitehouse.gov [Accessed 8 January 2014].

[14] U.S. Commodity Futures Trading Commission, 2012. Volcker Rule. Available at: http://www.cftc.gov [Accessed 16 December 2013].

[15] L'Assemblée fédérale suisse, 2013. Postulat 13.3365 - Davantage de transparence dans le secteur des matières premières. Available at: http://www.parlament.ch [Accessed 16 December 2013].

The transparency-themed reform agenda that now approaches the commodities sector intersects with longer-standing governance questions about the sector's contribution to the sustainable development of CDDCs. Many of these countries began exploiting their resource wealth decades ago, but through the 1980s and 1990s, their development trajectories were characterized by stagnant economic growth, boom-bust consumption cycles and unsustainable borrowing (Deaton 1999).

After the ongoing boom in commodity prices began in 2003, we observed improved GDP growth for most CDDCs, but a continued absence of durable development outcomes for their citizens. For example, despite strong average GDP growth rates, poverty reduction has stagnated in most resource-rich African countries, and has even retreated in Angola, the Republic of Congo and Gabon (World Bank 2012, 19–20). For CDDCs whose dominant export is not oil, the prices of imported food and energy have risen faster than their export receipts, worsening their food and energy security (UNCTAD 2013b).

Economic growth without durable development has meant that, despite the commodity price boom, 14 of the 20 resource-rich countries in sub-Sahara Africa have had, for a number of years, a lower Human Development Index[16] (HDI) standing than their income rank would suggest. A number of these countries show extreme discrepancies between the two measures. Moreover, in 2011, nine of the 12 countries at the bottom of the HDI were rich in resources (Africa Progress Panel 2013).

TRANSPARENCY THEMES IN THE COMMODITIES SECTOR

The intersection of these two reform themes - transparency and the governance of resource wealth - is strongest in the commodities sector when discussing solutions to four harmful behaviours: 1) detecting and punishing corruption at the country and project level; 2) ensuring governments convert resource revenues into durable development outcomes for their citizens; 3) detecting tax evasion by vertically integrated companies that (mis)use transfer pricing in the accounting of their activities; and 4) reducing the volatility on commodity markets that results from speculative trading based on an inefficient and asymmetric flow of information.

Corruption

Corruption can involve companies making illicit, undeclared payments to government agencies or officials to favourably influence their business interests in the country. Such corruption is understood and condemned in most societies. Indeed, many jurisdictions have enacted anti-corruption laws, with varying degrees of success in implementing them. For example, the USA enacted its Foreign Corrupt Practices Act (FCPA) in 1977, but its legislators, regulators and courts are still actively updating the country's laws to keep up with innovation in modes of corruption.

Particularly in the extractive sector, tracking corruption in resource sale transactions is most obvious, as cash and product are exchanged within a relatively

[16] The Human Development Index "measure[s] development by combining indicators of life expectancy, educational attainment and income into a composite human development index." UNDP. Human Development Index. Available at: http://hdr.undp.org [Accessed 6 January 2014].

short time, and documentation is typically better. But tracking the resource sale transaction is often insufficient, as payments made earlier, in the contracting of exploration and exploitation rights, for example, are likely the ones that have most distorted the competitive landscape. These upstream, contract-related payments are more difficult to track, due partly to the time lag before the paper trail of physical transactions begins.

In 2009, the engineering firm Kellogg Brown & Root (KBR) provided a clear example of corruption in the awarding of upstream contracts, when it pleaded guilty in US District court in Houston to FCPA violations related to paying US$180 million in bribes to Nigerian officials, over the course of a decade, to obtain a variety of contracts in the construction of a liquefied natural gas (LNG) plant at Bonny Island, in Nigeria.[17] KBR's former CEO Albert Stanley admitted that the criminal activity related to the Bonny Island plant was sanctioned by the company's leadership.

Insufficient value for resource owners

Citizens of a country are the theoretical owners of its resources. But when citizens-owners feel that the sale of those resources does not return sufficient value to them, economists call this an “agency dilemma,” in which the citizens’ designated agent, the country’s government, does not act in their best interests.

In the commodities context, one agency dilemma involves a government accepting below-market terms in the sale of its country’s resources. Whether or not corruption was involved in the negotiation, the terms themselves represent the government neglecting its agency responsibilities towards its citizens, and instead favouring the purchaser.

A subsequent agency failure involves the government failing to transmit the full value from resource sales to citizens and communities in the form of investments and programmes.

A paper by Gauthier and Zeufack (2011) describes the classic "resource curse" example of agency dilemma in Cameroon. Since its oil began to flow in 1977, the country's development outcomes have actually deteriorated, in spite of the oil windfall. Oil is Cameroon's most valuable export and contributed 33% of government revenues in 2007.

The Cameroonian government's mismanagement includes a corruption component: from 1977-2006, the authors estimate that Cameroon captured US$20 billion in oil rents. Of this total, only 46% was transferred into the government budget, with the balance presumed stolen or misappropriated. But the mismanagement also extends to investment and spending decisions: for example, the Cameroonian government long had a policy of investing its oil revenues in foreign bank accounts, starving its economy of much needed capital.[18]

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[17] US Department of Justice, 2009. Kellogg Brown & Root LLC Pleads Guilty to Foreign Bribery Charges and Agrees to Pay $402 Million Criminal Fine. US Department of Justice. Available at: http://www.justice.gov [Accessed 7 January 2014].

[18] Although, in its early years, this policy was applauded by international development institutions.

Therefore, despite soaring oil revenues in the 2000s, the period 1995-2005 brought a comprehensive decline in the quality of life of the average Cameroonian, as shown by the following indicators for the 1995-2005 period:

- Average life expectancy fell from 56 to 50 years;
- Infant mortality rates increased from 61 to 78 per 1,000 children and child malnutrition rose from 14% to 22%;
- Primary and secondary school enrolment rates dropped;
- Overall poverty increased, and when compared against other income groups, the poorest segments of Cameroonian society suffered the greatest decline across most economic, health and education outcomes.

Transparency initiatives, strengthened by legislated penalties, are needed to combat all three levels of agency dilemma: detect and punish corrupt payments; certify that resources are sold according to equitable terms; and ensure that governments transmit commensurate value from resource sales to their citizens and communities.

Tax evasion

Resource owners are indirectly deprived of value when the purchasing company evades paying taxes on the fair market value of its operations in their country. In the commodities context, vertically integrated TNCs can evade taxes in the country where they produce their raw materials, by using transfer pricing to shift their taxable income to a lower tax jurisdiction. A recent study by the African Development Bank and Global Financial Integrity (2013) estimated that, between 1980-2009, African countries lost between US$597 billion and $1.4 trillion in net resource outflows, the majority of it in the form of tax evasion.

Used responsibly, transfer pricing is a benign accounting practice that allows vertically integrated companies to log transactions between its subsidiary units that do not involve an arms-length exchange of cash for goods – the key accounting principle being to apply fair market value to each cashless entry. But to evade taxes, TNCs can manipulate the value of transactions between subsidiaries in different tax jurisdictions values, for example by overstating the transportation costs charged by the importing subsidiary, or by understating the price of raw materials shipped by the exporting subsidiary. Both entries would shift the TNC's overall taxable income to a lower tax jurisdiction.

A recent, high-profile case of alleged tax avoidance in the commodities sector involves the trading company Glencore. In 2000, it bought a controlling stake of Mopani Copper Mines Plc, a Zambian company that owns mines and processing facilities producing copper and cobalt. Mopani has since become the second largest mining company in Zambia. Glencore controls Mopani through a holding company registered in the tax haven of the British Virgin Islands.[19]

[19] Keane, Bernard, 2011. Glencore and the cautionary tale of Zambia. *Crikey*, 18 April. Available at: www.crikey.com.au [Accessed 31 December 2013].

In 2011, an audit by accounting firm Grant Thornton of Mopani's 2000-2008 tax filings in Zambia was leaked on the internet. The auditors had found overwhelming evidence that Glencore and Mopani had actively manipulated transfer pricing in their books to shift their tax liability away from Zambia. For example (Grant Thornton 2010):

- The auditors found no evidence that arms-length principle was respected in accounting for sales (p. 8);
- Using Mopani's reported costs in 2007 as an illustration, the authors estimated that Mopani overstated its total costs in that year by 90%, or US$381 million (p. 10).
- From 2003 to 2008, the price Mopani charged for the copper it sold to its parent Glencore fell steadily below the benchmark market price.[20] The auditors found that this hedging strategy is consistent with efforts to avoid taxes. From 2003-8, this deflated Mopani's revenues by a total of US$700 million, relative to benchmark market prices (pp. 14-15).

In its report, Grant Thornton does not speculate on the lost tax revenue that these irregularities represent for Zambia. But the NGO ActionAid estimates that through transfer pricing, Glencore avoided more than US$100 million of annual tax liability in Zambia over the period in question.[21]

Tax evasion by TNCs using transfer pricing is not limited to the commodities sector, so compliance and punishment should fall within the wider discourse of tax evasion, tax havens, and so on.[22] Instead, transparency efforts in the commodities sector can focus on imparting specific knowledge to tax authorities of the commodities value chain's activities and prices, so that they can identify transfer pricing-related irregularities in TNCs' tax filings.

Market-level effects

Whatever their importance to investors, commodity markets fulfil a fundamental function for commercial actors. Producers sell contracts for future delivery so as to hedge their up-front expenditures against future price drops, and other risks; merchants purchase these contracts to secure a guaranteed delivery of the products on which their operations depend. The interaction of these fundamental supply and demand signals help both parties discover a market price.

Between the two commercial ends of a delivery, financial investors trade the contract many times over. This activity has a mixed benefit: it injects more buyers and liquidity into the market, but it also introduces non-commercial price signals, such as when financial investors buy commodity futures as part of a diversification strategy. Provided non-commercial signals are not too distortionary, the added liquidity could be considered as a net benefit to commodity markets. But if

[20] The auditors used the London Metal Exchange (LME) benchmark.

[21] Doward, Jamie, 2011. Glencore denies allegations over copper mine tax. *The Guardian*, 17 April. Available at: http://www.theguardian.com [Accessed 31 December 2013].

[22] The laws, practices and infrastructure that support tax enforcement may also need improvement, but that discussion is beyond the scope of this paper.

financial signals begin to dominate commercial ones in price formation, the market's core commercial risk management and discovery functions are impaired.

In a recent paper, Filimonov et al. (2013) studied short-term trading behaviour on the futures markets of five commodity product groups.[23] Their analysis demonstrated that as much as 60-70% of trades were motivated by the arbitrage of price movements, while only 30-40% of them were responding to demand and supply signals, muddying the price discovery function on which commercial actors depend.

From a transparency perspective, this situation demands a level of disclosure on commodity markets that: creates a more efficient flow of information between buyers and sellers; reduces the informational asymmetry enjoyed by insiders; and thereby minimizes speculative arbitrage and its distortionary price signals. Experience with disclosure regulations in other capital markets suggest that increased transparency will reduce this short-term, speculative activity without threatening the volume of patient, investment-grade transactions (Asquith, Covert, and Pathak 2013).

EXAMPLES OF COMMODITY-RELATED TRANSPARENCY INITIATIVES

In this section, we review three of the most visible transparency-related initiatives whose objectives and approaches are of relevance to the commodities sector. These three initiatives are: the Extractive Industries Transparence Initiative (EITI), the Marine Stewardship Council (MSC) and the Kimberley Process Certification Scheme (KPCS).

Marine Stewardship Council

Unilever and the World Wide Fund for Nature (WWF) created the Marine Stewardship Council (MSC) in the late 1990s. For its part, the WWF wanted an independent organization that could fill the governance void for fisheries in international waters, which were being depleted by overfishing and poor management practices. To achieve this, the WWF structured the MSC along similar lines to the Forest Stewardship Council (FSC) that was successful in the forestry sector.

The MSC programme comprises three components: certification, chain of custody and an ecolabel.

At the certification step, the MSC works with the latest fisheries science to establish sustainability standards in three areas: management of fish stocks, fishing practices and environmental impacts. Individual fisheries - usually represented by the consortium of harvesters that fish a specific species, with a specific gear type, in a geographic location - apply to the MSC for certification. If the MSC agrees to proceed, it contracts private certification bodies to conduct an extensive assessment, at the applicant's expense. If successful, the applicant group of harvesters is licenced to apply the MSC ecolabel to the fish caught in the certified fishery, subject to periodic reassessment.

[23] The five commodity product groups are: corn, oil, soybean, sugar, and wheat.

For the chain of custody component, the MSC requires that any intermediary that buys seafood from an MSC-certified fishery must have its documentary chain of custody certified, to have the right to sell that product down the chain as "MSC-certified."

Suppliers' adherence to the MSC programme is a result of consumers' demand for its ecolabel, which appears on MSC-certified seafood products in retail stores, and on restaurant menu items prepared from certified seafood. Especially in Europe, the MSC has had success raising awareness about sustainably produced seafood, thereby generating consumer demand for MSC-labelled products.[24] This consumer demand motivates harvesters and intermediaries to submit to the certification and chain of custody requirements, and it allows the harvesters that hold the certification to charge a premium for their MSC-branded seafood.

The MSC is the most recognizable sustainability programme in the seafood industry. As of late 2013, it had certified 218 fisheries worldwide, representing annual catches of approximately 10 million metric tonnes of seafood, although this represents only 10% of the annual global catch.[25]

Beyond these aggregate numbers, Ponte (2012) observed that the MSC's reach is predominantly limited to wealthy Northern economies: both in terms of the consumers who demand MSC-labelled products, as well as the fisheries that produce them. Southern fisheries are relatively unrepresented, which limits the potential global impact and long-term relevance of the MSC. Ponte also highlights the need for study on the sociological effects of MSC certification: for example, how does MSC certification affect competition with uncertified fisheries; and how does it affect the balance of power among supply chain actors?

As for the direct environmental objectives of the MSC, Martin et al. (2012) reviewed the certification assessments for the 400+ fisheries that have applied to the MSC, both to evaluate the effectiveness of the certification process, as well as to determine its eventual environmental impacts. They found that auditors recommended to 80% of applicant consortiums that they undertake significant improvements to the management and conduct of their fisheries before proceeding with a full assessment. This seems to suggest a rigorous assessment process (i.e. not a "rubber stamp"), which is correlated to real biological and environmental improvements in the fisheries, such as increases in the biomass of targeted species, or the development of protected habitats.

The governance issues related to seafood are different from those related to extractive commodities, for example preserving a living resource, meaning that the MSC's certification programme may not be relevant to the extractive sector. But whatever regulatory regime unfolds in the extractive sector, the transmission of its outcomes to the market would benefit greatly from commodity traders using MSC-style chain of custody requirements to distinguish ethically produced commodities.

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[24] The MSC's research shows that in a selection of 10 OECD countries in 2012, 30% of shoppers recognized the MSC ecolabel. MSC. 21 facts about MSC. Available at: http://www.msc.org [Accessed 3 February 2014].

[25] MSC, 2013. MSC in numbers. Available at: http://www.msc.org [Accessed 3 February 2014].

Extractive Industries Transparency Initiative

The EITI assembles governments, companies and civil society actors to set voluntary transparency standards that are adopted by resource-rich countries. Once a government endorses the initiative, both it and all extractive companies operating in the country must disclose payments in all resource-related payments, with the two sides of the transactions independently reconciled. At the time of writing, 25 countries comply with all EITI standards, and 16 countries have "candidate" status.[26]

In May 2013, EITI adopted more stringent rules. The new EITI standards require, among other things, contextual information about the extractive sector; full government disclosure of all revenues received from the extractive industries; disaggregated reporting in line with new US and EU regulations; and more transparency in the activities of state-owned companies.

EITI's credibility lies in its multi-stakeholder process, which in turn relies on stringent reporting and auditing standards and an external validation process. Capital markets have, to a certain extent, recognized the value of the EITI process, meaning that compliant governments enjoy a slight advantage in raising capital and aid, over their non-compliant competitors (David-Barrett and Okamura 2013).

Nevertheless, the reach of the EITI process remains limited. At the international level, it has raised awareness of transparency issues in the extractive sector. But, given that major extractive producers, such as Russia, Saudi Arabia and the USA, do not participate, altogether 80% of world extractive production sits outside of EITI standards. Even in countries where it has been implemented, there is a general lack of awareness of the EITI among the public and legislators (Aaronson 2011).

Kimberley Process Certification Scheme

The UN-mandated Kimberley Process Certification Scheme (KPCS) was established in 2003 to prevent the trade of so-called "conflict diamonds."[27] It has 54 member states, from among both producer and consumer countries. The industry is represented by the World Diamond Council and civil society by Partnership Africa Canada.[28]

Member states ratify into law KPCS principles related to the trade in rough diamonds, must issue a KPCS certificate with each diamond shipment, and may only trade with other KPCS signatories.

In addition to the international treaty component of the KPCS, the World Diamond Council has developed a series of principles to which its members must comply, including a declaration on their invoices that all of their diamonds are conflict-free, based on their upstream documentation.

[26] Extractive Industries Transparency Initiative. EITI Countries. Available at: http://eiti.org [Accessed 8 January 2014].

[27] Kimberley Process. About. Available at: http://www.kimberleyprocess.com [Accessed 3 February 2014].

[28] Along with Partnership Africa Canada, Global Witness was one of the founding civil society participants in the KCPS, but withdrew in 2011, saying the scheme had failed to stem the flow of conflict diamonds.

Nevertheless, a variety of observers have found that the Kimberley Process has failed to live up to its mission. For instance, in a recent investigative article, Sharife and Grobler (2013) give examples of the ways in which stakeholders have manipulated the Kimberley Process, thereby undermining its ability to stop the illicit diamond trade. They include:

- The systematic laundering of diamonds of questionable origin through tax havens such as Dubai, which can grant their own, new certificates of "mixed origin," which boost the value of the diamonds in onward markets;
- Under-reporting of diamond exports from African countries to evade taxes;
- The co-opting of the Kimberley Process by member states for their political objectives, for example to authorize the certification an ally's questionable diamonds;

In 2011, Global Witness, one of the Process's founding civil society members, quit the initiative, saying that its politically motivated compromises and refusal to upgrade enforcement mechanisms had undermined its effectiveness and reduced it to being a "cynical corporate accreditation scheme."[29]

Grant (2012) provides a more balanced review of the first 10 years of the KPCS. He concludes that the initiative has succeeded in achieving wide acceptance among actors: 99% of countries and firms involved in the diamond trade are signatories. This makes it more difficult, and therefore costly, to send conflict diamonds across borders and to find buyers for them.

As for the KP's shortcomings, Grant uses the examples of its slow and toothless response to the noncompliance of members Venezuela and Zimbabwe to argue that, if the KP is to remain relevant, it must modernize it enforcement mechanisms. Specifically, he writes that it must rework its consensus model of decision making to allow more rapid and forceful punishment of noncompliance by members.

For the commodities sector, the Kimberley Process represents a potential model for achieving sector-wide take-up. But whereas the Kimberley Process is narrowly centred on the politically charged, human rights issue of conflict diamonds, the issues in the commodities sector are more technical, related to corruption, agency dilemma and tax evasion. This implies that the Kimberley Process's system of certificates of origin applied to outgoing shipments would be insufficient. Effective end-to-end governance of the commodities value chain would likely require coordinated scrutiny at several points along the chain, for example: at the contract stage, with each sale transaction, and then with the disaggregated accounting of government receipts and corporate tax filings.

[29] Global Witness, 2011. Why we are leaving the Kimberley Process - A message from Global Witness Founding Director Chairman Gooch. Available at: http://www.globalwitness.org [Accessed 4 February 2014].

CONCLUSION

Over its two-day programme, the Global Commodities Forum will ask participants to reflect and debate on the theme of "Global value chains, transparency and commodity-based development."

On the first day, the concept of global value chains (GVC) provides a dynamic, effective framework through which to evaluate to perennial problems faced by commodity-dependent developing countries (CDDC) in the governance of their resource wealth, problems such as:

- How to the foster political cooperation between government, lead firms and local producers that is necessary to implement the components of a durable GVC entry and upgrading strategy?
- How to foster inter-ministerial cooperation in embedding a GVC strategy within wider industrial and development plans?
- How to flank a GVC strategy with environmental, social and governance policies that channel its benefits towards desired development objectives?

Central to answering all of these questions will be discussions about the potential for governance reform in the commodities sector. From the GVC framework, this demands an assessment of the complexity, availability and transmission of the types of information that public policy makers and corporate strategies require to help steer market outcomes.

There is a long tradition of secrecy in the commodities value chain: from the contracting of exploration and exploitation rights; to the initial sale of resources; to their trade to overseas markets. This will certainly need to evolve for effective governance to take root. It is simply impossible to formulate efficient regulations and ensure their fair application across a competitive marketplace, without a detailed visibility of the underlying transactions.

This governance thread links the two sub-themes of this year's GCF - global value chains and transparency - and will lead participants into the second day of the programme, devoted to transparency.

Transparency is a hot topic in commodities and development discourse. It relates to social behaviours that are condemned throughout the world: corruption, poor governance and tax evasion. And it is a robust, dynamic concept, just as useful in abstract strategy and policy discussions, as it is in detailed technical implementation plans.

Questions of transparency and governance reform in the commodities sector are timely. The reform agenda that arose after the 2008 financial crisis has followed financial flows out from the banking sector at the centre of the crisis, to the interconnected derivatives and extractive sectors, and soon into to the trading sector.

This global value chain perspective on governance reform is promising, as it allows for an end-to-end regulation of outcomes, beginning at the production of commodities (e.g. the extractive sector), continuing through their marketing and distribution (i.e. trading), and eventual securitization (i.e. derivatives).

The eventual commodities governance architecture that emerges will comprise, on one hand, the various pieces of legislation in Northern economies that shape the behaviour of the transnational corporations (TNC) operating in CDDCs. The ubiquity of capital and credit markets means that the sections in the USA's Dodd-Frank Act related to extractive payments and the commodity trading activities of financial institutions, and their equivalents in the EU's new disclosure requirements, will impact the activities of foreign companies as well. As a result, other Northern countries with important extractive activities overseas have already begun conforming to the US and EU rules, countries such as: Norway, Switzerland, Canada and the UK.

The governance of domestic actors in CDDCs will spring from each country's legislation, and from multilateral initiatives related to equitable, transparent governance of resource wealth. The Extractive Industries Transparency Initiative (EITI) is an important component of the commodities governance movement, but so far the scope of its monitoring is limited to the extractive function, meaning that its principles are not necessarily enforced throughout the rest of the value chain, and that its work remains isolated from end users, whose consumption choices can have an important economic and political impact on the success or failure of market-based governance initiatives.

Two other market-based governance initiatives with relevance to the commodities sector are the private sector Marine Stewardship Council (MSC), which certifies sustainable capture fisheries, and the multilateral Kimberley Process Certification Scheme (KPCS), which certifies shipments of conflict-free diamonds.

Each of these two initiatives has enjoyed only partial success, but on different ends of the spectrum. The MSC has effectively imposed strict standards on its certified fisheries, helping them to achieve real environmental improvements in the management of their resources. But these standards cover only 10% of world capture fishery catches, and is largely absent from fisheries in Southern countries.

By contrast, the Kimberley Process boasts the enrolment of 99% of countries and companies involved in the world diamond trade, making nonparticipation in the Process a serious disadvantage. But to achieve this widespread take-up, the KPCS has adopted political and enforcement mechanisms that are widely criticized as slow, toothless and too easily manipulated by member countries.

As they discuss legislative and multilateral policy options, participants at the 2014 Global Commodities Forum will debate these many compromises: the balance between public and private measures; stressing consensus or decisiveness; etc. Indeed, the event's programme challenges participants to outline an equitable, transparent governance architecture for the commodities value chain.

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