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EXPORT DIVERSIFICATION, MARKET ACCESS AND COMPETITIVENESS

Report by the UNCTAD secretariat

Executive summary

Export diversification contributes to reducing the economic vulnerability of commodity-dependent developing countries and increasing the value added generated and retained in the country, and it generates dynamism in the economy.

Market access is a precondition for diversification and commodity-based development. Agricultural subsidies are particularly important for certain commodities. Supplying products of high quality and meeting the requirements of consumers, supermarkets and large processing and trading firms are necessary for effective participation in international value chains.

At the same time, without enhanced competitiveness in terms of cost, quality and business practices, as well as improvements in supply capacities, market access is useless. Efforts are needed to improve the generic competitiveness of commodities and provide a supportive material and institutional environment for enhancing enterprise-level competitiveness.

The international community should assist commodity-dependent developing countries, particularly least developed countries, in diversification and commodity-based development by offering better market access conditions and technical as well as financial cooperation. UNCTAD's supportive role in this process is rooted in its integrated approach to the problems of development and international trade and its specific focus on commodities.

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INTRODUCTION

1. This report focuses on the nexus of export diversification, market access and competitiveness from the point of view of commodity-dependent developing countries. Assuming that development is the principal objective, it aims to show how these three important concepts are linked and why they are all crucial for successful development. It is argued that all three are necessary, but that none of them alone is sufficient to pave the way to development. It is hoped that the report will assist members of the Commission in their deliberations and provide useful ideas in view of the approaching UNCTAD XI conference as well as multilateral trade negotiations and preferential regimes.

2. The commodity situation, market access issues, the diversification experience of commodity-dependent countries, and the constraints and opportunities affecting success have been discussed in detail in earlier reports by the UNCTAD secretariat.[1] The project "Capacity building for diversification and commodity-based development" has also provided insights about problems and measures as seen in the field.[2] This report puts particular emphasis on developing a conceptual framework for understanding the problems faced by commodity-dependent countries as well as the opportunities available to them.

I. EXPORT DIVERSIFICATION

A. The concept

3. The importance of commodities for the development process in many developing countries, in particular African countries and least developed countries (LDCs), is well known. There has also been ample discussion of the negative impacts on a country's development of dependence on a few low-value commodities, often exported in unprocessed forms, for the bulk of foreign exchange earnings. Generally accepted consequences of this dependence include large negative impacts of international price fluctuations and declining

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[1] UNCTAD. Diversification of production and exports in commodity-dependent countries, including single-commodity exporters, for industrialization and development, taking into account the special needs of LDCs, Background Note by the UNCTAD secretariat, TD/ B/COM.1/EM.18/2, 19 April 2002. Statistical Annex to the above note, UNCTAD/DITC/COM/Misc.44, 26 June 2002. Report of the Expert Meeting on the diversification of production and exports in commodity-dependent countries, including single-commodity exporters, for industrialization and development, taking into account the special needs of LDCs. TD/B/COM.1/50, TD/B/COM.1/EM.18/3. World commodity trends and prospects. Note by the Secretary-General, A/57/381, 5 September 2002. *The Least Developed Countries Report 2002,* United Nations publications, sales number E.02.II.D.13, New York and Geneva, 2002, especially Chapter 3, parts E and F (pp. 118–130), Chapter 4 (pp. 137–165) and Chapter 6, part F (pp. 230–234). Ways to enhance the production and export capacities of developing countries of agriculture and food products, including niche products, such as environmentally preferable products, Background Note by the UNCTAD secretariat, TD/B/COM.1/EM.15/2, 11 May 2001. Impact of the reform process in agriculture on LDCs and net food-importing developing countries and ways to address their concerns in multilateral trade negotiations, Background Note by the UNCTAD secretariat, TD/B/COM.1/EM.11/2 and TD/B/COM.1/EM.11/2/Corr.1, 23 June 2000.

[2] Available at *r0.unctad.org/infocomm/Diversification/index.htm.*

terms of trade on the domestic economy; the accrual of an insufficient proportion of the value of the final product to producers, processors and traders in the country of origin; and the vicious circle of poverty associated with this dependence.

4. Diversification is often suggested as a way out of this predicament. However, what is meant by diversification is not always clear, and it is questioned on two grounds. First, it is emphasized that the theory of comparative advantage calls for specialization. Would not diversification reduce the benefits of trade? Second, difficulties in deciding what areas to diversify into and the "fallacy of composition" argument are evoked. Whatever one diversifies into, there is the likelihood of others' doing the same, with the result that markets become flooded and prices fall.

5. It is true that effective and economically beneficial participation in international trade calls for specialization in products for which a country has a comparative advantage. Thus, diversification may appear to be an idea that contradicts this basic principle. Comparative advantage, however, is an evolving concept. It needs to be looked at from a dynamic perspective, and diversification itself is a dynamic process. It is part of a long-term, staged process of economic transformation that makes the best possible use of the country's factor endowment. Elimination of key bottlenecks and adoption of appropriate strategies at the governmental and entrepreneurial levels can enable firms to spot hitherto unrealized opportunities that in turn can be turned into economic gains, provided market access conditions do not prevent it and competitiveness is ensured. Exploiting these opportunities while continually seeking to diversify into products that generate more value added is the essence of a successful diversification process.

6. This is also the only way to deal with the adding-up problem, which has been treated as being prompted by actions at the country level, particularly in countries with a large share of a particular commodity's market. In the current economic context, decisions by enterprises, rather than by governments, determine the composition of a country's exports. Therefore, a focus on the actions of enterprises is necessary. The focus on the country level is justified, however, to the extent that government policies and support affect enterprises' decisions.[3]

7. Diversification is an indication and a result of dynamism and improved competitiveness in the enterprise sector. A stable macroeconomic environment and entrepreneurial drive at the micro level are prerequisites for economic development but are not by themselves sufficient to spur the desired structural transformation. Governments have to act at critical junctures to facilitate the conduct of business, and entrepreneurs have to adopt modern business strategies.

[3] For a discussion of the adding-up problem, see Schiff M, Commodity exports and the adding-up problem in LDCs: Trade, investment and lending policy, *World Development*, 1995, 23 (4): 603–615.

B. Diversification of the commodity sector in developing countries

8. Diversification of the commodity sector should not be construed as an attempt to produce and export a diversified set of products and services at any cost. It should aim to make the commodity sector a positive factor in generating a virtuous circle of development. This has been done in the past by countries such as the United States, Canada and Australia, and more recently in some South East Asian and Latin American countries. International trading rules, however, are much less accommodating now than they were earlier for the implementation of supportive policies by Governments.

9. Diversification in commodity-dependent countries calls for improved competitiveness and supply capacities. It entails the addition of value to raw materials through industrialization and processing (for both domestic and international markets), better positioning in global product chains, increased participation in marketing and distribution networks, and the ability to produce and export higher-value commodities.

10. It may even be economically rational to produce and export low-value unprocessed commodities. (For example, the United States exports large amounts of unprocessed cotton rather than textiles made of this cotton.) Moreover, for some countries the continued predominance of primary commodities in the export mix may be the most viable path to increasing incomes and employment and improving welfare. But the decision should be based on rational choice and profitability concerns, rather than stemming from the inability to do anything else. For countries such as small island developing states (SIDS), whose limited resources may preclude a feasible way out of dependence on low-value commodities, special assistance can be envisaged to help them deal with this predicament.

11. Previous analysis has shown "that there is a clear link between dependence on exports of primary commodities and the incidence of extreme poverty".[4] The level and volatility of prices and their negative impact on export earnings and gross domestic product (GDP) form the most obvious link.

12. Variations in global supply are the principal cause of price fluctuations for agricultural commodities, particularly food products. Variations in demand, linked to income and industrial activity, are important causes of price fluctuations for agricultural raw materials, especially minerals. While supply shocks for annual crops are relatively easy to correct, large supply-versus-demand imbalances for tree crops produce changes in market fundamentals. Large increases in the production of palm oil in South-East Asia in the early 1980s, in the production of coffee in Vietnam in the 1990s and, more recently, in the production of sugar and coffee in Brazil have had such impacts. Subsidies also increase supplies and depress prices. It has been estimated that cotton prices, which were recently at their lowest level in nominal terms since 1972/73, and probably their lowest level in real terms since the cotton gin was invented in 1793, would be US$0.31 (i.e. about 75 per cent)

[4] UNCTAD. *The Least Developed Countries Report 2002*. United Nations publications, sales no. E.02.II.D.13, New York and Geneva, 2002, p. 137.

higher in the absence of direct subsidies.[5] Between 1999 and 2002, if the prices of coffee, sugar and cotton had remained at the levels at which they were in 1998 (when they were "average"), coffee-producing countries, sugar-producing countries exporting to the free market and West African cotton-producing countries would have earned respectively US$19 billion, 1.4 billion and 1 billion more than they actually did.[6]

13. Export earnings provide a large share of the GDP in many developing countries, particularly LDCs. Since these countries depend on a small number of commodities for their export earnings, the impact of price changes is particularly important. For example, the 30 per cent decline in cotton prices has meant a loss of 3 per cent of Mali's GDP. Similarly, the halving of coffee prices meant a loss of 2 per cent of Uganda's GDP. The brunt of this loss of GDP is borne by small producers. The multiplier effect of a decline in farmers' incomes is high, since farmers spend a large proportion of their income on domestically produced products.

14. In principle, farmers can shift between crops, depending on relative prices. For mineral commodities, this is not even a theoretical option. The extent to which farmers can actually shift between crops is severely constrained by economic as well as social factors. The options may be further limited by nature. Substitution is generally easier in more developed countries than in LDCs and SIDS. For example, while farmers in Australia, Brazil or the United States can shift relatively easily from cotton to soybeans, cotton growers in Africa have much less scope for substitution.[7]

15. Commodity-dependent developing countries have to deal with frequent boom-and-bust situations outside their control. They are affected by sharp falls in foreign exchange earnings and by rapid increases in prices of imports such as oil. For instance, Ghana mainly exports cocoa and gold and imports oil. Between 1998 and 2000, the prices of cocoa and gold fell by 47 and 5 per cent respectively, while oil prices increased by 116 per cent. The situation reversed itself in 2001–2002 with an increase of 76 per cent in cocoa prices and a fall of 15 per cent in oil prices. Managing such cycles is a major macroeconomic task, further complicated by movements in exchange rates.

16. The size of price shocks, a country's exposure to them, and its capacity to react to them are the three elements of the risk that a country faces.[8] Diversification of the export structure reduces the risk associated with the first two elements. Risk management, which is an important factor in determining the capacity to react to shocks, does so by reducing exposure.

17. Special arrangements such as the sugar quotas of the European Union and the United States limit the amount of world trade taking place under competitive conditions. Therefore,

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[5] International Cotton Advisory Committee. Cotton: Review of the world situation. 2002, 55 (5): 3, 13.

[6] World Commodity Trends and Prospects, A/57/381, p. 5.

[7] Badiane O, Ghura D, Goreux L and Masson P. Cotton sector strategies in West and Central Africa. World Bank Policy Research Working Paper 2867, July 2002: 13.

[8] Combes J-L and Guillaumont P. Commodity price volatility, vulnerability and development. *Development Policy Review,* 2002, 20 (1): 25.

only a small part of trade and production is affected by price variations, and all the impact of supply and demand imbalances falls on this part. This magnifies the effect of price variations and shifts the burden of adjustment exclusively onto a small number of producers that do not benefit from special arrangements.

18. One of the most obvious impacts of price declines and volatility on competitiveness is the limitation of resources available for investment. In addition, commodity price volatility negatively affects total factor productivity. In fact, it has been found that the negative impact of commodity price volatility on total factor productivity is greater than its negative effect on capital accumulation.[9]

19. The significance of diversification for development is not confined to counteracting the negative impacts of price declines and volatility. Diversification means an upgrading of skills in production and management. Entering new markets and exporting high-value commodities requires production and management skills more similar to those required for manufactured goods than to those needed for exporting traditional bulk commodities. These skills prepare entrepreneurs for competition in other sophisticated markets and generate a demonstration effect. Suppliers of material and service inputs to these diversifying enterprises also have to improve their production and management. From a long-term developmental perspective, this effect may be more important than counteracting price volatility. Moreover, diversification generates other positive externalities that help improve competitiveness, such as the opportunity to use market channels established for one product for others.

20. In addition to unawareness of alternatives and the inability to produce anything other than the traditionally produced items, there are other exit barriers making diversification in the commodity sector relatively difficult. These include the time needed for the new product to bear fruit, particularly in the case of tree crops, and the lack of bridging finance for that period. The risk associated with entering a new area with uncertain market opportunities also discourages diversification. In addition to improved access to information, structured finance and risk management instruments for alleviating some of the uncertainty would facilitate entry into new areas.

21. In many cases, expanding export earnings from commodities also calls for geographical diversification. Historical and linguistic ties have led to special links with a few markets and to dependence on them. Preferential market access conditions, such those between the countries of the European Union and the African, Caribbean and Pacific Group of States (ACP), have reinforced this dependence. On a regional basis, during the three decades since 1970, the proportional importance of developed regions as export destinations for commodities has generally declined in favour of developing regions. The only exception is the importance of European Union for Africa, which has increased. The importance of preferential access conditions is also illustrated by the increase in African exports to the United States in conjunction with the implementation of the African Growth and Opportunity Act.

[9] Combes and Guillaumont, p. 30.

II. ACCESS TO MARKETS

A. The concept

22. Naturally, both the possibility of entering foreign markets and the ability to do so are essential for exports. The *possibility* of entering depends on market access conditions, which are determined by the legal and administrative conditions imposed by the importing countries under internationally agreed trade rules. The *ability* to enter a market, however, is a function both of the competitiveness of the exporter, which in turn is determined by the relative cost and quality of the product, and the characteristics of supply chains and the structure of markets (e.g. the degree of oligopoly).

23. One important conceptual difference between competitiveness and market access or entry is that, while the exporting side can do a lot *by itself* to improve its competitiveness, market access conditions, market exigencies and the characteristics of supply chains are to a large extent exogenous to developing-country exporters, which are often small and wield little power. Naturally, international trade rules broadening market access are the result of intergovernmental negotiations, and therefore all States Members of WTO have the right, if not the power, to affect the scope and content of these rules.

24. Governments, however, have neither direct involvement nor much leeway in influencing the characteristics of market structures and supply chains, apart from implementing rules for competition. Here, large firms determine the *modus operandi* of supply chains and, thus, effectively the distribution of value added and who gains how much from trade. Especially since the withdrawal of the state from commodity-exporting activities in many developing countries, these large firms are almost exclusively those of the industrialized countries. These firms are active in the trade, processing and distribution of products. Smaller firms can influence the functioning of the supply chains and the distribution of total value added only if they have specialized and differentiated products – in other words, if they can turn the value chain into a producer-driven one.[10] A new phenomenon that is radically changing market entry conditions, particularly in the case of agro-food, is the recent growth of international supermarket chains, which is discussed in some detail in the box on page 12.

B. Market access and market entry for commodities

25. Commodities, particularly agricultural products, face very tough market access conditions. Tariffs for agricultural products are higher than those for industrial products, and

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[10] For more information on value chains, see Gereffi G, The organisation of buyer-driven global commodity chains: How U.S. retailers shape overseas production networks, and Gereffi G, Korzeniewicz M and Korzeniewicz R, Introduction: Global commodity chains, in Gereffi G and Korzeniewicz M, eds., *Commodity Chains and Global Capitalism*, Westport, Conn., Praeger, 1994; Strategies for diversification and adding value to food exports: A value chain perspective, UNCTAD/DITC/COM/TM/1,UNCTAD/ITE/MISC.23, 14 November 2000.

there is steep tariff escalation. This not only prevents full exploitation of comparative advantage but also acts as a disincentive for processing and vertical diversification, as well as for foreign investment into processing industries. The European Union and Japan, for example, have steep tariff escalation for coffee, tea and spices, and for fruits and vegetables. In these two markets, tariffs rise respectively from averages of 1.63 per cent and 0.11 per cent for the raw materials to 20.02 per cent and 8 per cent for the final product in the case of coffee, tea and spices, and from 7.07 per cent and 8.12 per cent to 17.92 per cent and 19.15 per cent in the case of fruit and vegetables. The tariff structure shows a bias against products exported by developing countries, which are often commodity-based items. In 2002, the United States collected $1.6 billion of tariff revenue from $110 billion worth of automobile imports and $1.63 billion of tariff revenue from $15 billion worth of shoe imports.[11]

26. Tariffs on minerals and metals are generally low or nonexistent, and there are few nontariff measures affecting developing-country exports of these products. However, antidumping actions concerning mineral and metal products have become increasingly common.

27. In addition to tariffs, and possibly more importantly, market access for several agricultural commodities is affected by subsidies provided to producers and exporters in developed countries. This not only restricts exports of, and opportunities for diversification into, many temperate-zone products but also leads to increases in supplies from uncompetitive producers, distorting worldwide allocation of resources and depressing prices. Cotton production in West Africa, for example, is characterized by consistently high-quality crops with high average yields and high ginning ratios. West African cotton growers are among the world's lowest-cost producers. Nevertheless, competing in world markets with subsidized cotton from developed countries is difficult.[12] Negotiations in the World Trade Organization on the Agreement on Agriculture are crucial for dealing with this problem. The WTO dispute settlement mechanism is also being used to challenge actions that are seen as contravening the rules.[13]

28. Investing abroad to circumvent market access barriers is an option open to some enterprises. A case in point is that of the Brazilian orange juice companies Cutrale and Citrosuco, which since 1996 have produced part of their juice in Florida, where they purchased local plants[14] and where orange juice imports from Brazil face a surcharge, in addition to high tariffs.[15] This alternative, naturally, is open only to enterprises with substantial financial means. It also siphons jobs and income from the developing country concerned (in this case Brazil). Access to distribution networks and shelf space is another reason for undertaking investments abroad. Colombian flower exporters have taken over one

[11] The truth about industrial tariffs. *Finance and Development*, September 2002: 14.
[12] Badiane O, Ghura D, Goreux L and Masson P. Cotton sector strategies in West and Central Africa. World Bank Policy Research Working Paper 2867, July 2002: 9.
[13] On 3 October 2002, Brazil challenged United States cotton subsidies at the WTO (DS/267). Argentina, India and Zimbabwe later requested to join consultations.
[14] Protectionism in the North punishes citrus growers threefold. SUNS, No. 5049, 30 January 2002.
[15] *The Economist*. The geopolitics of orange juice. 14 September 2002: 54.

of the major flower importers in the United States, and canned tuna exporters from Thailand and Indonesia have taken over major United States companies.

29. While market access opens up avenues for diversification, ironically in some cases its lack can also be an incentive for diversification. When faced with entry barriers, dynamic enterprises are induced to diversify and to exploit market outlets for alternative products. For example, Turkey, which encountered quota limitations for lower-value textile products, successfully improved its competitiveness in, and graduated to, higher-value items for which market opportunities existed.

30. Preferential market access conditions can also significantly affect the potential for diversification. For some commodities, access to certain markets may be so restricted that it is impossible for suppliers without tariff preferences to export, regardless of any realistic degree of competitiveness.[16] This seems to be the case for sugar and beef exports by ACP countries into Europe, where most-favoured-nation (MFN) tariff rates are between 60 and 70 per cent, as well as for bananas. For some other products, such as horticultural ones, tariffs amount to around 10 per cent and do not keep sufficiently competitive exporters out of the market.[17] The success of Kenya and Zimbabwe in the European Union market has been helped by preferential margins, but without competitiveness in costs, prices, quality and management skills, this success could not have been realized.

31. Large preferential margins are sometimes necessary to enable some single-commodity exporting countries with adverse resource endowments (such as some SIDS) to enter import markets. Preferences with prohibitively large margins, however, also reinforce geographical and product dependence. For example, production of Swaziland sugar, which benefits from preferential access to the European Union, is projected to rise by about 10 per cent from 2002/2003 to 2003/2004. However, for this increase to materialize, the area allocated to sugar will have to expand at the expense of other products, “threatening the country’s ability to feed itself”.[18] Such dependence, if not backed by competitiveness, can lead to significant adjustment costs if the preferences are eliminated.

32. The rules of the multilateral trading system that affect market access conditions for commodities, and thus diversification opportunities, are not confined to those in the WTO Agreement on Agriculture. The Uruguay Round agreements on the Application of Sanitary and Phytosanitary Measures (SPS) and on Technical Barriers to Trade (TBT) and the TRIPS Agreement also contain rules with vital implications for agricultural trade. In contrast to preferential tariff schemes, preferential market access is not accorded in the areas covered by these agreements, and in principle all countries have to fulfil the same requirements.

33. Meeting the requirements of the SPS agreement is one of the principal concerns of agro-food exporters. This is complicated by the multiplicity of these requirements across different markets. Considerable costs must be borne in order to meet the health and

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[16] Caribbean and African sugar exporters benefiting from preferences are opposing the challenge by Brazil and Australia to the European Union sugar protocol at the WTO.

[17] Stevens C. Value chains and trade policy: The case of agriculture. *IDS Bulletin*, 2001,32 (3): 48.

environmental requirements, and to apply the Hazard Analysis Critical Control Point (HACCP) principles. These requirements would definitely create difficulties in the short term, but in the long run exporters would be forced to increase their competitiveness. Considerable difficulties are, however, presented by the way the standards are set, and challenging their legality is extremely difficult, particularly for developing countries. Even in the case of internationally agreed norms, developing countries' concerns are often inadequately reflected owing to their lack of technical skills and negotiating ability.

34. An important aspect of failure to meet SPS requirements is that if one exporter has problems, all exporters from that country can be penalized. This has much wider implications than a firm's failing to meet the requirements put by an importer. In the latter case, other exporters have the possibility to export if they can prove that they fulfil the requirements, although the failure of a even single firm would harm the reputation of the whole country.

35. Another agreement whose implications for diversification are sometimes overlooked is the TRIPS Agreement. For example, the rules governing geographical indications (GI) have been designed with the products of industrial countries in mind,[19] and traditional knowledge is not sufficiently protected. Moreover, importers are sometimes apprehensive about purchasing from developing countries because they worry that seeds and other inputs utilized in production may not satisfy the requirements of the TRIPS Agreement. This has affected some high-value horticultural products such as cut flowers, which offer significant opportunities for export and diversification. An example is that of the limitations placed on India's exports of roses to France. The fact that larger producers can more easily meet not only the requirements of the SPS and TRIPS agreements but also those set by supermarkets and importing firms makes it more difficult for smaller producers and, therefore, the poorer strata of society to benefit from diversification and trade.

36. While market access barriers and international trade measures implemented by Governments comprise the first hurdle to selling in international markets, clearing this hurdle does not guarantee that a product will appear on retailers' shelves. For instance, SPS requirements define the necessary but not sufficient conditions for being able to export. Many, and in most cases much more stringent, quality and labelling requirements, as well as conditions regarding production and processing practices, are imposed by importing firms themselves. Particularly in the case of food items, meeting the requirements of importing firms and distribution and retailing channels is the ultimate prerequisite for success. Moreover, these requirements are usually more stringent than the government regulations reflected in measures undertaken in accordance with the requirements of the SPS Agreement. When requirements are made by private enterprises, there is no way to contest them legally, except in situations where rules of competition are violated.

37. The requirements set by Governments and firms go beyond product specifications to cover the way in which the product is produced. Competitiveness in many instances depends

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[18] Hall J. Swaziland hunts for sweet returns amid growing hunger. Reuters, 5 November 2002.

more on the production process than on the product itself. Not only do small producers lack the financial means and technical skills to meet these requirements, but when they do meet them, they have significant disadvantages. Traceability is important: buyers want to know for sure how production has been carried out by all suppliers. When a large number of small producers are involved, the transaction costs incurred by the buyer are significantly bigger than those involved in dealing with a small number of large producers. A rational buyer would like to avoid these extra costs by using large suppliers.

38. These requirements are ultimately dictated by consumer concerns. Particularly for fresh products, these concerns are often transmitted through supermarket chains, which are internationalized and shape not only international but also national trade. For tropical beverages and processed foods (and inputs used to produce these), large transnational trading and processing firms are the key actors in defining the conditions to be met by producers.

39. Even small producers with disproportionately little bargaining power have to enter into direct transactions with these large firms. These relationships, however, have an important positive aspect when they involve technical assistance to upgrade production processes, product quality and management practices, with the result being improved competitiveness. They may also involve assistance in entering new areas of production, which contributes to diversification.[20] On the other hand, the creation of dependency relations for the producers can be considered a negative consequence of this situation.

40. Using specialized channels such as "fair trade" networks can also facilitate market entry and improve the earnings of producers that participate in them. "Fair trade" provides higher and more stable revenues to producers that meet certain social and environmental conditions in their export-oriented production. However, these channels exist only for a small number of products, such as coffee and bananas, and the share of the market held by "fair trade" products is rather small. The adoption of some "fair trade" principles by large firms engaged in commodities trading, at least for some part of their trade, may help improve the revenues of producers in developing countries while promoting increased environmental and social responsibility.[21]

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[19] For the impact of these rules on South Africa's wine industry, see Weatherspoon D et al., Emerging business: The South African wine industry case, Michigan State University, Agricultural Economics Staff Working Paper No. 99-54, October 1999.
[20] For examples, see UNCTAD, *World Investment Report 2002*, United Nations publications, sales no. E.02.II.D.4, New York and Geneva, 2002, especially pp. 154–157.
[21] A project on this issue, focusing on coffee, is being conducted jointly by UNCTAD and IDRC/IISD.

The Changing Dynamics in the International Agro-food Chains

Over the last decade, a small number of global supermarket chains have gained increasing influence in international agro-food markets. According to some views, "we live in an era of supermarket dictatorship."[i] Currently, three of the top five global grocery retailers – Carrefour, Ahold, and Metro – are each present in more than 20 countries. Their growth and dominance are reflected in the marked surge of foreign direct investment (FDI) flows into the retailing sector in the 1990s.[ii]

With the advent of the "global supermarket", the distinction between world and local markets is fast disappearing. Quality concerns and modern business practices reminiscent of the international markets are being transferred and diffused into domestic markets.[iii] Those who can meet the requirements of supermarkets in the domestic markets are likely to do so in international markets as well.

Supermarkets often prefer dealing directly with producers because direct procurement enables savings of 10 to 20 per cent.[iv] While some small producers, particularly those that are organized in associations or can enter into contractual relationships with the supermarket chains, find opportunities for increased sales, others are marginalized and face exclusion. Recent changes in market structures favour larger producers.

The dominance of supermarkets makes it even more difficult than before to put products on the market. For example, it costs about US$50 to place, say, a jar of speciality pickles on the shelves of all four major grocery chains in the United States city of Tampa, Florida. It has been reported that between 50 and 75 per cent of the retailer's net profit comes from numerous fees demanded of producers.[v] Moreover, while retailers receive their revenue as soon as the product is sold, the suppliers have to wait for 30 to 45 days before being paid, which provides supermarkets with a significant opportunity for financial gain.[vi]

It is virtually impossible for producers to venture into value-adding aspects of developing and marketing "own" labels and brands without having to first link up with established brand names or a supermarket's own brand. The Vietnamese Phu Quoc fish sauce is a case in point. Although it is a national product with an "appellation of origin" certification, it will be marketed in supermarkets by Unilever, under the latter's Knorr label. The knowledge that it is bottled under conditions controlled by Unilever, a globally recognized name, is expected to facilitate acceptance by consumers.[vii]

In light of these structural changes, Governments and international development agencies need to internalize the fact that, increasingly, "product markets" mean "supermarkets". It is crucial for Governments and donor agencies to help small farmers and entrepreneurs invest in equipment, technology, management and commercial know-how, and the development of strong and efficient organizations to meet the requirements of this system.[viii]

i. A Brazilian wheat farmer, quoted in Farina E, Consolidation, multinationalization and competition in Brazil: Impacts on horticulture and dairy products systems, *Development Policy Review*, 2002, 20 (4): 447, 450.
ii. Reardon T and Berdegué JA. The rapid rise of supermarkets in Latin America: Challenges and opportunities for development. *Development Policy Review*, 2002, 20 (4): 376.
iii. Alvarado I and Charmel K, The rapid rise of supermarkets in Costa Rica: Impact on horticultural markets. *Development Policy Review*, 2002, 20 (4): 483.
iv. Schwentesius R and Gómez MA, Supermarkets in Mexico: Impacts on horticulture systems, *Development Policy Review*, 2002, 20 (4): 496; and Ghezán G, Mateos M and Viter V, Impact of supermarkets and fast-food chains on horticulture supply chains in Argentina, *Development Policy Review*, 2002, 20 (4): 398.
v. Bunyard P. When cheap isn't cheerful. *The Ecologist*, 2002, 32 (3): 31.
vi. Gutman G. Impact of the rapid rise of supermarkets on dairy products systems in Argentina. *Development Policy Review*, 2002, 20 (4): 411.
vii. Cohen M. Pungent pride. *Far Eastern Economic Review,* 3 October 2002: 50.
viii. Reardon T and Berdegué JA, *op. cit.,* 385–386.

III. COMPETITIVENESS

A. The concept

41. Competitiveness is, by definition, a relative concept. It depends not only on the conditions in a given country and what is done by a given enterprise, but also on what the competitors do. It requires not only doing something well but doing it better than others, and doing it better not only in export markets but also in the home market. Abstracting from the impact of market access conditions, such as tariffs and subsidies, it depends on the ability to supply a product of a given quality more cheaply than the competition or providing a better-quality product than others can at a given price. Price competitiveness is relatively more important for homogeneous commodities traded in bulk and those entering as inputs into manufactured goods. Although in most cases the share of the primary product in the value of the final product is small, competition among substitutable inputs is fierce.

42. Price is an easily identified, quantifiable attribute. However, while quality can be defined objectively and quantitatively, in the minds of buyers it is often associated with an image of a particular exporting country, a specific origin, or a trademark. Building this image is a long and costly affair usually out of the reach of developing countries and their firms.

43. While ultimately the relative efficiency and business skills of the supplying enterprise determine its competitiveness, Governments have an important role in providing the appropriate environment and incentives for inducing enterprises to undertake the necessary steps.

B. Competitiveness in the commodity sector

44. For commodities, two levels of competitiveness can be ascertained.[22] At the macro level is the competitiveness of a certain product with respect to others. This can be competition between natural and synthetic items, as for cotton, or between different natural products, such as the sugar and corn syrup and cocoa and other fats used in chocolate. Micro-level competitiveness exists among different suppliers of the same commodity.

45. The case of cotton provides a good example of competition at the macro level. Cotton's share in the world fibre market, which between the mid-1970s and the early 1990s was slightly less than 50 per cent, has since declined to about 40 per cent, and is expected to remain at that level.[23] The causes of this decline are not in the cotton sector but in the proliferation of relatively cheap synthetic fibre supplies, often with government support, particularly in several Asian countries.

46. Price competition also exists among different grades of commodities used in blending – for example, to produce instant coffee. Particularly with improvements in technology, which reduce the significance of quality specifications, even small changes in relative prices can lead to significant variations in competitiveness and demand. For example, advances in coffee-processing technology (e.g. steam cleaning for coffee) and longer processing that compensates for poor bean quality in producing cocoa, now allow low-quality raw materials to be included in prestigious blends.

47. In addition to price, factors such as environmental and health considerations also affect the competitiveness of commodities. The rapidly growing demand for organic food demand, expressed preferences for white meat over red meat, and recent changes in the material composition of cars are examples of this. "Alternative uses" can also increase the demand for a commodity. Expanded use of ethanol utilization as a fuel has had a significant positive impact on the demand for sugar. Here, government legislation plays a crucial role in determining consumption patterns. For some products, such as geotextiles obtained from jute or other hard fibres, which have environmentally preferable characteristics, technical specifications and acceptance by the industry are the critical factors affecting competitiveness.

48. Perceptions and publicity campaigns mounted to form these perceptions crucially influence the competitiveness of one product vis-à-vis another. For example, the "up-market" image of cotton fabrics is an important factor preventing it from losing more market share. This macro-level competitiveness is an area where the suppliers of a product have a common interest and would benefit from cooperation on generic promotion.

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[22] Apart from the macro- and micro-level competitiveness that is discussed in some detail in the text, there is also competition – particularly relevant for commodities composed of natural resources, such as minerals – where countries compete for investment resources. Competitiveness in this respect is determined both by the quality of the countries' natural resources and by the attractiveness of their investment climate, including political risk, taxation and other legislation on natural resource exploitation.

[23] International Cotton Advisory Committee. *World Textile Demand, 2002*. Washington, D.C., 2002: 27.

49. For commodities used as inputs for final products, the quantity demanded depends not only on the competitiveness of the raw material but also on the demand for, and the competitiveness of, the final product. Besides price and consumer preferences, market access conditions for the final product affect the quantity demanded of it, and thus of the raw material. For example, if, as is generally accepted, developing countries can provide cheaper textiles than developed ones, but if they are constrained by market access conditions, then it can be argued that more liberal market access for textiles produced by developing countries will reduce prices and lead to a greater demand for textiles. This would, then, mean increased demand for fibre, which would benefit producers of cotton.

50. Within the framework set by macro-level competitiveness, the micro-level competitiveness of specific producers and exporters determines who participates in the supply chain, and how. Competitiveness at the micro level can also be examined from two points of view: costs and product quality.

51. For homogeneous commodities, in particular minerals such as copper, differentiation is impossible, apart from considering the grade of the product. Thus, costs are the key element of competitiveness. In Chile, average production costs for copper are about one half of those in Zambia. Because of its higher costs, Zambia's copper industry is under severe threat. Costs, however, are a function not only of the physical properties of the mine but also of management skills and technology, as exemplified by efficiently operating mines even in high-cost areas.[24]

52. Apart from the cost of inputs, labour and financing, exchange rate variations also affect costs and competitiveness. Devaluations make imported inputs more expensive in local currency for the producer, but they also mean higher revenues in terms of local currency from products that are exported.[25] Devaluations have a relatively strong impact on agricultural trade, since increasing supplies is easier in agriculture than in industry, owing to smaller capital requirements for capacity expansion.[26] The 50 per cent devaluation of the CFA franc in 1994 allowed cattle and poultry exports from Burkina Faso and Mali to Benin, Côte d'Ivoire, Mali and Nigeria to regain some of the markets that had been lost to heavily subsidized meat from the European Union.[27]

53. Although one would expect that the more cheaply a product is produced, the more competitive the supplier is likely to be, this is not always clear, particularly in the case of commodities, for several reasons. First, high tariffs and subsidies can enable producers and traders of higher-cost products to appear more competitive than the more efficient ones.

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[24] Letter from Pascall P, *The Economist*, 2002, 22 June 2002: 18.

[25] Another important impact of devaluations is to make imported food more expensive, creating difficulties particularly in net-food-importing developing countries.

[26] UNCTAD. The world commodity economy: Recent evolution, financial crises, and changing market structures. Report by the UNCTAD secretariat to the fourth session of the Commission on Trade in Goods and Services, and Commodities, TD/B/COM.1/27, 16 July 1999: 13.

[27] Yade M et al. The role of regional trade in agricultural transformation: The case of West Africa following the devaluation of the CFA franc. Michigan State University, Agricultural Economics Staff Paper No. 99-20. Presented at the Workshop on Agricultural Transformation (Tegemeo Institute, ECAPAPA), Nairobi, Kenya, 27–30 June, 1999.

(Cotton provides a glaring example in this regard.) Second, costs are incurred at different levels of the supply chain, and ultimately it is the cumulative impact that is determinant. Despite low production costs and relatively high yields (e.g. for cotton in West Africa), the share of the international price paid to farmers of a commodity can be low, reflecting inefficiencies in the non-production stages, including marketing,[28] and/or oligopoly rents.

54. Margins between farm-gate prices and f.o.b prices are often high in developing countries. Poor physical infrastructure and mismanagement increase the costs of transforming products through space, form and time. Poor institutional infrastructure implies high transaction costs associated with gathering information as well as negotiating, monitoring and enforcing contracts. Reforming the agricultural sector in the context of structural adjustment programmes and reducing government involvement in agricultural input and output markets as well as agricultural finance has led, in most cases, to "greater efficiency in output marketing, but higher transaction costs to financing the production"[29] and quality assurance. The net effect on cost competitiveness has been mixed, but that on competitiveness in terms of quality has been negative. The principal problems that small producers face – namely, access to financing and other support services, including information services – stem from the inability of the local private sector to fill the void created by the disappearance of an established institutional structure. Improving farmers' competitiveness and bargaining power necessitates reducing both the transformation costs (through physical investments) and the transaction costs (through institution building).

55. A crucial part of transaction costs is related to information. The Internet provides new and inexpensive opportunities for obtaining information and bypassing some intermediaries, thus reducing transaction costs. Social and ethnic networks can also reduce transaction costs by "letting suppliers know that consumers in a particular country will be receptive to their products, or enlightening suppliers on how to adapt their products to consumer preferences in a given country". The impact of an ethnic link goes beyond provision of information. It has been calculated that a 10 per cent increase in immigrants to the United States will increase United States exports to the country of origin by 4.7 per cent and United States imports from the country of origin by 8.3 per cent.[30]

56. Even when a product has cost advantages at the farm or factory gate, and even at the port of exportation, this competitiveness may be lost when transport costs are added. Transport costs are a very important factor impeding the competitiveness of landlocked and small island countries.

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[28] Badiane O, Ghura D, Goreux L and Masson P. Cotton sector strategies in West and Central Africa. World Bank Policy Research Working Paper 2867, July 2002:.8–9.
[29] Winter-Nelson A. Institutional adjustment and transaction costs: Product and inputs markets in the Tanzanian coffee system. *World Development*, 2002, 30 (4): 561–562. For an extensive review of the impact of reforms on the agricultural sector in Africa, see Kherallah M, Delgado C, Gabre-Madhin E, Minot N and Johnson M, *Reforming Agricultural Markets in Africa*, International Food Policy Research Institute, 2002.
[30] On networks, see Rauch JE, Business and social networks in international trade, *Journal of Economic Literature*, 2001, 39 (December): 1184–1185.

57. It is also important to realize that in many cases the price paid to the farmer, who operates from a competitive situation, facing oligopolistic market conditions both at the upstream and downstream stages, is a residual. What are called "costs" associated with these stages are, in fact, the earnings (value added) of someone, including for the provision of services such as marketing. In some cases, these high "costs" reflect inefficiencies, but in others they reflect oligopoly rents. Who will benefit from reducing the inefficiencies, where they exist, depends on power relations in the value chain.

58. Increasing productivity and yields in agriculture – in other words, enhanced competitiveness – has often not led to substantial gains for the producers or even the consumers. Particularly over the last two decades, the margins between c.i.f. prices and the price that the consumer pays have widened for many products.[31] For coffee, in the early 1990s, the annual earnings of coffee-producing countries from exports were US$10–12 billion and the value of retail sales of coffee about $30 billion. Now the value of retail sales exceeds $70 billion, but coffee-producing countries receive only $5.5 billion.[32] Part of this change is caused not by price declines but by a change in the coffee value chain that has allowed traders, processors and retailers to increase their earnings substantially.

59. Producers can improve their earnings by upgrading their position in the value chain. Differentiating one's product and establishing special relationships with buyers are among the main avenues for achieving this. Modes of differentiation have changed recently in line with changes in commodity market structures and the liberalization of agriculture in developing countries.[33] "The classical agro-commodity chains offered smallholders broadly based but shallow upgrading possibilities, the rewards of which were calculable and predictable. The new chains offer more narrowly based but deeper rewards, although the basis of the latter's calculation is less transparent." Earlier, it was often national origins, with a national marketing board ensuring quality, that provided the means for differentiation and upgrading. Particularly with the disappearance of marketing boards, more of the commodities such as coffee and cocoa are being sold through international traders in undifferentiated form. This process has gone furthest for cocoa, so that the only nationally denominated cocoa still recognized is from Ghana (which happens to be the only producing country where a state marketing monopoly still plays an important role). Differentiation now involves, in many cases, strategic alliances with large transnational firms. Relations have been developed between industrial processors in industrialized countries and "more or less dedicated" suppliers in developing countries. Usually, this involves an extended period of practical collaboration, followed by "certification". Examples include "estate coffees" and the emergence of "homologized" rubbers, specially cultivated for "single-rubber tyres", introduced by European manufacturers partly to avoid the costs of blending.

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[31] Morisset J. Unfair trade? The increasing gap between world and domestic prices in commodity markets during the past 25 years. *The World Bank Economic Review*, 1998, 12 (3): 503–526. UNCTAD secretariat estimates for coffee have also shown that this margin has widened more in markets with more concentrated structures.

[32] Osorio N. The global coffee crisis: A threat to sustainable development. London, 21 August 2002. Submission by the International Coffee Organization to the World Summit on Sustainable Development.

[33] Much of this paragraph is from Gibbon, P, Agro-commodity chains: An introduction, *IDS Bulletin*, 2001, 32 (3).

60. Competitiveness in international markets also requires expenditures for building a presence, and it requires persistence. Lack of financial resources makes it difficult for developing-country exporters to do this. Nestlé, for example, expects to generate savings of US$3.5 billion over four years, and 70 per cent of this amount is expected to be used for advertising and promotion. The same company also provides a good example of why it is necessary to pursue a long-term strategy and persist through hard times, both of which require access to substantial amounts of cash. Before becoming highly profitable in Republic of Korea and China, the firm lost money in these markets for a decade,[34] but it did not quit.

IV. CONCLUSIONS AND PROPOSALS

61. Diversification, as it has been defined above, provides a road map for development in commodity-dependent developing countries. The process of diversification and development takes place in an environment defined by market access conditions and the structure of international markets, and it is inextricably linked to the competitiveness of enterprises, which are the ultimate actors in this process. The easiest way, if a rather superficial one, of measuring the success of export diversification is the change in export earnings. However, there are other more important indicators that are much more difficult to measure.

62. Indicators that are more important for development than export earnings include (a) foreign exchange earnings measured in net terms; (b) value added retained in the country; and (c) the dynamic impact of the change on the domestic economy, including the domestic distribution of the benefits from diversification. All of these are also critically dependent on the nature of market access conditions, the structures of international markets and supply chains, and the manner in which competitiveness is improved. Market access conditions and market structures influence the choice of sectors to which Governments give priority, and enterprises would not invest to produce or improve competitiveness for goods that will be kept out of markets. This influences the attractiveness for foreign investment.

63. Without competitiveness and market access, diversification and development are very difficult, if not impossible, to achieve. Increased competitiveness may help overcome some of the negative impacts of unfavourable market access conditions, and preferential market access may counterbalance some degree of uncompetitiveness. But in order for the full benefits of international trade and diversification to be realized, competitiveness and a liberal market environment are necessary.

64. The conclusions emerging from the preceding analysis are that (a) diversification is a desirable process the extent of which depends crucially on market access conditions and competitiveness; (b) without competitiveness, exporting countries cannot make full use of whatever market access they have; and (c) without market access, it is impossible to reap the full benefits of increased competitiveness.

[34] *The Economist*. A dedicated enemy of fashion. 31 August 2001: 46.

65. Analysis of the nexus of diversification, market access and competitiveness leads to the identification of several critical points where action is needed to increase the contribution of the commodity sector to development. UNCTAD's role in promoting the development of commodity-dependent countries includes the provision of analysis and information as well as technical assistance in all of the areas listed below. Providing a forum for the exchange of experiences is also an important contribution. Expanding the analysis and responding positively to requests for technical cooperation would, however, require a considerable increase in extrabudgetary resources.

(a) An enabling macroeconomic environment is necessary for development. Given the importance of the commodity sector in their economies, developing-country Governments need to include in their evaluation of macroeconomic and exchange rate policies the specific impacts that will be felt by the commodity sector, and the impact of the response by the commodity sector on the success of these policies.

(b) The international trading system is a crucially important determinant of the extent to which the commodity sector can contribute to development. Commodity-dependent countries have to identify their specific needs, particularly in respect of several WTO agreements, such as the Agreement on Agriculture, the SPS and TBT Agreements and the TRIPS Agreement. Developed countries should respond positively to these needs, and should provide the necessary resources for support at both the negotiation and implementation stages. Preferential trading arrangements significantly influence the patterns of trade for some commodities and countries. Both the impacts of such arrangements and the implications of their termination need to be better understood, including in the context of MFN liberalization and preferential trading arrangements among developed countries. UNCTAD can provide analytical and technical support for assessing the impacts of alternative outcomes of multilateral negotiations and preferential arrangements, and for designing and implementing government policies as well as enterprise strategies that would fit the current international trading framework.

(c) The long-term decline and fluctuations of commodity prices are a constant concern. Cooperation between producing and consuming countries is the most effective way of dealing with this problem. However, producers can also act alone. On the *supply* side, a better understanding of the likely impacts of increasing supplies may mitigate the decline by leading to more informed decisions regarding changes in production. Assistance for facilitating the withdrawal of inefficient suppliers from markets and their diversification into more promising areas would also help. The elimination of market-distorting subsidies is another crucial requirement for bringing supply into balance with demand for several commodities. On the *demand* side, generic promotion, along with improvements in technical qualities, particularly of some agricultural raw materials, could help. Consideration should also be given to setting up a system to mitigate the adverse effects of instability in export earnings on the agricultural and mining sectors, and to instituting risk management mechanisms that reduce the negative impacts of price fluctuations. UNCTAD could help in assessing the effectiveness and applicability of risk management instruments and alternative schemes for mitigating the adverse effects of export earnings instability, and could assist in their operationalization.

(d) Increasing the value added retained in the exporting country and fostering the dynamic effects of diversification are key aspects of commodity-dependent countries' development process. Action is required by Governments, enterprises and the international community. The most basic requirement is access to timely and reliable information. UNCTAD assists in this respect, *inter alia* through the Infocomm portal.

(e) To increase retained value added by reducing costs, productivity should be increased and inefficiencies leading to high transaction cost should be corrected. The former calls for upgrading skills, technology and physical infrastructure; the latter requires improvements in institutions that facilitate the conduct of business. Both are primarily government functions.[35] Given the budgetary constraints that most commodity-dependent developing countries face, financial and technical support is necessary. It is important to identify the missing links in the provision of services for exporting commodities, generated by the disappearance of institutions such as marketing boards. UNCTAD could help in this identification and in the search for ways to overcome the problem. Value added can also be increased by more effective participation in international value chains. UNCTAD could play a significant role in providing analysis and information on the functioning of modern international value chains for commodities and on modalities for optimal participation in them, taking into account the special characteristics of individual countries and country groupings.

(f) Generating linkages with the rest of the economy is an important aspect of fostering the dynamic effects of diversification. This calls for facilitating the development of government policy at both the national and local levels. UNCTAD's experience in capacity building at the local and regional levels to develop systems for diversification planning, particularly in mining-dependent regions, can be a useful input in this respect.

(g) Product differentiation offers one way for enterprises to increase the value added that accrues to them. While the high financial cost of establishing trademarks can be an obstacle, enterprises and countries can build an image by

[35] For a brief but comprehensive article on actions in Brazil that have led to significant advancement in agriculture, see Ogier T, Farms buck downward trend, *Financial Times*, 3 July 2002.

committed efforts to supply high-quality products. Such efforts also call for investments in equipment and human skills. Cooperation with multinational firms may help. Innovative financing schemes such as structured financing for commodities may reduce borrowing costs. UNCTAD can provide advice to Governments and the enterprise sector on the use of such instruments and on regulatory and institutional requirements for their application.

(h) Modern supply chains are inherently disadvantageous for small producers. Apart from government support for upgrading these producers' technical skills and facilitating access to finance, establishment of better cooperative arrangements is crucial. UNCTAD can contribute to the design and implementation of government support programmes and to the establishment of cooperative arrangements among small producers.

(i) While all commodity-dependent developing countries need support for fostering diversification, market access and competitiveness, in the special case of LDCs, the necessity of "support for the diversification needs of their production and export base" has also been recognized in the Doha Ministerial Declaration (para. 42). With its integrated approach to commodity-based development and its central role in assisting LDCs, UNCTAD has a significant role to play in fulfilling this recognized need.