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COMMODITY POLICIES FOR DEVELOPMENT: A NEW FRAMEWORK FOR THE FIGHT AGAINST POVERTY*

Background note by the UNCTAD secretariat

Executive summary

This report examines the relationship between development and commodity production and trade, focusing on how UNCTAD projects and programmes to enhance the capacity to produce and trade in commodities can contribute to poverty reduction. Three fourths of the 1.2 billion people living on less than $1 a day live and work in rural areas. About half of the world's hungry people are from smallholder farming communities, another 20 per cent are rural landless and about 10 per cent live in communities whose livelihoods depend on herding, fishing or forest resources. As a result of recent and expected developments in demand for commodities, now is the best opportunity in many decades for improving the economies of commodity-dependent developing countries. This requires action by developing-country governments and by the international community.

The first chapter discusses how producers in developing countries can improve their participation in global supply chains for commodities. The second chapter deals with the need to improve the supply capacity of developing-country commodity producers. The third chapter discusses the management of the commodities sector. The report concludes that many of the necessary actions, including the integration of relevant aspects of commodity policies into poverty reduction programmes, fall within the competence of governments of individual developing countries, which will in many cases require assistance from the international community for successful implementation. The report's recommendations could form the core of a more ambitious approach to poverty reduction based on the need to give poor people an opportunity to lift themselves out of poverty through their own efforts.

* This document is being issued on the above date for technical reasons.

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Introduction: Mainstreaming Commodity Policies into Poverty Alleviation Efforts

1. The first of the eight Millennium Development Goals is to eradicate extreme poverty and hunger. 75 per cent of the 1.2 billion people living on less than $1 a day live and work in rural areas. It is estimated that about half of the world's hungry people are from smallholder farming communities, another 20 per cent are rural landless, and about 10 per cent live in communities whose livelihoods depend on herding, fishing or forest resources. In least developed countries (LDCs) and sub-Saharan African countries, poverty is concentrated in rural areas, dominated by subsistence agriculture. These countries depend on a small number of traditional agricultural commodities or minerals for most of their export earnings, and they export very limited quantities of higher-value and processed goods.

2. Commodity prices, the most visible indication of the commodity situation, have increased considerably over the past three years, especially for fuels and industrial raw materials. The recovery has been from historically low levels, however, and for most commodities the overall price levels remain low, especially in real terms. Moreover, variations in exchange rates, particularly between the US dollar (in which most commodity prices are expressed) and currencies in which imported goods are priced, also affect the actual gains obtained from increasing commodity prices. It is expected that rapid growth in developing countries in Asia, particularly China and India, will continue to bring dynamism to international commodity markets, resulting in the opening of a “window of opportunity” for developing countries to increase their earnings from commodity exports. If developing countries can successfully respond to the increase in global demand for commodities and the potential of South-South trade, a virtuous cycle could emerge, at least for a number of commodities.

3. While stronger demand may help improve prices in the medium term, it is unlikely to mean a long-term sustained increase or reduced instability. Reversing the long-term decline in real commodity prices through intervention in markets is unlikely unless very strong political will and commitment are present. While further research and discussions on how to improve the price situation will be useful, experience shows that even short-term stabilization of prices is extremely difficult. Attempts to influence either the trend or the variability of commodity prices have proved unsustainable. This is not to say that an improvement in prices is unimportant. On the contrary, the current situation offers the best opportunity in many decades for an improvement in the economies of commodity-dependent developing countries whose export commodities are benefiting from this positive development.

4. Unstable export earnings are a critical problem for commodity-dependent countries. Compensatory financing schemes need to be made user-friendly and operational and turned into effective safety nets and innovative risk "mitigants". An important step by UNCTAD in this direction is the appraisal of alternative schemes and an analysis of the nature and sources of instability so that an appropriate and effective mechanism can be designed to deal with external shocks and to alleviate the impact of problems such as fluctuations in world commodity prices and events beyond the control of economic actors (e.g. natural disasters).

5. For improving the competitiveness of the commodity sector in developing countries, diversifying towards new and higher-value products, and ensuring that more of the value added to commodities is retained in local economies, government policies and private-sector strategies need to serve these objectives. Not only is there a risk of oversupply, but diversification is risky, and the risks must be reduced. New production techniques and business practices can be different from traditional activities and difficult to adopt. Small producers, in particular, need to be prepared for and assisted in entering into new spheres of activity, while high-cost producers need help overcoming exit barriers. Capacity and institutions for identifying opportunities and meeting market requirements in terms of quality,

traceability, standards, volumes and continuity of supplies need to be strengthened. Physical infrastructure, including storage facilities, needs to be improved, as do quality testing laboratories and support services. Improving competitiveness and supply capacities requires targeted national policies complemented by massive international support for enhanced productivity and meeting market requirements.

6. Developing countries may benefit much less from the current dynamism if developed countries use the demand increase as an excuse for taking a complacent view of the need for reductions in agricultural tariffs and support to domestic producers, or, worse, if they decide to exploit the market growth for their own exclusive benefit by continuing high levels of support. What happens will depend largely on the outcome of the current negotiations in the context of the Doha work programme of the WTO. A prolonged period of growing demand and improved price stability should make it easier for developed countries to overcome domestic resistance to reduced support, thereby facilitating the transition to a more level playing field in world agricultural trade.

7. Aid for trade is a crucial instrument for enabling commodity-dependent developing countries to enjoy the benefits emerging in world markets. Specific areas related to aid for building trade-related infrastructure and improving supply capacity as well as competitiveness are mentioned later in this report. A third area where aid for trade is required for various countries is for adjustment to the changes in trade rules with a significant impact on products such as sugar and bananas, which have traditionally operated under special arrangements.

8. To ensure that the policies are oriented towards objectives relevant to national welfare, it is essential to mainstream commodity policies into the overall framework of poverty alleviation efforts and development plans. In fact, international assistance is often constrained by a lack of emphasis on the commodity sector in national development strategies – for example, in Poverty Reduction Strategy Papers.

9. The report has three chapters: improving participation in the supply chain; improving supply capacity; and improving management of the commodity sector. Several programmes act in more than one area, but this structure could help distinguish the main targets and the conditions for programme success. The report shows that meaningful action in the commodity domain is feasible, and that there is ample scope for commodity sector projects and programmes, mostly built on partnership approaches, which can reduce poverty in a cost-effective manner. Together with international support, these projects and programmes can turn a vicious cycle of poverty into a virtuous cycle of growth. The report does not attempt to list all the alternatives available to the international community and governments, but focuses on recent examples from UNCTAD’s work where special expertise has been developed.

I. Improving Participation in the Supply Chain

10. Farmers generally receive only a small part of the price paid by consumers for their products; this is the case even in "fair trade". For internationally traded agricultural commodities, a share of 4 to 10 per cent is common. The participation of developing countries in downstream activities is very limited, and much of the value added of commodity production escapes these countries’ economies; this is true across the range of commodities, from agricultural products to minerals and fuels. Inputs are often imported, essential services (including such services as banking and insurance) are provided by foreign companies, and, overall, the “development multiplier” of commodity production, processing and trade is lower than it could be.

11. Greater participation by developing-country producers, processors and service providers in the commodity chain can improve the returns to producers (particularly if producers are empowered through organization and greater information) and enhance the multiplier effect of commodity exports on economic growth. This chapter addresses experiences in three areas where there is great potential for improvement: empowering farmers to become proactive in the supply chain, strengthening trade-support institutions that reduce transaction costs, and improving the bargaining position of small operators through better information.

Improving small farmers' ability to supply global markets

12. While globalization provides opportunities for economic growth, it also brings increased competition and heightened uncertainty, influencing the extent to which local enterprises can survive and grow. Many small producers are not competitive and are handicapped in doing business and meeting market exigencies.

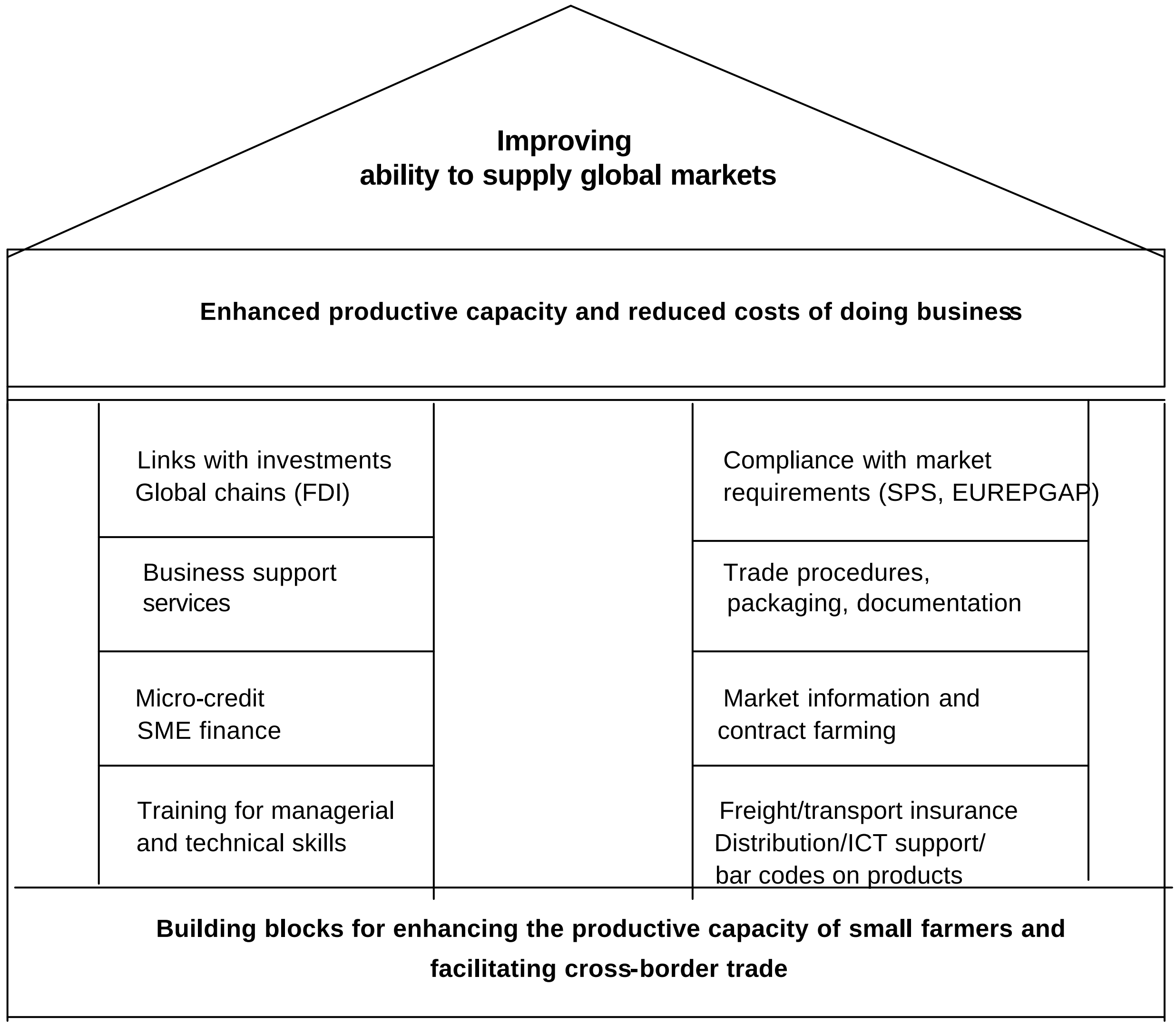
13. Barriers to competitiveness include inefficient operational and production processes, weak management capabilities and labour skills, and inadequate technology and information. Women farmers, who constitute almost half of small farmers, and women entrepreneurs face additional barriers attributable to their social roles. Similar barriers affect other disadvantaged groups such as young people, who migrate in high numbers to urban areas in search of earning opportunities without having the required skills. Moreover, most small and medium-sized enterprises (SMEs) have a low degree of inter-firm networking and cooperation, which hampers their ability to enjoy economies of scale and become competitive.

14. Some commodity-dependent countries have diversified their economies, and large distributors such as supermarkets are increasingly sourcing products from them. But without the ability to provide products at competitive prices and meet quality and quantity requirements, the possibilities for small farmers to do business with large distributors and tap opportunities offered by growing markets remain very limited.

15. To address some of these problems, UNCTAD has assisted in a partnership between the Swiss supermarket chain Migros and small producers in Ghana. The partnership aims to strengthen the capacities of small producers of fruit and vegetables in Ghana with regard to market entry and bargaining power. It also aims to help them achieve high returns while ensuring traceability and consistent product quality and quantity, to guarantee sustainable methods of production, and to enter into profitable contracts.

16. The initiative uses a modular approach that facilitates prioritization, piloting, testing and replication. The programme is implemented using a market-driven approach beginning with market assessment and identification of various products, followed by identification of existing and potential suppliers and, in order to determine the need for technical assistance, of constraints the farmers already face or could face. Migros and 10 producers' associations are involved at various stages of the process. Specific products with concrete market opportunities for the target groups were mapped out and their supply chains assessed in collaboration with Migros. This was followed by a consultation with stakeholders to choose regions and sectors/products for the project.

Figure 1. Elements guiding the model of contractual arrangements between the Swiss supermarket chain Migros and small producers in Ghana



17. Linking small producers' associations to large distributors such as supermarket chains can provide an effective, sustainable channel for gaining access to growing markets and to know-how, financing and technology. This model of cooperation offers entry points and opportunities for small producers to tap opportunities in growing markets. It also contributes to ensuring capacity building for small producers in terms of upgrading their productivity, product quality and capacity to supply, which results in improved competitiveness and profits for all actors. Producers' associations play a major role here, acting as the main channel for reaching their members with relevant services.

18. UNCTAD plays a crucial role in the programme as a "facilitator", providing technical assistance to ensure that farmers and existing business development service providers (public and private) can meet the requirements of the Swiss market. The project develops business models that can be scaled up and replicated. Linkages are developed with the ministries and agencies responsible for trade, industry and agriculture, as well as with local authorities. In line with the Government of Ghana's decentralization policy, the project interfaces with local structures in supporting local economic development efforts.

19. The Migros Ghana programme could easily be extended to other producer countries and supermarket chains, provided that resources for the organization and empowerment of producers can be made available. Practical measures that are immediately useful to small farmers should also be of interest to providers of technical assistance funds. The Swiss Import Promotion Programme has expressed its intention to support replication of the programme in some other countries. It is hoped that other donors will also orient their activities in this direction.

Trade institution building: commodity exchanges and risk management

20. India's smallholder farm sector supports an estimated population of 500 million people. Despite decades of government-directed investment into its agricultural markets, many farmers remain excluded from effective participation in commodity supply chains. This marginalization reinforces a vicious cycle of low investment and low returns that inhibits economic development and poverty reduction. However, since the turn of the millennium, the Government of India has instituted a programme of sweeping reform that has begun to yield tangible benefits throughout the commodity sector.

21. The institutional fulcrum at the centre of India's reform programme is three newly created national multi-commodity exchanges. While they cannot resolve all the problems of the sector, commodity exchanges can boost market efficiency, enhance competitiveness, increase resilience to shocks and integrate into the sector critical auxiliary services such as commodity finance and warehousing. In particular, by helping to improve the participation of the most vulnerable actors in the supply chain, commodity exchanges can support economic development and poverty reduction.

22. The most basic function of a commodity exchange is to boost market efficiency through reducing transaction costs by concentrating trade in one place. Buyers and sellers save time and resources that would otherwise have been expended searching for suitable counterparties. This has been a major impetus behind recent efforts to establish a pan-African commodity exchange. In its work to support this initiative, UNCTAD has argued that a pan-African exchange would provide producers in Africa’s fragmented markets with an expanded market for their products and could, by acting as a single procurement forum for international commodity purchasers, become a gateway for efficient trading of African commodities – both a wide range of products for local and regional markets and a more limited range of products (primarily bulk commodities) that are exported to world markets.[1] With improved access to OECD markets and strong incentives to develop South-South trade, commodity exchanges can enable developing countries to tap reservoirs of newly accessible demand.

23. An exchange can act as an "island of excellence" in an otherwise disordered marketplace, extending high levels of performance and integrity across the supply chain and imposing discipline on the physical market. By defining standards for the acceptance of products to be delivered to the exchange and applying a rigorous grading procedure, the exchange encourages producers to meet the requirements of the end users of the traded commodities. It can also be an important mechanism for overcoming new barriers to trade such as increasingly stringent sanitary and phytosanitary requirements. This would stimulate investments in improving standards.

24. Access to an exchange’s pricing information ("price discovery") can benefit producers otherwise disconnected from the market and vulnerable to receiving suboptimal prices from better-informed intermediaries. In India, the installation of price tickers in remote local markets has resulted in

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[1] UNCTAD, "Progress in the Development of African Commodity Exchanges", paper submitted to the Second Extraordinary Session of the Conference of Ministers of Trade, African Union, 21–24 November 2005.

shrinking spreads between the spot prices of commodities in these local markets and commodity exchange prices. (Indeed, India's largest food buyers, temple foundations that distribute food to the poor, have also had such price tickers installed and are now able to better negotiate prices with traders.) As an advisor to the Indian national exchanges, UNCTAD has championed the development of new exchange business models made possible by advances in information and communication technologies (ICT). Explicitly pro-development in outlook, such models are designed to bring marginalized commodity producers into the market and in so doing increase farmer welfare. The principles underlying the Indian national exchanges can stimulate rural development throughout the developing world and its large and dispersed rural populations in Africa, the Asia-Pacific region and Latin America.

25. Given the difficulty, if not the impossibility, of solving the problem of price instability for commodities, the management of price risk becomes a key goal, and this is a core function of mature commodity exchanges. (It is nevertheless recognized that not in all countries and for all products will exchanges evolve to this stage.) When evaluated through the prism of poverty reduction, the notorious price volatility that has long plagued world commodity markets is among the most pressing of challenges facing developing countries. Price volatility breeds risk, and vulnerability to risk is recognized as one of the four dimensions that constitute poverty. Commodity exchanges can help cope with one aspect of this issue.

26. Commodity exchanges make it possible for farmers to achieve price predictability and security, despite the volatility, over a crop cycle (and, for storable commodities, for a further six months to one year). This is particularly relevant because, with the withdrawal of government support for developing-country agricultural producers, short-term shocks in the prices of key export products are increasingly felt at the level of the farmer. Commodity price risk undermines livelihoods, not just through direct loss of seasonal income but also by locking producers into a cycle of low investment and low returns. With greater certainty over the planting cycle, farmers can commit themselves to investments that yield longer-term gains, and they can invest in planting higher-risk but higher-revenue crops. Even in the face of a long-term decline in the prices of their commodity, the ability to hedge against shorter-term price movements provides farmers with a window of time in which to adjust cropping patterns and diversify their risk profile. Given that even the most far-reaching reform of international agricultural trade would still leave developing-country producers vulnerable to dramatic volatility in world commodity prices, commodity price risk management is one of the essential measures for securing the welfare gains that may result from such an agreement. It is crucial to recognize the realistic possibilities and practical limitations of using price risk management tools by small farmers. In recent years, however, governments and the international community have done very little (other than a small World Bank programme and UNCTAD's even more constrained activities) to empower small farmers to understand and access risk management markets, and to overcome the constraints (in awareness, capacity, institutional support, and access to the financial system) that now block most farmers from using exchanges.

> "The insecurity that . . . subjects vulnerable people to abrupt penury related to economic downturns demands that special attention be paid to the dangers of sudden deprivation. Human security demands protection from this danger and the empowerment of people so that they can cope with – and when possible overcome – this hazard."
> – Amartya Sen in *Human Security Now*, Report of the Commission on Human Security (2003)

27. Successful commodity futures exchanges now operate across the developing world. However, UNCTAD receives many demands from governments for advice on establishing new commodity exchanges or developing existing ones. This indicates that much more needs to be done to enable commodity sectors throughout the developing world to benefit from the full range of services that an

exchange can offer, benefits that the commodity sector in India is only now beginning to enjoy. This is just one effect of neglecting commodity sector capacity- and institution-building needs in the programmes of donor agencies and indeed, many developing-country governments. It is worthwhile to reconsider this lack of attention.

Commodity information: reducing asymmetries

28. Cocoa farmers in Cameroon receive anywhere from one fourth to one twelfth of the average international price for each kilo of cocoa they sell at harvest time. The price spread between Yokadouma (800 kilometres from the port of Douala) and Mbanga (60 kilometres from Douala) is as much as 50 per cent. This type of gap, which exists in most developing countries, results from market failures, mainly asymmetries in accessing key commodity market information. This in turn impedes market efficiency and worsens the situation, particularly of smallholders. Many traditional reservoirs of information have disappeared, and the remaining commodity-related sources of information are quite dispersed and not always well structured. Access to information is now widely recognized as a key factor behind inequitable distribution of the benefits of trade. Asymmetric information leads to asymmetric growth.

29. Commodity trade requires a great deal of organized information. It is very difficult in commodity-producing countries to get timely and relevant information on all aspects of international markets, such as prices, market structures and marketing chains, quality standards, international companies, outlets, technology and marketplaces. Lacking proper information, stakeholders are unable to optimize their marketing decisions, identify new dynamic outlets, increase their competitiveness by adopting innovative technologies, or negotiate properly.

30. Here the ICT revolution can play a big role. UNCTAD, having initiated pioneering work connecting market analysis with innovative tools to gather and disseminate strategic information and empower the stakeholders along commodity chains, has emerged as a key agency providing commodity information, market intelligence and knowledge management. Several developing countries have benefited greatly from increased commodity market transparency. In Cameroon, a country with 900,000 cocoa and coffee smallholders, better understanding of these markets contributed to changes, in April 2005, in the national trade laws on green coffee and cocoa. These changes adapted the laws to new market realities. Increased transparency also increased farmers' awareness of the potential demand for their cocoa in Brazil and has already led to new sales to this

UNCTAD's package of commodity information services

UNCTAD's programme, which is largely financed by contributions from the Government of France, is based on five building blocks:

The ***Infocomm*** portal provides up-to-date information on major commodities in order to monitor these sectors and to gather key strategic information on fundamental factors influencing market functioning.

Infoshare is a flexible tool which allows interested partners to gather information as regards farm gate and other prices and to collect information in relation to intermediate costs (e.g. inputs, local transportation, storage, inspection). Different qualitative information (e.g. national quality standards, list of exporters, interest rates used in the selected sectors) can also be gathered.

Statistical publications and databases providing an overview of the development of commodity trade and production.

The ***World Commodity Survey*** is a recurrent publication providing unique and practical information on markets, structures and innovations for more than 80 commodities.

Innovative e-products and tool kits provide in-depth analysis of specific commodity sectors.

country – an example of the South-South trade that has resulted from better information. Further work is planned to generate participative tools for collecting and distributing information to empower small farmers.

31. Other initiatives to monitor commodity markets include the development of Infoprix in Benin, a system to monitor 64 rural markets (including those for the 25 most important staple foods), and Fintrac in Kenya, to help 35,000 horticultural smallholders access the international market.

32. A key development in the emerging ICT society is the opportunity to set up communal services drawing on synergies and complementarities. Such an approach enables commodity producers to benefit from the knowledge and experience of other stakeholders along the chain. In addition to empowering smallholders, sharing common information on commodities through a joint platform creates better cohesion and strengthens solidarity among the different actors.

33. At the international level, strategic information on commodity sectors enhances global transparency and improves commodity strategies and policies. In the long run, various spillover effects can also be derived, such as the possibility of setting up market-based schemes (e.g. tools to calculate basis risk for a number of commodities and countries) and the development of international benchmarks and indicators (which can be used, for example, as references in the WTO dispute settlement mechanism, intellectual property discussions and competition policies). Finally, better dissemination of commodity information could prompt the donor community to increase its support to the commodity sector through identification of key areas with potential for effective actions that promise quick results.

II. Improving Supply Capacity

34. Subsistence farmers rarely lead comfortable lives. Most are locked into a vicious cycle of poverty. To escape this situation, they have to participate more profitably in the marketplace. In some cases, farmers are impoverished because of increased exposure to the market (especially if government-provided safety nets are removed too suddenly). More commonly, developing-country farmers not only have difficulties accessing technology and finance but also suffer from competition with subsidized exports from developed countries. The main problem is that many, particularly poorer farmers, are unable to meet the demands of the market and have difficulties inserting themselves into supply chains.

35. Any effective programme of poverty alleviation has to address the problem of supply capacity in the commodity sector. UNCTAD's work in this area, while limited by resource constraints, shows that meaningful actions are within the reach of governments and the international community.

36. This chapter focuses on three such action areas. It begins with a discussion of experiences with ways and means to enable farmers to diversify into new and dynamic commodity sectors. This is followed by a look at practical approaches that can empower farmers to meet the standards and other market entry requirements imposed on the international marketplace (and by large local buyers in developing countries, such as processors and supermarkets). The final section describes how improved access to finance for investments and trade can enhance supply capacity and, in the process, reduce transaction costs.

Enabling developing countries to benefit from new and dynamic commodity sectors of world trade

37. The predominant directions of international trade are changing. Despite the importance of South-North trade, South-South trade is growing rapidly. Because of environmental and health concerns, new demand characteristics have appeared in developed countries. Some products have acquired a new dynamism in developed countries owing to changes in consumers' tastes. For instance, consumers have become used to a variety of fresh tropical fruits, vegetables and flowers.

38. The share of traditional commodities in developing countries' exports has declined, while that of higher-valued-added exports, mainly manufactures, has increased, but only a few developing countries have participated in this trend. Trade between developing countries is becoming more important not only in Asia, which accounts for four fifths of this trade, but also in Africa and Latin America. This additional demand can create incentives for entering new and dynamic commodity sectors of world trade.

39. Identifying new or dynamic emerging sectors among commodities requires a careful analysis and a deep knowledge of the underlying factors. A recent series of expert meetings, together with regional and national workshops on commodities, have reinforced the analytical capacity of UNCTAD and have allowed the identification of some sectors that offer good prospects for developing countries. In this context, the growth rate of export value over the past two decades has been used as the main indicator for identifying dynamic sectors. This indicator is valid for well-known commodities which are already internationally traded, and for which statistics are available.

40. Manufactured products such as textiles and clothing have shown vigorous dynamism for developing countries. Some of these countries have been able to use their commodity base for vertical diversification. For example, some have integrated the process of transforming cotton first into fabric and then into clothes. Trade in value-added products such as shellfish and fish preparations has also increased. Worldwide exports of other commodities such as tropical fruits or horticultural products have also increased significantly.

41. For some commodities, potential trade dynamism is not visible in international statistics. This can be the case for traditional products, such as karite (shea butter), for which data hardly exist. In the case of karite, new European Commission directives allowing the incorporation of vegetable fat into chocolate have a direct positive impact on demand. Another statistical limitation comes from the segmentation of commodity markets. For instance, in coffee, some market segments may be extremely dynamic even as the overall market faces an oversupply crisis. Sales of fair-trade, eco-labelled and organic products are often small compared to the international market, but they are growing and can be attractive for developing countries.

42. Ideas for new uses of commodities can also be developed and disseminated. Current high crude oil prices and growing concerns about climate change have boosted the biofuels sector. Brazil, which started the processing of sugar into ethanol more than 20 years ago, is currently the only potential exporter of biofuels. High oil prices and constraints arising from the Kyoto Protocol have led to increasing demand for fuels from renewable sources to replace traditional sources of energy.

43. However, such demand will not automatically increase biofuels trading, especially North-South trade. Biofuels production is an attractive alternative for Northern agricultural production, and benefits to developing countries from this new demand may thus be limited. But production of biofuels is also a way to lighten the burden of the energy bill. Moreover, they can be produced in remote areas and be used for local energy production – for instance, to provide electricity in small villages and allow adults to attend school after their workday. Biofuels production gives farmers an

opportunity to arbitrage by selling their crop either as a traditional product or as a biofuel, whichever provides the better return.

44. As the case of biofuels shows, UNCTAD's role extends beyond analytical work to technical assistance to help developing countries enter dynamic sectors and, more specifically, build export capacity.

Meeting the standards of the international marketplace

45. Developing countries' ability to engage successfully in agricultural exports to developed countries and to enter new markets depends critically on their ability to meet a wide array of stringent quality and safety standards. While food products are the ones that first come to mind in this context, the same situation holds for most other products, including agricultural raw materials such as cotton and other fibres and even plywood. The requirements go beyond the traditional quality standards and require suppliers to make responsible use of chemicals, energy and water, as well as to reduce social and environmental impacts. These high standards change frequently and are often difficult and costly to meet.

46. Some standards are developed to ensure that products conform to specified physical characteristics, and their certification relies on the testing of products or on the certification of processes at various stages of production. Other standards are applied to ensure that production conforms to specified characteristics in order to achieve goals defined in terms of processes or their impacts (e.g. EurepGap standards, ISO 14000). Moreover, standards differ according to whether they are official or commercial. While official standards refer to mandatory standards developed by governments and can be the subject of WTO dispute settlement procedures, commercial standards include those established by non-governmental organizations, producer associations and businesses (private standards). Normally the latter are not officially disputable.

47. To get an idea of the difficulties faced by LDCs in meeting international quality standards, the UNCTAD secretariat in 2004 implemented a project on Compliance Costs on SPS and Agrifood Standards in three African LDCs. The project was funded by the Government of Finland. The primary concerns regarding the standards were quite similar in each of the selected countries. With respect to governmental institutions, the primary concerns are with difficulties in informing the private sector about norms and regulations, and with the low capacity of equipment and training for national quality control services. In the private sector, stakeholders point out that developed countries' markets are more demanding than national and regional markets regarding quality control and traceability. Suppliers frequently lack accurate information on market requirements, have inadequate training and equipment, and suffer from organizational deficiencies which prevent them from meeting standards through cooperative efforts and from implementing coherent strategies to access external markets.

48. The following conclusions can be drawn:

- National capacity needs to be strengthened and the gap between national policies and international regulations and standards reduced. Scarcity of financial resources for upgrading infrastructures and assisting the private sector is a serious constraint. Decision makers in developing countries need to orient policies towards agriculture that is not only productive but also marketable. In line with international trends, governments should reinforce or review national legislation concerning food safety, including the implementation of concepts such as the Hazard Analysis and Critical Control Point System (HACCP).

- There is an urgent need to improve skills and enhance technical capacity. Government institutions should strengthen existing capacities (e.g. staff trained in quality management, accuracy of laboratories, inspection services) to reach international standards. Private-sector stakeholders need to be kept informed of the frequent changes in export markets' legislation with regard to agrifood standards.

- There is a need to provide information to and organize producers. Support from government institutions is a key factor in integrating domestic and external markets. As has repeatedly been suggested by participants in UNCTAD workshops, the national administration has to reinforce and support the organizational and operational capacities of producers and exporters through such means as organizing farmers into small groups to facilitate technical training sessions, sharing ideas and experiences over time, and learning from "success stories" to better understand ways and means to manage assistance to small producers.

- Producers have difficulties accessing finance to help them meet market requirements. Compliance with standards is costly. Governments, in collaboration with the private sector and farmers' associations, could examine the possibility of establishing a revolving fund to finance infrastructure facilities and training needs in this area. In addition, access to affordable credit and funding needs to be considered: access to bank credit, loan guarantees or national measures to facilitate investments should assist producers and exporters in their efforts to reinforce the competitiveness of their activities. (This issue is discussed further in the next section.)

Enhancing supply capacity through improved investment and trade finance

49. In 2002, as much as 75 per cent of the crop was lost and all 41,000 villages were declared drought stricken in India's state of Rajasthan. Farmers who needed to buy seeds for the next harvest season had to approach money lenders, since many of them, being landless, had no collateral or third-party guarantees. Finance was available, but at an interest rate of over 10 per cent a month. Such credit constraints can lock farmers into a vicious cycle of poverty. Fortunately for these farmers, a few Indian banks and agro-industrial firms have, over the past two or three years, developed new financing schemes which require neither land collateral nor third-party guarantees. While micro-finance (the standard approaches of which are not very suitable for agricultural lending) depends on the strength of social relationships rather than on individual borrowers, these new financing schemes depend on the strength of economic relationships – and, more concretely, on the strength of commodity supply chains.

50. This form of finance is known in western banks as structured commodity finance. It is the art of transferring risks in finance from parties less able to bear those risks to those more equipped to bear them in a manner that ensures automatic reimbursement of advances from the underlying assets. Banks in developed countries have used this financing mechanism since the late 1980s as a way to continue providing finance to developing countries, despite the perception of increasing risks. The mechanism has proven remarkably resilient even in times of severe economic crisis.

51. For more than a decade, UNCTAD has worked to mainstream these new concepts of commodity finance into financiers' (and in particular local banks') practices and policies, and to bring them ever deeper into developing countries' economies, as close as possible to the farm gate. From a financier's perspective, the cost and availability of credit are guided by perceptions of risk. Unfortunately these perceptions are, at the majority of banks, mired in traditional practices and inadequate risk management abilities. Changing this perception and boosting risk management capacity can unlock a large volume of new lending. The basic tools are not very complicated. For example, the purchasers of a commodity can make direct payments to the financiers, effectively reducing credit risk; risks can

be shifted from the borrower to field warehouses; banks can take control of the goods. The possibilities for innovation are innumerable, as many successful cases demonstrate.

52. The majority of the methods under the umbrella of structured commodity finance view the borrower (producer, farmers' association, processor or trader) as part of the commodity supply chain. Loans are based on the performance of the borrower in the chain, rather than on the borrower's credit risk. In agricultural finance, for example, the financier would be concerned only with the farmer's ability to perform (produce) as anticipated (and even this risk can be mitigated), and would no longer have any concerns about the farmer's willingness to reimburse the loan. In practice, banks would have to go beyond financing and look at bundling services, building supply chain partnerships and providing end-to-end solutions. While a comprehensive review is outside the scope of this report, a few examples can give a better idea of how the key mechanisms operate.

53. In the Philippines, the Rural Bank of Panabo set up a rice mill and marketing enterprise as a "corporative" organized and managed by the bank in partnership with small farmers. Through the "corporative", it provided marketing services as well as investment and working capital finance. This mechanism not only assured the bank of credit recovery (in kind) but also, over time, enabled the farmers to become majority owners of a rice mill. In India, banks have not only been partners in contract farming schemes set up by agri-business companies but also taken the initiative, bringing suppliers and buyers on board. For example, Rabo India Finance has set up agro-service centres in rural areas which provide baskets of services including contract farming, inventory finance, equipment renting and information.

54. There are many examples of successful innovative agricultural financing mechanisms in developing countries. The key challenge lies in knowledge sharing, in adapting and replicating these models. UNCTAD has built a database of innovators and has organized expert meetings to bring them together. Successful models such as tapping into capital markets for commodity financing (Colombia), linking infrastructure finance to trade finance (Zambia, Zimbabwe) and using technology and agricultural marketing companies for accessing small farmers (India, Kenya, Mozambique, Zambia) have aroused much interest among developing-country banks. To facilitate the application of the principles of structured finance to specific commodity sectors, UNCTAD has also produced blueprints for sectors such as horticulture, renewable energy, fisheries, and oil and gas services.

55. However, if innovative financing mechanisms are to work successfully, it remains important to overcome institutional weaknesses, both at the government level (UNCTAD has been advising developing-country governments on the necessary legal and regulatory frameworks) and at that of the private sector (UNCTAD has been advising and training local and regional banks and is developing an online training programme). Also, stronger institutions supporting commodity finance (collateral management agencies, commodity exchanges) are needed, and UNCTAD has been instrumental in setting up several such entities. Furthermore, there is room for new regional arrangements. With South-South trade growing at almost three times the speed of world trade, an important focus in the area of commodity finance is strengthening the institutions for such trade. Export-import banks and development finance Institutions form key building blocks of international trade finance, and, recognizing the tremendous gains from greater cooperation among them, UNCTAD has initiated the creation of a network of these institutions.

56. By interlocking supply chain partners, structured finance opens up new opportunities for farmers, processors and other local entrepreneurs, reduces the costs of trade, enhances South-South trade and investments, and brings attractive returns to those providing the finance. With greater support from the international community, many of the proven models can be introduced in many countries, helping farmers and others to tap opportunities in local, regional and international markets.

III. Improving the Management of the Commodity Sector

57. The economies of the majority of LDCs remain heavily dependent on commodities, and so do large segments of the populations of other developing countries. While in the long run this dependency needs to be reduced, in the short run it is necessary to extract the maximum development contribution from these commodity resources, both to improve the direct development impact of commodity production, processing and trade and to generate resources for growth and diversification.

58. This section discusses experiences at the corporate, national and international levels in improving management of the commodity sector. While the discussion gives an idea of the problems and possible solutions, it does not provide a complete picture: for example, price risk management at the farm and enterprise levels, to which UNCTAD has developed a sizable body of work,[2] is not discussed, nor are some of the proposals for modified or new international facilities to help developing countries cope with specific risks (e.g. ways to improve compensatory financing schemes, or the international food finance facility discussed within the WTO framework), which have been extensively discussed in other recent UNCTAD publications.

Improving resource management at the corporate level: corporate social responsibility strategies for commodity companies

59. Every morning, a large crowd of people looking for work gathers outside the gates of the BHP Billiton Tintaya mine in the Cuzco region in Peru. Most of them return home disappointed. The mine cannot hire all those who need employment in the province of Espinar, located 4,000 metres above sea level and far from major urban centres, where few economic activities offer any prospect of success. While the mine has raised local incomes, many criticize the mining company and the local government for failing to deliver the hoped-for dramatic income increases and accelerated development. When the mine closed most of its operations temporarily in 2002 because of low copper prices, the repercussions on the local economy were serious, and the criticisms became louder. Discussions between the mining company, the provincial government and local civil society eventually led to the conclusion of a framework agreement under which the mining company devotes 3 per cent of its pre-tax profits, or a minimum of US$1.5 million annually, to funding local infrastructure and other development projects. The projects are chosen by a committee representing all stakeholders.

60. The problems faced by the inhabitants of Espinar, the provincial government and the mining company are not unusual. Large mining projects cause major demographic and economic changes at the local level, and the adjustment problems can be serious. Physical and social infrastructure is subjected to increased demands, and administrative and political structures come under pressure as they seek to respond to both the exigencies of the new economic activities and the aspirations of the local communities. Mining offers an opportunity for local people to escape poverty and the prospect of a broader-based, more sustainable local economy. New employment is created (in poor regions it is not unusual for each mining job to lead to 10 new jobs in other sectors), and incomes rise. However, expectations easily become inflated, and communities may be disappointed when their hopes are not met.

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[2] The most recent paper is "Farmers and Farmers' Associations in Developing Countries and Their Use of Modern Financial Instruments", January 2002 (UNCTAD/DITC/COM/35); this contains references to further literature.

61. Charting a course for local economic development is difficult for provincial governments, particularly since their experience and resources are usually severely limited, so that hard choices have to be made. While all may share the goal of using the stimulus provided by the mining project to build a flourishing and diversified local economy that does not collapse when mining eventually ceases, exactly how to do this is likely to be a matter of debate. The plan has to be developed through a process in which all stakeholders are heard and taken into account.

62. Companies can show a responsible attitude with regard to development, apart from an exclusively social responsibility, by supporting efforts by local governments and civil society to build sustainable economies. Such support can take different forms. Companies can target local suppliers of goods and services, provide training and technical assistance to help them attain necessary standards of performance, and help fund local initiatives. While companies cannot and should not attempt to replace government, their support can make a crucial difference.

63. UNCTAD has a long history of cooperating with a broad range of stakeholders, including private companies, to promote diversification and local economic development in areas that depend on commodity production. In Espinar, UNCTAD provides support to regional development planning and to the process of screening development projects through a project funded by the Common Fund for Commodities. UNCTAD cooperates with the provincial government, BHP Billiton Tintaya, civil society and the University of San Agustin in nearby Arequipa in building capacity and maximizing the development impact of the funds provided by the company. Similar cooperative arrangements can be envisaged for projects for agriculture and forestry, where large companies are directly involved in rural areas.

Recycling commodity revenue and managing macro-level commodity-related risks

64. In 2004, when copper prices were higher than they have been for many years, the Government of Chile received US$3.009 billion in taxes and dividends from the state-owned mining company Codelco. This sum corresponded to 14.7 per cent of government income, or about 5 per cent of total development assistance from OECD countries. That year, Chile's export earnings from copper were US$14.53 billion, or about 55 per cent of exports, an increase of almost US$7 billion over 2003 earnings. The corresponding numbers are even higher in oil-exporting countries; in Nigeria and Angola, for instance, 83 per cent and 90 per cent respectively of total public-sector revenue comes from oil.

65. Windfall gains from the high price of an export commodity may make possible many development projects that would otherwise remain unfunded, and may boost economic growth. Poorly managed revenue, however, can cause appreciation of the real exchange rate and reduce the competitiveness of the non-booming part of the economy.

66. Efficiently allocating that part of increased revenues over which governments exercise direct control may also be a challenge for governments, as is illustrated by many ambitious projects that were abandoned when it was realized that they were out of proportion to needs, or when the source of funds dried up. Both economic doctrine and common sense dictate that the revenues resulting from a drawdown of natural resource capital should be invested in other forms of capital, be it physical or human. In practice, however, governments find it difficult to resist demands to spend more on consumption.

67. UNCTAD has a long experience of addressing issues relating to macro-economic balance in resource-dependent economies. Most recently, it has conducted an in-depth study together with the

International Council on Mining and Metals and the World Bank. The study proceeds from the commonsense assumption that it is worth finding out what went right in cases where mining has contributed to rapid growth and poverty reduction and where conflicts over the distribution of revenue have been avoided. How do the countries where this happened differ from others? What did the governments do that was different? Can other countries imitate them, and if so, how? The study, to be published in late 2005 by the International Council on Mining and Metals, is organized around case studies of four countries: Chile, Ghana, Peru and the United Republic of Tanzania.

68. When commodity prices fall, the problems facing resource-dependent economies are the reverse of the ones caused by rising prices; in fact, they are more severe because they cause immediate social catastrophes. Sudden falls in government revenues may jeopardize development and income transfer programmes. Cutting expenditures sharply at short notice has adverse effects on the economy, and borrowing more to sustain budgetary plans can be costly. As was highlighted at UNCTAD's African Oil & Gas Trade and Finance conferences (Africa's largest annual energy meetings), oil-importing countries face exactly the same types of problems when oil prices rise, and the same recipes apply. Budgetary spending can be sustained through the price cycle when there is an effective risk management system in place. It calls for solutions that guarantee income and insulate government expenditure and repayment of debt from swings in oil prices. Solutions such as stabilization funds, where windfalls are set aside to balance budget shortfalls, have attracted considerable attention and are considered to have worked well in some countries such as Chile. In other countries, experiences are less positive, usually because governments have found it difficult to observe the necessary fiscal discipline. The major drawback is that funds are fungible and exhaustible. They act as a capital source whenever investments are needed in other sectors of the economy. It is recognized that funds work best where there is a tradition of good governance and transparency with respect to fiscal revenues and expenditures and central bank operations.

69. A more promising alternative at the macro level is to hedge price risk using financial instruments or raising finance for development expenditure on a commodity-price-linked basis. Not all instruments offered on exchanges are necessarily appropriate for developing countries, but tailor-made, privately negotiated financial instruments that are traded over the counter can meet their needs. For hedging to work efficiently and catastrophic eventualities to be avoided, there must be political will, a good monitoring system to prevent abuse, money available for premiums and sudden cash calls, and, most crucially, a good understanding of how instruments work.

70. UNCTAD has invested considerable effort in studying how to overcome these obstacles and implement risk management programmes, especially because of the potential benefits in terms of poverty alleviation. As a result, UNCTAD has developed practical risk management training programmes that provide advice on selecting tools to mitigate risk and on monitoring and evaluation, as well as guidance in dealing with over-the-counter providers. The most urgent task at the moment is to improve the understanding of financial instruments and encourage developing countries to embrace risk management techniques.

Conclusion

71. With the majority of the world's poor dependent on commodity production and trade and spending a large part of their meagre resources on commodity consumption, there is a need for a wide, multi-pronged approach to commodity sector issues. With its focus on integrated issues of trade, development and finance, UNCTAD has been able to do pioneering work on improving commodity sector practices and policies. Its experience shows that through appropriate approaches, it is possible to achieve great leverage in reducing poverty through commodity sector projects and programmes.

72. This report has discussed various policies and measures that merit attention. Many of the necessary actions, including integration of relevant aspects of commodity policies into poverty reduction programmes, fall within the competence of governments of individual developing countries, but success is unlikely without a supportive international environment and without sufficient as well as effective and targeted international assistance. The international community can increase the likelihood that the political will and economic measures undertaken by commodity-dependent countries yield the desired results. Increased technical assistance and aid for trade can help build the capacity needed for developing-country producers to enter supply chains and overcome supply-side obstacles.

73. This report has provided several examples of capacity-building programmes as well as policies and measures that directly or indirectly contribute to improving the livelihood of the poor. Such programmes are far from having exhausted their usefulness and should be deepened and broadened. Beyond assistance, the establishment of a more level playing field in international agricultural trade, including improved market access and dramatically reduced producer support in developed countries, remains the most obvious, effective and cost-efficient way for the international community to reduce injustices and inequalities in world commodity markets. Other measures, all of which were recommended by the Group of Eminent Persons on Commodity Issues that met under UNCTAD auspices in 2003, include addressing the problems of oversupply for commodities; making compensatory financing schemes user-friendly and operational; and pursuing the possibilities for the creation of a new International Diversification Fund. These recommendations continue to attract attention from policy makers and could form the core of a more ambitious approach to poverty reduction, based on the need to give poor people an opportunity to lift themselves out of poverty through their own efforts. Aid for trade – with particular attention to the needs of commodity-dependent countries, addressing trade-related infrastructure, supply capacity and competitiveness and trade adjustment – is a crucial instrument that will help progress in this direction.