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High-level Round Table on Trade and Development: Directions for the Twenty-first Century

ECONOMIC DEPENDENCE ON COMMODITIES

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High-level Round Table on Trade and Development: Directions for the Twenty-first Century

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ECONOMIC DEPENDENCE ON COMMODITIES*

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* The views expressed in this paper are those of the author and do not necessarily reflect the views of the UNCTAD secretariat.

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Executive Summary

Most of the population in developing countries depends on the production and export of primary commodities. Consequently, the economic and social development of these countries remains largely dependent on changes in world commodity markets and, in particular, on changes in commodity prices. These prices fell sharply in the early 1980s, and have remained at depressed levels since then, leading to a huge trade loss. This has been a major factor in the large rise in the foreign debt of commodity-exporting countries.

A continuation of these depressed price levels would be very damaging for such countries, as it would further limit their growth potential and undermine their efforts at domestic policy reform, debt restructuring and external resource mobilization. The commodity problems of developing countries have, however, received little, if any, attention in international forums for the past two decades. It would now seem timely for this issue to be given serious consideration by the international community.

This paper proposes three principles on which a new international commodity policy could be based:

- A judicious combination of free market and market regulation mechanisms to be used as appropriate, in attaining agreed objectives;

- A distinction between different types of price problems, which differs by commodity and thus require different remedies;

- A consideration of the relationship between commodity problems and other sectors, particularly financial markets.

The paper then considers appropriate remedial measures for each type of price problem. Measures to raise depressed levels of commodity prices – essentially a long-term issue – could start with some form of supply management, followed by diversification away from commodities in persistent excess supply. Also much greater research and development efforts, where appropriate, could improve the technical characteristics, and thus the competitive position, of natural materials exports of developing countries, which are subject to displacement by synthetics.

Medium-term sharp price cycles – particularly notable for various tree crops – could be substantially attenuated by appropriate adjustments to production as a result in the light of improved forecasts of future market trends, together with efforts to expand consumption as necessary. Finally, short-term price fluctuations could be minimized by adequately-funded international buffer stocks; alternatively, the adverse impact of such fluctuations could be avoided if exporters in developing countries were to use commodity-linked financial instruments to hedge their commercial risks. The paper suggests that a review be made of the extent of usage of such instruments, and of their cost and effectiveness for developing countries.

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ECONOMIC DEPENDENCE ON COMMODITIES

Alfred Maizels

I. THE ROLE OF THE COMMODITY SECTOR

The great majority of the population in developing countries depends, for its welfare and livelihood, on the production and export of primary commodities.[1] A strong commodity sector is thus crucial for the progress, both economic and social, of the commodity-exporting developing countries. There are two ways in which this sector could promote economic and social development in these countries: by providing an increasing volume of food and raw materials to support domestic industrialization and economic growth; and or by earning foreign exchange from commodity exports to finance the imports of capital goods and other essentials for domestic development. The relatively small size of domestic markets has held almost all such commodity-dependent countries to follow the latter route. As a result, their economic development has been determined, to a large extent, by changes in world commodity markets. This dependent relationship has proved to be a major handicap in the efforts of the commodity-exporting countries to promote their economic and social development.

Several aspects of this handicap can be distinguished, reflecting the inelasticities of supply and demand operating in world commodity markets. The first is the tendency to deterioration in the long-term 'commodity terms of trade' (i.e. a decline in the prices of commodities exported by developing countries relative to the prices of manufactures which they import from developed countries). This tendency is, to a large extent, the result of the low income-elasticity of demand for primary commodities in the developed countries, so that their real income growth has been accompanied by relatively little growth in demand for these commodities. For many commodities exported by developing countries, there has also been substantial substitution by synthetic materials over the past two decades, while a shift away from traditional 'heavy' industries, such as iron and steel, has also limited the rate of expansion in demand for natural raw materials. Second, low price elasticities of supply for many commodities mean that, following a rise in price, supply can be increased only after a time-lag; however, efforts to expand supply are often self-defeating, since increased supply when combined with inelastic demand, results in lower prices and reduced export earnings. This process gives rise to a sequence of multi-year price cycles.

[1] In this paper, the terms 'commodities' and 'primary commodities' are used interchangeably, and exclude petroleum, which is best treated as a special case.

The third consequence of low demand and supply elasticities in many commodity markets is the persistence of large short-term fluctuations in prices. Such price fluctuations inject substantial uncertainty into expectations about future sales and profitability, and are thus likely to limit the volume of investment in new productive assets in the commodity sector.

Countries heavily dependent on commodities that are exposed to wide short-term swings in prices for the bulk of their export earnings are generally acknowledged to experience additional constraints on their economic development. Fluctuations in export earnings result in fluctuations in domestic incomes (including multiplier effects on non-export sectors) and in domestic savings, as well as in government revenue (often largely dependent on taxes on export sector earnings) and, as mentioned earlier, they tend to affect adversely the level of investment in productive assets. High export instability can also increase the general climate of business uncertainty, and can lead to capital flight if savers prefer to invest abroad. Alternatively, private investment may be channelled into domestic projects yielding short-term profits rather than into more risky ventures, even though the latter may reflect the country's comparative advantage.

The various difficulties confronting developing countries in coping with the low elasticities of demand for commodities are accentuated by the structural characteristics of commodity supply. Most developing countries are small- or medium-sized producers, none one of which can influence world prices by varying their own supplies. There is thus an in-built incentive for such countries to expand their exports since, other things being equal, this will result in higher export earnings. But if many such countries expand their exports simultaneously, this will result in lower prices and reduced export earnings for all of them. This underlying conflict of interest has become a significant element in the commodity problems developing countries have faced over the past two decades.

II. PHASES OF POSTWAR DEVELOPMENTS IN WORLD COMMODITY MARKETS

Two main phases can be distinguished in the working of world commodity markets since the mid-1950s. The first, lasting until 1980, was dominated by large short-term price fluctuations for a wide range of commodities exported by developing countries, with resultant fluctuations in these countries' export earnings. The 1970s had been a decade of successive 'shocks' to world commodity markets. It began with a sharp increase in petroleum prices in 1973–74, which brought on fears of a more general rise in commodity prices, while a succession of shortages of some commodities (e.g. sugar and coffee) in particular years resulted in exceptionally large price swings. During that decade, the trend of real commodity prices was gently upward.

A major change occurred, however, after 1980, when the dominant feature of the commodity markets was a drastic general fall in real commodity prices which have remained at depressed levels ever since.[2] By the end of the 1980s, the commodity price recession was more severe, and considerably more prolonged, than that of the Great Depression of the 1930s. From 1990 to 1997, there was no significant trend, upwards or downwards, in the commodity terms of trade, but there was a further sharp deterioration during the following two years as a result of the Asian financial crisis and the consequent depreciation of the currencies of the major Asian economies.[3]

The immediate cause of the fall in commodity prices in the early 1980s was the imposition of restrictive monetary policies in the main industrial countries in order to reduce inflationary pressures. This resulted in a marked slowdown in their economic growth rates, and in a sharp contraction of the growth in demand for raw materials. Since then, their growth rates have remained low by postwar standards, which is one reason why commodity prices have failed to show any substantial recovery.

The other main reason for the failure of commodity prices to recover is that the volume of commodity exports from developing countries rose rapidly, by over 40 per cent, from 1980 to 1990. With prices depressed, it would seem perverse for supply to expand at all, but a new factor came into play. A foreign exchange squeeze – largely a result of the earlier collapse in world commodity prices – together with the high interest charges on foreign debt and the virtual cessation of new commercial loans until the early 1990s, put pressure on commodity exporting countries to expand exports. At the same time, loans from the IMF were usually accompanied by strict conditionality, including currency devaluation aimed at promoting exports.

Commodity prices in real terms have now been at historically depressed levels for two decades. One result has been that commodity-exporting countries have suffered large terms-of-trade losses over this period. The rate of loss has risen sharply, from about $5 billion a year for the period, 1981–1985 to almost $55 billion a year for the period 1989–1991. Total terms-of-trade loss from 1980 to 1992 was about $350 billion,[4] with a considerably greater cumulative loss since then. This terms-of-trade loss was a major factor in the rise of their foreign debt as these commodity-exporters strove to maintain a minimum of essential imports. Moreover, the burden of the commodity price recession has fallen disproportionately on sub-Saharan Africa, the poorest developing region, and the least able to make the necessary structural adjustments.

III. PHASES OF POSTWAR INTERNATIONAL COMMODITY POLICY[5]

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[2] Over the decade of the 1980s the fall in real commodity prices was some 45 per cent, if the fall in real commodity prices is deflated by the United Nations. Index of unit values of manufactures exported by developed countries, or about 35 per cent, if an index of commodity export unit values is used instead of the commodity price index.

[3] The UNCTAD index of free market commodity prices fell by 11 per cent between the first halves of 1997 and 1998, and by a further 17 per cent between the first halves of 1998 and 1999 (UNCTAD, 1999).

[4] Maizels, Bacon and Mavrotas (1997).

[5] A more detailed discussion of postwar international commodity policies can be found in Maizels (1992: 101–155).

In the early postwar period, trade policy was based essentially on free market principles and on non-discrimination, as set out in the Havana Charter of 1948. The Charter recognized that trade in some commodities may be affected by special difficulties, and approved the use of international commodity agreements (ICAs) to prevent or alleviate such difficulties only if "adjustments between production and consumption cannot be effected by normal market forces alone as rapidly as the circumstances require". The Charter principles were accepted by ECOSOC in 1947 and a number of price stabilization agreements (for coffee, sugar, tin and wheat) were concluded under United Nations auspices.

A new phase of international commodity policy began with the first UNCTAD Conference (1964) when, for the first time, trade policy in general, and commodity policy in particular, were linked directly to the development needs of Third World countries. A comprehensive strategy for strengthening the commodity sector of the economies of developing countries, in the form of an Integrated Programme for Commodities (IPC) was approved by UNCTAD IV in 1976. This Programme envisaged the negotiation of price stabilization agreements on a range of commodities of export interest to developing countries on the basis of common general objectives and within a common time-frame, with the aims of avoiding excessive price fluctuations, and achieving price levels remunerative to producers and equitable to consumers.[6] The IPC resolution also called for the negotiation of a Common Fund as a central financing facility for the whole Programme.

There followed a series of intensive consultations and negotiations over a period of years, but the results were very limited with only one new ICA – that for natural rubber – being concluded. Moreover, the Common Fund, which was established after several years of difficult negotiations, was a much weaker instrument for achieving price stabilization than had been envisaged in the original proposal. The original idea had been for a Fund with substantial capital of its own, able to borrow additional funds if necessary, and providing an assured source of financing for the stock operations of existing, or new, ICAs. The Common Fund agreement of 1980, however, provided that it would be financed by associated ICAs, though it had the power to borrow additional funds from capital markets as required.

This reversal of the relationship originally envisaged between the Common Fund and the associated ICAs implied that the central role of the Fund in providing financial support for the price stabilization operations of ICAs, now depended on the success of the negotiations to establish new price-stabilizing ICAs, or to renew old ones. The failure of these negotiations meant that the Common Fund could not function as envisaged.

By the end of the 1980s, all the then existing agreements, except that for natural rubber, had either collapsed or had abandoned their price-stabilizing functions. The 1990s thus opened with no effective market-stabilizing mechanisms in place and, moreover, no consensus between developed and developing countries on the need for such mechanisms. It is, perhaps, ironic that

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[6] The IPC resolution also specified a number of longer-term objectives, including improvement in market access, diversification of production, and improved competitiveness of natural products competing with synthetics.

this impasse in international commodity policy, which has continued throughout the 1990s, began just as the dominant feature of world commodity markets changed (as explained in the previous Section) from excessive short-term price volatility to a sharp downward trend in real commodity prices. If anything, commodity-exporting countries needed greater support, not less, from the international community during this period.

In considering the reasons for the present impasse, it must be recognized that there were undoubtedly a number of technical weaknesses in the various ICAs, which adversely affected their smooth operation and, at times caused a breakdown.[7] However, from the early 1980s, the major weakness was that none of these agreements was equipped to cope with the downward trend in prices of unprecedented magnitude and duration. This situation inevitably resulted in a sharp conflict of views between exporting and importing countries as to the correct interpretation of the objectives of price stabilization. The exporters generally argued that an agreement should defend the agreed 'floor' price so as to protect their decreasing export earnings. The importers, on the other hand, insisted that in a period of falling prices, the agreed price range had to be adjusted downwards in line with market trends.

This stance of the importing countries conformed with their more general view that regulation of the international commodity markets was an unnecessary interference with the free play of market forces, which would result in a misallocation of productive resources. Though this view was not generally accepted by exporting countries, the collapse of most of the existing price-stabilizing ICAs by the early 1990s allowed that free market influences to prevail in practice.

IV. THE NEED FOR A NEW INTERNATIONAL COMMODITY STRATEGY

The focus on free market influences, and the absence of any new initiative in favour of appropriate intergovernmental market regulation has not, however, succeeded in restoring the real export earnings of the commodity-dependent countries to anywhere near their level of two decades ago. On the contrary, these earnings appear likely to remain depressed for many years to come.[8] In the absence of a new initiative to strengthen the commodity sector of these countries, a 'solution' to this problem will eventually be achieved by a contraction, or even a cessation, of commodity production in small or poor high-cost countries. This will involve a further contraction in real incomes, which will add to the existing deflationary forces in the world economy.

A continuation of recent trends would indeed be very damaging for the majority of developing countries. It would limit their growth potential, and undermine their efforts at

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[7] For example, setting the price ranges to be defended at levels inconsistent with market trends, and allocating insufficient funds to finance buffer stock operations.

[8] Recent estimates by the World Bank (1999: 24) put the level of real commodity prices in the year 2007 at 16 per cent below the 1998 average, almost all of the decline being due to a projected rise of 17 per cent in the unit value of manufactures exported by the G-8 countries.

domestic policy reform, debt restructuring and external resource mobilization. While the low-income and least developed countries would suffer the most, many other developing countries, including the recently industrializing ones, would also experience significant losses. Moreover, in the absence of a positive international commodity strategy, commodity prices and commodity export earnings of developing countries will continue to experience substantial degrees of instability.

As a result of these various factors, the debt burden of the commodity-exporting countries can be expected to remain high in relation to their export earnings, resulting in continuing pressure to expand exports to assist in meeting their debt service obligations. For many such countries, the interrelationship between exports and the foreign debt is likely to create a 'low-income trap', since depressed export prices have been, and remain, a major reason for the rise in their foreign debt. At the same time, the higher level of debt demands an expansion in export supply to service that debt, a process which further intensifies the depressive forces on world commodity markets.

If world commodity markets are left to the 'free play of market forces', while much high-cost agriculture in developed countries – even after the Uruguay Round – continues to be subsidized, the underlying problem of the downward trend in real prices of commodities exported by developing countries is likely to persist. Indeed, over the short-term, the downward trend might even be reinforced as the result of the working of the 'low-income trap' already mentioned. The commodity sector of developing countries' economies has been seriously weakened, while the retreat from the use of ICAs has removed an important 'safety net' which could have supported the real export earnings of commodity-dependent countries during the commodity price recession of the 1980s.

Developed countries, as well as developing ones, can be seriously harmed by large swings in commodity prices. Sudden and sharp price increases, for example, by causing a deterioration in the balance of payments of importing developed countries, and an increase in their inflationary pressures, can result in more restrictive monetary policies, thus adversely affecting their domestic growth rates. More generally, the continuing instability in commodity markets is likely, as already argued, to inhibit investment in productive capacity in the commodity sector and, to this extent, it would limit the future growth potential of the world economy.

The commodity problems of developing countries have received little, if any, attention in international forums for almost two decades. It now seems high time for this issue was given serious consideration by the international community. The essential elements of a new international commodity strategy are discussed in some detail in the following sections, drawing on the lessons of the recent past.

V. RAISING DEPRESSED LEVELS OF COMMODITY PRICES

A. Supply management

Since the prolonged period of depressed prices has become the dominant feature of world markets for the commodity exports of developing countries, an effective international commodity strategy needs to pay special attention to this problem. The objective here should be to devise effective measures to raise depressed prices to more 'normal' levels in a manner that would be acceptable to commodity-importing countries as fair and reasonable. Since depressed price levels reflect the persistence of excess supplies, the logical remedy would be some form of supply management.

Supply management is not, of course, a new idea. Buffer stocks and export quotas, as used in past ICAs, are themselves a form of supply management, as are arrangements designed to reduce or eliminate excessive stocks 'overhanging' a particular market. Several developed countries, too, have operated domestic 'set aside' programmes to reduce productive capacity for particular farm products in market surplus; while in cases of chronic overcapacity, developed country Governments, have on occasion, encouraged the major firms involved to reach informal arrangements to reduce capacity.

A practical programme of supply management to reduce excess supply, and to bring a better medium-term balance into the market, would need to be based on detailed assessments of trends in world demand for, and supply of, each of the major commodities experiencing persistently of depressed prices, the related trends in world stocks, and the expected future price trends, so as to determine the need for supply management in particular cases.

The appropriate form of any supply management scheme would need to address the underlying cause of price depression. A large stock overhang, for example, would require some form of stock retention by producers for, presumably, the limited period during which stocks fall to more normal levels. Such a scheme could be based on national stocks, subject to international coordination.[9] Where the problem is a faster growth of commodity supply than of commodity demand, an alternative policy could be based on export quotas, provided steps are taken to avoid the difficulties that arose in the operation of past export quota schemes.

Yet another alternative, for certain commodities, might be a uniform *ad valorem* export tax levied on shipments from the main producing countries. This would have the advantage of not altering the relative competitive position of the various producing countries, while acting to raise export prices generally. However, the export tax route would not be suitable for commodities having low short-term price elasticities of supply,[10] or where there is a large domestic market for the commodity.[11]

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9 An international buffer stock, as used in many past commodity agreements, is more suitable for reducing short-term price fluctuations.

10 There is an inverse relationship between the export tax rate required to yield a given rate of increase in export revenue and the short-term price-elasticity of supply, so that as the latter approaches zero the required tax rate rises sharply, for a given demand elasticity.

11 An export tax is likely to divert supplies from export to the domestic market in this case.

Supply management, in whatever form, is not, however, a panacea for dealing with the underlying long-term causes, of which depressed price levels are symptoms. Rather, it is to be viewed as an instrument for reducing serious market imbalances in the short- or medium-term. Over the long term, other measures would need to be considered to adjust the economic structures of commodity-dependent countries to world market trends. The two issues discussed below are particularly relevant in this context.

B. Diversification

Since the persistence of depressed levels of prices reflects a situation of chronic oversupply, a longer-term solution must be sought by diversification of the economies of commodity-dependent countries away from the production of the commodities concerned. Diversification, both within the commodity sector – into the production of non-traditional items with growing markets, or into the processing of commodities – and in manufacturing and service activities, has progressed in many developing countries over recent decades. But almost all such diversification has occurred in the larger countries, with have more extensive economic infrastructures, higher levels of labour and technical skills and better access to financial sources, than the small or poor countries, especially those exporting commodities in structural surplus. Such low-income countries find considerable difficulty in attracting private foreign investment or loans from commercial banks, while loans from the international financial institutions have generally been concentrated in the larger countries.

The low-income commodity exporters would appear to need much greater technical assistance than hitherto provided to help them identify and formulate diversification projects which could attract adequate external financial support. Without such support, countries exporting commodities in persistent surplus will not be able to finance the necessary structural adjustments to their economies. In this context, the present efforts of the World Bank and of the regional Development Banks to promote economic diversification in low-income countries will need to be expanded.

A shift towards the processing of many commodities in developing countries has been limited in past years by the escalation of import duty rates according to the degree of processing which has been applied by developed countries. Though the GATT Uruguay Round made some progress in reducing this duty escalation, higher duty rates applicable at higher stages of processing may still discourage commodity-dependent countries from diversifying into the processing stages of production for a number of commodities so as to benefit from added value.[12]

The forthcoming WTO Round of trade negotiations would appear to be an appropriate occasion for substantial reductions in the various import barriers to commodity trade, including trade in processed commodities, with a view to extending the global market for the commodity exports of developing countries, and to promoting needed diversification of their economies.

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12 This point is also made in the UNCTAD X Round Table paper by Binswanger and Lutz (1999).

Some new interagency forum might also be considered to bring together experts in the problems of particular commodity markets, or of countries about to diversify, to ensure that their diversification programmes, when taken together, are not likely to result in lower export revenues from some commodities or for some exporting countries.

C. Making natural materials more competitive with synthetics

Many natural raw materials exported by developing countries have been displaced by synthetics or by other materials produced in developed countries, resulting in persistent oversupply and depressed levels of prices for the natural product. The most promising longer-term remedial policy is likely to be a well-designed and adequately financed programme of research and development to improve the technical qualities, and thus the competitive position, of all the major natural raw materials.

Producers of cotton and wool have already followed this approach, and have retained their competitive position by technical improvements justifying their sale as quality fibres. It should be possible, by appropriate Research and Development projects, to improve the technical characteristics of each of the principal natural materials exported by developing countries in a similar way. This is an area in which the Common Fund for Commodities has a special responsibility through its Second Account.[13] From 1991 to 1st May 1999, the Common Fund had approved 74 individual commodity projects with a total funding of some $220 million, about half the amount being financed by the Common Fund. Of these, 33 projects related to 9 different natural raw materials, with a total of $43.4 million in Common Fund commitments, plus approximately the same in co-financing and counterpart funds.[14] This represents an annual average commitment of $11–$12 million for commodity development measures for the natural materials covered. Though this is an impressive start to what is necessarily a long-term programme, it may, none the less, be too small in scale to have a significant impact on the overall competitive positions of natural and synthetic materials in world markets.[15] Donor Governments may therefore need to consider ways in which funding for Common Fund development projects could be substantially increased.

VI. MINIMIZING MULTI-YEAR PRICE CYCLES

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13 The Agreement establishing the Common Fund for Commodities (1980) specified that commodity development measures under its Second Account "shall include research and development, productivity improvements, marketing and measures designed to assist….vertical diversification" (Art. 18.3(a)).

14 Common Fund for Commodities (1999).

15 The commitment of $11–$12 million a year represents only about 0.02 per cent of the approximately $50 billion of annual exports of natural raw materials from developing countries in the mid-1990s. By contrast, research and development expenditures by the large synthetic materials enterprises of developed countries are often above 5 per cent of the value of production.

As mentioned earlier (see section 4), some important commodity exports of developing countries have traditionally been subject to sharp price cycles, which arise when there is a multi-year delay in the adjustment of production to shifts in demand (and thus in world prices). This phenomenon is most marked for the tropical tree crops – cocoa, coffee and tea – though certain other commodities may also be affected.

The issue first came to the fore in the negotiations for a fifth International Cocoa Agreement (1993). Previous Agreements for cocoa had relied on a buffer stock plus export quotas, or on a buffer stock alone, to correct temporary or short-term market imbalances. However, the consensus among countries participating in the 1993 negotiations was that international cooperation on cocoa should address the longer-term problem of price cycles, and not concentrate on short-term price stabilization. This was a radical departure, not only from the earlier Cocoa Agreements, but also from all other international commodity agreements, since none of the latter had distinguished between short-term price fluctuations and multi-year price cycles. This in itself had caused difficulties in the operation of various agreements, since the nature of the problem, and the appropriate remedial mechanisms, are quite different in the two cases.

Under the 1993 Cocoa Agreement, two main Committees have been established under the International Cocoa Council. After the Council makes annual reviews and six-year forecasts of the world cocoa market, the Production Committee decides what adjustments would be necessary to future production levels to maintain a balanced market. This enables producers to make informed decisions about their individual production plans. The Consumption Committee examines consumption trends and problems in each country, and proposes actions on how to increase consumption, particularly in low-consuming countries.[16] It is expected that countries will collectively plan their production more effectively, while consumption will be stimulated as necessary, thus reducing the severity of the price cycle.

This new approach to commodity price problems is still at an early stage, and there is, no doubt, room for improvement in the mechanisms used. One major problem so far seems to be how best to improve the six-year forecasts, but these will become more reliable if proposals to conduct surveys of cocoa tree stocks in the main producing countries go ahead. The general approach of the 1993 Cocoa Agreement does, none the less, appear to be an important innovation in the mechanisms of international commodity policy, and, moreover, operates within the framework of a producer/consumer agreement. Producers and consumers of other commodities with a significant supply lag could usefully consider emulating this approach.

VII. MINIMIZING SHORT-TERM FLUCTUATIONS IN COMMODITY PRICES OR REDUCING THEIR ADVERSE EFFECTS ON DEVELOPING COUNTRIES

[16] UNCTAD (1993).

Though the dominant feature of international commodity markets since 1980 has been a generally depressed level of prices for a number of important commodity exports of developing countries, short-term price instability has remained high. The degree of instability has been greatest for sugar, reflecting the residual nature of the free market for that commodity, and the substantial annual variations in exports of subsidized sugar from the EU in recent years, as well as in exports from developing countries. High short-term price instability was also found in the markets for rice, most vegetable oils, jute and certain non-ferrous metals, of which copper is the most important.

Unregulated commodity markets tend to exhibit significant short-term price instability, making such markets inefficient mechanisms for optimal resource allocation, since prices in unstable markets cannot reliably indicate the relative profitability of alternative lines of investment in the production of different commodities. High price instability of a country's commodity exports would therefore tend to favour investment (e.g. in financial assets) for short-term gain, whereas low price instability would tend to favour long-term investment in productive assets. The constraints on economic development arising from excessive short-term instability of commodity export prices would be accentuated by the consequential variability in imports of capital goods and intermediate products into commodity-dependent countries.

A. International buffer stocks

The traditional approach to the problem of excessive commodity price instability has been the use of international buffer stocks and/or export quotas within the framework of an ICA. However, even if the degree of price instability were substantially reduced by such mechanisms, the export earnings of individual commodity-exporting countries could still exhibit large short-term fluctuations if the volume of their commodity exports was also subject to unduly large variations. An adequate system of compensatory finance for temporary shortfalls in commodity export earnings would, therefore, be an essential complement to the price stabilizing function of an ICA. Unfortunately, for many of the past ICAs using buffer stocks, these were not adequately funded, while the availability of compensatory financing, especially during the 1980s, represented only a small proportion of the export shortfalls experienced by commodity-dependent countries.

The failure of the various ICAs to defend the agreed 'floor' prices during the 1980s (as mentioned earlier), was no doubt one important reason for disillusionment by many commodity-exporting countries with this approach. More recent examples are the withdrawal in the course of 1999 of both Malaysia and Thailand from the ICA for natural rubber for the same reason. As already explained, the defence of a price 'floor', or the raising of depressed levels of prices, is a different problem from that of excessive short-term price fluctuations, and therefore, requires different remedial measures.

If the ICA approach is ever resuscitated, the objective of short-term price stabilization should be explicitly separated from that of price raising, while the agreed price range would need to be market-related. Moreover, any new international buffer stocks would need to be adequately funded and supported by an adequate system of compensatory financing. Such a system should be conditional, in appropriate cases, on recipient countries taking measures to reduce short-term fluctuations in the volume of their commodity exports.

B. Risk management

An alternative approach to minimizing the adverse effects of excessive short-term fluctuation in prices of commodity exports from developing countries has been strongly advocated by the World Bank since the late 1980s, namely the use of commodity-linked financial instruments to hedge against future price risks. This issue was considered at UNCTAD VIII in 1992, which recommended that "as far as possible, market-risk instruments should be used to alleviate the consequences of short-term variations in prices." Since 1989, the World Bank has put much effort into training commodity traders in various developing countries on the use of these financial instruments. In addition, the remit for the Common Fund for Commodities was extended in 1995 to include, *inter alia*, "the enhancement of commodity market risk management and commodity trade financing."

Nevertheless, it would seem unlikely that these relatively sophisticated financial instruments, which include futures contracts and derivatives, options and swaps, will come into general use by commodity producers and traders in developing countries for many years to come. Particularly for peasant producers, and small trading firms, the need to keep in constant touch with market trends, and the possibility of having to meet unexpected margin calls, are likely to limit their use of such financial instruments.

Now that there is a full decade of experience with this approach, the time may be ripe for a review of the scope, efficacy and cost of the market-risk management approach. Such a review could show, for example, the problems that have arisen, and the measures taken to meet them; the degree to which commodity exports from developing countries are now covered by market-risk instruments; the magnitude of the reduction in the short-term fluctuation in prices received by commodity producers and exporters using these instruments; and the magnitude of the reduction, if any, in the short-term fluctuation in export revenue of the commodity-exporting countries.

The role of market-risk financial instruments in a new and comprehensive international commodity policy may also merit closer consideration. While the widespread use of such instruments would reduce individual commercial risks, this would not by itself reduce the degree of price instability in world commodity markets. Commodity price instability interacts with instability in world financial markets and thus tends to accentuate the instability of the global economic system. A system of adequately funded international buffer stocks, by contrast, would act as an important stabilizing element in the global economy.[17]

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[17] This stabilizing influence of international buffer stocks was strongly emphasized by J M Keynes (1942) in his famous wartime proposals for the postwar international economic and financial institutions.

VIII. PROTECTING THE NATURAL ENVIRONMENT

It is generally acknowledged that the global economy is far from achieving a sustainable process of development in the sense of being able to meet present needs without compromising the ability of future generations to meet their own needs. Particularly over the past 50 years, global economic activity has resulted not only in growth in real incomes but also in serious environmental depletion and degradation. The principal underlying cause of continuing environmental damage has been that market processes do not reflect environmental costs and benefits. In many cases, the hidden environmental costs in the commodity sector are passed on to the general population, for example, through polluted air or water supplies, or to taxpayers through the cost of land reclamation after mining has ended.

Governments therefore need to devise mechanisms, where these do not at present exist, to internalize the environmental costs of economic activities, particularly for those which have adverse environmental effects. Such mechanisms could include, for example, taxes on the production of items harmful to the environment, or the removal or reduction of existing subsidies on inputs, such as fertilizers and pesticides, which also have harmful effects. Conversely, financial incentives could be introduced for environmentally friendly activities.

It is now generally accepted that poverty in developing countries is a major cause of environmental damage (e.g. to forests). Poverty alleviation policies should thus help to meet environmental goals in many developing countries, with consequent benefits for developed countries also. Equally, some changes in developed countries' policies, – such as reductions in existing trade barriers – would help to raise the commodity export earnings of developing countries, thus providing more resources and more flexibility for these countries to deal with problems of economic and social development, including poverty and environmental issues. Increased capital inflows, by assisting economic growth in developing countries, could also contribute to the attainment of environmental objectives. To the extent that supply management for commodities in excess supply can improve depressed levels of commodity prices, it could also be expected to reduce the pressure on environmental resources.

A number of natural products exported by developing countries have environmental advantages over their synthetic competitors. The world market for environmentally friendly natural products could be significantly expanded if developing countries took steps to promote the environmental attractiveness of their natural commodity exports.

IX. CONCLUSION

The main points that arise from the above discussion of the problems of commodity-dependent countries are:

(i) A high dependence on exports of primary commodities has been a major handicap in the efforts of developing countries, and particularly of the poorest among them, to promote their economic and social progress.

(ii) Since 1980 the dominant feature of world commodity markets has been their persistently depressed price levels, with consequent large terms-of-trade losses for commodity-exporting countries. These losses have played a major part in the rise in their foreign debts and the decline in their growth rates and in their standards of living. The low-income and least developed countries have been worst affected.

(iii) Over this period also, international action to strengthen the commodity sector of developing countries' economies has been marginal or non-existent.

(iv) There is now a strong case for a new international initiative to deal effectively with the commodity issue in all its aspects. This should be a cooperative effort by developing and developed countries in the longer-term interests of both. Such cooperative action, to be fully effective, should include both free-market instruments and selected forms of market intervention, where appropriate, in dealing with specific commodity problems.

(v) The various pricing problems facing commodity-dependent countries must not be conflated. Short-, medium- and long-term pricing problems have distinct causes and require distinct remedial policies.

(vi) A new initiative in the commodities field should give priority to raising the present depressed levels of prices of the major commodities exported by developing countries. Supply management measures would be needed to reduce excessive stocks 'overhanging' a commodity market, combined, as appropriate, with measures to promote diversification away from commodities in persistent oversupply, or with additional measures to improve the technical characteristics of natural materials in competition with synthetics or other substitutes. Developed countries could support a new initiative on these lines by negotiating substantial reductions, and eventual elimination, of the various barriers to commodity imports, including tariff escalation on processed commodities from developing countries.

(vii) For commodities whose markets are subject to multi-year price cycles, consideration should be given to adopting the type of production management now being developed for cocoa. Where the main problem continues to be excessive short-term price fluctuations, the use of risk-management techniques will, no doubt, spread more widely, though it seems unlikely that they will come into general use by commodity producers and traders in developing countries for many years to come. There is, thus a case for instituting, as soon as practicable, a detailed review of the scope, efficacy and cost of this approach, which could be used to minimize the adverse effects of excessive short-term price fluctuations of the commodity exports of developing countries.

(viii) Governments need to devise mechanisms, where these do not at present exist, to internalize the environmental costs of economic activities. Poverty alleviation policies in developing countries should also help to meet environmental goals. These countries could expand their export market if they took steps to promote the environmental attractiveness of their natural commodity exports.

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