

# *Commodity dependence and development*

*Suggestions  
to tackle the  
commodities  
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# Abbreviations and Acronyms

ACP	African, Caribbean and Pacific Countries
BSFF	Buffer Stock Financing Facility
CCFF	Compensatory and Contingency Financing Facility
CDDCs	Commodity dependent developing countries
CFF	Compensatory Financing Facility
COMESA	Common Market for Eastern and Southern Africa
EU	European Union
FOB	Freight on Board
GDP	Gross Domestic Product
GNP	Gross National Product
HIPCs	Highly Indebted Poor Countries
ICAs	International Commodity Agreements
ICO	International Coffee Organization
IMF	International Monetary Fund
ISA	International Sugar Agreement
ITA	International Tin Agreement
LDCs	Least Developed Countries
ODA	Official Development Assistance
UHT	Ultra High Temperatures
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States
WTO	World Trade Organization

## Executive Summary

A positive correlation has been found between dependence on primary agricultural commodities and poverty, as measured by the human development index. This is due to three prominent features of commodity markets: price volatility; the secular decline of long-term prices; and market concentration.

Commodity price fluctuation is anathema to economic development for commodity-exporting developing countries: it translates into export earning fluctuations. These in turn lead to fluctuations, hence uncertainty, in domestic income, savings, and in government revenues (often largely dependent on taxes on the export sector). As a result there is an adverse effect on domestic investment in productive assets.

Therefore, commodity price volatilities lead to macroeconomic instability, which is detrimental to economic development. The challenge is typically more onerous for countries that have difficulty in borrowing abroad to smooth short-term volatilities. The demise of the interventionary functions of international commodity organizations and national commodity boards which in the past have served as vehicles for stabilization, albeit with their weakness and limitations, has exacerbated volatility in commodity markets. In particular the abolition of the trading activities of national commodity boards has eliminated their role as providers of auxiliary functions, such as extension services.

The persistent decline in long-term prices of commodities is the trend that has dominated agricultural commodity markets for over five decades. There has been a nominal recovery in prices in recent years mainly due to a structural shift in demand. The shift is primarily due to the higher demand from China and India for commodities. However, this increase in demand is mostly concentrated on oil and minerals, hence it has not had any significant positive impact on the poor who mainly depend on agricultural commodities, even though there may have been some benefits for producers of fruit and cotton. In addition, there has been little improvement in real terms. In fact, despite the recent nominal

improvement in the prices for some commodities, the purchasing power of most commodity-dependent developing countries has either deteriorated or has not improved significantly, particularly in the case of those for which oil and foodstuff commodities account for a significant share of their import baskets.

In recent years, increased downstream market concentration in commodity value-chains (i.e. monopsony power) has appeared to be an important contributor to low export prices for traditional tropical commodities. Often market power is concentrated in the hands of a few processors, traders and retailers. These companies have buying power (oligopsony power) hence they have increasingly controlled, governed and dominated commodity markets, making immense profits at the expense of suppliers and consumers.

Recently, the commodities problem has been at the forefront of international debate. This demonstrates a considerable progress given that these issues were consigned to oblivion during most of the second half of the past century. In recent years industrial countries and international organizations have pledged to step up their financial and technical assistance, as well as creating an environment conducive for enabling policies. This situation is exemplified in various United Nations resolutions for the creation of an international diversification fund; the Monterrey consensus on financing for increasing official development assistance (ODA); promises to expand and strengthen international compensatory finance mechanisms to address short-term balance of payments and export earnings volatilities; and promises to create a fair and balanced multilateral trading system through the elimination of trade-distorting subsidies and by reducing tariff and non-tariff barriers to provide meaningful market access to developing countries. While these steps are financially and technically feasible, a lack of political will has hitherto made any practical progress improbable. This report argues that the focus of the development community should be on mobilizing the political will to make progress on these issues.

The report also considers that solutions for the commodities problem require an active government role through such mechanisms as supply management schemes for some commodities as well as regulation and promotion of industrial policy with broad and strong stakeholders' participation. In other words, unlike the import substitution strategy of the past, current industrial policy thinking is that governments play a crucial role in addressing the dysfunctions of market forces (see Hausmann and Rodrik, 2003). The paper argues that financing for diversification and policy space is crucial for economic diversification. Therefore it is vital that developed countries fulfill their pledges to increase ODA and establish diversification funds. In terms of policy space, it is fundamentally important that the existing rules that govern the flows of trade, investment, finance and technology are reformed to promote development in developing countries.

Finally, the report argues that national, regional and international competition policies could have a considerable role to play in addressing the concerns related to corporate concentration in commodity markets. The report recognizes the complexity of using national competition policies in most developing countries to address buyer power due to institutional and human capital weaknesses. However, good practices from several developing countries show that a national competition policy that aims at addressing buyer power is possible and of crucial importance. In addition, options for a regional competition policy should be investigated as a way to overcome some of the challenges that national competition policies may face. There are already some regional initiatives such as the COMESA competition regulation.

The role of international cooperation on competition should also be rethought. The unwelcome emphasis on market deregulation of what is known as the World Trade Organization (WTO) Singapore agenda on competition policy has made developing countries skeptical about the idea of negotiating international agreements

on competition policy. However, the lack of international cooperation on competition deprives developing countries of a useful instrument to address the problem of market concentration on commodity value chains. The status quo has continued to benefit multinational corporations and their subsidiaries. Therefore, there is a need to rethink and reexamine this issue.

It should be recalled that the Singapore agenda was not the pioneering attempt for multilateral cooperation on competition policy. The Havana Charter, which was negotiated in 1947-48, had provisions on competition policy. In addition, in 1980 the United Nations Conference on Trade and Development (UNCTAD) promulgated the *Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (the UNCTAD Code)*. The United Nations General Assembly accepted the Code as a non-binding recommendation by a consensus resolution. The Code explicitly states that the rules should be interpreted for the benefit of the trade and welfare of developing countries. This did not suit the United States, which withdrew its support to the Code (Fox, 2002). The Code contains several clauses that may be useful to address some of the challenges of market concentration and could be used as a starting point for multilateral discussions on competition. This report argues that such discussions can be held under the auspices of UNCTAD and outside the WTO.

Poor farmers' active and effective participation in all recommended mechanisms is crucial. Poor farmers are often sidelined by commercial landlords and big traders during the development of national public policies. To make sure any response to the current commodities crises contributes to poverty reduction, it is essential that poor farmers' interests are represented through strong and transparent social participatory processes.

# 1. Introduction

The most prominent feature of the exports of commodities of developing countries is that one single or relatively few commodities account for a large share of their total export earnings. According to the report by former United Nations Secretary-General Kofi Annan to the 58th session of the UN General Assembly, as many as 38 developing countries are dependent on a single commodity for more than 50 per cent of their income; while 48 depend on only two.<sup>1</sup> Striking examples of single-commodity dependence include Burundi, Sao Tome and Principe, Ethiopia, Malawi and Uganda. In these countries, the export share of a single commodity exceeds 50 percent of total merchandise exports. The top single commodities are green coffee in Burundi, Ethiopia and Uganda; cocoa beans in Sao Tome and Principe; and tobacco leaves in Malawi.

Countries that depend heavily on primary agricultural commodities are low on the human development index, implying generally low levels of education, life expectancy, access to health facilities, high infant mortality, and so forth. (See Lines, 2004). This is mainly due to excessive short-term volatility of agricultural commodities and persistent long-term price declines. In addition, over the past two decades, an increasing imbalance of market power between producers on the one hand and processors and other intermediaries and retailers on the other has squeezed the producers' share in the final sales value of commodities. A number of other factors such as the abolishing of the marketing role of national commodity boards, primarily under the Bretton Woods Institutions structural adjustment programmes, the demise of international commodity agreements, the distortion of trade in agricultural primary commodities, due to developed country subsidies and market-access barriers and weak institutional mechanisms such as the existing compensatory financing mechanisms, have contributed to the persistence of the commodities problem. The lack of finance for diversification and the narrowing of policy spaces through the unfavourable governance of flows of trade, technology, finance and investment have made economic diversification improbable.

In recent years, some aspects of the policy options for addressing the commodities problem have been intensively discussed in academic and policy circles. These discussions will not be repeated in this report. Instead, the objective of the report is to provide analytical insights in order to bridge gaps in the debate and to highlight solutions that are known about but are controversial (i.e. supply management), or to provide new ideas where little has been discussed (i.e. competition policy to address buyer power). The report also identifies several pledges that industrial countries and international organizations have made in the past in order to address the commodities problem but have failed to make good on. In so doing, the report argues that the commodities problem could indeed be addressed if developed countries and the international community at large can mobilize the necessary political will to do so.

In terms of scope, the focus of the report is limited to primary agricultural commodities, with some emphasis on tropical commodities. The paper is organized as follows: following the introduction, Section 2 reviews the commodities problem, its causes and implications. Section 3 provides a case study of market concentration in coffee. This section highlights in some detail the dynamics of market concentration in tropical commodities and the development challenges posed to producers and developing countries. Section 4 undertakes a critical review of past and existing policies and mechanisms and provides pointers on how to address the commodities problem. Section 5 provides conclusions and recommendations.

1. see at <http://info.worldbank.org/etools/docs/library/57495/sgreport.pdf>

## 2. Revisiting the Commodities Problems: Causes & Implications

### 2.1. THE COMMODITIES PROBLEMS

Generally speaking, agricultural primary commodities can be classified in three broad categories on the basis of the terms under which they are exported to the European Union (EU) or the United States (US):<sup>2</sup>

- i- Commodities for which particular countries have had preferential access to the EU and the US markets (e.g. sugar and bananas);
- ii- Commodities produced in both tropical and temperate (or Mediterranean) climates, in which developing countries exports are handicapped by extreme protection and subsidies in European and US markets (e.g. cotton in both US and EU; groundnuts and soybeans in the US; and tobacco in the EU); and
- iii- Tropical crops for which the international market is highly liberalized (e.g. coffee, cocoa and tea).

All these commodities experience similar problems; yet for different reasons. In general, the commodities problem takes three forms: price volatility; secular decline of long-term prices; and market concentration in commodity value chains. These problems are not mutually exclusive.

#### Commodity Price Volatility

Highly fluctuating short and medium-term prices are among the key features that distinguish traditional food and raw material commodities from manufacturing commodities. The erratic nature of commodity prices has been the main focus of international concern that led, during the early post-war decades, to the establishment of a number of price-stabilization agreements under United Nations auspices to which both producing and consuming countries were parties.

As observed by the South Centre (1996), the two

decades up to the end of the 1970s were characterized by little or no marked trend in real commodity prices (i.e. nominal commodity prices deflated by the prices of manufactures exported by developed countries), and hence the problem of the price trend remained overshadowed by the general consensus in the international community on the need to deal effectively with excessive short term price instability. Even then, developing countries were greatly concerned by the low-level prices for their commodity exports, associated with low wages and low real incomes in their export industries.

However, starting in the early 1980s, international commodity markets have undergone dramatic changes. These changes include the abolition of international and national commodity stabilization institutions with the rise of neo-liberal economic policy thinking. The period marked the starting point for a prolonged period of low levels of real prices that has aggravated the position of commodity-exporting developing countries. This was mainly due to the resulting large falls in the export earnings of commodity-dependent developing countries. At the same time, the markets for many individual commodities have continued to be characterized by high short-term price instability. As a consequence, many commodity-exporting developing countries have now experienced multiple external shocks: price fluctuations and exceptionally depressed prices.

As a result, since the 1980s, the short-term fluctuations in commodity prices have taken place around continuously declining long-term price trends. The nature and magnitude of the price volatilities vary according to the commodities. For example, Parimal (2005) calculated the 'instability index' for a large number of commodities and found that commodity price instabilities fell on aggregate from 17.27 in 1970 - 79 to 9.32 in 1990 - 99. For all food items on aggregate, the price instability index declined from 22.22 in the 1970s to 10.65 in the 1990s. Similarly, for tropical beverages on aggregate the instability index declined from 22.97 in the 1970s to 10.99 in the 1990s. However, the aggregate figures conceal important variations across individual commodities. When desegregated, the instability

2. See Lines, 2004:14.

indices show that price volatility has in fact increased for some commodities. For example, Parimal (2005) showed that the price instability indices of coffee, tobacco, cotton, wool, tropical sawnwood, and rubber increased in the 1990s from their levels in the 1980s.<sup>3</sup>

Commodity price fluctuation is anathema to economic development for commodity-exporting developing countries: it translates into export earning fluctuations. These in turn result in fluctuations, hence uncertainty, in domestic income, savings, and in government revenues (often largely dependent on taxes on the export sector). As a result there is an adverse effect on domestic investment in productive assets.

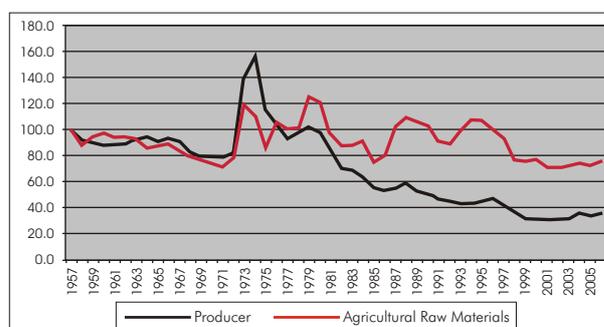
Therefore, commodity price volatilities lead to macroeconomic instability, which are detrimental to economic development. The challenge is typically more onerous for countries that have difficulty in borrowing abroad to smooth short-term volatilities.

### Box 1: Price instability of primary commodities

A high degree of price instability of primary commodities, coupled with worsening terms of trade, leads to a contraction in export earnings and instability in the commodity-dependant developing countries (CDDCs). To quote a few examples, Burundi is dependent on the export of coffee and tea to an extent of 87%. Between 1986 and 1987, the prices of coffee and tea fell by 37% and 20% respectively. As a result Burundi's annual exports fell from USD 154 millions to only USD 90 millions - a decline of almost 40%. In 1988, with a marginal improvement of 7% in coffee prices, coupled with an increased volume of exports, total exports rebounded to USD 132 million. However, they contracted drastically again in 1989 to USD 78 million only due to a 20% fall in coffee prices. In 2003, after a passage of more than 15 years, Burundi's total exports were only USD 37 million. Parimal, 2005.

### Declining Long-term prices

In the two decades preceding 1980, the long-term pattern of commodities was somewhat stable. The pattern changed dramatically in the 1980s with the secular decline of nominal and real long-term prices becoming a major feature of commodity prices. The decline in real commodity prices since 1980 has, in fact, been so severe as to constitute a phenomenon not seen since the Great Depression of the 1930s. Nominal commodity prices continued to decline until mid-2001 with the exception of some short-lived interruptions such as the sharp rise in coffee prices in 1994 in the aftermath of frosts in the Brazilian growing areas.



Source: IMF commodity index, World Economic Outlook 2006 statistical data

In fact, the situation of commodity prices has now changed due to a structural shift in demand. The shift is primarily due to the higher demand by China and India for commodities. For example, between 2000 and 2004, China and India together accounted for 40 per cent of global import growth for precious stones, 30 per cent for crude oil, 20 per cent for metallic ores and 10 per cent for woods.<sup>4</sup> Petroleum, metals and agricultural raw materials account for 85 per cent of Africa's exports to China and India.<sup>5</sup> The immense demand for primary commodities by China and India has been crucial to the recovery of commodity prices in the last few years. However this increased demand is mostly concentrated on oil and minerals, hence it has not had any significant positive impact on the poor in the exporting countries, who mainly depend on foodstuff commodities, in the exporting countries even though it has produced some benefits for producers of fruit and cotton.<sup>6</sup>

3. Price instability index is a measure of price volatility. It is measured as the average monthly deviation of prices from an exponential price trend.

The above figure shows the aggregate real prices for food commodities and agricultural raw materials for the past five decades. It clearly shows that as far as food and primary agricultural commodities are concerned, in real terms, the recent improvements in price have been marginal. In addition, despite the recent improvement in price for some commodities, the terms of trade of most commodity-exporting countries have either deteriorated or have not improved significantly, particularly in those countries where oil and foodstuff commodities account for a considerable share of their import basket. Furthermore, commodity price volatility still continues to be a critical problem.

The major reason for the decline in long-term prices for tropical agricultural commodities, such as coffee and cocoa, has been structural oversupply. It can be defined as a persistent expansion of productive capacity and production at a rate that is faster than the growth of consumption. The structural oversupply could be due to demand-side-shocks such as sluggish growth in demand or supply-side shocks, such as a productivity increase or productivity in synthetic substitutes. In the supply-side case, the structural adjustment programmes of the Bretton Woods Institutions, which include policies such as currency depreciation to promote exports and the abolishing of the market intervention and trading role of national commodity boards, have played a significant role in the expansion of the supply of tropical agricultural commodities. The simultaneous application of structural adjustment policies by several countries that produce the same or competing commodities led to a remarkable expansion of supply, leading to lower prices. This phenomenon is known as the 'fallacy of composition'. The structural oversupply in commodities implies that market forces often fail to equilibrate demand and supply, within reasonable time periods and at a competitive price that is fair to both sellers and buyers. For commodities such as cotton, subsidies in the North and the ensuing increased supply have been the cause for the depression of prices.

4. Broadman, H.G., 2006, *Op. cit.* 43.

5. *Id.*

6. See the Department for International Development, 2005, "The Effect of China and India's Growth and Trade Liberalisation on Poverty in Africa", DFID, London.

## Market Concentration

In recent years, increased downstream market concentration in commodity value-chains (i.e. monopsony power) has appeared to be an important contributor to low export prices for traditional tropical commodities. Often market power is concentrated in the hands of a few processors, traders and retailers. These companies have buying power (oligopsony power) hence they have increasingly controlled, governed and dominated commodity markets, making immense profits at the expense of suppliers and consumers. This concentration has meant that companies both upstream and downstream of agricultural producers are in a position to capture ever more of the value created in commodity supply chains. A large number of producers and exporters are confronting an increasingly small number of input suppliers, processors and retailers. The shrinking number of these companies in the market has allowed them to exercise increased market power and as a consequence a smaller share of the total value goes to developing countries, and a larger share goes to suppliers, processors and retailers based in the developed world.

Market concentration has been particularly high in the case of foodstuff commodities where trade with multinationals accounts for about 60% of global trade.<sup>7</sup> For example, four multinational corporations control over 60% of the global coffee market.<sup>8</sup> Similarly three companies control 85 % of the world's tea market; two companies handle 50% of world trade in bananas; and, four multinational companies control 95% of cocoa processing in Cote d'Ivoire.<sup>9</sup> Market concentration is also high in dairy markets where for example Nestlé controls 80% of milk production in Peru.<sup>10</sup> In addition, the number of vertically-integrated large supermarket chains, as well as their share in the retail of foodstuffs, has been increasing spectacularly in developing countries.<sup>11</sup>

7. ActionAid International, 2005.

8. Oxfam. 2002.

9. ActionAid International, 2005.

10. *Id.*, 2005.

11. See Reardon et al., 2004.

## 2.2. MAJOR CAUSES OF COMMODITY PRICE VOLATILITY AND LONG-TERM DECLINE

### Causes of Commodity Price Volatility

#### i. Low responsiveness of demand and supply of commodities to changes in price

The key structural factor for commodity price fluctuation is essentially the low responsiveness of demand and supply of commodities to changes in prices – a phenomenon that economists call low price-elasticity. This implies that a given shift in the quantity of supply, or of demand, results in a more than proportionate change in price. The dynamics is straightforward. Let us take demand as example. The low responsiveness of demand to price changes means that once the market is saturated, to sell an additional percentage point of a commodity requires lowering the price of the commodity by more than one per cent. Similarly, a percentage of excess demand makes a price increase of more than a percentage point. Hence, any factor that affects the balance between demand and supply causes substantial changes in prices.

On the supply side the low elasticity reflects the producers' difficulty to adjust supply rapidly in response to changes in demand.<sup>12</sup> The difficulty arises from, among other things, a time lag between rising prices and an increase in supply, in response to the rising price. In other words, the time-lag shows supply-side rigidity. For example, for tree-crops such as coffee, cocoa and tea, supply cannot be increased quickly enough in response to an increase in prices. Neither can it be promptly curtailed during periods of low prices. Tree-crops need several years to grow; hence supply-side response may take multiple years.

#### ii. Business cycles in consuming countries

On the demand-side, several factors cause commodity price fluctuations. These include: cyclical income fluctuations in consuming countries as well as fluctuations in international financial markets such as movements in exchange rates and interest rates. Cyclical income fluctuation in major commodity-consuming

countries could lead to fluctuations in demand. This is particularly the case for raw material commodities. A slow down of economic growth in consuming countries in general leads to a sharp decline in the demand for industrial raw materials. However, the effect of cyclical fluctuations on foodstuff and tropical beverage commodities is limited.

#### iii. Fluctuations in exchange rates and interest rates

The prevailing global exchange rate régimes also influence commodity price fluctuations. Cudding and Liang (2003) observed that flexible exchange rate régimes have induced more volatility in commodity prices than was the case under fixed exchange rate régimes. Frankel (2005) observed a similar effect. Excessive fluctuations in exchange rates imply that commodity prices fluctuate more in terms of major currencies other than the currency that in which the price is denominated.

The macroeconomic effect of this is significant for those countries, say, where their export commodities are quoted in US dollars but their major imports are from the EU or other countries. In such cases, even when the US\$-denominated price of the commodity remains fixed, the volatility of the exchange rate implies that the commodity price is unstable in terms of the Euro. Furthermore since the holding of inventories of virtually all primary commodities, even the non-perishable ones, tends to involve significant costs, they are in turn considerably affected by the prevailing rate of interest. Thus movements in the rate of interest, which affect the costs of holding these inventories, may lead to variations in the prices.<sup>13</sup>

Excessive instability in commodity markets implies that the market is not always an optimal mechanism for the allocation of resources, because, unstable prices are not reliable indicators of the relative profitability of alternative lines of investment in the production of different commodities. Measures that reduce excessive commodity price instability will thus contribute to the more efficient functioning of commodity markets by improving the rational use of resources.<sup>14</sup> Moreover, high commodity price

12. Other factors for the supply-side shocks for agricultural commodities include supply disruptions caused by elements such as vagaries in the weather.

instability leads to major uncertainty about the future profitability of investments in the commodity sector, which in turn tends to favour investment -- usually in financial assets -- for short-term gain; substantially reduced instability is likely instead to favour longer-term investment in productive assets.<sup>15</sup>

### **Causes of Long-Term Declines in Commodity Prices**

The major cause of the long-term declines in commodity prices has been the oversupply of commodities. This is due to imbalances between demand and supply, the lack of rapid adjustment mechanisms in commodity markets and abolition of the regulatory institutions that used to play coordination and supply regulation roles. The major factors that have led to oversupply in many commodities include:

#### **i. Abolishing market intervention by state trading enterprises and international commodity organizations**

The secular decline in real prices is mainly due to structural oversupply in commodity markets. The collapse of international commodity agreements and the abolition of the marketing role of national commodity boards as part of structural adjustment programmes are among the major causes for the structural oversupply of many traditional tropical commodities such as coffee, cocoa and tea. There are still national commodity boards operating in some countries. However, stripped of their marketing role and their role as last-resort buyers of excess supplies thereby leading to stabilization of markets, the national commodity boards have been reduced to organizations for recording and disseminating price and market information.

#### **ii. Increased Productivity**

A further contribution to oversupply is increased productivity due to technical advances, in particular the introduction of high-yield varieties of many staple crops by some traditional producers in Latin America and Asia; expansion of land allocated to production (for instance, in Brazil); the emergence of new producers (Malaysia of cocoa in the 1970s-1980s and Indonesia and Viet Nam as coffee and tea producers in the 1980s/1990s).<sup>16</sup>

13. Parimal, 2005.

14. South Centre, 1996

15. Id.

Low-quality coffee beans have also aggravated the excess supply problem, as new blending techniques currently available, enable roasters to use cheaper and lower-grade coffee that would not have been traded 10 years ago.<sup>17</sup> In addition, the development of synthetic materials and other substitutes (produced in developed countries), and changes in industrial structure away from the old 'heavy' industries have been among the key structural causes of the declining real commodity prices.

#### **iii. Trade Distortions**

For such commodities as cotton, groundnuts, sugar and wheat that are produced in the both in the North and the South, market distortions, in particular import barrier measures and subsidies in the North, have been the major cause of oversupply. Import barriers reduce market access to lower-cost competing commodity producers thereby increasing domestic prices and reducing domestic consumption in these countries. On the other hand, subsidies used to dump excess supplies on the international market at prices below the cost of production also contribute to excess supply. This has led to declining world commodity prices and added to the instability of world commodity markets. For example, a case in point is the staggering US subsidy for cotton, which was estimated to be US\$ 4 billion in 2004, has made the United States the biggest world exporter of cotton.

## **2.3. MAJOR IMPLICATIONS OF THE COMMODITIES PROBLEM**

### **Implication of Price Volatility and Decline i. External Shocks**

Pervasive volatility of commodity prices has been one of the major sources of macroeconomic shocks and instability in commodity-dependent developing countries. Defining a price shock as a decline in real prices of at least 10% from one year to another, the International Monetary Fund (IMF) calculates that between them 30 low-income developing countries suffered 204 shocks between 1981 and 2001, an average of one shock per country every three years.<sup>18</sup> The average size of

16. UNCTAD, 2004.

17. Id.

18. International Monetary Fund, 2003.

these shocks was just over 20%. Gibbon (2004) noted that low-income countries are 13% more likely to experience a price shock than other developing countries, and 60% more likely to experience terms-of-trade shocks. Price shocks directly affect gross domestic product (GDP), while shocks in terms of trade affect balance of payments. Kose and Riezman (2001) documented that trade shocks (both caused as a result of long-term decline and short-term volatility) account for roughly half of the fluctuations in aggregate output in Africa and cause prolonged recessions by inducing a significant decrease in aggregate investment. Similarly, citing Kruger, Mason and Vakis, Gibbon (2004) asserted that for the five main coffee-producing countries of Central America, the international coffee price decline of 1999-2001 alone led to a 1.2% drop in GDP for the countries as a group. If the multiplier effects are considered the effect is in fact worse.

In addition to being dependent on only a few commodities for export earnings and employment, many developing countries also depend on only a few industrial country markets. This combined dependence on few commodities and few markets has increased the risk of trade shocks in developing countries. The concentration of a typical developing country's exports in few geographical markets exposes the country to risks of exchange rate fluctuations between numerarie currencies the currency at which the country sells its exports - and other key international currencies.<sup>19</sup> The effect has been more daunting for countries that earn much of their export earnings in one currency and pay for many of their imports in another currency.<sup>20</sup>

## ii. Deterioration of terms of trade and macroeconomic instability

In addition, a steady decline in the relative long-term prices of most non-oil traditional commodities implies that the terms of trade, hence the purchasing power, of developing countries that depend heavily on non-oil traditional commodities, have declined. Terms-of-trade shocks directly affect the stability of exchange

rates, raising the odds of highly disruptive currency crises. Booms and busts in commodity terms of trade have been linked to booms and busts in investment. Pervasive volatility in investment in turn could generate pervasive volatility in capital return, including in interest rates, with adverse implications for domestic investment demand.<sup>21</sup> Commodity price booms and busts have thus been the major causes of recurring macroeconomic instability in developing countries. The combined effect of all of these is to deter economic growth, which is the major prerequisite for poverty reduction.

## iii. Indebtedness

As a relative price of exports and imports, a country's terms of trade determines the direction of its current account balance. A country with a protracted deterioration of its terms of trade is likely to face current account deficit. A country can finance its current account deficit by running down its official reserves, through net capital inflows (foreign direct investments or portfolio investment), aid and/or debt. In general, official reserves and net capital inflows are either low or negative in most developing countries. As a result, most developing countries have depended on foreign aid and debt to finance their current account deficit. It is not, therefore a coincidence that almost all Highly Indebted Poor Countries (HIPCs) are commodity-dependent countries.

In general, the effects of commodity prices on macroeconomic instability and household income have been well documented in economics literature.<sup>22</sup> However, a reasonable policy cure that is consistent with the institutional and structural realities of developing countries has yet to be found.

## Implications of Corporate Concentration

As already mentioned, corporate concentration has a deleterious impact on the earning of producers. Processors, retailers and intermediaries with buying power in commodity markets have been claiming the lion's share in the final sales value of a large number of commodities.

19. For detailed analysis see Chen and Rogoff (2002).

20. For instance, the recent slight recovery of commodity prices in dollar terms was partially offset by the depreciation of the US currency against other major currencies. The actual effect of the price recovery was therefore lower for developing countries that earn much of their primary export earnings in US dollars and pay for their imports, say, in Euros.

21. Razin et al., 2002.

## Box 2: Corporate concentration in national and global agrifood markets

### 1. Seed and agrochemicals

- ❖ In 1994, the top 12 companies had an 80 per cent share of the global pesticides market. By 2002, that number had halved, and the top six companies between them controlled 80 per cent of the global market.
- ❖ Just two companies, Du Pont and Monsanto, controlled 65 per cent of the world's maize seed market in 2002.

### 2. Bulk Commodity Trading

- ❖ Two companies, Chiquita and Dole, controlled nearly 50 per cent of world banana trade in 2002.
- ❖ In 1998, the top six coffee trading companies had 50 per cent of the world market. By 2002, that number had almost halved, and the top three traders controlled 45 per cent of the market.
- ❖ In 2002, just two companies Cargill and Archer Daniels Midland controlled three-quarters of the global grain trade.

### 3. Food Manufacturing and Processing

- ❖ Just two companies controlled nearly 60 per cent of the world market for roasted and instant coffee in 2002.
- ❖ Three companies control 85 per cent of the world's tea market.
- ❖ One company, Nestlé, controls around 80 per cent of Peru's milk production, and has a virtual monopoly over the UHT milk market in Pakistan.

### 4. Food Retail

- ❖ One third of world grocery sales are in just 30 companies.
- ❖ Wal-Mart controls 40 per cent of Mexico's retail sector
- ❖ Four companies account for three-quarters of all food sales in the UK.

Source: ActionAid; Power Hungry, 2005, Bill Vorley; Food Inc., 2003.

The next section demonstrates in some detail the impact of market concentration using the case of the coffee market to illustrate the argument. The case study provides insights into the trend and effect of corporate concentration for other commodities.

Before reaching the consumer, coffee is traded between countries by international coffee trading companies, and then roasted in the importing country, in a process, which has become extremely concentrated among a handful of trading and roaster companies worldwide since the 1990s.

In 1998, the top six companies controlled half of the international coffee trade. By the early 2000s, following a series of mergers, the number of companies had halved, with half of the market controlled by just three companies Neumann, based in Hamburg, Germany; ED & F Man, based in London, and Esteve based in Switzerland.<sup>23</sup>

A similar process has occurred in the roaster market, with even higher levels of concentration. There, just two companies (Nestlé and Philip Morris/Altria) control nearly 60 per cent of the market.<sup>24</sup> One company, Nestlé, dominates the soluble [instant] coffee market with a world market share, which reached 57% in 2001.<sup>25</sup>

22. See, Dehn, 2001 for comprehensive literature on this issue; for the effect of natural wealth and conflict, see Collier, 1996 and Collier and Hoeffler, 2005.

23. Agritrade (2007).

24. ITC (2002), p. 29. Since this was written, Philip Morris has divested its Altria subsidiary, which has returned to its former name of Kraft Foods.

25. [www.checkout.ie/MarketProfile.asp?ID=21](http://www.checkout.ie/MarketProfile.asp?ID=21)

## 3. Case Study: Market Concentration in Coffee

### 3.1. RECENT TRENDS IN THE COFFEE MARKET

#### Trends in the coffee export market

The most commonly used indicator of changes in the coffee market is price. Coffee prices since the 1970s have been on a steady downward trend, falling 77 per cent in real terms between 1977/9-2004/6, with occasional, and so far unsustainable, increases. Over the last ten years international prices have gone down and then back up again. This is part of the normal cycle on the coffee market. Given the extent of price falls in real terms since the 1970s, and the pattern of prices since 1997, it is likely that over the last two to three years there has been no more than a regular cyclical recovery, rather than any secular change in price trends for coffee. The recovery has been considerable with prices rising by 100 per cent from 2002 to 2006, and continuing to rise through 2007 and into 2008 though by January 2008 even the average nominal price had not yet risen to the peak of the last coffee boom in 1997.<sup>26</sup>

The overall decline in the price of coffee conceals big differences in the fate of the different varieties of coffee on the world market. There has been a rapid divergence between the prices for robusta coffee and the various kinds of arabica, and price trends have been much worse for producers of robusta coffee and the countries, which specialize in it.

In the late 1970s, producers of robusta coffee were earning more than three-quarters of the price per kilo than earned by arabica exporters. However, by 2001, producers of robusta earned less than 40 per cent of what arabica producers earned. In 2007, robusta producers gained ground relative to arabica producers and received

nearly 70 per cent of what arabica producers received per kilo.<sup>27</sup> The recovery in the price of robusta relative to arabica continued into January 2008.

There have also been changes in the geographical spread of the coffee market, and smaller countries risk being squeezed out. The three biggest national suppliers (Brazil, Vietnam and Colombia) are now of much greater interest to the roaster companies than smaller, more remote countries in Africa and elsewhere, such that in the ten years from 1995 to 2005, Africa's share of world coffee exports fell by nearly one-half (from 13.9 per cent to 7.3 per cent), and that of the least-developed countries (LDCs) by more than one-third (from 8.6 per cent to 5.5 per cent).<sup>28</sup> This comes as a consequence of increased market concentration in both the trading and processing (roasting) parts of the supply chain. Part of this decline is also due to the fall in the price of robusta relative to arabica, which has reduced the market share calculated by value of the robusta-exporting countries compared to the rest.

A comparable trend is seen in the weightings for different kinds of arabica coffee in the make-up of the International Coffee Organization's (ICO) Composite Indicator of coffee prices. Between 2001 and 2007 the share of natural arabicas (from Brazil, Ethiopia and Paraguay) in its composition increased from 20 per cent to 31 per cent, while Other Milds fell from 30 per cent to 20 per cent. The Other Milds group is composed of 22 mostly smaller coffee-producing countries, and this shows how dramatically their combined market share has fallen since the coffee crisis a few years ago. They include some very poor countries such as Bolivia, Burundi, Malawi, Papua New Guinea, Rwanda and Zambia.<sup>29</sup>

#### Trends in the coffee retail market

While the picture of coffee export prices over the last thirty years has been one of volatility within a context of an overall decline in prices, the

26. All data on coffee prices is from the International Coffee Organisation, [www.ico.org/prices/pr.htm](http://www.ico.org/prices/pr.htm)

27. The actual prices were: 1977, robusta price 224 cents and naturals 308 cents; 1978, robusta 147 and Colombian milds 185; 1979, robusta 165 and Colombian milds 183; then in 1998, robusta 83 and Colombian milds 143; 2001, robusta 28 and Colombian milds 72; and in 2007, robusta 87 cents per pound and Colombian milds 126 cents.

28. [stats.unctad.org/Handbook/TableViewer/tableView.aspx](http://stats.unctad.org/Handbook/TableViewer/tableView.aspx), Table 3.2. Total world coffee exports were worth \$15.6 billion in 1995 and \$15.8 billion in 2005. Of these amounts, developing countries in Africa accounted for \$2.16 billion in 1995 and \$1.16 billion in 2005; and LDCs for \$1.33 billion and \$868 million respectively.

situation at the other end of the supply chain is very different. While average export prices fell by 56 per cent between 1977/9 and 2004/6, average retail prices rose by 24 per cent in the same period.

Price trends have varied in different consuming countries. The prices in six leading markets (France, Germany, Italy, Japan, the UK and the USA) are shown in Table 1, in comparison with the ICO's Composite Indicator Price (compiled from export prices of the four different types of coffee).

In three of the five countries for which there is a full time series, the average retail price has risen over the last 30 years, while in the US it is much the same now as then and in France it has fallen by more than \$1 per pound. Retail prices are highest in the UK and Japan, in large part because their markets are led by instant coffee and canned coffee respectively, both of them highly-processed forms of the product.

**Table 1: Annual average ICO Composite Indicator Prices and retail coffee prices in leading consumer countries**

*All prices are in US cents per pound*

	1977	1978	1979	1990	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
<b>ICO Composite Indicator</b>	229	155	170	72	134	109	86	64	46	48	52	62	89	96	107*
<b>France</b>	438	389	386	373	276	278	255	215	199	207	250	272	275	297	—
% above ICO Indicator	91	151	128	421	106	155	197	234	337	334	381	338	207	210	—
<b>Germany</b>	480	476	461	339	403	404	342	283	263	273	318	333	406	433	—
% above ICO Indicator	109	207	172	458	201	271	299	341	478	471	513	435	355	352	—
<b>Italy</b>	435	428	418	531	545	553	516	444	433	457	547	601	613	629	—
% above ICO Indicator	90	176	146	643	307	408	502	591	850	858	953	867	586	557	—
<b>Japan</b>	—	—	—	1,026	1,422	1,352	1,532	1,292	860	813	819	875	822	816	—
% above ICO Indicator	—	—	—	1,334	962	1,141	1,688	1,911	1,786	1,602	1,477	1,308	820	752	—
<b>UK</b>	767	847	895	1,055	1,490	1,542	1,433	1,291	1,177	1,211	1,334	1,456	1,474	1,582	—
% above ICO Indicator	235	446	428	1,375	1,012	1,315	1,571	1,909	2,480	2,436	2,469	2,242	1,550	1,552	—
<b>USA</b>	347	310	292	297	411	377	343	345	309	292	292	285	327	320	—
% above ICO Indicator	51	100	72	315	207	246	300	437	578	512	462	359	266	235	—

Source: Lines (2008) calculations based on data from the ICO website ([www.ico.org](http://www.ico.org)).

\*January-November only.

A dash indicates no data.

N.B. Some figures might not tally because of rounding.

### 3.2. DISTRIBUTION SHARE IN THE COFFEE VALUE CHAIN

While the coffee export price is commonly used as the indicator for changes in market conditions, the export price represents only one point along the value chain. A better measure of the total value produced in the coffee chain is the retail price, which is the final price, incorporating all the others. The discussion below looks at three points in the chain the price received by farmers, by developing countries as a whole, and by retailers, in an attempt to see how the various groups have fared under the changes to the coffee market in the last 30 years.

Problems with comparing data mean that calculating the farmers' share (the first point in the chain) of the average retail price (the last point in the chain) is not straightforward. The best approximation is to make the calculation in two stages first to look at the farmers' share of export prices in various countries, and then to look at average export prices as a share of average retail prices. While this does not show the exact share going to farmers, it can provide an indication of trends.

### Farmers' share of export prices

The farmers' share of export prices for green coffee rose sharply nearly everywhere between the 1970s and the late 1990s. It is not clear why this is the case, since very different policies were pursued in different places. It is clear however, that since the 1990s in many countries farmers have been successful since the 1990s in capturing a greater share of the export earnings of the country.

However, declines in the export price meant that coffee farmers' real earnings were still lower in 2007 than they were ten years ago and far lower than they were 30 years ago, at the time of the ICO's export quotas. The ICO's Composite Indicator Price, which is a weighted average of the export prices of the different categories of coffee traded on world markets remains substantially lower than it was ten years ago. In 1997, coffee exporters earned an average of 134 cents per pound. By 2007, they were still only earning an average of 108 cents per pound.<sup>30</sup> It is clear that while domestically governments might have been improving the position of coffee farmers, they are still seeing a steady decline in income due to international market factors.

### Export prices as a share of retail prices

Evidence of an increased share of export revenues going to farmers should not lead to the conclusion that they are getting an increased share of the total value in the coffee supply chain. Using the export price as the basis for the comparison means that farmers' incomes are calculated as a proportion only of the total going to exporting countries, not of the total value in the supply chain. The next stage is to calculate the export price as a percentage of the retail price.

Retail prices in consumer countries have been more stable than either the international prices, as measured by the ICO's indicators, or farmgate prices. They have also tended to rise over time. Average retail prices in the top five consuming countries, weighted according to their share of consumption, rose by 24 per cent between 1977/9 and 2004/6. They have also risen consistently as a percentage of the export price

30. [www.ico.org/prices/p2.htm](http://www.ico.org/prices/p2.htm)

31. *Calfat & Flores (2002), p. 14, Table 2.*

over the last thirty years. Table 2 below shows a stark decline in the export price as a share of the retail price since the late 1970s.

**Table 2: Average export prices as a share of average retail prices, 1977-2006**

	1977-79	1997-99	2004-06
Average world export price	185	110	82
Average retail price, main consuming countries	400	569	494
Export price as % of retail price	46	19	17

Looked at country by country (Table 1), it is clear that over the last thirty years the retail mark-up over the export price has increased almost everywhere. Of course, during this period coffee traders, processors and retailers in the developed countries have faced big increases in wages and other costs. However, this does not alter the fact that a greater share of the final value has remained in consuming countries, while the real prices paid to the producers and exporting countries fell sharply.

Among the six markets shown, the percentage mark-up has increased the most in the UK and Italy, whether starting from 1977-79 or 1997. In the UK, the average retail price was \$15.82 per pound in 2006, when international prices averaged 96 cents; and the UK's price mark-up in the depths of the crisis in 2001 amounted to 2,480 per cent, meaning that the retail price was nearly 26 times as high as the typical import price.

Both the UK and Italian markets are highly concentrated. In 1997, Nestlé alone enjoyed a 51 per cent market share in the UK, while Kraft Jacob Suchard (maker of the Maxwell House brand, among others) had 21 per cent, meaning that two companies controlled nearly three-quarters of the market.<sup>31</sup> Much the same applies to Italy: in 2007, Lavazza was reported to have 48 per cent by value

of the Italian coffee market, almost as much as Nestlé in the UK.<sup>32</sup> These highly concentrated markets could explain the rapid rise of UK and Italian retail prices in relation to world market prices.

The more modest increases in mark-up in the French market are less easily explained, while from this perspective the recent decline in Japanese retail prices, both absolutely and in relation to import prices, is a puzzle. However, market volume has been growing rapidly in the UK and Italy while in Japan it has slowed down after rising rapidly in the 1980s and 1990s, and in France, Germany and the US it has been fairly steady in recent years.<sup>33</sup> It is likely that, as well as world market conditions for green coffee, and the changing structure of coffee markets globally and at a national level, varying market conditions at the retail end will also affect the allocation of value along the value chain.

Over the last 30 years, the export price of coffee has been on a gradual decline though with cyclical upturns while the retail price has been on a steady upward trend almost everywhere. This represents a gradual shift in value in coffee supply chains over the last thirty years towards the retail end, and a smaller share of total value going to exporting countries. In the late 1970s, exporting countries received nearly five dollars for every ten dollars spent on coffee in consuming countries. By 2006, this had fallen to less than two dollars for every ten spent on coffee.

At the same time the position of the poorest coffee-producing countries, and especially LDCs and countries in Africa, has weakened sharply - so that within the group of exporters, the smaller and poorer exporting countries have been faring worse than others in this diminishing market.

Despite improvements within developing countries, so that farmers are getting a larger share of the export price of coffee, farmers in developing countries have been seeing an ever-smaller share

of value in the total supply chain. There is at least circumstantial evidence to indicate that the falling farmers' share of final prices is related to market concentration and increased buyer power among the roaster companies.

If international commodities trade is to be a vehicle for development and poverty reduction, it is clear that policy has a role to play in ensuring that earnings within commodity value chains are distributed fairly. In particular, levels of market concentration in international markets need to be tackled through competition policy, ensuring that companies cannot abuse their market power and extract unfair profits from the supply chain.

32. Reuters (2007).

33. ICO data for coffee disappearance in importing countries ([www.ico.org/asp/display11.asp](http://www.ico.org/asp/display11.asp)).

## 4. Treatment/Actions to Address the Commodities Problems

The commodities problems are not insurmountable. As underlined by the South Centre (2008), with the right domestic institutions, and macroeconomic and investment policies; with reforms to create supportive international trading and financial systems; with sufficient financial support from donor countries and organizations, commodities problems are solvable. Financial, institutional or expertise constraints, although important, are not the major hindrances for achieving these solutions. In fact, year after year, donor countries and agencies, one after the other, have pledged to mobilize sufficient resources to address development problems. However, the political will and machinery that is required to transform promises into actions have been the major missing element and obstacle.

### 4.1. ADDRESSING PRICE VOLATILITY AND DECLINE

#### Supply Management

A supply management programme can be defined as policy intervention aimed at controlling production and supply of commodities in order to achieve a desirable price objective in a relevant market.<sup>34</sup> The relevant market could be domestic or international, depending on the objective of the program and the nature of the commodities covered under the programme. The price objective of a supply management programme can be higher price, price stability or both. Supply management can take numerous forms: it can be national or international; state-controlled, farmer-controlled or corporate, voluntary or compulsory; and it can use quotas, buffer stocks, import tariffs and other mechanisms.<sup>35</sup> Historically, supply management programmes have been used as major price stabilization instruments in international commodity markets. According to Lines (2007), the use of supply management by governments for the stabilization of prices dates back to 1920s. Unfortunately, in current mainstream policy thinking, there is strong disapproval of market intervention for controlling the supply side of the market.

As already mentioned, structural oversupply has been among the key reasons for sustained depressed prices for many commodities. As a result, the importance of government intervention for rectifying optimum social outcomes cannot be overemphasized. Supply management schemes are one policy option for such interventions. However, supply management schemes are not a panacea. The literature on supply management shows they have mixed results. Often, they are generally easy and best applicable when the number of countries and the number of producers are small; when the average cost structure of producers within and among countries is comparable and when there are entry barriers to new producers; and when these schemes are sufficiently flexible to changing structural demand and supply conditions and used for a short period of time.

#### i. Forms of Supply Management

The most well known forms of supply management are international commodity agreements (ICAs) and national commodity boards. As Robbins (2005) observes, neither ICAs nor marketing boards were established with the primary objective of lifting farm-gate prices. ICAs were designed to stabilize prices and marketing boards were instruments used by governments to manage and control their agricultural industries, and, in some cases, to generate tax revenue.

#### a. International Commodity Agreements

The immediate post World War II period saw the establishment of international commodity agreements (ICAs) under the auspices of UNCTAD. This was because of the importance attached by the industrial countries to the stabilization of commodity markets to ensure a sustainable supply of raw materials from developing countries; it was seen as critical for the reconstruction of their war-torn economies. The first post World War ICA was set up in 1953 with the establishment of the International Sugar Agreement (ISA) and the International Tin Agreement (ITA), under the auspices of the United Nations. In subsequent years, the International Coffee Agreement, the International Cocoa Agreement and the International Natural Rubber

34. South Centre, 2005.

35. Lines, Thomas, 2007.

Agreement came into existence. All these agreements had explicit economic instruments that allowed them to intervene in the market as required.

The evidence on the extent to which the ICAs helped to achieve price stabilization is mixed. Lines (2007) argues that in general, supply management has had the most prolonged success where it took the simplest forms and its controlling agents have had the greatest market power; such as the case for the diamond and aluminum markets. But even for such products as coffee and cocoa, which are produced by dozens of countries and millions of producers, the respective ICAs achieved noteworthy price stabilization for over two decades. The coffee and cocoa ICAs had to face several design and operational challenges ranging from the lack of compliance among member states to the persistency of commodity shocks, and problems derived from poor financing, design, and operations, and free-riding and rent-seeking activities. However, their demise was due to the withdrawal of the major consumer countries from the agreements and the ensuing underfinancing of the ICAs' operations.<sup>36</sup> However, the Tin Agreement collapsed because the buffer stock manager was unable to defend the base price as he did not have sufficient finance to purchase excess supplies of tin.

The collapse of the ICAs has ushered in an era of uncoordinated supply of commodities leading to depressed and highly volatile commodity prices.<sup>37</sup> The market-based risk hedging instruments that have been promoted as substitutes for market stabilization instruments have been useful in some cases but have not been adequate to address these problems. Unlike the ICAs that were intended to reduce commodity price volatilities, the market risk hedging instruments are intended to reduce or manage the risks that producers and consumers face without attempting to reduce the variability of commodity prices themselves. Despite their appeal to hedge risks by transferring them from those that are less able and unwilling to take them to those that are willing and capable, the market-based risk management instruments have not been suitable for the conditions that producers

in developing countries face (See Box 3).

The aforementioned evidence attests to the useful role that ICAs played in the past, despite the design and operations limitations that they encountered. There is scope for the ICAs to play a role in stabilizing commodity prices at remunerative levels. One way of doing this is through producers-only agreements, as has been proposed by the African Group in the World Trade Organization (WTO) negotiations on agriculture. In this regard, there are lessons to be learned from past mistakes. Nonetheless, at this stage, it is of primary importance for developing countries to secure the necessary policy flexibility at the WTO for the effective regulation of supply under producers-only agreements. This is also important to address the potential tension that producers-only agreements may create between consuming and producing countries, including the possibility of the use of competition or anti-trust law by the EU, the US and other industrial countries to discourage the use of producers-only agreements by developing countries.

### **Box 3: Major Limitations of market-based risk hedging instruments**

- ❖ Short-term maturities that make the instruments incapable of addressing problems associated with structural oversupplies of commodities and the enormous imbalance of market power among different players along the value chains of commodities.
- ❖ While dealing with short-term commodity price risks, the market instruments divert attention from the need to control the core sources of price instability.
- ❖ The prices of commodity market instruments such as futures and swaps are only slightly less volatile than the spot prices of commodities.
- ❖ Risk-hedging instruments cannot bridge the

36. For a detailed analysis, see South Centre, 2004.

37. For detailed analyses, see also ul Haque (2004), Oxfam (2002) and Gilbert and Wengel (2003).

- ❖ institutional vacuums that have been created by the dismantling of market stabilization institutions such as marketing boards, as the activities of such institutions included the provision of information, extension services, fertilizers and credits.
- ❖ Lack of access to credit markets limits the accessibility to internationally-traded commodity derivatives for producers in developing countries. This is partly because of the general higher country risk rating of developing countries, which implies that producers in developing countries have to pay higher risk premiums or to provide higher-value collaterals that simply are beyond their ability.
- ❖ Commodity derivatives are generally absent in most LDCs; and where they are available their operations are technically complicated; and their operational efficiency is undermined due to lack of regulatory, supervisory and contract enforcement capacities.
- ❖ Commodity derivatives are catered to fit the conditions of producers and traders in developed countries and do not generally fit to the circumstances faced by producers in developing countries.

*South Centre, 2004.*

## **b. National Commodity Boards**

National Commodity Boards in developing countries have played a critical role in rural development by providing agricultural extension services, inputs, quality control, and credit. In some cases they played a critical role in the development of commodity sectors. For example, the Kenya Tea Development Authority pioneered smallholders' production of tea and led that country to become the largest tea exporter (Lines, 2007). They have also been important for mobilizing national bargaining power in commodity value chains where multinational companies have the commanding weight due to buyer power.

However, national commodity boards did have their own weaknesses, for which they have been severely criticized. Some of the major criticism includes the fact that they distort market outcomes, thereby causing allocative and productive costs; they are harbours of corruption, bureaucracy and interest-group politics; and that they create a wedge between export price and farmgate prices; as well as unfairly affecting consumers in importing countries. It has been argued by orthodox economists and institutions such as the World Bank that welfare in developing countries is improved by market reforms involving the dismantling of market interventionary institutions and instruments such as marketing and export boards, export taxes, the introduction of competition in marketing, the elimination of administered prices and the privatization of state-owned assets.

As a result, the 1980s and 1990s saw the abolition of many commodity boards primarily under structural adjustment programmes. Those that remain have lost their marketing role and their ability to provide ancillary services to farmers. It was envisaged that the abolition of the marketing boards and their marketing role would increase the FOB (freight on board)<sup>38</sup> prices received by producers. This particular objective of the market reform programme has been undertaken under the 'getting prices right' maxim of the infamous structural adjustment programmes.<sup>39</sup>

The dismantling of the marketing boards and their marketing role in developing countries took place in parallel with increased intervention in the domestic agricultural markets of developed countries through farm support policies. Gilbert and Varangis (2003:3) characterized this as "hypocrisy". They conclude that the developed countries and the Bretton Woods Institutions are "guilty of pursuing self-interested policies in developing countries."<sup>40</sup>

Experience since the abolition of the marketing roles of marketing boards has been mixed. Akiyama et al (2003) found that the liberalization of the commodities market increased the producers' share in final export prices. However, Gilbert and Varangis (2003) noted that the producers' rising share has been wiped out by a

secular decline in international commodity prices.

In addition, the fact that the abolition was undertaken, without first putting in place alternative institutions as a safety net that would counteract the negative effects on welfare of market failures, has created institutional vacuums that cannot be bridged by market forces.<sup>41</sup> This implies that the rising share of producers' income in the export price has been accompanied by decreasing export prices. The domestic terms of trade has thus turned against producers in exporting countries that liberalized their markets. Therefore, the overall effect on welfare was negative.

#### **Box 4: How are farmers faring without Marketing Boards?**

The lack of transport, roads, communication systems, packing materials, credit and fixed market places often means that farmers [in developing countries] are isolated from the main centres of trade and know little about up-to-date market prices. The quantity of the harvest in any area may be very small and the farms may be difficult to access. This often means the amount of business available only justifies the attention of a single trader and, without competition from other traders, farmers must sell at almost any price the trader offers. Indeed, reports of collusion among traders are commonplace. Small-scale local traders may not be able to weigh, sort, pack or transport the commodity very far and must sell the products they have bought from the farmer to a larger-scale trader. There maybe as many as five transactions between the farmer and the exporter and each trader in the chain must reserve a profit margin for himself. Multiple handling costs and wastage add to the difference between the price paid to the farmer and the price paid by the exporter.

Although marketing boards did not serve the farmer well, they at least raised revenue for the country and eliminated the need for farmers to spend time bargaining one-sidedly with traders. Since the dismantling of ICAs, the market price of these crops has become very volatile and since multinational traders have a far superior knowledge of price movements than farmers or intermediary traders, they can buy during a period of low prices and refrain from buying when prices are high. Where once marketing boards extended credit to farmers in the form of inputs, the private sector now remains the only source of credit that farmers can depend on to tide them over between harvests. Farming is an inherently risky business, however, and private banks have no inclination to lend money to farmers with little or no collateral. Some traders are prepared to pre-pay for beverage crops but often at usurious rates of interest.

*Peter Robbins, 2005.*

In addition, while the increase in the share of producers in export prices, resulting from the abolition of commodity boards, implies the transfer of welfare from governments to producers within a country, the decline in export price implies transfer of welfare from producers and governments in exporting countries to economic agents in importing countries (mostly industrial countries). Therefore, the major beneficiaries of the abolition of commodity boards in developing countries have been importing developed countries.

38. *FOB price refers to the cost of an export good at the exit point in the exporting country loaded in the ship or other means of transport in which it will be carried to the importing country. It is equal to the CIF (Cost, Insurance and Freight) price at the port of destination minus the cost of international freight and insurance and the unloading onto the dock.*

39. *See Lines, 2004.*

40. *Gilbert and Varangis, 2003:3.*

41. *This provokes the question as to whether the appropriate policy approach in the commodities market should be through optimising government intervention rather than reducing it through market liberalization.*

42. *Lines, 2007.*

The abolition of the commodity boards in developing countries has exposed producers to the vagaries of malfunctioning market forces. As a result, farmgate price volatilities have increased. For example, in the case of cocoa, producer prices were more volatile in countries where the cocoa marketing boards were dismantled (Cameroon, Côte d'Ivoire and Nigeria) than in those that maintained them (for example, Ghana).<sup>42</sup> This suggests that producers were better off under the system of marketing boards, which provided some stabilization of prices, better terms of trade and other ancillary services.

Therefore, it is clear that the deregulation of marketing boards has been harmful to developing country producers. There is a need to rethink the active role of governments for agricultural development in developing countries. This may include the resumption of some of the traditional roles of national commodity boards while taking into account lessons learned from past mistakes and shortcomings.

## ii. Schemes similar to supply management

There are other alternative approaches that are similar to supply management schemes. The most common among these are stock overhang reduction schemes. The key difference between a supply management scheme and a stock overhang reduction scheme is that the latter tends to reduce or eliminate oversupplies and has no price objective in the form of either increasing or stabilizing prices.

### Box 5: Stock overhang reduction schemes

*A stock-reduction scheme.* The scheme opts to reduce an abnormally high stock-overhang in an orderly manner without affecting the price mechanism. This scheme does not have any price objective and is easier to negotiate than, for example, quota arrangements. The scheme would do little in terms of raising prices from their depressed levels.

*An 'export-quota scheme for reducing stock-overhang'.* This approach is linked to the stock-reduction scheme and pursues a reduction of commodity oversupply. The major difference between traditional export quotas and an export quota scheme for reducing stock-overhang is that the former opts to achieve an agreed price level while the latter only intends to influence prices through sentiments by reducing high stock-overhangs. In other words, while the traditional export-quota scheme affects price through reducing quantities, would otherwise be sold in the market within a reasonable period, the export-quota scheme for stock-overhang intends to reduce only the supply, which is residual of demand. Hence, the price effect of the latter scheme is achieved through reducing commodity stockpiles rather than creating immediate supply shortages in market.

*A production-reduction scheme.* This scheme refers to an agreed uniform cut of production by exporting countries in order to reduce large stock-reserves of commodities. This scheme is often negotiated for a limited period.

*Imposition of a uniform ad valorem export tax.* This approach is intended to raise prices by imposing a uniform export tax on exports from all main producing countries. This approach is easy to negotiate among exporters because the uniformity of the tax renders the approach non-discriminatory. The disadvantage is that a relatively large tax is required to achieve the same increase in export revenue that would be obtained by a relatively small reduction in supply.

*South Centre, 2005.*

Stock-overhang reduction schemes in general have the advantage of being easier to negotiate and agree upon than supply management programs. However, to the extent that the desired development objective is to raise commodity prices from their low levels or to maintain and stabilize higher commodity prices,

supply management schemes are more desirable as development policy options. What price level is remunerative is, of course, open to argument, and varies from one commodity to another.

### Compensatory Financing Mechanisms

The most well known international compensatory financing mechanisms include the IMF Compensatory Financing Facility (CFF), the Compensatory and Contingency Financing Facility (CCFF), the Buffer Stock Financing Facility (BSFF) and the EU FLEX and COMPEX mechanisms.<sup>43</sup> International compensatory mechanisms are instruments for addressing temporary external shocks “without having to resort to undue and unnecessary adjustments” (IMF, 1999).<sup>45</sup> As such, the compensatory financing mechanism is meant to address through smoothing, the effects of export-revenue instabilities arising from external shocks.

The relevance of the mechanism cannot be overemphasized for commodity dependent developing countries that are vulnerable to external trade shocks, in particular commodity price instabilities. Commodity price instabilities translate into instabilities in export revenue. This in turn culminates in macroeconomic instability including balance of payment instability. The abolishment of national stabilization schemes such as national commodity boards and other state intervention mechanisms means that external shocks are readily transferred into the economy of developing countries leaving them completely exposed to full market vagaries.

Unfortunately, the laissez-faire paradigm that has dominated development thinking during the last three decades has painted compensatory finance mechanisms as outdated. As a result most existing compensatory financing mechanisms have not been utilized as such. The BSFF for example has been dormant for over two decades because of the lack of support and the non-existence of buffer-stock-based commodity market stabilization. The utilization of the CFF and BSFF has been low because of the complex and restrictive eligibility

requirements including conditionality on “cooperating with the IMF” a polite way of asking countries to surrender their economic sovereignty to the technocrats of the IMF.<sup>46</sup> This is despite the IMF's acknowledgment that the rationale for compensatory financing mechanisms is to provide loans at low or relatively low-conditionality requirements to address external-shock-induced short-term balance of payment problems in a timely way.

The EU FLEX mechanism, which is the existing EU system of compensatory finance for African, Caribbean and Pacific (ACP) countries, also suffers from restrictive and complex requirements. Stringent eligibility criteria and the bureaucratic delay in reimbursing funds have made the mechanism, as has been the case in the past, with the COMPEX system, a non-efficient, cumbersome and pro-cyclical, rather than countercyclical, mechanism.

In general, the existing compensatory financing mechanisms are dysfunctional and of little use to fulfill their intended objective of addressing short-term shocks in export revenue and balance of payments. The prevailing neo-liberal paradigm places little trust in these mechanisms, making it politically unfashionable to take bold measures to simplify the schemes, in particular the restrictive and cumbersome eligibility requirements and slow disbursements. Nonetheless, the need for these mechanisms is even more real today than in the past. A number of empirical studies indicated that shocks for most commodities last for over a year.<sup>47</sup> This shows that rapid, unexpected, and often large movements in commodity prices are an important feature of commodity prices. It therefore implies that mitigation of the short-term and medium-term shocks should be an immediate area of concern for policy makers. If the Millennium Development Goal of halving poverty by 2015 is to be met, the need to provide a safety net and a cushion for developing countries and millions of their farmers from the vagaries of external shocks should be addressed. A compensatory financing mechanism is one instrument to achieve this. There is a

43. FLEX is a system, under the Cotonou Agreement, for the stabilization of a sudden fall in export earnings. FLEX has substituted the old system, COMPEX.

44. COMPEX is a system for revenue-loss compensation for non-ACP LDCs.

45. <http://www.imf.org/external/np/ccffbsff/review/index.htm#i>

46. For a detailed discussion on this see IMF (1999).

fundamental need to strengthen the existing mechanisms by simplifying the eligibility requirements and disbursements, and to make the schemes effectively countercyclical instruments.

## 4.2. ADDRESSING MARKET CONCENTRATION

The current rules in international trading systems and the dominant neo-liberal ideology do not provide practical solutions to the challenges of addressing market concentration. However, the challenge that corporate concentration has brought has been increasingly felt in developed countries as well. As a result, public discord, with the rising power of corporations and the use of this power as leverage to extract profit, has been growing. However, the most notable action has taken place in the UK. The UK's Competition Commission has recently ruled that UK supermarkets are abusing their buying power and exploiting suppliers. The Commission is currently considering the establishment of a regulator to enforce a code, setting out acceptable limits of behaviour by supermarkets towards suppliers. This is a model that might be considered in other value chains characterized by high levels of corporate concentration.

Undoubtedly, national competition law in developing countries could play an important role by addressing some of the abuses of market power, especially by domestic intermediaries or domestic subsidiaries of multinational corporations. However, this requires that competition law should encompass a wider perspective of addressing buying power in order to protect millions of small, vulnerable and powerless producers. In this regard, Asfaha (2005) argued that if antitrust law is concerned with the rights of consumers to buy products from competitive and efficient markets, there is no reason why it should not also be concerned with the rights of sellers to sell their products in a similar competitive environment.

The use of national competition law to address buyer power is not an easy task - it is complex - yet critical and needed. Tsegay (2008) documented some good practices in the use of competition policy to tackle buyer power in developing countries. However, he noticed that the

multi-jurisdictional nature of certain mergers and anti-competitive practices, among other things, pose a serious challenge to using antitrust laws to counter buyer power. Similarly, UNCTAD's (2005) review of recent experiences in the formulation and implementation of competition laws and policies in selected developing countries highlighted that the majority of developing countries do not have adequate institutional and human capacity to enforce competition policy to address corporate concentration.

Therefore, options for regional competition policy should be investigated as a way of overcoming some of the challenges that national competition policies may face. There are some regional initiatives in this direction. The Common Market for Eastern and Southern Africa (COMESA) competition regulation is an example.<sup>48</sup>

The role of international cooperation on competition should also be rethought. The attempt in the WTO in what is known as the Singapore agenda on competition policy - to bring market deregulation under the cover of a competition agreement has made developing countries skeptical about the idea of discussion international cooperation on competition at the multilateral level. The developing countries' resistance to negotiating the Singapore agenda on competition policy was the right decision. However, the absence of international cooperation on competition has deprived developing countries of a tool to address the concentration in the value chain of commodities and its consequences for producers. Therefore, there is a need to rethink and reexamine this issue.

It should be recalled that the Singapore agenda is not the pioneering attempt for multilateral cooperation on competition policy. The Havana Charter, which was negotiated in 1947-48, had provisions for an agreement on competition policy. In addition, in 1980, UNCTAD promulgated a *Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business*

47. For example, see Cashin et al., 1999; Cashin et al., 2004; and DFID, 2004.

48. See Common Market for Eastern and Southern Africa (COMESA). COMESA Competition Regulations. Draft. February 2003.

*Practices (the UNCTAD Code)*. The United Nations General Assembly accepted the Code as a non-binding recommendation in a consensus resolution. The Code explicitly states that the rules should be interpreted for the benefit of the trade and welfare of developing countries. This did not suit the United States, which withdrew its support to the Code (Fox, 2002). The Code contains several clauses that may be useful to address some of the challenges of market concentration and could be used as a starting point for multilateral discussions on competition. Such discussions could be promoted under the auspices of UNCTAD and outside the WTO.

In the short term, developing countries and their farmers need to organize themselves in order to increase their power in commodity chains. Farmers' organizations are key to protecting farmers in harsh times, and to bargaining for a higher share of export prices. As Lines (2007) noted, supply management agreements might well be a part of the solution, redressing the imbalances between exporting countries and international companies.

Voluntary ethical initiatives such as fair trade have played a useful role in assisting some producers to obtain a higher price for their products than they would have otherwise. In spite of the limited extent to which they can address the problem on a large scale, these initiatives nonetheless need to be encouraged and promoted as they make a difference to the lives of some producers. They also play a significant role in increasing awareness of the deleterious livelihood challenges that producers in developing countries face due to the imbalances in market power.

### **4.3. ECONOMIC DIVERSIFICATION THROUGH VALUE ADDITION**

There is almost a consensus that the sustainable solution to the commodities problem lies in achieving structural transformation, which can be defined as economic diversification through value addition. Central to structural transformation is technological transformation, through the adaptation of new technologies and the

upgrading of existing ones. A good example of this is a shift from the production of raw materials to processing raw material into intermediary or final high-value-added products and services.

According to Hausmann, Hwang and Rodrik (2005) countries become what they produce. This implies that the structure of a country's production and trade has a direct bearing on its growth. Obviously, specializing in some products brings higher growth than specializing in others.<sup>49</sup> Countries that specialize in high-value-added products with a high technological and skill content do better on the economic scale than countries that specialize in low-value-added products with a low technological and skill content.<sup>50</sup> There is a clear-cut difference in the technological and skill content of exports from developing and developed countries. This difference could explain some aspects of the development gap between developing and developed countries. By and large, developing countries have specialized in low-value-added products, mostly primary commodities and raw materials, while developed countries in general have specialized in technology and skill-intensive products.

It is, therefore, critical that developing countries allocate their resources for upgrading their production structure towards high-value-added or high-income products. However, there are two major obstacles to this transformation: lack of sufficient policy space and lack of finance to support diversification.

#### **Box 6: The concept of value-chain upgrading**

The concept of upgrading – making better products, making them more efficiently, or moving into more skilled activities – has been often cited by literature on competitiveness (Porter, 1990, Kaplinsky, 2000), and is relevant to our present aims.

Following this approach, upgrading is decisively related to innovation. Here we define upgrading as innovating to increase value added. Enterprises may achieve this aim in

49. Hausmann and Klinger, 2006.

50. *Id.*

various ways, such as for example by entering higher unit-value market niches, by entering new sectors, or by undertaking new productive (or service) functions.

In addition, within this context, innovation is clearly not defined only as a breakthrough into a product or a process that is new to the world. It is rather a story of marginal, evolutionary improvements to products and processes that are new to the firm, and that allow it to keep up with an international (moving) standard. This involves a shift to activities, products and sectors, which sustain higher value added and enforce higher entry barriers.

In sum, upgrading within a value chain implies going up on the value ladder, moving away from activities in which competition is of the “low road” type and entry barriers are low.

Source: Giuliani et. al, 2003.

### **Policy space for economic diversification**

The neo-liberal reform agenda that was championed under structural adjustment programmes in many developing countries was primarily based on the view that the “marginalization” of developing countries in international trade and investment flows were the major impediments to their development. This is why mainstream orthodox institutions often aspire to persuade and sometimes, through aid conditionalities, impose on developing countries to embrace bilateral and multilateral trade, investment and intellectual property agreements. But more often than not, such agreements contain provisions that do not favor the development of the local entrepreneurship, innovation and technological learning and upgrading, which are required for achieving structural economic transformation.

The continued shrinking of policy choices due to obligations arising from multilateral and bilateral agreements on trade, investment and intellectual property has made economic diversification impermeable and complex. Therefore the need for policy space cannot be overemphasized.

Addressing the policy space concern requires providing the developing countries with meaningful flexibility that supports their economic development. This may include flexibility for adequate levels of tariffs and subsidies, access to technology and local content requirements. The creation of a fair, balanced and inclusive multilateral governance of trade, investment and technology is therefore crucial for improving the livelihood of millions of poor in commodity-producing developing countries. Particularly, the active role of government through industrial policy is fundamental for addressing market failures in developing countries.<sup>51</sup>

### **Financing for diversification**

The lack of finance has been another major stumbling block in the developing countries attempt to diversify their economies. This challenge has been well recognized. For example, the UNCTAD Meeting of Eminent Persons on Commodity Issues in 2003 proposed the establishment of a Diversification Fund. Recently, the Brasilia meeting on the Global Initiative on Commodities proposed that international organizations establish export diversification funds, arguing that new policies should be promulgated for the effective mobilization of the capital necessary for financing diversification programmes.

In the past two decades, several pledges have been made by industrial countries for increased development assistance including for financing diversification. In the Monterrey Summit on Financing for Development, which took place in March 2002, developed countries made a commitment to contribute 0.7 per cent of their gross national product (GNP) as ODA to developing countries. They also pledged to provide 0.15 to 0.20 per cent of their GNP to the least developed countries, as reconfirmed at the Third United Nations Conference on Least Developed Countries, held in Brussels in May 2001. However, to date, only a handful of developed countries have met these targets. Many even have been reluctant to maintain their meager contributions. As a result, ODA has been declining significantly over the last few years.

In addition, in 2004 the United Nations launched

what is known as the initiative towards the Diversification of African economies. This initiative culminated in the “United Nations New Agenda for the Development of Africa”. The agenda calls on the international community to support the establishment of the Fund with resources of US\$50-75 million for an initial period of three to four years. However, the Fund, never saw the light of day. Recently, pledges were made at the WTO to increase “Aid for Trade”. The initiative still lacks clarity and there is little hope that fundamental changes in the amount and quality of aid will come out of it, at least in the short to medium term.

These points show that what is missing is the political will to provide genuine support to establish an international export diversification fund. Such a fund is critical for enhancing economic transformation in commodity-producing developing countries. As the South Centre (2008) argued, the meeting of UNCTAD XII could perhaps be used as an opportunity to gather steam for concrete actions towards mobilizing the political will to transform these pledges for a diversification fund into reality.

## 5. Conclusion and Recommendations

This report argues that the lack of political will of the developed countries to take concrete action to address the commodities problem is manifested by the many promises that they have made but have failed to fulfill. The report further argues that as a result, the primary focus of the development community at such meetings as the UNCTAD XII Ministerial Conference, should be on mobilizing the political will to bridge the gap between promises and actions.

In addition, the prevailing neo-liberal paradigm that places absolute trust in market forces has denied credence to the role of government. The advent of neoliberalism in developing countries under the Bretton Woods Institutions' structural adjustment programmes led to the demise of the active marketing role of national commodity boards. This has increased the producers' share in export prices; however it has led to a decline of export prices. The net effect was that the producers lose and the lion's share of the benefit accrues to the multinational and domestic traders, processors and retailers that have consolidated market power. It also exposed producers to the full vagaries of market instability, making them vulnerable to external shocks. This report sees a crucial role for effective and countercyclical compensatory financing mechanisms for dealing with short-term export revenue and balance of payment instabilities. Therefore, it argues for reinvigoration of the IMF and EU compensatory financing mechanisms. In addition, it makes the case for policy space to allow active government intervention, including marketing roles, in domestic commodity markets.

Similarly, the dominant feature of commodity markets during the fourth quarter of the last century was one of persistent decline interrupted by short-term upward prices. The demise of the market stabilization roles of international commodity agreements and increasing market concentration have been major reasons for the persistent decline of prices for some agricultural commodities, in particular tropical and foodstuff commodities, such as coffee and cocoa. For these

51. See, *Rodrik (2004, 2006) and Hausmann and Rodrik (2003)*.

commodities, the dismantling of the international commodity agreements has led to oversupply that decreased farm-level prices. Apart from the design and operational problems, the reluctance of developed countries to continue their membership in international commodity agreements has contributed to their demise. However, evidence shows that international commodity agreements played a considerable role in maintaining some stability of prices at levels remunerative to producers. At the same time, it is improbable that agreement can be reached on resuscitating the past schemes. After all, as the buyers of commodities, developed countries have benefited from depressed commodity prices and it is unlikely that they will support such schemes. Hence it may be advisable for developing countries to consider producers' only agreements. Such schemes could be possible for commodities such as cocoa, the production of which is dominated by a few developing countries.

In addition, the rise of market concentration has reduced the producers' share of earnings in commodity value chains for tropical and foodstuff commodities. The consolidation of buyer power through mergers and acquisitions and vertical trade restraint have enabled multilateral processors and retailers to claim the lion's share of the final sales value in commodity value chains. In contrast, farmers in developing countries have seen their share squeezed. This report argues that national, regional and international cooperation on competition could play a crucial role in addressing some of the concerns related to market concentration. With respect to multilateral cooperation on competition, the report underlines that discussions should not follow the approach of the WTO Singapore Agenda on competition policy which, contrary to the development needs of developing countries, emphasized market deregulation. Instead, the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (the UNCTAD Code) that was promulgated in 1980 by UNCTAD, could serve as a starting point. The code was accepted by the United Nations General Assembly in 1980 in a non-binding recommendation. The Code was pro-developing country in approach and content, and explicitly states that its rules be interpreted for the benefit of

the trade and welfare of developing countries. The Code contains several clauses that may be useful to address some of the challenges of market concentration. This report argues that discussions on multilateral cooperation on competition should be spearheaded by UNCTAD rather than by the WTO.

Poor farmers' active and effective participation in all recommended mechanisms is crucial. Poor farmers are often sidelined by commercial landlords and big traders during the development of national public policies. To make sure any response to the current commodities crises contributes to poverty reduction, it is essential that poor farmers' interests are represented through strong and transparent social participatory processes.

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**ActionAid International**

PostNet Suite #248  
Private Bag X31  
Saxonwold 2132  
Johannesburg  
South Africa

**Telephone**

+27 (0) 11 880 0008

**Fax**

+27 (0) 11 880 8082

**Website**

[www.actionaid.org](http://www.actionaid.org)

**South Centre Geneva**

CP 228  
1211 Geneva 19  
Switzerland

**Telephone**

+41 22 791 80 50

**Fax**

+41 22 798 85 31

**Website**

[www.southcentre.org](http://www.southcentre.org)

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**Author:**

Samuel Asfaha

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