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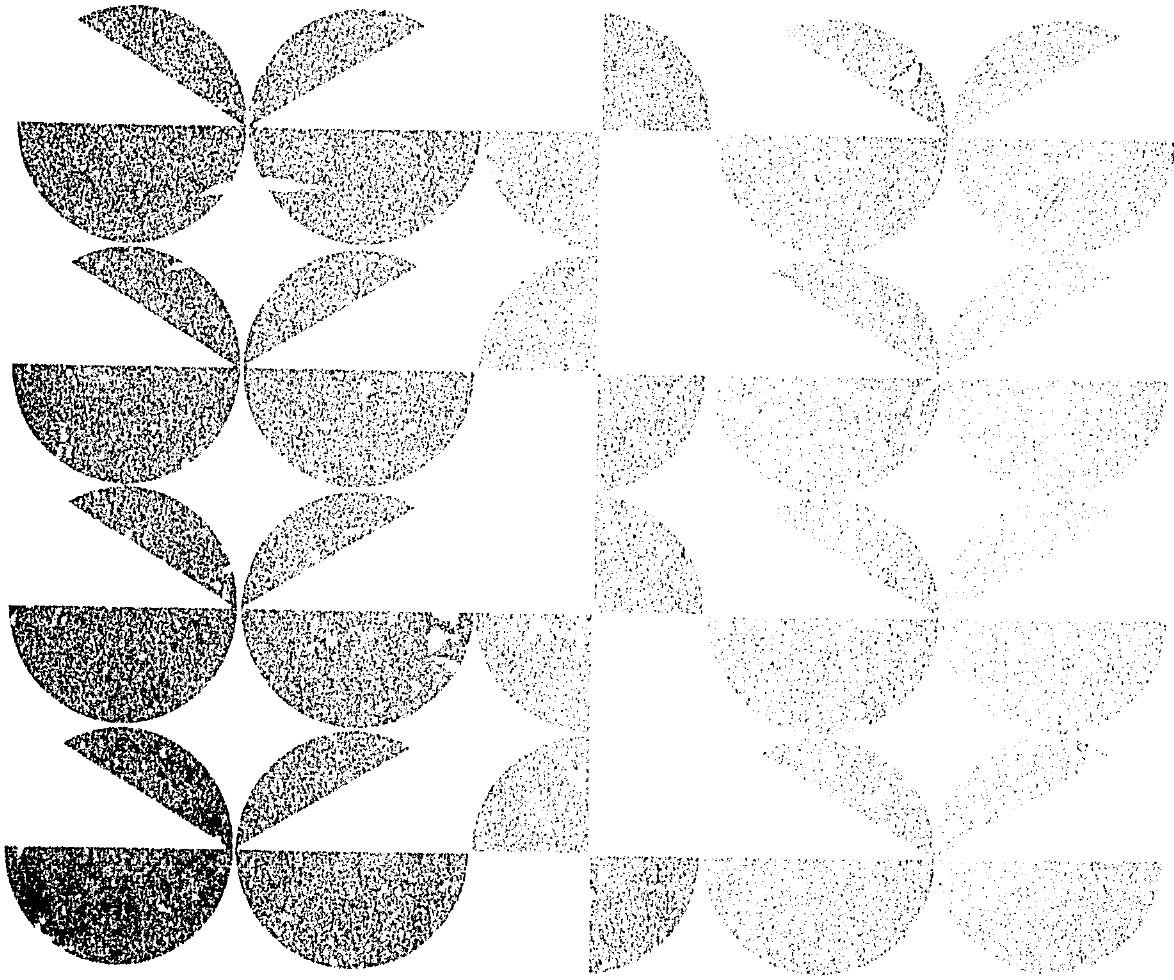
# U.S. Commodity Trade Policy and the Developing Countries



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# U.S. COMMODITY TRADE POLICY AND THE DEVELOPING COUNTRIES

by

Constantine Michalopoulos

January 1977

## AID DISCUSSION PAPERS

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## I. Introduction

Commodity trade issues will be one of the most important topics in North-South discussions in the next two years. Pursuant to resolutions passed at UNCTAD IV, a program of international consultations and negotiations is projected on the establishment of commodity agreements and a Common Fund in support of such agreements. In addition the IMF/IBRD Development Committee as well as the OAS are studying the U.S. proposal for the establishment of an International Resources Bank (IRB).

As this scenario is played out the possibility of disagreement between the U.S. and developing countries over commodity issues is heightened. The traditional U.S. view has been that basically free markets tend to promote both consumers' and producers', developed and developing country interests. The developing countries have challenged this view and have called for the implementation of an integrated program of action involving market intervention through commodity agreements and the establishment of a Common Fund for the financing of buffer stocks set up in support of commodity agreements.

The purpose of this paper is to analyze the circumstances under which U.S. and developing countries interest in commodities coincide and those where they diverge.1/ The analysis then leads to a discussion of various

* I wish to thank John Mellor and Lorenzo Perez for their helpful comments and suggestions and Greg Fager for statistical assistance. All remaining errors are my responsibility.

1/ The discussion excludes food grains. Whereas the issues in food grains are also of great importance to U.S. and developing countries, they have not been the focus of developing countries demands for commodity arrangements.

measures to address commodity problems through international action and U.S. policy alternatives on commodity issues of importance to developing countries.

## II. U.S. and Developing Countries Perspectives

### A. U.S. Objectives and Policy

The basic U.S. objective in the commodity field has been the development of secure and adequate supplies of raw materials and commodities at reasonable prices for U.S. industries and consumers. At the same time the U.S. is a major producer of raw materials. But it can be broadly assumed that U.S. interests as a consuming nation generally outweigh whatever interests it might have as a producer, since most of domestic production of raw materials is processed domestically rather than exported in its primary form. Benefits that U.S. would derive from increased prices of raw materials are simply increased costs to U.S. processors which would ultimately be reflected in increased costs of final products to U.S. consumers.

A secondary objective has been the promotion of economic development of developing countries which are often the source of supply of commodities and raw materials. To date this objective has received only scant attention and little weight in the formulation of U.S. policy. It deserves more attention at present because developing countries have made commodity issues central to their discussions with the U.S. and other developed countries over broad aspects of economic development. This in turn has raised the issue of the weight that should be given to the development objective, especially if its attainment conflicts with the pursuit of specific U.S. economic interests, and how the two objectives can be reconciled.

Traditional U.S. attitudes on commodity trade can be summarized as follows: (a) operation of free markets in commodities promotes worldwide efficient resource allocation and as a result is in the interest of both the U.S. as a consuming country as well as the producing developing countries; (b) market intervention should occur on a case-by-case basis, under circumstances in which market organization through commodity agreements is clearly beneficial to both consumers and producers; (c) such agreements have to be approached with great caution since they have often tended to reduce supply, raise prices and hence hurt consumers as well as distort resource allocation in developing countries; (d) instability in developing countries export earnings can be a significant development problem. 2/

Since basically free markets tend to promote both developed and developing country interests, the U.S. sees no conflict between the two objectives of obtaining adequate supplies at reasonable prices and promoting developing countries growth. Consistent with the case-by-case approach, the U.S. has participated in several agreements such as those on coffee and tin. It has also recognized the need to address developing countries problems deriving from instability of export earnings, and for this purpose supported the liberalization of the IMF Compensatory Financing Facility in early 1976.

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2/ See statement by Julius Katz, Deputy Assistant Secretary for Economic and Business Affairs before the Committee on Foreign Relations, U.S. Senate, July 27, 1976; see also Katz's address "Agricultural Trade and Commodity Arrangements" made before the Chicago Board of Trade, September 24, 1976.

The U.S. has also argued that one of the major problems developing countries face is inadequate exploration and development of mineral and energy resources, because "resource development is often discouraged by the very countries which are most in need of it. Nationalization and forced change in the terms of concessions in some developing countries clouded the general elimate for resource investments in the developing world. As a result comercially viable projects have been postponed, cancelled or relocated, and capital management and technology have been diverted to the production of higher cost ~~memo~~ materials in the industrialized world"[3/] Thus the U.S. proposed the establishment of the IRB for the purpose of promoting the exploitation of resources on the basis of joint agreements between international private companies, the IRB and developing countries. Such arrangements would hopefully ensure that developing countries obtain reasonable returns from the investment, as well as that foreign investors are protected against expropriation, and other risks.

B. LDC Perceptions, Problems and Proposals

Prebisch drew attention to developing countries commodity problems more than twenty-five years ago. However, the urgency with which developing countries are pursuing solutions through international action has increased following the 1973 energy crisis and its aftermath, both because of the increased payments problems many faced when commodity prices fell in 1974 and 1975, and because of their perception that, with the help of OPEC members, they could extract more concessions from developed countries than had previously been possible.

3/ Address by Secretary of State Henry Kissinger, before UNCTAD IV, Nairobi, May 6, 1976.

The essence of developing countries' current position on commodities can be summarized by the following propositions, assertions, conclusions and proposals for action. The problems identified tend to affect production and trade of various commodities and various countries in different degrees, and some not at all, but the perception of their existence forms the basis for their present demands for international action. The proposals for action tend to receive broad support at a general plane in political fora such as UNCTAD, but individual developing countries often take different stances on many issues when specific actions affecting them are proposed.

1. Problems

a. Demand for commodities is mostly inelastic at the relevant price ranges. Thus, for any given level of demand, producers will maximize total as well as per unit rents and enhance their development prospects by offering lower rather than higher levels of supply.

b. Demand for commodities grows over time less rapidly than demand for manufacturers. Thus, for similar supply shifts, prices of commodities would tend to decline secularly relative to prices of manufactures. Since commodities form a large proportion of developing countries exports and manufactures a large proportion of their imports,, the barter terms of trade for developing countries will tend to decline secularly; also, increases in relative commodity prices will benefit developing countries more as producers than they would hurt them as consumers.

c. Markets for commodities tend to be characterized by competitive conditions, while considerable oligopoly elements dominate production and export of manufactures. Hence, supplies of commodities tend to expand faster for given changes in demand, and thus exacerbate the price problem discussed above.

d. Inelastic demand as well as inelastic supply for commodities tends to lead to fluctuations in commodities prices, export earnings and producers'incomes. Such instability has adverse repercussions on development prospects by inhibiting investment and introducing uncertainties in development planning. It is desirable to reduce both individual commodity price fluctuations as well as overall export earnings fluctuations.

e. Producing countries derive too low a share of the benefits (rents) from commodity and especially raw material production and trade, relative to the share obtained by Multinational Enterprises (MNE) often involved in production and trade.

f. The commodity and raw material producing sector has only limited linkages with the rest of the economy. Thus, expansion of raw material production does not promote expansion of value added and employment in related industries or sectors. MNEs are partly to blame for this problem as well, because their decisions on location of processing facilities are designed to maximize overall MNE profits, and may or may not be compatible with the maximizing of host country development objectives.

2. Proposed Solutions

To deal with inelastic, slow growing demand in a competitive market structure developing countries argue that:

a. It is in the economic interest of producers to organize markets, regulate and to the extent necessary restrict supply growth so as to maximize total returns from commodity production and exports. Since developing countries are not the only actual or potential producers of commodities important to their trade market, organization can best be achieved through international agreements which include to the extent possible all actual and potential producers as well as consumers of individual commodities.

b. International agreements should aim at maintaining commodity prices constant relative to prices of developing countries imports, so as to avoid deterioration in their terms of trade.

c. To the extent that developing country consumers are hurt by supply restrictions, provisions should be made to extend to them offsetting assistance through funding established in support of commodity agreements.

To address the instability problem, stabilization of commodity prices should be pursued through commodity agreements. Such action should be in addition to the recent liberalization of the IMF compensatory Financing Facility which extends to developing countries balance of payments assistance to offset fluctuations in overall export earnings.

To increase their share of the rents from raw material production, developing countries themselves should take steps which either increase the rate of effective taxation on MNEs, increase the local equity participation or actually expropriate foreign owned enterprises involved in commodity and especially raw material production.

To increase links to the rest of the economy, developing countries should encourage and obtain assistance leading to the establishment of processing activities within their borders.

Developing nations views on needed international action are articulated in UNCTAD's Integrated Program (IP). The program is based either explicitly or implicitly on a diagnosis of the problem similar to that outlined in Section 1 above. It calls for two major actions: (1) a firm commitment by developed countries to negotiate commodity agreements for a set of at least ten commodities,[4/] (2) the establishment of a Common Fund to finance buffer stocks in support of the commodity agreements negotiated. The Common Fund is envisaged to have other uses as well, such as diversification or assistance to developing countries hurt by the establishment of commodity arrangements.

However, the thrust of the program is on the establishment of commodity agreements and the Common Fund which would permit significant intervention in commodity markets. Little attention is paid to alternative approaches to address commodity problems, or to questions of processing and the distribution of rents from resource development. The latter two issues have been important components of developing countries

4/ The UNCTAD secretariat has identified 18 commodities of interest to LDCs in an integrated program but has singled out 10 as the core commodities. The core commodities are: cocoa, coffee, tea, sugar, hard fibers, jute and manufactures, cotton, rubber, copper and tin. The commodity resolution in UNCTAD IV does not make the distinction and also includes as commodities of interest to LDCs bananas, bauxite, iron ore, manganese, meat, phosphates, tropical timber, vegetable oils and oil seeds.

platforms in UNIDO and in the context of the negotiations of an investment code for MNEs respectively.

C. Possibility of Conflict

At UNCTAD IV, the U.S. was skeptical about the usefulness of the Fund and indicated that: "A decision on a financial relationship among buffer stocks will need to be considered in the light of developments on individual funds. However, since there may be advantages in linking the financial resources of individual buffer stocks, we will participate without any commitment (emphasis added) in preparatory meetings to examine whether further financing of buffer stocks including common funding are desirable". 5/ Since UNCTAD IV, U.S. opposition to the Fund has rested on the arguments that: (a) price stabilization is not in itself, a generally feasible and desirable measure to improve LDC export earnings and (b) there is not clear indication that the absence of financing impedes the establishment of commodity agreements. 6/ Underlying both arguments is the fear that to agree to set up a Common Fund would tend to prejudge the outcome of commodity negotiations, since there would be pressure to reach agreements which use the available buffer stock funding.

The LDCs on the other hand opposed the IRB at Nairobi partly because they did not view it in their own interest and thought it was intended as a last minute substitute to the Common Fund and partly because they were disgruntled about the U.S. reserva tion on the commodity resolution.

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5/ UNCTAD IV, U.S. statement of Reservation and Interpretation.

6/ See Katz Chicago Board of Trade Speech, op cit.

There are significant weaknesses in both the current U.S. and LDC positions which impede resolution of important economic issues in the commodity area. The developing countries tend to put too much stress on commodity agreements as the cure for all types of problems. The U.S. on the other hand by stressing free markets for commodities and increased exploration and resource development through the IRB, tends to downplay the possibility that in some circumstances these may be contrary to the interests of developing countries. If U.S. and developing countries economic interests conflict then the U.S. must face squarely the thorny problem of how much weight, if any, it has to place to the pursuit of development objectives in the poor countries through its commodity policy. To give no weight at all is likely to cause significant problems in our political relations with the Third World. So far, it has been simpler to try to convince the developing countries that commodity policies which benefit the U.S. are also conducive to their long run development. While in some important situations this is the case, in others it is not.

## III. Commodity Problems and Policy Alternatives

Developing countries exaggerate when they assert that demand for commodities is generally stagnant or secularly declining. On the basis of current assumptions about developed countries growth to 1980, the IBRD estimates that growth rates of developing countries exports by volume of seventeen commodities will be higher in 1974 to 1980 than in the period 1960-2 to 1972-4, including exports of bauxite, rubber, phosphate rock and beef. Export growth in 15 others, including oil, coffee, copper and jute will be lower, while for 3 others the rate of growth can be expected to remain unchanged. Export volume is estimated to grow by more than 5% per annum in bauxite, copper and phosphates, by only 1.5% for tea and lead, and actually decline by 4% per annum for jute. Thus, the prospects are decidedly mixed.[7/]

Similarly it is very difficult to say what will happen to the purchasing power of commodity exports or the developing countries terms of trade. A lot depends on the commodities, countries and periods covered. According to the same IBRD estimates, the purchasing power of 34 commodities produced by developing countries (excluding oil) fell by 29% relative to prices of manufactures exported by developed countries between 1950-52 and 1967-69; rose 34% between 1971 and 1974 and fell 33% between 1974 and 1975.[8/] According to UN estimates, the barter terms of trade of developing countries were the same in 1973 as they were in 1950-52.[9/]

On the other hand the evidence favors the view that demand for commodities is typically price inelastic.[10/] Elasticities are significant in the short run for commodities facing competition from synthetics such as fibers or rubber. In some commodities, e.g. copper, long run elasticities are significant but substitution is likely with other commodities also produced by developing countries, e.g. aluminum.

7/ IBRD, Price Prospects for Major Primary Products, Report No. 814/76, June 1976, p. 44.

8/ Ibid, p. 14

9/ United Nations, Monthly Bulletin of Statistics, various issues.

10/ IBRD - op. cit.

Also, there is little disagreement that demand and supply rigidities lead to larger fluctuations of price, volume and earnings for developed countries. For example Naya has calculated that the mean fluctuations and the coefficient of variation in developing countries export earnings was double that of the developed countries in the 1960's. 11/

A. Stabilization

There is little disagreement that more price stability in commodity markets is better than less for both producers and consumers, developed and developing countries alike. Yet, there is a question as to whether additional measures are needed and for what purpose.

In early 1976, the IMF Compensatory Financing Facility was significantly expanded. During the first half of 1976, the Facility has lent $1.1 billion to developing countries. It is estimated that by the end of the year, total lending would be $2.63 billion or more than twice the amounts lent in the previous 10 years of its existence. 12/ The operations of these facilities should effectively cope with a good deal of instability in export earnings. It is this instability which through its impact on capacity to import and its link to investment has been shown to the most detrimental to developing

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11/ Seiji Naya, "Fluctuations in Export Earnings and Economic Patterns of Asian Countries," Economic Development and Cultural Change, vol. 21, no. 4, part 1, July 1973, p. 633.

12/ Similarly the establishment of the STABEX agreement between the European Countries and 46 developing countries can provide up to approximately $90 million of financing annually for this purpose.

countries' capacity to plan and develop.[13/] Although there are limits to individual countries borrowing, it could be argued that the earnings instability problem can be largely dealt by the Facility. Full compensation is probably not desirable as it would eliminate all incentives for corrective action by the developing countries themselves. What then is the justification for efforts to promote price stability in commodity markets?

From the developing countries producer standpoint price stability is a desideratum in its own right for the following reasons: Export earnings stabilization by borrowing from the IMF is not usually linked to internal institutional arrangements stabilizing incomes to producers, (and of course does not necessarily promote price stability). Separate arrangements such as buffer stocks, marketing boards etc. are needed to carry out effective internal stabilization. While these internal institutions do not require

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13/ While there was some controversy as to whether LDCs growth does indeed suffer from export earnings instability partly because of the writing of Alasdair I. Macbean: Export Instability and Economic Development, Harvard University Press, 1966, there is little disagreement at present that it is a problem. For evidence see, P. Kenen and C. Voivodas,"Export Instability and Economic Growth," Kyklos, Vol. 25, no. 4, 1972, pp. 791-804; and C.Glexakos, "Export Instability and Economic Growth: A Statistical Verification, "Economic Development and Cultural Change, vol. 21, no. 4, part 1, July 1973, pp. 670-78.

international action to attain their objectives, their operation is significantly facilitated in the context of lower fluctuations in international prices which could be obtained through international agreements.

Little attention has been paid to the costs of commodity and especially raw material price fluctuations for developed countries. Given the existence of the IMF Facility, developed countries may be the chief beneficiaries of commodity price stabilization. First, developed countries and the U.S. in particular are likely to benefit from more price stability because they are significant producers of many commodities. On the other hand instability tends to be costly to them as consumers of raw materials in that: (a) it may promote inflationary tendencies, and provoke restrictive monetary policies tending to reduce business activity; (b) it tends to reduce long run supply; (c) it adversely affects consumers by introducing uncertainty. 14/

The first effect is likely to result from asymmetrical responses of firms and monetary authorities to price increases as opposed to price decreases. Raw material processors typically operate in oligopolistic markets characterized by price leadership. In a climate of rapidly rising raw material prices, the absence of good market

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14/ These effects are discussed in Richard N. Cooper and Robert Z. Lawrence, "The 1972-75 Commodity Boom", Brookings Papers on Economic Activity, 3:1975, pp. 671-715.

information may permit them to raise prices of processed goods in excess of that justified by raw material price increases. The reverse would not tend to occur during a period of falling prices.

The magnitude of this effect is difficult to gauge, in part because the degree of asymmetry is hard to pin down. However, the impact of raw material price increases on the overall price level may not be insignificant. For example, it has been estimated that a 14.5 percent increase in prices of non-food, non-fuel raw materials, increases the U.S. consumer price index by one percent; [15/] and prices of these materials have been known to increase in the course of a year by significantly more than 14.5% recently. [16/]

Increases in prices in particular sectors in turn often provoke restrictive action by monetary authorities. Such action would tend to dampen general business activity. Large increases in commodity prices can thus result in significant real costs to an economy via the policy response to them. However, again the response is not fully symmetrical. It is less likely that price declines, even if they were to occur in specific sectors, will evoke expansionary measures.

Uncertainty as to price creates multiple costs to consumers: First, there is a cost of obtaining cover in forward markets so as to

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15/ Joel Popkin, "Commodity Prices and the U.S. Price Level, "Brookings Papers on Economic Activity, 1:1974, p. 256, quoted in Cooper and Lawrence, op.cit.

16/ See IBRD op.cit.

reduce uncertainty. Second, larger fluctuations tend to induce holding of higher inventories which would also tend to increase costs of the final product. Finally, price fluctuations may themselves inhibit investment due to uncertainty. This would retard expansion of supply which would result in higher costs of raw materials in the long run and hence would be contrary to basic U.S. objectives in the commodity area.

In sum, price instability is likely to be costly to developed and developing countries. Efforts to reduce it through commodity agreements aimed at price stabilization are in the interest of U.S. and developing countries alike. In light of this coincidence of interest, it is perhaps surprising that the U.S. and other developed countries have not been strongly supportive of price stabilization arrangements. Yet, there are important reasons for their resistance: First, even pure stabilization arrangements have significant financial costs in the original establishment of buffer stocks. At the same time the consumer benefits of increased stability are scattered and difficult to measure. Second, and most important, while commodity agreements have always ostensibly been set up to stabilize prices, they have invariably tended to shift emphasis in practice to raise prices over what the long term trend would have been. Third, commodity price stabilization through buffer stock management is technically difficult to carry out, given present knowledge and market conditions. Buffer stock managers have been known to ezr and exacerbate the problem of instability. Thus, the U.S. and other consumers, uncertain about the benefits they would derive and apprehensive about their true intent, have shied away from participating in efforts to stabilize prices through commodity arrangements.

B. Demand Problems and Restriction of Supply

Developing countries' efforts to address what they perceive as demand problems primarily through restriction of supply lie at the core of the controversy between U.S. and developing countries on commodity trade issues. If demand is price inelastic, as it typically is, restriction of supply through an agreement among suppliers will maximize their total earnings, and reduce consumer surplus. The simple implication is that the interests of the U.S. as a typical consumer and the interests of developing countries as producers are contrary and conflicting. In practice, however, the situation is quite a bit more complex.

First, supply restriction by developing countries acting alone is not commonly feasible. With the exception of a few tropical products such as coffee, tea, cocoa, and bananas, developing countries are not the sole actual or potential producers of many commodities. Restrictive practices on their part in the context of an unregulated market tend to result in the development of supplies elsewhere especially in developed countries and a decline in the developing countries' share of total trade. Developing countries have often under-estimated demand elasticities, facing individual suppliers, and restrictive policies have indeed led to declines of their share in some markets e.g. their share of bauxite and rubber production and exports fell significantly between 1960 and 1974. 17/

17/ However, shares rose in many others.

The most important question is the desirability of supply restriction as a means of addressing the demand problems discussed earlier. Restrictions in general benefit developing countries and other producers already well established in producing and exporting raw materials. For them, a lower growth in supply simply means they will be able to enjoy higher rents on lower output. These countries would be interested in assuring limited expansion of supply from lower cost sources in both developed and developing countries, and for that, the best instrument is commodity market regulation.

Supply restriction obviously would tend to hurt consumers and net importers including the U.S. and other developing countries. It would also be inimical to the interests of those developing countries which have large unexploited resources, and for whom expansion of supply and gaining a larger share of the market is more attractive as a development policy.

Supply restrictive arrangements are potentially most beneficial to participants yet most difficult to implement in cases where demand is price inelastic and rising. Implementation is difficult because of the strongly divergent interests between already established producers and those with underdeveloped resources which wish to expand their market share. OPEC, the typical example of successful cartelization in a rising demand situation is not easily replicable for many commodities of interest to developing countries. Its success seems to hinge at least in part on the willingness of the major exporter, Saudi Arabia, to significantly restrict supply more than others so as to preserve the unity of the cartel.

For commodities facing stagnant or falling demand, supply restriction is probably a necessary but not sufficient condition to improve the welfare of producers. In a free market, the relative price of these commodities will tend to fall thus presumably producing an incentive for factors of production to move to alternative employment. However, in many developing countries, their very underdevelopment often implies that alternative opportunities are limited and that individual producers faced with declining prices try to maximize income by producing more rather than less output, thus aggravating the problem. In this instance, government intervention to restrict supply is appropriate. Such action must be taken in conjunction with measures to diversify production and opening up alternative employment opportunities -- otherwise efforts to restrict supply alone may not be effective.

Diversification is simple in principle and difficult in practice. In many instances, it is synonymous with broad efforts to promote agricultural development -- not a simple task.

In such cases international agreement to restrict supply is important primarily as a means to assure that independent action by one country does not result only in a reduction in its export share, with no impact on aggregate supply or price. Agreements aimed at raising prices without effective supply restrictions at the national level are doomed to failure. For commodities with demand problems such agreements tend for a time to try to prop the price by artificially adding to demand, through purchases by a buffer stock. These agreements, ostensibly designed to stabilize price but really to raise it, eventually collapse for lack of financing, as unacceptably large funding is needed to continue to add artificially to existing market demand.

Producers of commodities where demand is stagnant need to emphasize measures to stimulate demand. Market research, and development of new uses are important aspects of production and merchandising of most manufacturers which have been inadequately addressed by primary commodity producers.

Finally, demand problems in commodities such as jute can be traced in part to supply and price instability problems relative to synthetic substitutes. Under these circumstances, the remedies should be sought more in improved supply conditions and market development than in the conclusion of international arrangements aimed at restricting supply or artificially increasing demand.

To these direct effects of restricting supply and increasing prices of commodities of importance to developing countries, it is necessary to add the indirect effects. The latter were abundantly evident in the case of oil. It can be argued that the OPEC action to raise the price of oil has hurt the developing world as a whole in two fundamental ways: (a) directly through a deterioration of the terms of trade of all oil importers as well as through the imposition of a financing burden which some have not been able to meet without significant declines in output growth; (b) indirectly, by raising prices of manufacturers and retarding economic growth in developed countries, which in turn reduced purchashing power and adversely affected demand for developing countries exports and hence production levels and GNP growth.

Quite clearly, similar effects will occur if prices of all commodities were raised. While the indirect effects may not be as large as those associated with oil, their cost would have to be subtracted from whatever benefits developing countries experienced from the original supply restrictions.

In sum, the overall effects of restrictive supply arrangements by developing countries producers on the totality of developing countries interests are difficult to estimate. Their effect on individual countries or groups of countries will vary depending on the commodities involved, whether a particular country is a net importer or exporter; if an exporter, whether it is better off through policies which expand its share of the market or policies which maintain shares constant but raise prices; whether a net exporter or importer, by the importance of the indirect effects on its output and trade.

It is also difficult to determine the implications of supply restrictions on developing countries by income groups. Generally, the lower the income, the more the country is dependent on primary commodities for production and exports, simply because industrialization is typically associated with higher per capita income. However, the effects are difficult to predict because many commodities are produced by both high income and low income developing countries - e.g. coffee - Brazil v.s. Ethiopia; copper - Chile v.s. Zaire. Also, some low income countries such as India, are major importers of commodities and raw materials.

It is quite clear however, that supply restriction in some specific commodities could be beneficial to both producers and the developing countries as a whole. Such supply restrictions would tend to be inimical to U.S. economic interests. The probability of divergence of objectives and conflict with developing countries has increased because established producers attitudes have tended to dominate developing countries' views especially in political arenas such as UNCTAD. To promote cohesion among developing countries, producers have exerted pressure to conclude a wide number of agreements, so that the expected benefits can be spread among a number of countries and to provide for compensation to developing country consumers. Organization of a large number of commodity markets has the added advantage for the developing countries that it limits the possibilities of inter-commodity substitution which could occur, if arrangements to restrict supply were concluded for one commodity, e.g., aluminum, and not for a potential substitute such as copper or tin. Thus there is a clear danger that U.S. economic interests as a consumer of raw materials are in direct conflict with U.S. interests in promoting economic development and other foreign policy objectives in developing countries.

C. Commodity Agreements as an Aid Instrument

Developing countries efforts to restrict supply by acting alone are unlikely to succeed in many cases. Thus, their efforts have focussed on organizing agreements with the participation of developed countries as producers and consumers.

Commodity agreements, rarely, if ever, are billed as efforts to raise prices and restrict supply. Their aim is stated to be price stabilization. However, in practice it is quite difficult to ascertain what the long term price trend of a commodity is so as to design commodity arrangements which would tend to stabilize price fluctuations around that trend. This problem is accentuated by the presence of overall inflationary trends in trade, which must be taken into account in designing appropriate price policies for individual commodities. Current demands of developing countries also include indexation which implies stabilizing relative price trends, since it can be assumed that inflation will tend to affect their import prices over time.

Past practice with commodity arrangements is not encouraging. In several instances commodity arrangements have broken down when upward pressure on prices has developed, lending credence to the argument that their basic intent had not been to stabilize but to stabilize along a trend line which was higher than would have occured in the absence of the agreement.

Thus while the emphasis in the developing country rhetoric has traditionally been on stability, the emphasis in practice has been on trying to raise prices. The main question then is simply whether the U.S. and other developed countries should adhere to commodity arrange-ments which are designed to stabilize prices but which frequently would tend to raise them. The question boils down to whether the U.S. and other developed countries wish to use commodity arrangements as an instrument for making resource transfers to the developing countries, since frequently it may not be in their basic economic interests as consumers. A subsidiary question is whether stabilization relative to import prices is acceptable, and the corollary, whether, if import prices were to rise faster than commodity prices, whether to pay the additional cost of indexation.

The basic argument against using commodity arrangements as an aid instrument is on the grounds of efficiency. If commodity prices through internationally agreed supply restrictions are kept at levels higher than would have prevailed otherwise (assuming competitive market conditions) a transfer would occur. However, this transfer would be associated with a misallocation of resources in developing countries and the world as a whole since, if prices are raised above the free market equilibrium level through supply restriction, too few resources are devoted to the production of that particular commodity.

The possibilities for misallocation are accentuated if some indexaction measure relating commodity prices to import prices is used. When everything is changing, it would be a miraculous coincidence if constant relative prices of developing country commodity exports and imports, would coincide with efficiency in developing countries resource utilization.

From the standpoint of the developed countries the transfer of resources involved is equal to the reduced consumer surplus resulting from the higher prices. If they were interested in extending such assistance they could do so through other means which do not involve these inefficiencies.

Against these efficiency arguments several points need to be raised: First, it is clear that competitive market conditions do not prevail in markets for many commodities. Thus, if monopsony imperfections exist, commodity agreements might partly offset them. While this would not necessarily result in reaching a competitive equilibrium solution, a more equitable distribution of benefits between producers and consumers may ensue. Second, aid through commodity arrangements has the advantage as far as the developing countries are concerned that: (a) it is more likely to be additional to other financing, in part because usually it would not require particular budget appropriations, (b) it is of the highest possible quality, since it comes with no strings attached either with respect to the use of the funds or with respect to internal developing country policies. It should be quickly added that these very reasons make aid through commodity agreements unattractive to most developed country donors concerned with developing countries policy and implementation.

The second major drawback to using commodity agreements as an aid instrument is equity. The countries that need aid the most may well end up as net losers, if increased direct and indirect costs are taken into account. It could be argued that since most developing countries produce and export commodities, the IP package would yield benefits to a large number; but this is not enough. The need for foreign transfers varies considerably among developing countries all of which may produce a given commodity. Also, the resource transfer elements in various commodity arrangements with different membership would tend to vary.

Finally it can be argued that resource transfers through commodity agreements result in inequities within the developed consumer countries. The burden for making the transfer falls on consumers indiscriminately and could be regressive.

D. Processing, Foreign Ownership and the Development Link

One of the classic characteristics of underdevelopment has been the existence of a small commodity or raw material based export enclave, often foreign owned or controlled, within a large subsistence agriculture economy, with limited links between the two. In the last two decades developing countries have reduced significantly the importance of foreign ownership and control of commodity and raw material production and exports. Through outright expropriation, as in Chile with copper, Venezuela with oil, Sri Lanka with tea, or through taxes as in Jamaica with bauxite, or other devices, developing countries have tried and usually succeeded in raising their share of total rents obtainable through commodity and raw material production within their borders.

There is little doubt that these developing countries actions have retarded the flow of equity investment to commodity production. There is also little doubt that developing countries as a whole have benefited from having taken over a larger share of the rents obtainable from commodity production that they would have otherwise been. It is a moot point whether their nationalist fervor drove them to overplay their hand in many instances and whether they would have done better overall with a more moderate attitude.

While the question of foreign ownership and control of natural resources exploitation has been at the center of international discussion, less attention has been devoted to the critical question of developing the appropriate linkages between the commodity export producing sector and the rest of the developing countries economy. Even countries which have assumed complete control of production at the primary level have not been able to make significant progress in establishing closer links between the commodity export sector and the rest of their economies through further processing of commodities.

Developing countries are prone to blame MNEs for this problem. In cases where developing countries have assumed control at the primary production level, MNEs may retain control of processing and marketing channels. MNEs may decide that profit maximization dictates the establishment of processing operations in developed countries even if it is less costly to do so in developing countries in order to spread the risk of seizure or punitive taxation on their assets. Developing countries also tend to blame the patterns of tariff escalation in developed countries for providing incentives for processing industries to locate there.

The issues are quite complex and the problems not amenable to easy solutions. Processing industries may well maximize profits by locating near the major market, usually the developed countries, rather than near the raw material supply. Developing countries often do not have the capacity or potential to process commodities at various stages efficiently. Sometimes, development of that capacity can occur slowly and only as part of an overall industrialization process. Finally, tariff escalation is hardly typical only of developed countries. Developing countries are probably much more guilty of excesses in this area. In any case, it is questionable whether tariff escalation alone is an important enough cost factor to affect locational decisions of MNEs.

Significantly more research and analysis as well as feasibility studies are needed to explore the complex factors affecting location decisions for processing activities worldwide. Development involves increasing the value added of production. The processing problem must be addressed within this broad context. However, great care must be exerted to assure that expanding developing countries capacity to process indigenous raw materials does not result in the distortions and inefficiencies that uninhibited and haphazard import substituting industrialization has led to in many developing countries in the past and still plagues a number of them today.

E. The IRB

Against this background of developing countries concerns and problems the U.S. proposal to establish an IRB has been controversial. The IRB, in theory at least, is designed to promote U.S. interests by: (a) expanding supplies of raw materials and helping relieve upward pressures on price resulting from future increases in demand; (b) securing the investments of U.S. and other multinational corporations in raw materials and energy exploitation in developing countries by providing IRB backing against potential expropriation and other non-commercial risks.

In practice it is questionable whether the IRB can achieve its major objective of expanding raw materials supplies by increasing the rate of their exploitation. The basic question is whether it will result in additional resource development, or simply guarantee projects which would have gone forward in its absence. While there is evidence of reluctance of MNCs to invest in LDCs, it is not clear whether this is due to the hostile climate in LDCs, and the fear of expropriation, or to other factors related to the financial problems faced by many LDCs at present in the aftermath of the oil crisis.

On the other hand, a great deal of investment in raw materials and energy is going on at present. The opportunities of developing countries to borrow financial capital in the Eurodollar market have increased tremendously. Developing countries arranging for such credit are often able to combine borrowing with equity participation by MNEs or otherwise to secure the appropriate technology and marketing expertise they need. Thus, they have become less dependent on MNEs alone to provide the technology and financial package required for resource exploitation.[18/]

However, the proposal's major flaw is that it appears so well tailored to serve U.S. and other developed countries economic interests that it has not been considered responsive to developing countries concerns. The U.S. introduced the IRB at Nairobi by arguing that the problem in the world of the future will be posed by inadequate supply and rising demand for commodities. But this is to argue into a deaf ear, since the developing countries tend to view this not as a problem but as a panacea. In practice this attitude may be unjustified for particular countries or

18/ See C. Fred Bergsten, "An Analysis of U.S. Foreign Direct Investment and Policy and Economic Development." AID Discussion Paper #36, Washington, December 1976.

with respect to particular commodities.

But for developing countries already well established in producing and exporting raw materials the IRB would not be attractive since a lower growth in supply simply means they will be able to enjoy higher rents on lower output. And their attitudes have dominated developing countries thinking on this issue for decades. In addition, the IRB, by calling for international arrangements for exploitation of natural resources, flies against the emotion ridden developing country demands for national control over the exploitation of their natural resources. Finally, for a time the IRB was viewed as a U.S. ploy to provide an alternative to the UNCTAD Common Fund proposal.

The IRB proposal thus has tended to be viewed by developing countries with considerable suspicion. While the IRB may be in the best economic interest of the U.S., there is some question as to whether its proposal promoted the U.S. interest in pursuing a dialogue on economic issues important to developing countries.

F. The Common Fund

Developing countries have focused their demands for international action in commodities on the establishment of a Common Fund with an original capitalization of $2 billion, to finance primarily buffer stocks in support of existing or yet to be concluded commodity agreements.

While some of the grounds for U.S. opposition to the establishment of such a Fund are not open to question, others are. First, it is clear that buffer stock arrangements may not be feasible for a variety of commodities of interest to the developing countries. For commodities such as bauxite, phosphates and vegetable oils, buffer stock operations are not easily manageable because of problems with respect to multiple grading. Second, the U.S. argument that financing is not a problem and hence the Fund unnecessary, is only partly correct. Past experience has shown that buffer stocks can be financed from contributions of participants to agreements such as tin or coffee. However, financing costs are an important, if not the paramount problem, in establishing a buffer stock for copper.

Underlying these arguments lies a fundamental mistrust, often justified, of commodity arrangements and developing countries efforts to organize markets. The fear is that the establishment of a Common Fund in support and in advance of a variety of agreements, will lead to the establishment of unworkable arrangements, and that the resources of the Fund would be frittered away on schemes aimed at artifically raising prices in the face of declining or stagnant demand and in the absence of effective control of supply.

There is very limited justification for agreeing to set up a Common Fund of a certain size prior to actual agreement on individual commodities. Difficulties in financing buffer stocks often involve disagreements over the size of the stock needed which disguise basic disagreements over the future range of price 'stabilization'. It makes more sense to set up a Common Fund for any buffer stocks agreed simultaneously with the conclusion of commodity agreements.

It also makes sense that financial resources raised in support of particular commodity arrangements be pooled in a Common Fund simultaneously or ex post. Separate buffer stocks are less economical than a common fund since it can be expected that price movements in the different commodities covered by various agreements will not be completely uniform and at least partly offsetting.

Developing countries' stress of buffer stock financing as the main purpose of the proposed Common Fund, and developed country opposition, has had the unfortunate effect of pushing to the background many of the very real problems developing countries face in the commodity field. Diversification, market development, improving quality and stabilizing supply, increased processing and in some cases increased exploration and resource development are at least as important an objective for a Common Fund as buffer stock financing in addressing the totality of developing country commodity problems.

## IV. Towards a New U.S. Policy on Commodities

The commodity issue will continue to be at the center of discussions with the developing countries in the next several years. It is important that the U.S. play a role of leadership in the ongoing discussions both in order to provide overall leadership to the developed countries and because of its importance as an exporter and consumer of commodities. This will require a change of existing policy to some extent but primarily a recasting of existing policy positions so that they become more responsive to developmental concerns of developing countries.

The first requirement is recognition of the potential conflict of economic interest between the U.S. and developing countries on commodity issues. From this recognition flows the implication that some U.S. economic interests in commodities may be incompatible with the U.S. support of economic development objectives in particular developing countries. In the past the U.S. has tended de facto to assign extremely low priority, to development concerns in formulating its commodity policy. At the same time, an often doctrinaire attachment to free markets may have led the U.S. to missing some opportunities for promoting true stabilization which would have been beneficial to the U.S. as a consumer.

It is tempting to argue that commodity trade and especially commodity agreements should be systematically used an an instrument to raise the amount of concessional U.S. resource transfers to the developing countries. These transfers have declined significantly in real terms during the last decade. However, this would be an erroneous approach primarily because of the world-wide inefficiencies and inequities that would be associated with such a transfer mechanism. Instead a new U.S. policy on commodities should be based on the twin pillars of promoting true stability and free access in world commodity markets, and support of institutions and programs aimed at addressing long term development problems faced by low income countries in the commodity field. The key elements for such a policy are outlined below.

A. Commodity Arrangements

With respect to commodity agreements, a pragmatic case-by-case approach should be continued, since the feasibility and desirability for both the U.S. and other participants for concluding such agreements is likely to vary commodity by commodity. The objective in each case should be price stabilization.

For such a policy to succeed the U.S. should first, abandon its doctrinaire opposition to commodity agreements, in statements, speech announcements and various other signals given to developing countries. The "case-by-case" approach loses its credibility if it is accompanied by numerous statements doubting the wisdom of interfering with the private market process.[19/] The record shows that the U.S. participated in various commodity agreements and that it interferes significantly in its own internal markets. However, this pragmatic approach which has led the U.S. to participate in various agreements is belied by a substantial rhetoric against commodity agreements in general. It is this rhetoric which has in many instances made it difficult to convince developing countries of our intentions to negotiate in good faith towards reaching agreements in particular commodities.

Second, in anticipation of the forthcoming UNCTAD consultations a U.S. government decision should be reached on which set of commodities to try to conclude agreements. This set of commodities would most likely be a subset of the list presented by UNCTAD. The list of commodities should be drawn up on the basis of intensive analyses of the market factors in each commodity, the degree of instability involved, the impact of such instability on both producers and consumers and the beneficiaries from stabilization both in terms of countries and groups within countries.

Third, in the context of commodity negotiations the U.S. and other consuming countries, should obtain assurances from participating producers

19/ See for example the remarks of Assistant Secretary of Treasury Gerald L. Parsky before the Chicago Board of Trade "Agriculture and Commodity Policies: More Government Intervention or Less" Chicago, Ill., June 9, 1976.

for continuing access to raw material supplies. This is a useful quid pro quo both for the U.S. and probably more so for other developed countries which are more dependent than the U.S. on raw material imports. In many respects it is lack of access to raw materials which is more important to developed countries than slightly increased prices, since it is interruption in supplies which is likely to have potentially disruptive effects on developed country economies.

Fourth, stabilization should not be tied to indexing to import prices, because the latter would result in resource misallocation of probably significant magnitude and unknown direction. Adverse balance of payments effects resulting from terms of trade shifts should best be dealt in the context of overall short-term balance of payments assistance to the developing countries through the IMF. To the extent that commodity arrangements reduce price instability and this in turn leads to reduced fluctuations in export earnings, the demands on the IMF Compensatory Financing Facility would be lessened. The IMF facility could then focus on addressing residual earnings fluctuation problems, as well as perhaps be partly modified to address significant short term adverse movements in terms of trade by partly compensating developing countries for changes in import prices.

While the U.S. may be seeking stabilization as the only objective, it runs the risk that some agreements would result in higher prices than may have prevailed in their absence. The actual negotiation of price ranges for stabilization is fraught with great uncertainty in which the outcome based on bargaining between producers and consumers is hard to predict. The U.S. could still pursue some such agreements, along the following guidelines:

(a) If it is likely that agreements will be concluded in any case and result in a higher level of prices, or even worse, in potential loss of U.S. access to supplies without U.S. participation than with it; under these circumstances, organization of a particular market may be better than the alternative of a producers cartel. The range of commodities in which this could occur is limited. Yet, the possibility cannot be completely discounted. A decade ago the likelihood of an effective cartel in oil was also believed to be very small.

(b) If the price levels proposed are within reason, yet perhaps slightly higher than would have otherwise prevailed, U.S. participation may be justified if: 1) the benefits for consumers of price stability offset the costs of higher prices, or 2) if the agreements tend to benefit relatively poorer developing countries and 3) the ultimate beneficiaries within the developing countries were the lower income groups. The latter two criteria could provide a justification for a minor "aid" component when the beneficiaries both in terms of country and income groups are those deserving of assistance consistent with U.S. Government policy under the Foreign Assistance Act.

If these conditions do not prevail, the U.S. should oppose agreements. In doing so it should ally itself with those developing countries whose development interests coincide with those of the U.S., primarily consumers and producers with an interest in expanding their share of the total market.

B. A Common Fund for Commodities

The Common Fund proposal as conceived by developing countries has considerable deficiencies. However, there is a clear need for focusing international attention and mobilizing financial and technical assistance to address various developing countries problems in the commodity field. The U.S. could support the principle of establishing a Common Fund for commodities but with its objectives and manner of operation significantly changed so as to permit it to perform a variety of functions other than buffer stock financing and without any advance commitment with respect to the size of the Fund to be established.

The U.S. could indicate early on in the consultations for the establishment of a Common Fund that it supports an arrangement whereby buffer stocks individually negotiated are linked in the end as part of a Common Fund. The size of buffer stocks established would depend entirely on the requirements of specific commodity arrangements. It is impossible to specify in advance what agreements will be concluded and hence how much financing will be required for this purpose.

The financing for each buffer stock would be individually negotiated among producers and consumers. Financing would be expected to be provided as in the past by developing and developed countries that participate in individual agreements. The total financing thus agreed upon could then be linked and form a part of the Common Fund for commodities.

The financial resources of the Fund could be augmented by additional contributions by developed countries as well as members of OPEC. The objectives of these contributions would be to provide: (1) Technical Assistance for (a) market development and promotion, (b) quality control and stabilization of supply. (2) Technical and financial assistance for the purpose of (a) product diversification in other sectors (b) vertical integration through increased processing of materials in developing countries, (c) exploration and resource development; (3) Financial Assistance for buffer stock financing on an emergency basis in addition to the amounts agreed under individual commodities.

Under such an arrangement, decisions to intervene in particular commodity markets would continue to rest with the participants in individual commodity agreements. Decisions with respect to allocations of the Fund resources contributed by the developed countries and OPEC outside of support of specific commodity arrangements would be shared by developed and developing countries alike. Claims on the Fund's contributed resources for use in support of buffer stock arrangements would have to be weighed by the totality of the Fund membership against other equally valid claims for assistance aimed at other developing countries commodity related problems.

It is not envisaged that the Common Fund would develop its own staff and expertise for the purpose of carrying out the specific assistance functions discussed above. Rather, it should use available expertise and technical resources of existing international institutions such as the IBRD and the various U.N. specialized Agencies.

It could be argued that the fund will not result in additional financing and that if it is to operate through existing institutions, it might be better simply to enlarge the capacity of these institutions. Additionality is difficult to prove or disprove. The main justification for setting up a new Fund is to mobilize and focus attention to commodity problems, something which could not be achieved as effectively through existing institutions which have responsibility for promoting a variety of development objectives. The establishment of a properly functioning Fund would also be a major political gesture to developing countries in an area in which they have expressed strong interest.

There is no particular size for such a Fund in the abstract. It could aim at contributions of $1 billion plus whatever is negotiated for individual buffer stocks in support of individual commodity agreements. The terms of such assistance would vary deperding on the financial capacity of the recipient. Provisions could also be made for periodical replenishment similar to those of IDA.

The mixture of assistance instruments and buffer stock financing would vary commodity by commodity. Resources of the Fund need not be allocated in support of particular commodity agreements, but be reserved to assist developing countries on commodities in which no stabilizing agreements have been concluded. Buffer stock financing would be operated separately but integrated with different aspects of other assistance making different packages of instruments for individual commodities.

Finally, the U.S. efforts to promote the IRB should probably be abandoned. To the extent that there are residual problems related to insufficient resource exploitation in LDCs because of insecurity in MNEs investment in these countries these could be addressed in a variety of alternative ways. The successful negotiation of a code of investment for MNEs would provide an overall umbrella for protection of MNEs making the specific guarantees associated with IRB unnecessary. In addition, the objective of promotion of resource development by those developing countries that seek it can usefully be pursued within the context of the new Common Fund, or under existing arrangements involving co-financing by the private sector and International Financial Institutions, such as the World Bank.

In summary, the above set of proposals is designed to address both the basic U.S. economic interests in commodity trade and the promotion of economic development. By continuing to emphasize stability, access and expansion of supply and resisting restrictive agreements, the U.S. would be pursuing its basic economic objectives. By supporting a Common Fund grounded on development needs and participating in some useful commodity agreements, it would be assisting legitimate developing countries objectives.

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