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Article — Digitized Version

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Intereconomics

Suggested Citation: Ahmad, Jaleel (1985) : Commodity price stabilization and the developing countries, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 20, Iss. 6, pp. 284-287,
<https://doi.org/10.1007/BF02925469>

This Version is available at:

<https://hdl.handle.net/10419/140000>

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Commodity Price Stabilization and the Developing Countries

by Jaleel Ahmad, Montreal*

Discussions on the development problems of commodity producing countries have been dominated by proposals for stabilizing world prices of commodities, in particular via the establishment of a "Common Fund" within the framework of UNCTAD's Integrated Program for Commodities. Professor Ahmad argues that price instability is, however, merely a symptom of other, underlying problems, and outlines the implications of this for development policy.

The most comprehensive and ambitious of the proposals for stabilizing world prices of commodities mainly exported by the developing countries is the Integrated Program for Commodities adopted at the 1976 session of the United Nations Conference on Trade and Development (UNCTAD) in Nairobi, which has been the focus of attention since then. The key proposal – the establishment of a "Common Fund" to finance the resources required to fund the various international commodity agreements – was again the center of attention at the sixth session of UNCTAD in Belgrade in June 1983. While the commodity program has given rise to much controversy, its presumed benefits to the producing developing countries are almost always regarded as self-evident, requiring no further debate. In fact, the majority of writing on the subject, both official and academic, is devoid of any critical assessment of the Program's likely consequences for economic growth and structural change in the developing world. The priority given to the problem of the variability of commodity prices on world markets has tended to focus attention exclusively on the very short run, and has thus precluded consideration of more fundamental macro-economic and sectoral implications of the program. The major weakness of the program in its present form is a total lack of attention to its long-run consequences for allocation of resources and future economic growth. When viewed in the light of its probable long-run consequences the commodity price stabilization program may in fact turn out to be no more than a particularly costly error.

The commodity program seems to have a great intuitive appeal to certain countries and international agencies because of the erratic and often extreme fluctuations in world prices of primary commodities and the consequent periodic deterioration in developing

countries' barter terms-of-trade. Price stabilization by reducing or eliminating planning uncertainties for producers, it is argued, will not only stabilize their current earnings but also raise the level of investment and employment in commodity sectors. However, the basic assumptions underlying the program and its implications for future growth need to be critically examined. The program contains major flaws in the diagnosis of the commodity problem in developing countries, which considerably weaken its case. These basic difficulties and their various implications are examined below.

While the undesirable short-run effects of erratic price variability are clear enough, it is misleading to suggest that they are the major problem that besets the commodity producing countries. Repeated statistical investigations have neither confirmed nor contradicted a strong inference of prolonged deterioration of terms-of-trade against commodities (or, for that matter, against manufactures) in world trade.¹ What the statistical series do reveal is that any trend toward deterioration or improvement of terms-of-trade is either extremely weak or is quickly reversed. Moreover, over the long haul, price fluctuations *per se* seem to have no excessively adverse impact either on investment or on the level of economic activity. What negative evidence there is indicates that these effects have been negligible.

The undesirable macroeconomic consequences of price instability and the extreme specialization in a few commodity sectors for export are not unconnected. The real problem is low earnings from a limited number of export commodities, which in itself is the result of past

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¹ Cf., for instance, J. Spraos: The Statistical Debate on the Net Barter Terms of Trade Between Primary Commodities and Manufactures, in: Economic Journal, Vol. 90, March 1980; and I. B. Kravis and R. E. Lipsey: Prices and Terms of Trade for Developed Country Exports of Manufactured Goods, NBER Working Paper No. 774, Cambridge, Mass. 1982.

failures in orienting domestic production to changing economic conditions. Price instability in world markets simply magnifies the underlying instability caused by extreme concentration in commodity production. The dependence of economic growth in the majority of developing countries on a narrow range of commodity exports is both the principal manifestation as well as the major contributor to economic underdevelopment. Its adverse consequences are all too familiar and need not be repeated at this point. But two of its critical implications are particularly relevant here.

Commodity Composition of Exports

First, far from being the prime cause of underdevelopment, the extreme vulnerability to even minor cyclical fluctuations in commodity prices is merely the most obvious symptom of underdevelopment whose causes lie somewhere else. Therefore, the basic assumption underlying the UNCTAD commodity program – that improving barter terms-of-trade is tantamount to improving the growth prospects – is simplistic. Terms-of-trade which influence the real national income are relevant to economies which have solved their basic structural problems and have built self-sustaining, pluralistic mechanisms for economic growth. In developing countries, the direction of the terms-of-trade is less relevant for future growth than the commodity composition of exports. It is not too difficult to conceive of a situation in which a country may continue to have stable or even improving terms-of-trade without any of the changes in production structures which are essential for growth. In reality, terms-of-trade changes alone without major structural shifts in the composition of production and exports are unlikely to generate or sustain meaningful economic development in countries where the major policy task consists in nullifying the dead-weight loss of exporting raw materials for processing abroad. The institutional and highly organized attempts to preserve the stability of the terms-of-trade, of the kind envisaged in the Integrated Commodity Program, can only distort the future movement of resources and hence retard economic growth. Therefore, a direct assault on the fundamental causes of instability through bringing about desirable changes in the patterns of production and trade may prove to be more effective.

Second, as long as primary commodities continue to dominate the pattern of production and exports, it is difficult to visualize any significant change in the profitability of non-commodity production, and hence in the overall prospect of growth. What is more likely is that commodity price stabilization (and possibly indexation

to some composite price index of manufactures) will have a further negative impact on the viability and future growth of processing and allied manufacturing activities by drawing resources of labor and capital away from the latter. The resource-pull effect of commodity price stabilization is, therefore, inimical to the process of economic diversification and can only lead to further fragmentation of economic structures.² The initiation and development of primary processing activities is an essential link in the transformation of primary producing countries into more diversified economies. The commodity price stabilization program, despite its possible short-run gains in current incomes, effectively paralyzes that link by softening the incentives to diversify. If this link is to be preserved and utilized, purely financial measures for dealing with temporary instability in export earnings, such as the IMF Compensatory Financing Facility and to a lesser extent the EC's Stabex schemes, are preferable in so far as they are not contingent on the maintenance of any particular production structure.

The primary issue is whether commodity price stabilization in the long run is likely to lead to a reduction in the profitability of processing of raw materials before exporting. Since price stabilization, if successful, is likely to increase the profitability of, and hence the demand for, factors in commodity sectors, the latter will be able to preempt productive resources from other sectors. This resource movement in the face of overall shortage of productive factors, particularly capital, is likely to work to the detriment of processing activities which are still in rudimentary stages of development. Thus, the resource movement effect of commodity price stabilization (and indexation) has a strong presumption for a negative impact on the viability and future growth of non-commodity sectors. While the lessening of production risks may confer short-run gains in consumption to owners of capital and labor in commodity producing sectors, it will generate stronger incentives not only to maintain but actually to increase the level of investment in commodity sectors, and thus aggravate the already lop-sided concentration of resources in a few sectors.³ The future growth of the economy would again come to depend more than ever on the commodity sectors alone.

² For a theoretical discussion of the resource-pull effects in the context of a two-sector model, see Jaleel Ahmad: *Commodity Prices, Indexation, and Structural Changes*, Department of Economics, Concordia University, Montreal, March 1983 (mimeo).

³ The inducements to potential increases in supply are likely to put intolerable strains on the limited resources of the Common Fund. Eventually, the buffer stock agency would run out of resources and price intervention will have to be abandoned.

Importance of Processing Industries

The extent to which various commodities are processed before they enter international trade varies considerably from commodity to commodity and from country to country. But it is clear that a very large proportion of developing countries' exports of commodities are in an unprocessed form. Despite modest progress in recent years, particularly in cocoa, oil-seeds and iron, the proportion of major commodities exported from developing countries in unprocessed form is over 60 per cent. Consequently, the potential for upgrading the stage of domestic processing before export is quite large. This is not to suggest that all primary commodity producing countries should or could establish processing industries on any significant scale, but it does suggest a radically different orientation to the problem of commodities. The plausibility of this alternative orientation is enhanced by further considerations discussed below.

First, processing of commodities before they are exported would add to producer countries' share of value-added in the gross value of final product, and thus increase the employment of domestic resources at possibly higher levels of earnings. The cost of bauxite mining, for instance, accounts for only ten per cent of the final cost of aluminum; refining the bauxite into alumina adds another twenty-five per cent to the final cost. Second, domestic processing before export would also increase total export earnings and have a favorable impact on the balance of payments, since the foreign currency equivalent of higher value-added exports would also be higher. Third, in a number of significant cases, processing activities are in fact relatively more labor-intensive per unit of output than primary production (e.g., production of alumina versus bauxite mining). Hence, the development of processing activities may be preferable also from the point of view of increasing the labor employment. Given the relatively abundant labor resources in most developing countries, their international comparative advantage would seem to lie in the early stages of processing rather than in producing larger quantities of raw materials which are frequently not only capital-intensive but also require lump investments.

The expectation that earnings from commodity sectors can be transferred effortlessly to non-commodity sectors – an expectation that is implicit in the "second window" provision of the UNCTAD Integrated Commodity Program – is always unrealistic, particularly when export earnings from commodities are not only high but rising. Several factors tend to make such a transition impracticable. First, this transition

presupposes that industrial infrastructures are fairly well-developed, and are capable of utilizing the potential investible resources. Second, market forces in resource-based poor countries tend to perpetuate their primary orientation, unless economic incentives are altered to arrest their momentum. Third, when export earnings from commodity sectors are high and rising, powerful vested interests among producers (e.g. *Latifundia*), land-owning absentee proprietors, and revenue-earning government agencies (at various levels) tend to build up in order to resist any curtailment of the flow of capital and other resources to commodity producing sectors. It then becomes difficult to resist the pressure to continually raise the level of investment in commodity producing sectors in the expectation of rising exportable surpluses and higher earnings. The history of international commodity agreements is replete with examples where efforts to maintain prices have resulted in rapid increases in world supply through the influx of new producers.⁴

A commodity price strategy which is contingent on maintaining a particular structure of production, such as the UNCTAD commodity program, is bound to be inherently unstable. With its built-in bias toward excess capacity and over-production, the commodity program is likely to further deteriorate the prospects of meaningful economic growth in developing countries. If primary exporters were able to initiate viable programs for extending the chain of processing their raw materials before exporting, the need for unrealistic and costly international agreements for stabilizing (and indexing) prices would become unnecessary. An alternative international effort designed to further the processing of raw materials in the country of their origin (given cost considerations relating to proximity to consuming markets) would not only be a more lucrative way of augmenting earnings from exports but would also provide a more stable foundation for the improvement of terms-of-trade. The development of processing capacity on any significant scale in the developing countries is, of course, likely to be hindered by the existence of escalating tariffs in consuming countries. However, international agreement to remove the worst features of escalating tariffs which discriminate against the import of processed goods would have a higher potential payoff than costly buffer stock arrangements. In any event, a careful development of processing activities in promising sectors can be expected to evolve into successively higher levels of competitiveness as they begin to acquire a momentum of their own through

⁴ Cf. Arthur Lewis: *The Evolution of the International Economic Order*, Princeton University Press, 1977.

interindustry repercussions and scale economies. If so, it would be difficult to resist comparative advantage.

The processing orientation of the commodity problem spelled out above does not rule out specific price support schemes for dealing with a small number of specific commodities, thereby enhancing their workability. However, this requires that the prime cause of price variability in each case be carefully determined.

Alternatives to Common Fund

Price instability of individual commodities may arise from variations either in demand or in supply, or often through a complex cobweb cycle whose oscillations are governed by both supply and demand. Lumping diverse commodities under the umbrella of a common fund is unlikely to eliminate the problem caused by the asymmetry in the origin of price fluctuations. A comprehensive set of interventions to deal with all possible sources of instability, even if it can be designed, will enormously increase the financial requirements of the common fund. It should also be noted that price stabilization does not always result in income stabilization.

If fluctuations in particular commodity prices are deemed undesirable, the correct policy would call for diversification of exports (and hence, production), at least partially toward products with lesser fluctuations or with fluctuations that are not synchronized. In a number of cases, an export quota or a tariff jointly levied by major producing countries would be preferable since it would improve the terms-of-trade without an influx of new resources and a consequent tendency toward over-production.⁵ This is because a quota (or an export tax) would raise world prices without raising producer prices. The terms-of-trade effects of buffer stocks and quotas are often identical but the two alternatives have quite different implications for resource movements and for the composition of future output.⁶ Buffer stock operations, of the kind envisaged in the UNCTAD program, are likely to lead to a further concentration of productive resources in commodity sectors. Consequently, diversification toward non-commodity sectors, such as processing, would become progressively weaker, and the economy increasingly dependent on primary exports. An export quota (or tariff), by contrast, does not adversely affect the

profitability of resource use in other traded and non-traded sectors and, therefore, does not have a contractionary effect on employment and output in those sectors.

In conclusion, the basic flaw of the commodity program as presently conceived is its inherent conflict with long-run economic growth. The combination of buffer stocks with price stabilization for exporting unprocessed commodities at agreed prices will only magnify the original problem, i.e. the inability to alter the composition of exports in response to changes in demand and supply. The price stabilization program may be likened to taking out an insurance against a doubtful risk whose premiums are more onerous than the loss which it is supposed to indemnify.

Policy Implications

The purpose of this paper is not to advance an alternative proposal for dealing with the commodity problem. Nor is there enough space here for a detailed critique of the current proposals. However, the converse perspective on commodity export prices presented in these pages does suggest a number of policy implications that are different from those currently being considered. In my view, any international action for relieving the problem caused by the variability of commodity prices must effectively deal with the underlying sources of instability. It must deal practicably with the need to provide incentives for economic reforms that will redirect future development on its correct path, even if it cannot eliminate all sources of disequilibrium. First, the Common Fund proposal should be replaced by an international program designed to develop and enhance the raw material processing capacity in the developing world. Second, the practical possibility of implementing export quotas or tariffs by major producers of selected commodities should be seriously examined. Third, concerted efforts to increase the scope and to liberalize the support conditions of the IMF Compensatory Financing Facility should be undertaken. Fourth, special efforts through existing international institutions should be made to remove prohibitive levies and quantitative ceilings on tropical products and other agricultural goods exported by developing countries. Finally, there is some room for international commodity agreements in the case of individual commodities where price instability is primarily demand-oriented and if price stabilization over the length of a business cycle is likely to be self-financing. By having a multi-pronged strategy, effective means can be devised to deal with peculiar problems that beset individual commodities.

⁵ For an empirical estimation of the differential effects of buffer stocks and quotas with respect to commodity exports of the Ivory Coast and Kenya, see H. Dick, S. Gupta, T. Mayer, and D. Vincent: *Indexation of UNCTAD Core Commodity Prices by Buffer Stocks or Export Quotas? A Comparison of the Benefits for Two Developing Economies*, in: *Journal of Development Economics*, Vol. 11, No. 3, December 1982.

⁶ For a theoretical discussion, cf. Jaleel Ahmad, op. cit.