

## COMMODITY PRICES: INVESTING IN DECLINE?

*Until recently primary product prices were, in real terms, lower than at any time in the twentieth century, with the possible exception of 1932. The weakness of commodity prices in the 1980s has added new fuel to arguments about the long-term prospects for primary products exported by developing countries (ldcs). Instability — fluctuations around the trend — has increased and in the 1980s the trend has been far worse than forecast, relative to other prices. This paper is about the longer-term and asks whether new investments in primary products are likely to offer reasonable rates of return. The 'special case' of petroleum is not considered in this paper; all references to commodities and primary products relate to non-oil products.*

### Price Trends and Prospects — an inexorable decline?

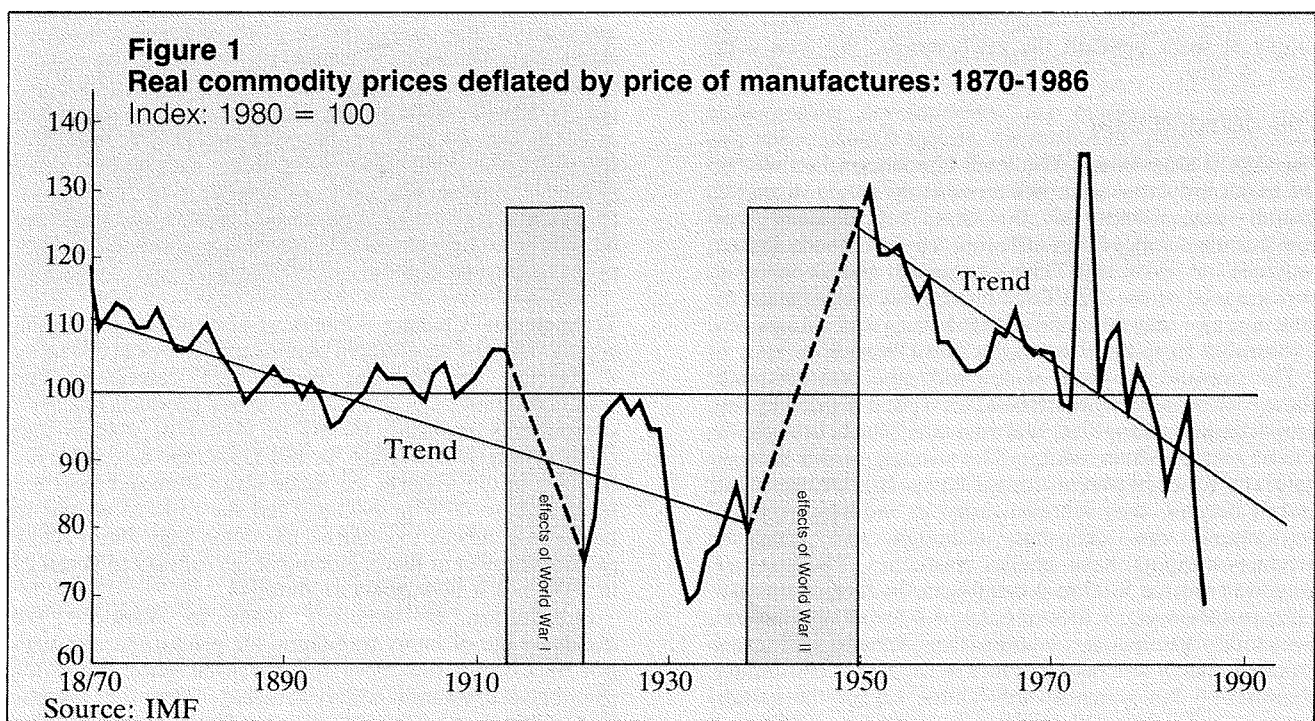
Generalisations about commodity prices are complicated by the fact that the prices do not all move together because they are influenced by rather different supply and demand factors. In recent years, metals and foods have fared particularly badly and agricultural raw materials rather better, while beverages have been wildly unstable. Large differences also occur *within* each product grouping. Composite indices of 'commodity prices' have to be treated with caution, and there are sometimes major deviations from the average. Accurate measurement of long-term changes in real commodity prices is difficult. Changes in a composite index series are much affected by the system of weights chosen. Thus, commodity indices weighted on the basis of industrial country imports (*The Economist*), or on world exports (the IMF), or on ldc exports only (UNCTAD) can give substantially different results. And whichever system is chosen, the weights alter over time, sometimes quite radically, distorting results and necessitating periodic revisions.

Then there have been changes in quality in both primary and manufactured goods. Some — not all — argue that improvements in the quality of manufactured products have been greater and, therefore, that an index of 'real' commodity prices deflated by an index of the prices of manufactures overstates the disadvantages of commodity exporters.

Price indices are, moreover, highly sensitive to movements in the currency in which they are denominated, commonly the US dollar. Here indices denominated in SDRs (based on a weighted average of leading currencies), are generally used, in order to minimise complications created by the fluctuating dollar.

On the other hand, the influences on supply and demand do have some strong common elements, so that there is a considerable degree of convergence in the long-term price experiences of most major primary products. A few years ago commodity prices were widely expected to rise, propelled by the recovery of the OECD countries after 1982. Indeed, early in 1983 the IMF was confident enough to say that 'a broad-based recovery in commodity prices' was under way, and prices did indeed rise in 1983 and 1984. It didn't last, however. In 1984-86 a composite index of prices fell by 23% in nominal terms. In 'real' terms, i.e. deflated by the prices of manufactured exports, the fall was 28%, although it would have been rather smaller for this period had the oil price been included in the deflator. In fact, the weakness of commodity prices in this period puzzled the forecasters. Thus, the annual forecasts of the OECD for 1982-86 were higher than actual outcomes in each of the five years, often by a substantial margin. As it turned out, average real commodity prices were by 1986 the lowest recorded in the twentieth century, with the sole possible exception of 1932, the trough of the Great Depression.

There was some apparent improvement in commodity



prices during 1987 and talk that the long-awaited recovery was at last under way. Much of the seeming recovery was spurious, however — the result of a depreciating dollar. Thus, the IMF's dollar index of commodity prices by November 1987 was 28% above the figure for 12 months earlier but was only up by 14% in SDR terms. It was also misleading because there was a spurt in world prices for manufactures and the Fund estimates that in *real* terms there was actually a 13% fall in 1987, on top of the 16% decline in 1986. There were, moreover, fears that prices would remain weak indefinitely.

Since the early 1950s there has been controversy about the thesis that there is a long term tendency for real primary product prices to deteriorate, first put forward by Singer and Prebisch. The thesis found ready support in ldes but elsewhere their arguments were criticised; statistical studies threw doubt on the existence of such a deteriorating trend; and their viewpoint went out of fashion during the 1970s. However the record of the 1980s has brought it back into vogue again.

While most recent studies show a falling trend for the twentieth century, the rate of decline varies widely depending on how the 1940s are treated and the nature of the statistical tests used. Excluding the 1940s, the data underlying Figure 1 yield an average rate of deterioration in 1900-82 of 1.7% p.a. but other tests reveal a range in trend values, down to a rate of decline of only 0.1% p.a.

The experience of the 1980s has nevertheless added strength and numbers to the pessimistic school. Some have written of the primary products economy having come uncoupled from the industrial economy and others of the 'end of the Era of Materials'. Less cataclysmic but more influentially, the IMF does not foresee any major recovery in commodity prices, expecting them to remain roughly unchanged in real terms in the medium term. On their last detailed projections, by 1991, prices would still be one-third below the 1980 level.

Looking forward to the end of the century, the World Bank expects real commodity prices to remain depressed for the remainder of the 1980s, to revive somewhat in 1990-95 and then to stagnate to the year 2000. By that year they expect the overall index to be 8% above the 1986 nadir but still 25% below the 1980 level. The forecasts just cited, moreover, were prepared before the global stock market crash, with its attendant recessionary risks.

## The Underlying Forces

To be able to take a view about future prospects it is necessary to go to the fundamental forces of demand and supply at work beneath the price trends. We deal with these in turn.

### The demand side

**The OECD Slow-Down.** The level of economic activity in the major industrial countries remains the single strongest overall determinant of the state of demand for commodities. Indeed, its influence on commodity prices provides a powerful link between the economic performance of the OECD countries and the fortunes of ldes; a major way, therefore, that booms and slumps are transmitted from the First to the Third World.

The 'income elasticity of demand' (the proportionate change in the quantity of demand for a good divided by the proportionate change in real incomes which brought it about) measures this linkage. The strength of this linkage naturally varies between product types. It is strongest for metals because they are demanded as industrial inputs. Agricultural raw materials, although also used as production inputs, have smaller elasticities. The smallest however, are for food and beverages. In fact, almost all estimates show elasticities of below 1.0 for all agricultural commodity groups — meaning that demand will grow proportionately less than incomes in the major consuming countries — but generally well above 1.0 for the metals group.

As is shown below, there are reasons for thinking that the size of the elasticities is tending to diminish over time (see also Figure 2). Moreover, the generally small elasticities for most commodities contrast strongly with the elasticities for many manufactured goods and for services. Demand for these latter items hence grows a good deal more rapidly than for commodities and helps to explain the persisting weakness of world primary product prices.

Nevertheless, the level of economic activity in the OECD countries remains a very strong influence; talk of 'decoupling' is much exaggerated. Aside from year-to-year fluctuations, the main fact about OECD growth in recent years is that it has slowed down. Industrial output and capital formation — which have a specially strong influence on demand for commodities — have been particularly affected. The following average annual OECD growth rates summarise the record:

	1970-79	1980-86
Gross National Product	3.3	2.2
Industrial Production	3.4	1.8
Gross Domestic Investment	3.5	2.1

The impact of this deceleration has been severe. UNCTAD studied 19 commodities which have experienced declining demand growth in recent years and found that over three-quarters of this decline was explained by the more sluggish OECD performance. The crucial question for the future is whether the West will return to the more expansionary days of the 1960s and 1970s. The conventional wisdom is that it will not, in which case the outlook for exports of commodities to these countries must be bleak, but the case for accepting the conventional wisdom is not overwhelming.

**Structural Change:** Among the factors tending to reduce income elasticities over time are changes occurring in the patterns of industrial-country demand and production. There is, first, the widely-noted movement away from industrial products in favour of services. Since the latter use far less by way of raw materials, that is bad news for the demand for commodities. In Britain the share of manufacturing in GDP has fallen from 33.4% in 1965, to 29.2% in 1975, to 25.1% in 1985. This is a particularly dramatic fall, partly because of the rise of North Sea oil, but there is a clear tendency for the share of manufacturing in GDP to decline for the industrial world as a whole. Even within manufacturing, changes are occurring which are unfavourable to primary product exporters, with a shift away from the heavy metal-using industries towards electronics. This helps to explain why in Britain the volume of sales of the mechanical engineering sector fell by 3.0% p.a. in 1978-85, while electrical engineering sales expanded at 3.9% p.a. At least in the more prosperous industrial countries, the demand for some items with high primary product contents is said to be nearing saturation, particularly for cars and consumer durables, and there are no significant new markets for consumer goods with a high primary product content.

**Technological Change:** While most of its effects are on the supply side, the accelerated pace of technological change is reinforcing the demand trends just described. The traditional materials content of finished products has been substantially reduced, mainly in favour of plastics and other synthetic materials. In the USA, for example, the fraction of the average car made up of iron and steel fell from 81% to 69% in 1975-85; and the ratio of weight to power in a railway locomotive has fallen from about 100kg per horsepower at the beginning of the century to about 25 in 1950 and is now down to about 14.

Substitution of materials tends to work to the disadvantage of many traditional ldc producers, although not necessarily the more industrialised ones, thus, for example aluminium is widely substituted for other metals. Car engines and metal cans are cases in point. There is also

much substitution of metals by plastics and ceramics; of man-made for natural fibres; of plastics and other materials for paper. Optical fibres are replacing copper in telecommunications (a 45kg length of fibre cable can transmit as much information as a tonne of copper wire).

The development of technologies for the re-cycling of materials is another factor. The increasing use of scrap metal is perhaps the most important instance. Thus, while the steel industry has been in decline worldwide, output from 'minimills', which use scrap as their "raw" material, has been expanding rapidly — at 10% p.a. in the USA. Modern information technology also permits the more efficient monitoring and management of inventory levels, meaning that a smaller quantity of stocks is now needed to maintain a given level of output.

**Agricultural Protectionism:** The high levels of protection enjoyed by agricultural producers in industrial countries, and the intense competition between them leading to large export subsidies and 'price wars', necessarily reduce prices in third markets and place a potent damper on the demand for a number of ldc agricultural commodities.<sup>1</sup> Sugar is the most striking example (see Box). The Japanese market is the most protected, with average agricultural producer prices a full 2.44 times higher than world prices in 1980-82; the ratio in the European Community was 1.54 and in the USA 1.16.

Not surprisingly, these countries have greatly reduced their imports in consequence. Thus, net EC grain trade has changed from net imports of 18m tonnes in 1970-71 to net exports of nearly 16m in 1985-86. While as importers, ldcs benefit from the lower world agricultural prices that result from this protectionism, as exporters they are big losers. A further factor is the escalation of protection according to stage of production, with even higher protective barriers against imports of processed goods, thus discouraging the higher value-added that ldcs could derive by undertaking more processing at home.

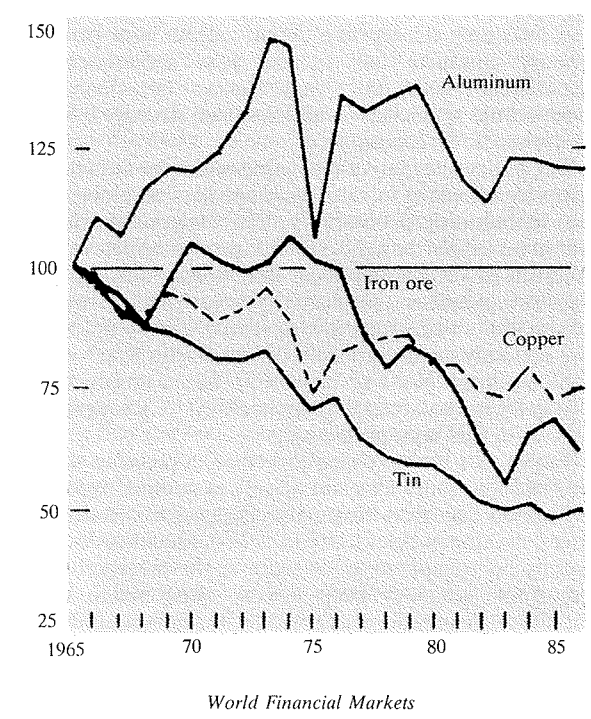
**Other Considerations:** Nor have we quite finished the catalogue of gloom. It might be expected that the fall in relative commodity prices would itself stimulate the demand for these goods. So it does to some extent, but not very greatly. The responsiveness of the quantity demanded to a change in price is measured by the 'price elasticity of demand' (not to be confused with the income elasticity used earlier). With few exceptions, estimates of price elasticities for primary products are well below 1.0. Typically they are in the range 0.4 to 0.6, meaning that a 10% fall in price will (other things being equal) only induce a 4% to 6% increase in demand.

One other explanation that is sometimes offered for the adverse prices received by ldc exporters is that these prices are manipulated by the industrial countries (or transnational corporations) using monopoly power as buyers. This has certainly sometimes occurred. We have already discussed the case of agricultural protectionism. The market for bauxite is dominated by a few giant aluminium producers; and multinationals still dominate the production of some tropical fruits. But as a general explanation, the 'market manipulation' argument is difficult to sustain and the basic fact is that the underlying forces of supply and demand are moving to the disadvantage of ldc commodity exporters.

Various factors thus conspire to dampen the demand of OECD countries for primary products. Changes in the structure of demand and output, technological progress and agricultural protectionism are among the factors that have produced the steep decline in OECD consumption of these commodities relative to incomes illustrated in Figure 2. This is why we suggested earlier that there is a tendency for income elasticities — already low for many items — to

**Figure 2**  
**World consumption of commodities**  
**per unit of GNP**

Index: 1965 = 100



decline. But while this decline in elasticities does weaken the link between OECD levels of activity and demand for primary products, that link remains powerful enough to mean that the slower OECD growth of recent years has compounded the weakness of demand.

### The supply side

**The Tendency to Over-Supply:** With prices drifting down, why does this not bring about a correction by discouraging production? One explanation is that there are strong pressures on ldcs to increase their production of primary products. The acute balance of payments pressure experienced by many of the exporting countries is one of the most potent. The world economic environment has become much less favourable for most ldcs during the last 15 years. Many of them have run into acute shortages of foreign exchange owing to both deteriorating balances of payments and burgeoning debt service obligations. 'Adjustment' programmes have been widely adopted, often in conjunction with the IMF and World Bank, and these have generally advised a strategy of export promotion. At the same time, avenues for the promotion of non-primary exports have been narrowed by increased protectionism in the OECD countries and by the successes of some of the early 'newly-industrialising countries'.

Faced with such a dilemma, an ldc government may regard the promotion of commodity exports as still the best option available to it, as indeed it might be were other governments not simultaneously making similar decisions. Thus, the Fund and Bank have been criticised for committing a 'fallacy of composition' by encouraging many individual ldcs into an essentially self-defeating process of export-led competitive adjustment (of which devaluation is a common ingredient). Their reply is that they are now paying more attention to food production and import substitution — and to ask, in any case, what else can they do in present-day conditions? Whatever the answer to that, balance of payments adjustment pressures surely help to explain the observed tendency to over-supply. And there remains a danger that ldcs seeking to adjust through the

1. For a fuller discussion of this topic in relation to the EEC see the June 1986 *Briefing Paper*, 'The CAP and its impact on the Third World'.

promotion of traditional exports are investing in decline.

A further factor helping to explain the downward movement of prices is that typically price elasticities of *supply* for primary products are small, especially in the short run. This means that even a small fall in demand will induce a large fall in price. In the short run the response of supplies to a fall in demand may be negligible, so that all the burden falls on prices. Estimates of short-term supply elasticities produce results of near-zero for the mining industries and values of 0.2 to 0.4 for other commodity groups. Even long-term elasticities are well below 1.0, generally in the range 0.3 to 0.8. For many products the time lags are lengthy and one of the factors in the commodities slump of the 1980s has been the delayed response of supply to good prices enjoyed in the mid- and later-1970s.

**The Biotech Revolution:** Just as technological advances are affecting the demand for commodities, so developments in biotechnology are also threatening the competitiveness of traditional ldc producers. Two different techniques are being developed which between them may revolutionise farming. *Tissue culture* allows tissues and individual cells to be isolated and bred into whole plants, enormously accelerating the breeding of new varieties and hence greatly enlarging the possibilities of incorporating desirable characteristics such as disease resistance. *Genetic engineering* appears to offer even greater possibilities, for it enables a breeder to isolate desired genetic characteristics from one cell and incorporate them in another, opening up the possibility of changing the genetic characteristics of living matter.

Unilever has used tissue culture to reduce the time necessary to develop oil palm varieties to one-thirtieth of the previous time; the results have already raised average yields from new trees by 30%; the expectation is that it will not be too long before yields are two to six times those obtained by older varieties, threatening the position of traditional cultivators and the producers of rival vegetable oil crops such as groundnuts and coconuts. Second, an American chemical firm has finished the first trials of a 'supertomato' which has resistance to parasites, viruses and herbicides built into it. It should soon be possible to extend these characteristics to tobacco, sugar beet and others.

One difficulty for ldc producers in these developments is that almost all biotech research is being conducted in the industrial countries, much of it now by private companies, so that a significant agricultural technology gap is opening up. With commercially-developed advances being subjected to the restrictions of patent laws, there is a danger that most commercial applications will arise in the industrial countries or be applied by multinationals based in them. It is already a feature of these developments that they rely for their commercial exploitation on very sophisticated methods of farming.

Relatedly, there is now the possibility of crops grown in the tropics being replaced by the output of factories in the West. See Box on sugar for one example. Cocoa butter is another product currently being researched for factory production, as are tobacco and pyrethrum. The Soviet Union as well as Western European countries are busy developing a technique for producing protein from a petroleum base for animal feeds in factories to replace imports of soya beans, fish meal and cassava from various ldc.

For those countries able to take advantage of these biotech advances there are large potential benefits to be secured from the higher productivities and lower costs. From the ldc viewpoint the dangers are that a high proportion of the applications will occur within, or to the benefit of, the industrial countries and that traditional producers which cannot keep pace with the technological advances will find themselves unable to compete, with devastating effects on their export earnings and economic prospects.

## It's all been happening to sugar

Although the sugar market has many peculiarities of its own, including privileged access to EEC, US and USSR markets for certain ldc cane producers, trends in world sugar supply and demand encapsulate in a single market much of what has been happening to ldc primary product exports in general. Consider the following:

**Prices:** The real price of sugar on the free market was lower in 1985 than at any time since the statistical series began in 1950 and only a fraction of the average for the period as a whole. This price is also one of the most volatile in the world, since most sugar is not traded on the open market and the 'world market' is effectively a residual market — a volatility illustrated by the fact that there was a no less than 30% rise in the world price during 1987.

**Demand and Trade Growth:** Income elasticities in the industrial countries are low, averaging only 0.2 for most industrial countries over the last 15 years, and are falling, so that they now approach zero in European and North American countries. Future industrial-country demand for sugar is therefore expected by the World Bank to grow at under 1% p.a., but this will be partly compensated by demand in ldc's growing at over 2%. Free market exports are expected to grow at only about 2%, and no substantial increase in the ratio of trade to production is expected. Within industrial countries, there have been structural shifts in demand, in favour of low-calorie high-intensity sweeteners such as saccharine and aspartame, which are up to 400 times as sweet as sugar. Industrial demand is substituting for sugar the recently-developed high fructose corn syrup (HFCS). Most cola drinks in North America, for instance, are now sweetened with HFCS.

**Technological Change:** HFCS is a product of the biotech revolution described in the main paper. It is extracted from corn by new enzyme techniques and modified in such a way as to be interchangeable with sugar in many of its uses. Other high-intensity sweeteners, biotechnologically produced in factories, have been or are currently being developed, including aspartame, acesulfame-k and thaumatin. Less recent and less high-tech were the advances in cultivation and processing techniques which substantially reduced the cost disadvantages of beet sugar grown in the temperate countries, even though such production is still only profitable behind high protective barriers. In consequence, there was a major upsurge in beet sugar output in the 1960s and 1970s which greatly reduced imports from ldc producers and turned the EEC from a net importer into a major exporter.

**Trade Protectionism:** Beet production has long taken place behind a high protective wall — high even by the standards of agricultural protection in the OECD countries. Thus, in 1984/85 sugar production subsidies as a proportion of the value of sales were 142% in the EEC, 84% in Japan and 140% in the U.S.A. Ldc producers have also been particularly heavy protectors of their sugar industries. Little wonder, then, that UNCTAD simulations show that among ldc commodity exports cane sugar producers would be far and away the biggest beneficiaries from trade liberalisation.

## Consequences

While it is obvious that the adverse trends described above will harm the economic prospects of commodity-exporting ldc's, it is necessary to trace the changing pattern of world trade in order to identify the consequences in more detail. Here it is important to recall that we are confining ourselves to *non-oil* commodities.

### The changing pattern of trade

Primary products make up a diminishing proportion of world trade; their share of world merchandise exports fell from 30% in 1966-67 to 17% in 1983-84. Within the primary products grouping, the share of food rose somewhat over the same period at the expense of agricultural raw materials, while minerals and metals roughly maintained their share.

The proportion of commodity exports produced by ldc's has also declined. Between 1966-67 and 1983-84 the share of ldc's in commodity exports fell from 33.9% to 30.3%, with a rather greater increase by the developed countries and a decline by Eastern European countries. Among developing countries, Asia has had the best export performance, having slightly increased its market share; the performance of Africa has been particularly weak, with a decline from 8.8% to 4.9% of world exports during 1966/67-1983/84, partly reflecting the stagnation of agriculture in many African countries during the period.

A rising proportion of raw materials produced in developing countries is being processed prior to export, so that the statistics on (unprocessed) commodity trade somewhat understate the value of this trade to ldc's; there were major increases in proportions processed in ldc's between the early 1960s and early 1980s for such items as cocoa, bauxite, phosphate rock and tin, and a general shift in metals production from industrial to developing countries. This development helps to explain the decline that is occurring in the importance of primary products in total ldc exports. Between 1973 and 1985 the share of commodities in total ldc exports fell from 38% to 21%, while the contribution of manufactured exports went up from 22% to 34%. Asia was particularly successful also in this expansion of industrial exports. Nevertheless, commodity exports remain crucially important for many ldc's, as the table illustrates.

**Table 1: Developing Country Dependence on Primary Product Exports 1982-84**  
average numbers of countries and percentages

Primary product exports as % of total exports	all ldcs	low-income ldcs
Above 75%	48 (33%)	21 (47%)
50-75%	36 (25%)	11 (24%)
25-50%	24 (17%)	9 (20%)
below 25%	37 (26%)	4 (9%)
Totals	145 (100%)	45 (100%)

Source: UNCTAD

At the same time, the proportion of commodities entering ldc's as imports has been increasing, from 15% in 1973 to 21% in 1985. Indeed, the Third World has been the most rapidly expanding market for commodities; and there has been a major expansion in this type of south-south trade. And while observers in prosperous industrial countries may talk of a satiation of demand for metal-intensive consumer durables the potential demand for such goods in Asia and elsewhere remains enormous. Increased South-South trade is probably an important way in which commodity markets will develop in future.

### Balance of payments effects

Given the wide variations in the importance of commodities in developing-country exports, the influence

on them of the price trends discussed earlier has similarly differed greatly between countries, and it is easy to exaggerate the overall impact. According to one estimate, for example, for oil-importing ldc's as a whole, a 10% decline in real commodity prices only results, on average, in a 3% worsening in their overall terms of trade (an index of the prices of all their exports relative to the prices of all their imports). Country-level studies find great differences and emphasise the dangers of broad generalisations. It is agreed, however, that the impact on the low-income ldc's is disproportionately severe because of their particular dependence on primary products.

While it is difficult to calculate exactly, the magnitude of losses from the price falls of the 1980s has undoubtedly been great. Controversial UNCTAD estimates for all ldc's show a total loss in 1981-86 of \$42 *billions* when compared with average prices in 1979-80 — an amount equivalent to 40% of their commodity earnings in the initial period. For the least developed the situation was even worse, with losses equivalent to 75% of annual 1979-80 earnings. These figures probably exaggerate the true loss, but nobody disputes that the total cost has been very high.

In fact, the adverse price trend goes far to explain the worsening in ldc balance of payments deficits in the 1980s, as well as the emergence of the debt problem. Particularly for the countries of Africa and Latin America, shortages of foreign exchange — partly the result of commodity price trends — have become the chief obstacles to resumed economic growth and development. Indeed, there have been major income falls in both regions. The deteriorating payments position has starved local industries of imported inputs and contributed directly to falling living standards; it has curtailed investment because of inability to import capital goods; it has reduced government revenues and exacerbated budgetary problems; it has depressed economic activity and employment. This situation and the need for associated adjustment programmes have imposed major economic and social costs, not least upon the poor.<sup>2</sup>

Policies which were able to reverse the downward drift of commodity prices would similarly add to ldc's import capacities and thus help them to escape the foreign exchange constraint. Amex Bank has estimated, for example, that a return of prices simply to what they describe as the long-run average would raise import capacity by nearly a fifth.

### Implications for ldc policies

How ought ldc exporters respond to the situation described in this paper? Firmly-based policy choices are near-impossible in the face of the great uncertainties with which ldc's are confronted. Future structural change and growth in the OECD economies, and the pace and effects of technological developments, are particularly important and unpredictable factors. Nevertheless, policy decisions do have to be made and the key choice is about the extent to which it is prudent to invest major new resources in traditional export commodities. Governments and potential investors will note that there is an absence of optimism among the forecasters. There is still much scope for substitution away from traditional materials, e.g. of ceramics for metals in engines. There remains a tendency to over-investment in mining and the metals industries. Many of these industries survive economically by treating past investments as 'sunk costs' and thus do not require revenues to cover these costs and yield a return upon them, whereas new investments cannot be made on that basis. The northern-based biotech revolution may bring important shifts in the global distribution of comparative advantage in agricultural products, to the disadvantage of the south.

Investment decisions on these matters tend to be made atomistically, by individual investors or governments who do not take into account decisions in other countries about

2. See ODI *Briefing Paper*, 'Adjusting to recession: will the poor recover?' [November 1986, revised February 1988].

investments in the same range of products. Balance of payments and adjustment pressures push each of them hard in favour of expanding capacity, with an aggregate effect on supply and thus price which prevent these investments from yielding adequate returns. Thus, the aggregated effect of the World Bank's country and project desk officers' assumptions about output and prices for primary products has in the past sometimes been inconsistent with the view taken by the Bank's commodities specialists — and has been strongly biased in an optimistic direction.

One policy alternative is to compensate for unfavourable prices by measures to raise productivities and lower costs, thus maintaining profitability. The danger, of course, is that many of the benefits of high productivities would be reflected in yet lower prices, thus raising once again the question whether productivity-improving investments would offer an adequate rate of return. On the other hand, ldc's certainly cannot afford to allow all the R&D work to be done in the West or in western-based multinationals, especially in the area of biotechnology. A stronger set of policies in this area is needed.

Taking this line of thought further, a possible strategy, for products where ldc's and dc's are in competition, would be for ldc exporters to pursue aggressive cost-reducing, price-lowering policies to try to out-compete the dc's, as has already been happening for some of the metals. It is also important that ldc's keep a very close watch on the important economic changes now being initiated in the Soviet Union and other centrally planned countries, and seek to influence the design of the reforms so as to create new trade openings for themselves. The potential additional demand, especially for the products of tropical agriculture, remains great in most of these countries.

Decisions whether or not to invest in new (or rehabilitated) commodities capacity can only, of course, be taken in the light of what alternatives might be available. To simplify, three broad possibilities can be identified: to diversify exports from traditional into 'new' primary products; to diversify exports out of unprocessed commodities altogether, concentrating instead on manufactures and services (including tourism, and the processing of products previously exported as primaries) and to concentrate more on import-substitution, including the promotion of greater food self-sufficiency. These are not, of course, mutually exclusive but it is significant that the 1987 Geneva UNCTAD VII conference took a gloomy view of medium-term prospects for commodity prices and placed some stress on the "horizontal and vertical diversification of (ldc) economies, as well as increased participation in the processing, marketing and distribution, including transportation, of their commodities..."

The range of realistic options is greater for some ldc's than others, however, and the 'best' policies will vary from case to case. As a broad generalisation, ldc's which already have some established manufacturing base have considerably more room for manoeuvre than countries whose output remains strongly based on agriculture and mining. And large countries generally face less acute difficulties than small ones, if only because the balance of payments gap is smaller relative to total economic activity. Those in the most unenviable position are the least developed countries with, typically, little of an industrial base and strictly limited scope for import-substituting manufacturing. As noted above, technological dependence on the north, and on northern-based companies, is a further factor limiting the room for manoeuvre, particularly in agriculture.

There should be scope too for measures to expand south-south trade in commodities. As mentioned earlier, developing countries have already emerged as the most

rapidly expanding market for metals and some other products and there is considerable scope for further expansion. There are also formidable obstacles, however. One of these is the high levels of protection which ldc's often afford their own farmers. Another is the inadequacy of the supporting international infrastructure for the encouragement of such trade, including transportation, insurance and export finance.

## Implications for international policies

What can the international community do if the downward trend in real commodity prices persists? Historically, much of the concern has been with the *stabilisation* of prices, i.e. strictly, the reduction of fluctuations around the trend. The classical devices of International Commodity Agreements (ICAs) and compensatory finance schemes designed primarily to reduce, or offset, price instability are not well suited to coping with long-run decline, although the EEC's compensatory finance scheme, Stabex, does have potential for that purpose.

It would, however, be possible to link such mechanisms — and UNCTAD's Common Fund, intended principally to finance ICAs — to schemes for financing the development of new uses for commodities, greater ldc participation in the processing, marketing and distribution of commodities, and the diversification of output. The so-called Window II of the Common Fund has precisely these objectives and it is likely that, operationally, much of the Fund's work will focus on such activities. Financial support for such programmes would, however, amount to development aid and not all donors will think that much aid should be allocated solely on the basis of primary product dependence.

Improved market access and *reduced protection* by industrial countries could bring major benefits to ldc exporters, and much interest will thus attach to the outcome of the 'Uruguay Round' GATT talks.<sup>3</sup> Of special interest will be whether the negotiations succeed in reducing the pervasive escalation of tariffs and non-tariff barriers according to stage of production which discourages processing in the country of origin.

More fundamentally, can it be in the interests of the industrial countries not to reform a system which starves ldc's of the foreign exchange they would use to buy their exports? Measures to stimulate growth and avoid recession in the OECD countries would, of course, be highly beneficial to commodity markets but, given past experience are unlikely to be adopted simply for this reason. The aid community should be more cautious about urging the inclusion of potentially price-depressing, and hence self-defeating, investments for expanded commodity production in adjustment programmes.

3. See 'The GATT Uruguay Round', ODI *Briefing Paper*, November 1987.

A complete list of the sources used in the preparation of this paper can be obtained from ODI on request. For further information please contact Tony Killick at ODI.

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