L.5.2

RFD 403

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

January 15, 1963

Problems of International Commodity
Stabilization

18 pages

Boris C. Swerling

This paper was presented at the annual meeting of the American Economic Association, Pittsburgh, Pennsylvania, December 28, 1962.

PROBLEMS OF INTERNATIONAL COMMODITY STABILIZATION 1/

Boris C. Swerling

Board of Governors of the
Federal Reserve System

The list of inconsistencies between the domestic and the international features of American commodity policies is a long one. Parity between prices paid and received by farmers remains a standard applied internally, but we resist all pressures to stabilize the commodity terms of trade between primary products and manufactured goods moving in international trade. Historical share of world markets is a rule endorsed for our own exports of raw cotton, but we would be considerably embarrassed if the same rule were extended to cover American overseas shipments of soybeans, corn, or inedible fats. Individual commodity agreements have not been entered into for imported raw materials subject to severe cyclical fluctuation in industrial demand, but we participate in agreements governing trade in wheat and sugar, in considerable degree as a means of buttressing domestic farm programs. At a time when there is some concern over the international competitive position of America's exports, we forego the advantages of cheap raw materials by artificial support of the domestic market for raw cotton, petroleum, and certain of the nonferrous metals. We are disturbed

1/ This paper was presented at the annual meeting of the American Economic Association, December 28, 1962, at Pittsburgh, Pennsylvania. It reflects the author's personal views and must not be interpreted as representing the opinion of the Federal Reserve.

by the level of agricultural protectionism likely to prevail within the European Economic Community but resort to a wide variety of devices to shield our own farm sector from movements in world-market prices.

Commodity policies have a particular relevance to current problems of foreign economic relations with the less-developed countries. Petroleum is a dominant factor in the political economy of the Middle East; rubber, tin, copra and rice are of prime importance to the economic well-being of the countries of Southeast Asia; coffee plays a pivotal role among the exports of the Latin American Republics; while the market fortunes of cotton, copper, and vegetable oilseeds significantly affect the foreign-exchange earnings available to individual African nations, both for implementing future developmental programs and for servicing international indebtedness already incurred. The enlarged representation of less-developed countries within the United Nations increases the political leverage of commodity interests overseas and with it the risk that the General Assembly will urge precipitous actions and false remedies for complex commodity problems.

Certain guidelines for the operation of intergovernmental commodity agreements, as originally drafted for the abortive Havana Charter for an International Trade Organization, received official sanction by a 1947 resolution of the Economic and Social Council. Flagrantly monopolistic abuses, such as characterized the Stevenson rubber scheme in the 1920's, were to be avoided by means of publicity in the form of open conferences and annual reports, as well as by the principle of equal voting power for importing and exporting countries. Economic efficiency was to be promoted by granting a preferred position to low-cost producers and paying due regard to the long-run equilibrium price. Where conditions of substantial surplus prevailed, ameliorative measures were to be taken during the life of the agreement.

Unobjectionable though these commodity principles may appear, a wide gulf separates the stated objectives from the actual attainments of the commodity agreement of longest postwar duration, that governing wheat. Here, as in several other instances, rapid changes in external circumstances have combined with the internal logic of the control mechanism to erode the basic instrument and to suggest that longevity in individual commodity agreements may be something less than a virtue.

The International Wheat Agreement, initiated in 1949, is the prototype of the multilateral long-term contract form of international commodity agreement (I.C.A.). Importers agreed to accept specified quantities if the market price fell to the Agreement minimum, and exporters agreed to supply stated quantities to member countries at the specified maximum market price. Between the floor and the ceiling, prices were expected to move freely and the contractual obligations to become inoperative. The four-year life of the original Wheat Agreement was marked by the currency devaluations of September 1949, high-level price supports in the U. S., the Korean commodity inflation, and a light world harvest in 1951 succeeded by a bumper crop the following year. I.W.A. prices held at or close to the Agreement maximum throughout the period, though for a succession of reasons and with diverse consequences. (1) In a falling market preceding the outbreak of the Korean conflict, there was some tendency for the I.W.A. ceiling to be regarded also as a floor price that exporting countries were reluctant to undercut. (2) A subsequent run-up in "free" wheat prices during 1950-52, in step with commodities generally, led importers to opt pretty much for their full I.W.A. quantities, stimulating wheat consumption and discouraging its production during a period of acute shortage. (3) Despite the bumper grain harvests of 1952-53, the Canadian Wheat Board held its "free" export price at a high level as a bargaining tactic for negotiating a higher price target in the new Agreement signed in 1953. (4) Importing countries, with the higher 1953-54 price ceiling in prospect, built up stocks by purchasing their remaining quotas before the lower maximum prevailing under the 1949 Agreement had expired. (Farnsworth, Q.J.E., May 1956, pp. 220-28)

Subsequent developments under successive extensions of the I.W.A. may be summarized more briefly. Actual wheat prices were not permitted to fall to the floor price specified in the 1953 Agreement by joint action on the part of Canadian and American wheat marketing agencies. In any case, while implicit income transfers from the relatively rich wheat exporters to relatively poor importers were tolerable during the earlier period of shortage, transfers in the reverse direction at the floor price would have been less conscionable. This was especially so when the U. K., the major importing country, failed to participate in the 1953 Agreement on the justifiable grounds that the new price range had been set too high. Far from bringing consumption and production into balance, the Agreements tolerated the rise of world wheat stocks to record levels. Disposal, particularly of American wheat, under special concessionary terms encompassed an increasingly large share of world trade, requiring the reciprocal commitments between importers and exporters to be restricted to commercial transactions, and for these only up to specified percentages of recent trade volume. The first substantial decline in world wheat stocks did not come until the end of the 1961-62 season, an outcome toward which an important role was played by the enlarged takings of a non-member country, mainland China.

Comment on other existing agreements must necessarily be more brief.

(1) The International Sugar Agreement of 1953 was of the more traditional export-quota variety. The floor price was under pressure from the beginning and such success as was had in maintaining it was due in large part to Cuba's willingness to severely restrict the size of its domestic crop. Yet existing stock accumulations proved too modest to offset inflationary pressures at the time of the Suez crisis, and world market prices about doubled within the span of a few months. For this commodity it has been

Cuba, the major exporter, that has traditionally been the major advocate of heavier volume even at somewhat lower prices. Ironically though it may now appear, long-sustained membership of the U.S.S.R. was originally heralded in some quarters as a harbinger of international economic cooperation. More recently, the Cuban-Soviet rapprochement, which led to the embargoing of Cuban imports into the U. S., has brought a wholesale rechanneling of international sugar shipments to the point where the crucial export-quota provisions of the Agreement have had to be suspended. Moreover, and for a variety of reasons, world-market prices for sugar have proved stronger since quotas were removed than during the period when they were actually in effect.

(2) The International Coffee Agreement, recently negotiated but not yet ratified, suggests interesting contrasts with U. S. sugar policy. Coffee, unlike sugar, has hitherto entered the U. S. market at the world price, duty free, and lacks any competition from domestic producers. But while U. S. sugar imports are allocated strictly on the basis of national legislation, total world marketings of coffee to traditional outlets are to be governed by export quotas specified in a multilateral instrument. Moreover, barter transactions in traditional markets are debarred under Article 54 of the Coffee Agreement, whereas the most recent extension of the U. S. Sugar Act gives a favored position to sugar exporters willing to contract for increased quantities of U. S. agricultural exports. Complications can also be expected to arise

for the Coffee Agreement because this is a less homogenous commodity, and regulation of total marketings can serve to distort price differentials prevailing as between robusta varieties, grown in Africa, and the Brazils and milds originating in Latin America.

(3) The buffer-stock provisions of the International Tin Agreement proved ineffective in holding the floor in the face of Soviet Union exports a few years back, whereas the current ceiling on tin prices is governed not so much by the price range specified in the Agreement itself as by the terms on which the U. S. disposes of tin in excess of the present needs of the strategic stockpile. Indeed, the existence of U. S. stockpiles of strategic materials as well as agricultural surpluses provides some assurance against major inflation in commodity prices along a broad front, and seriously undermines much of the argument for international buffer-stock accumulations as an instrument of current market support.

One can readily identify various factors that have operated so as to damp the instability of individual commodity prices in the postwar period. Of special importance has been the more moderate character of postwar business cycles to date. Modern production techniques in agriculture make major field crops somewhat less susceptible to fluctuation in yields. The range of intercommodity competition has considerably broadened, not merely because of the rise of synthetics and plastics but also as between structural steel and reinforced concrete, while soybeans now find extended uses over the general range of fats and oils, and aluminum has invaded traditional markets for steel and copper. But for the emergence of the American synthetic-rubber industry, the full impact of rising postwar demand, while bringing temporarily inflated profits to natural-rubber producers, would likely have induced cyclical overplanting of rubber trees comparable to that which has actually occurred for coffee. In the case of raw cotton, the U. S. price-support program has underwritten prices on a world-wide basis but has placed this country in the role of residual supplier, subject to wide year-to-year swings in exports while permitting other countries to increase their share of the total market. For tea, production excessive to export requirements has been rather readily absorbed by domestic consumers in the Orient.

At the same time, new elements of price instability have been emerging. Many of these have been peculiarly political in character, and accordingly all the more difficult to deal with. The rubber and wool markets have witnessed sudden entry and withdrawal of U.S.S.R. purchasing, for motives apparently related as much to cold-war strategy as to strictly commercial ends. In aluminum as well as tin, relatively small Soviet exports have on occasion had seriously disruptive effects. Control of Manchurian soybeans by a Communish Chinese regime is a supplementary factor of disturbance, while the Communish threat overhangs the rice bowl, the tin, and the rubber of Southeast Asia. Primary producing countries have also by their own actions set in motion serious commodity disturbances.

One need recall only Castro's actions in expropriating sugar properties, the Iranian oil episode, nationalization of Bolivia's tin mines, or the bearing of political crises in the Congo and the Rhodesias on copper supplies.

The minerals are a commodity category that is peculiarly involved in economic relations between the less-developed and the advanced countries. That trade is triply hazardous: first, because the changing technology of the industrial system raises or lowers the market value of successive minerals in unpredictable fashion; second, because sources of supply are distributed around the world in haphazard fashion; and thirdly, because rich portions of the world's mineral resources are subject to arbitrary regulation by newly-independent nations jealous of their sovereign prerogatives and prepared to pay a high economic price for a fervent anti-colonialism. Even in the less-developed countries, and in striking contrast with much agricultural production, mineral operations tend to be conducted on a large scale by heavily capitalized enterprises servicing metropolitan markets. In the interests alike of commodity stability and economic growth, the rules of the game by which private mineral enterprises are to operate in the less-developed countries need to be more clearly established. The risks of expropriation and of confiscatory tax burdens create an environment hostile to private savings, whether from domestic or foreign sources, and go far to negate even the best considered programs of foreign aid.

In the context of the European Common Market, broad sectoral problems and not merely those affecting individual commodities become important. While a strong motive for the founding of the European Coal and Steel Community was to mitigate the risk of future French-German hostility through unification of their heavy industries, that Community cannot be insulated against the effects of the emerging Common Energy Policy. Reconciliation is necessary between a host of conflicting considerations. Some recent events, such as the discovery of a rich field of natural gas in the Netherlands and the opening of oil fields in North Africa, together with the persistently high cost of Belgian coal, buttress protectionist sentiment on the continent. The heavy outflow of petroleum from the Soviet Union, partly through the intermediary of Italian refining, creates an important strategic issue for the N.A.T.O. powers. There has been a progressive undermining of the old international regime, based largely on the strong market condition of international corporations controlled by American, British, and Dutch capital; the international price structure for petroleum has been seriously disorganized; and new forms of market control are being considered by such an agency as the Organization of Petroleum Exporting Countries. The Soviet Union cultivates the favor of the traditional exporters by backing their criticism of the Western companies while the O.P.E.C. countries (with the possible exception of Venezuela) remain surprisingly insensitive to the deterioration in their own position as the result of Soviet competition.

The essential source of difficulty in the standard type of international commodity agreement, which merely sets a relatively high price target and allocates export quotas to enforce that price, is that appropriate canons of economic adjustment, of social equity, and of efficient administration are required to work at cross purposes. Unsalable current output is overt evidence that a commodity is already overpriced, yet the marginal incentive to expand output continues, while there is, depending on demand elasticities, some tendency to discourage consumption. The enormous advantages of price signals for coaxing rather than coercing needed adjustments are lost. Nor do benefits that are strictly proportional to marketings meet reasonable criteria of income redistribution, domestically or internationally. Through effects on capital values, moreover, better market prices today are built into higher price structures for succeeding generations of producers, with consequent dissipation of intended benefits.

For these reasons, we must recognize a standing challenge to devise new and unorthodox instrumentalities that provide for international transfer of funds without relying so heavily on artificial market support of individual commodity markets. In this connection, several mechanisms are of special interest:

(1) The system of variable import levies, which plays so important a role in the EEC's Common Agricultrual Policy, arouses exceedingly mixed reactions. Since the levies will tend to rise at times when external supplies are relatively abundant, the instability of world market prices will tend to be accentuated in the short run,

quite apart from long-run effects in increasing European agricultural output. Accommodation of British agricultural policy, with its reliance on a system of direct payments to growers, has proved a major stumbling block in negotiating the U. K. 's accession to the EEC, and for understandable reasons. For Britain, the changeover would involve abandonment of a technically superior system of agricultural support, a considerable rise in food prices to domestic consumers and, because U. K. imports are heavy, a disproportionately large British contribution to the common Agricultural Fund, part of which would finance export subsidies on agricultural surpluses subsequently generated on the continent. Yet the Agricultural Fund itself, as a rudimentary system of taxation, has served to initiate important discussions of fiscal burden and outlay that are relevant to a wider range of Common Market problems.

(2) In modern tax systems, the contribution of commodity levies is trivial as compared with direct taxation of personal and business income, but any international fiscal system must begin on a more primitive level. The United Nations Organization is plagued with serious budgetary problems, the solution of which is much in the interest of the primary-producing countries. Might the U. N. perhaps be enpowered to impose a levy on petroleum, a commodity peculiarly well suited to provide a broad tax base? It tops the list of internationall-traded products, and national consumption is closely correlated with level of economic advancement. By virtue

of the enormous physical quantities involved, the per-unit-rate could be held low and the marginal choice between alternative fuels little affected. U. N. revenues would rise in step with higher civilian consumption in the West and the growth of Soviet output. The principle would be established that this key raw material makes a special financial contribution to the international community, whether for technical aid or Congo-type operations and, similarly, that the international community has a clear interest in the rational management of petroleum resources.

(3) Of considerable more current interest is the serious attention now being given to international compensatory arrangements as an alternative to market support for the exports of primary producing countries. A considerable variety of technical arrangements are feasible, but the essential features are as follows: (1) There would be no direct intervention in commodity markets; (2) some estimate would be made of trend, whether in price of individual commodities, or in a nation's export proceeds from a given commodity or from primary commodities as a group; (3) if prices or receipts fell below trend by more than some stated margin, exporting countries would be entitled to receive financial compensation. Proposals vary on the extent to which reimbursement would be made in the reverse direction, should price or export proceeds rise above trend.

While an individual-commodity approach to compensation for export shortfalls would have the advantage of permitting maximum accommodation to the economic peculiarities of different primary products, so limited an approach would also suffer from certain serious limitations. Mere specification of "the" price to be taken as the standard runs into serious complications; e.g., there are customarily a number of sub-commodities whose price experience may show considerable divergence. A key assumption of the compensatory plan is that price instability is essentially beyond the control of the exporting nation, but for individual commodities the direct impact of such deliberate national policies as export subsidies or marketing controls is by no means inconsequential, and the volume of exports will also reflect changes in the rate of domestic absorption or policies affecting domestic price structures. The larger the number of countries participating, the more complicated becomes the process of decision-making. Yet to permit the existence of outsiders would mean that markets might in fact be responding to destabilizing imports or exports of non-participating countries. The individual-commodity approach would appear to be less appropriate to foodstuffs than to industrial raw materials, for which cyclical fluctuations in price and quantity can ordinarily be expected to be mutually reinforcing.

If we go beyond single-commodity compensatory schemes, a wide range of alternatives are open. Are shortfalls only in export proceeds, or earnings on current account, or the entire balance of payments of immediate concern, and is the level of reserves also a relevant variable to be taken into account? Are payments to be triggered by the export performance of individual primary-producing countries, or the import expenditures of a few industrial nations? Should the scheme be regional or global in scope? If shortfalls in export proceeds are chosen as the variable to be compensated, should the full export list be included or only a select group of primary products?

Consider this last point in more detail. It might appear that an ineligible group could readily be chosen according to various criteria: coal, because it is primarily an export of industrial countries; rayon, or synthetic rubber, both of them highly processed products originating from comparable sources; wheat, bacon, and butter, because of their association with a relatively rich group of exporting countries. Yet these commodity particulars do not stay put: iron ore has become an increasingly important export of the primary-producing countries. Difficulties would arise, similarly, in establishing the stage of processing at which eligibility is lost. Does one include both raw and refined sugar? only crude petroleum or also petroleum products? aluminum as well as bauxite?

The issue of global vs regional coverage raises a different set of equally explicit considerations. Perhaps the U. S. might begin with an arrangement limited to Latin America, a region with which our ties are particularly intimate. But major commodity fluctuations are world-wide in scope. An arrangement with Latin America would be less appropriate as a strictly contracyclical device than one that included the natural rubber economies of South-east Asia, and would also deny itself the financial contribution from expanding petroleum exports of other regions. Moreover, a heavily Pan-American flavor would push the world further away from multilateralism and in the direction of formalizing economic blocs.

A crucial question is whether compensatory arrangements are really to be regarded as a form of short-term credit, pending reversal of temporarily adverse circumstances, or as foreign aid involving international income transfers of a permanent sort. To the extent that the arrangement relies on loans that are to be fully repaid, operational questions can be intelligently decided but there is a good deal less appeal to its potential clientele. On the other hand, allocation of foreign aid proportionally to shortfalls in export proceeds has little appeal for a country like India, for which fluctuations as such are not a serious problem. Nor would it be easy to justify the relatively large transfers that would be enjoyed by Malaya, whose export proceeds have been liable to rather wide swings. The choice between credits and grants will also affect the appropriateness of employing the I.M.F. as the administering agency, through liberalization of the terms under which the primary-producing countries are entitled to borrow.

For Latin America, of all continental areas, a purley credit arrangement would seem particularly inappropriate. For no region of comparable size has the export performance since the mid-1950's been less satisfactory. There are, of course, national exceptions to that pattern, but there appears to have been a secular decline in the region's relative position in a considerable number of export staples -- tin, coffee, wheat, corn, and petroleum being notable examples. One need not engage in that great guessing game -- projecting the prospective terms of trade for primary products -- and yet be able to recognize that such gross shifts in regional sources of supply involve difficult problems of economic adjustment.

Among those whose allegiance to private enterprise is most solid, intervention in commodity markets is somehow more respectable than direct financial transfers that are less disturbing to the price system, the major organizational mechanism of a free economy. Legislators who endorse liberal political causes simultaneously espouse import quotas or tariffs for individual primary products, whether wool or the nonferrous metals, petroleum or sugar. Those who defend financial orthodoxy, exchange-rate stability, and a balanced budget in the interest of a sound dollar are major defectors on the issue of commodity price supports. In taking such positions, they parallel the views of producer groups anxious to conceal the financial costs, and ready to ignore the intangible burdens, of individual commodity controls.

Accordingly, the political pressures are strong to look to commodity agreements as a means of dealing with the unfavorable impact of the E.E.C. Common Agricultural Policy upon the products of the temperate zone. Similarly, at a time when the more direct forms of foreign aid are meeting increasing resistance in the U. S. Congress, it is tempting to fall back upon individual commodity agreements as an alternative means of assisting the less-developed countries. Yet a belief that such agreements can do more to alleviate than to perpetuate underlying commodity maladjustments must be based on something other than historical experience.