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PRODUCT AGREEMENTS

DESIGNED TO LIMIT EXCESSIVE PRICE FLUCTUATIONS

(Commission Communication to the Council)

PRODUCT AGREEMENTS

designed to limit excessive price fluctuations

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I. Introduction and objectives

In its "Communication to the Council of 21 May 1975 on raw materials in relation with the developing countries which export raw materials" the Commission gave an overall picture of the various measures which might be envisaged in this context.

The Commission proposed to forward more detailed communications to the Council on some of the aspects dealt with in the overall communication of 21 May.

This communication deals with the question of product* agreements designed to limit excessive price fluctuations. The problem of the security of supplies of the consumer countries, which is closely connected with product agreements, is not covered here. Moreover, this problem is also linked with the producer countries' export policies, in particular the export restrictions dealt with in the context of the multilateral negotiations under GATT and therefore not touched upon here.

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Within the meaning of this communication "product agreements" are agreements concluded between countries producing and consuming commodities, the aim generally being to stabilize the prices of the products in question in international trade. According to the arrangements established since the Havana Charter (1947-48) such agreements must normally be concluded between producers and consumers.

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* Throughout this communication the term "products" or "commodities" has been used since it has a wider meaning than "raw materials".

(see continuation overleaf)

TABLE A

MAIN TECHNICAL AND ECONOMIC CHARACTERISTICS OF 18 COMMODITIES (1972)

I	II	III	IV	V	VI	VII	VIII
Product	World exports (1)	Degree of concentration of exporters (2)	Price fluctuations (Gini index) 1963–1974 (3)	Homogeneity of product	Market independence (in relation to substitutes, related products)	Dependence of the European/ EEC countries (6)	Percentage of exports from the developing countries (1)
Wheat	4 366	4	19.1	average	high	3 % } (9)	4 %
Maize	2 298	4	12.5	average	average	42 % } (9)	14.5 %
Rice	1 120	6	19.7	average	high	33 % } (9)	39 %
Sugar(5)	3 334	12	17.9	high	high	0–8 % } (9)	67 %
	11 118						28 %
Coffee(5)	3 049	10	12.9	low	high	100 % } (7)	100 %
Cocoa(5)	723	4	35.9	average	average	100 % } (7)	100 %
Tea(5)	745	4	6.6	low	high	100 % } (7)	81 %
	4 517						97 %
Cotton	2 828	17	14.1	low	average	100 % } (7)	62 %
Jute and manufactures	762	2	6.0	average	very low	100 % } (7)	88 %
Wool	1 346	3	16.7	low	average	92 % (9)	12 %
Hard fibres	87	5	15.7	average	very low	100 % } (7)	96.5 %
Rubber	904	2	16.3	average	low	100 % } (7)	100 %
	5 927						60 %
Copper	4 113	8	32.3	high	fairly high	93 % } (8)	58 %
Lead	418	10	31.3	high	fairly high	75 % } (8)	28 %
Zinc	862	11	39.5	high	fairly high	61 % } (8)	22 %
Tin	730	4	22.9	high	fairly high	96 % } (8)	86.5 %
Bauxite }	305	} 10	8.7 (4)	} average	fairly high	} 51 % } (8)	} 56.4 %
Alumina }	609	(with Bauxite)	5.7	(with Bauxite)		(with Bauxite)	(with Bauxite)
Iron ore	2 608	7	3.5	average	fairly high	37 % } (8)	38 %
	9 645						50 %
Total	31 207						51 %

(1) Source: FAO, Trade Yearbook 1972 and national statistics.

(2) Number of countries supplying 75% of world exports.

(3) Source: UN Monthly Statistical Bulletin, March 1975

(5) Agreements existing or in the course of renewal.

(6) On imports from outside the region (percentage imports/ consumption 1972).

(7) Estimates

II. The products: conditions and characteristics

This suggests the main conditions which must be met if a product agreement is to have the greatest possible chances of success.

Table A[1] summarizes a number of data relating to these conditions.

(a) Essentially, the harmonious development of prices must be ensured.

In order to achieve this, the product in question:

i. Must have a price or a set of prices which is as independent as possible, that is the market for the product must not be dominated by a rival product (for instance, by synthetics in the case of jute or rubber); it must not be a by-product or part of a group of products in respect of which the prices and earnings may be manipulated arbitrarily, as is the case with chemical products (see column VI of Table A in this connection);

ii. Must be sufficiently homogeneous to enable a price - or a "close" family of prices - to reflect the economic trend of the product over a period of time.

This is not the case for various animal products (see column V of Table A).

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[1] This table, like most of the product data given in this text, relates to the eighteen UNCTAD products suitable for stockpiling, accounting for 55-60% of world trade in commodities.

TABLE A (continuation)

MAIN TECHNICAL AND ECONOMIC CHARACTERISTICS OF 18 COMMODITIES (1972)

I	IX	
Product		World exports (1)
Wheat		39 %
Maize		9 %
Rice		79 %
Sugar (5)		18 %
	31 %	
Coffee (5)		
Coffee (5)		4 %
Cocoa (5)		4 %
Tea (5)		31 %
	8 %	
Cotton		18 %
Jute and manufactures		24 %
Wool		6 %
Hard fibres		7 %
Rubber		9 %
	14 %	
Copper		5 %
Lead		7 %
Zinc		13 %
Tin		12 %
Bauxite)		6 %
Alumina)		
Iron ore		6 %
Total	5 %	16 %

iii. Lastly, the data published on the trend of prices must be representative of the market as a whole. Thus the prices of minerals do not meet these conditions, most of the mines being "captive" (iron and bauxite for example)[1].

(b) For a product agreement to play the role it is assigned effectively, it is important that it bring together the main producers and consumers.

i. The developed consumer countries, for their part, have up till now had mixed views on these agreements.

The attitude of the developed producer countries - namely Canada, Australia (virtually at all times) and a few smaller countries such as Sweden - towards product agreements is naturally determined by their interests as exporters.

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[1]It is also desirable that the share of world production in international trade should be substantial. This is not the case with rice, for example.

In the United States the situation as regards the main commodities is more or less balanced - though slightly weighted in favour of imports; the country is a major exporter of a number of commodities, such as cotton and phosphates, paper pulp, wood, leather, hides and skins and certain metals. Its situation is therefore basically different from the Community's. The country's attitude towards product agreements would seem to be under review.

The state-trading consumer countries have shown a changeable attitude depending on the products in question (see Table B in annex). Their participation is desirable to ensure that the agreements function properly.

It is important to stress the point that a number of developing countries are big importers of commodities.

ii. The situation regarding the producers is much more diversified.

For each product the list of producers varies- particularly widely in the case of minerals. Certain products - such as sugar, coffee, cotton, iron ore and bauxite - are exported by several dozen countries, whereas others are exported only by half a dozen or so.

Column III of Table A gives a simple index of this spread: the number of countries providing 75% of world exports. Here the figures vary widely.

(c) Column IV of the same table gives another indication which is important when examining a price stabilization system: the intensity of price fluctuations, reflected by the Gini index[1]. It can be seen for example that the prices of mineral products fluctuate more than others, especially where the minerals are not extracted from "captive" mines, as iron and bauxite are.

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[1] Average of the absolute values for the annual variations.

(d) Another characteristic, contained in column II, is the actual volume of trade to be stabilized; it is this which largely determines the amount of financing which might be needed to achieve stabilization.

There is a clear distinction here between the "major" products - wheat, copper, sugar, coffee, cotton, iron ore, maize, wool, rice - and the others.

(e) Also included in Table A are two sets of structural data which, though not a determining factor in a world context as regards the possibility of concluding agreements, must be taken into consideration by the Community as a potential partner.

These are:

the Community's degree of dependence on external imports for its supplies (column VII); and

the extent to which the products in question are exported by developing countries (column VIII).

(f) Although each of the columns in Table A enables an order of preference to be established between the products as regards their suitability for the conclusion of a product agreement, the order varies widely from column to column and it is difficult to analyse these data as a whole, especially as the various conditions or characteristics are not of equal importance and are not all quantifiable.

i. However, if the list of 18 products is examined, it can be seen that:

for wheat, maize, rice and sugar, proposals for product agreements have already been made in the context of the Multilateral Trade Negotiations;

agreements exist on tin, cocoa and coffee (to be renegotiated soon) and, unofficially, tea;

jute, hard fibres and rubber are too dominated by rival products to enable meaningful agreements to be concluded;

iron ore and bauxite supplies are largely captive and the free market is not representative.

Consequently, in studying the possible creation of new product agreements attention must be focussed on the following among the 18 products:

copper

zinc

lead

cotton

wool

Imports of these five products into the Community amount to $ 4 500 million per annum, that is 40% of total imports of the 18 products.

The following reservations should also be noted:

The two textile fibres' low degree of homogeneity and their dependence with regard to substitutes;

The relatively slight importance of lead and zinc, and particularly of wool, to the developing countries.

Low or average concentration of producers, especially as regards cotton.

ii. If certain products other than the 18 listed but often referred to in international discussions are examined, it will be noted that:

bananas and oleaginous products are extremely heterogeneous;

the same applies to wood and wood products, and leather, hides and skins - the latter being subject to keen competition from synthetics;

world manganese and phosphate reserves are very high and, in part, relatively secure;

chromium, tungsten and platinum present specific problems of security of supplies; the solution here would be to establish reserve stocks of a non-buffer nature.

The provisional conclusion stated under i. above with regard to the five products therefore remains valid if the analysis is extended beyond the 18 commodities.

III. Methods

The aim is to stabilize markets which are marked by frequent and substantial disparities between supply and demand, resulting in particularly sharp price rises and falls[1].

Numerous methods are employed to achieve such stabilization and ten or so have been studied. The main features of their operation are analysed below. Details of existing agreements are supplied in Table B, which is annexed to this paper.

A. Quotas

This is a method derived from producers' cartels: if supply exceeds demand - which is the typical case since the agreements have so far generally been devised with the primary aim of resolving the problems of producers[2] - a system of export quotas (or possibly production quotas) is applied.

Example: Agreements on sugar and coffee:

Advantage: Costs are limited to administrative expenses.

Disadvantage: No severe or automatic penalty.

Both agreements are at present in abeyance following operational difficulties:

i. The sugar agreement applied only to the world market, to the exclusion of the markets covered by the special arrangements of the USA, the USSR and the United Kingdom.

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[1] This instability of the commodity markets is noticeably more marked than that of the market in manufactured products.

[2] In the reverse situation, import quotas might be considered. The effectiveness of such machinery is questionable.

ii. In the case of coffee, the very large number of producers, the administration of the quotas and the relevant controls, plus disagreements between producers and consumers as to price levels, have resulted in serious difficulties.

B. Buffer stocks

An undoubtedly more effective, but also more costly method than quotas consists of setting up buffer stocks.

1. Traditional buffer stocks

These involve going against the customary trend of business operations since firms tend normally to stock when prices are rising and to run down stocks when prices are falling. Such stocks lie heavily on the market and intensify the fluctuations.

So here the strategy has to be reversed and a stabilizing effect produced by buying when prices fall, which helps to bring prices up, and selling when they rise, which helps to moderate the rise.

It is obvious that a practical effect will be obtained:

only if the stocks are administered jointly by all the parties concerned and there is sufficient agreement among them, in particular as regards maximum and minimum prices;

and if the financial resources or the actual stocks at the disposal of the stock-building authorities are sufficient to influence the market.

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[1] In the only such case in operation, concerning tin, those concerned so far have been the producer countries and, more recently, the Netherlands and France.

For the purpose of determining the extent of these resources, there has been a tendancy to follow until now the long-standing but rather simplistic rule, formulated by Keynes in 1942, according to which a buffer stock should be made up of the equivalent of three months' world exports of the products in question[1].

This question of the size of stocks is most important since the sums involved are very large. According to an UNCTAD estimate, the 18 products suitable for stock-piling on which it concentrated, involve a total of $11 000-13 000 million. To the cost of acquiring the stocks must be added the annual interest charges, warehousing, the cost of placing goods in stocks and taking them out again, and the costs arising from the deterioration of products, which is difficult to avoid. On the other hand any stocks which have been acquired - normally at times of slack market activity - should produce capital gains. Calculations comparing the advantages and costs arising from application of the system must be made very carefully in the various possible cases before any decision is taken in favour of this method, or any of the others for that matter.

2. "Cyclical" stock-building

It is possibly not essential, however, to resolve in advance the problem of the size of stocks provided one does not adopt as a rigid rule - which in any case would not be observed effectively - the maintenance of prices within a predetermined "tunnel"[1] and the prevention at all costs of speculation at either extreme[2], but is content to moderate the fluctuations by smoothing out the price curve.

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[1]Keynes subsequently suggested that it would perhaps be preferable to establish the size of stocks at six months' exports. In practice the tin stock corresponds to one and a half months' exports and the one being considered for cocoa represents exports over two and a half months. No conclusions can be drawn from the cocoa agreement since no stocks have yet been built up; the tin agreement works well when prices are falling but does not enable ceilings to be maintained satisfactorily.

[2]To do this, various rules have been devised and applied, particularly in the case of the tin agreement. The latest provides for the tunnel to be divided into three parallel bands: the upper and lower ones entail an obligation on the part of the stock authorities to sell or buy until funds or stocks are used up; more flexible rules apply in respect of the middle band.

One could invert the picture and suppose that the world community is ready to allot a certain sum for the purpose of helping to stabilize the price of a given product, the sum probably being calculated on the basis of the amount of annual trade and in the light of experience of the functioning of the market for the product in question.

This kind of stock-building, which might be described conventionally as "cyclical" stock-building, would perhaps produce a relatively better result for a given amount of capital expenditure than a buffer stock pure and simple, of the tin agreement type.

A simple calculation shows that, apart from the capital input necessary to build up the stock, the operation could be financed by a 3% levy on imports of the products concerned.

3. Coordinated national stocks

Another variant would consist not of centrally administered stocks, but of national stocks coordinated with a view to achieving stabilization.

It is this variant that the Community has proposed at GATT, in the context of the multilateral negotiations, for cereals, sugar and rice.

From the cost angle, if the costs borne by the various participants[1] are added together this variant must appear comparable to the centralized stocks variant; its effectiveness depends entirely on the cohesion of the stock-building countries.

x

x x

The stock-building systems referred to above, especially the first one, may give rise to frequently difficult negotiations on terms and above all on minimum and maximum prices.

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[1]It should be noted that offsetting one national component against another - a source of savings - cannot be undertaken easily in a decentralized system.

C. Long-term contracts

Another method of ensuring stability on the market of a product consists in concluding as many long-term contracts as possible which take account of forecast supply and demand.

But,

on the one hand, errors in forecasts and unforeseen factors are inevitable.

For this reason it is advisable to make provision for a "safety net" stock. This is what UNCTAD proposes in its integrated programme. It is probable that such a stock, being of an ancillary nature rather than the main stock, could be less costly than those referred to above.

On the other hand, the essential difficulty lies above all in the fact that although the socialist countries and most of the developing countries conduct their foreign trade in primary products through centralized bodies and can easily conclude the contracts in question, this is only partially so or not so at all in the case of the liberal developed countries.

Moreover, the UNCTAD document acknowledges this major difficulty, which, in present circumstances, makes recourse to systems of this kind extremely uncertain. The difficulty is increased by the recent tendency in international trade to abandon observance of the principle that agreements are to be honoured (pacta servanda sunt).

It should be pointed out that the functioning of systems based on long-term contracts - and indeed of quota-based systems - can be strengthened by financial mechanisms such as those dealt with below.

D. Financial mechanisms

These are to be distinguished from the mechanisms dealt with above by the fact that they involve the payment, on the basis of quantities agreed between sellers and purchasers, of sums of money which are to be used to mitigate the effects of extreme fluctuations of prices.

The stock is in a sense replaced by a fund and does not have to be built up physically.

For example the Commission's departments are studying, in the important case of copper, a system of negotiated floor and ceiling prices with levies paid:

by the consumers, if prices fall below the floor;
by the producers, if prices exceed the ceiling;
by both, if prices are between the floor and ceiling.

The attractive aspect is the simplicity of the mechanism, resulting in lower administrative costs. Furthermore, it is not necessary here to build up capital.

This mechanism, like others analysed here, permits differential treatment in favour of the developing countries and the possibility of subsidiary aims.

But this newly devised mechanism has never been tested.

E. Combined systems

Apart from the combinations referred to at the foot of page 13, a number of these have been proposed or put into operation.

(a) the cocoa agreement is based on quotas but also involves the setting up of a buffer stock should the quota arrangements not be sufficient to bring about stabilization.

(b) An interesting case is the proposal made by the Commission to the Council in 1970 on oleaginous products. It is probably the most complete system so far devised:

i. import levies;
ii. buffer stocks for the relatively homogeneous lauric oils;
iii. payments to the developing countries, in particular to enable single-product producers to diversify;
(iv) food aid.

(c) The various wheat agreements have contained a food aid component, the importance of which has been constantly increasing.

(d) National stocks, particularly those of the United States, the United Kingdom and France, serve not only as buffers but also as reserve stocks, particularly where there is a risk of the supply of certain strategically important products being cut off. Such products are, however, few in number and limited in value.

F. Other systems

There are a number of systems which are linked more or less closely with those mentioned above.

The following can be mentioned:

(a) the agreement on observance of prices for milk products proposed by the Community to GATT.

This involves maximum and minimum prices but no stockpiling. It should be possible to keep to these prices in view of the limited number of world market suppliers;

(b) the arrangements on whole milk powder and skimmed-milk powder (OECD 1963, GATT 1970), which are still in force, and on butter fat and butteroil (GATT 1972);

(c) the unofficial agreements concluded under the aegis of FAO on tea, on jute and hard fibres and on pepper.

These are "lightweight" agreements. They involve, in particular, the fixing of target prices and action on the part of the producers, who are few in number and (in the case of fibres) very much threatened by competition, with a view to limiting their exports;

(d) lastly, in an agreement such as that on olive oil a completely different objective is being pursued: that of information on and sales promotion for the product[1].

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[1] Apart from the agreements covered by the definition of product agreements, the following should be mentioned:

(a) the open international bodies concerned with a single product, in particular the study groups on lead, zinc, rubber and tungsten.
These bring together producers and consumers and have as their main function exchanging information and statistics and studying certain technical problems - for example the competition between natural and synthetic rubber;

(b) the bodies which are at least partly closed; consisting mainly of producers, these have tended to develop in 1974 and 1975. Examples are the international bauxite arrangement grouping together seven countries; CIPEC, grouping together the four non-industrialized producers of copper: Zaïre, Zambia, Chile and Peru (1967); the iron ore group (1974) which is holding negotiations and expanding; the manganese group; the mercury group (Algiers, May 1974); the phosphates group and the Union of Banana Exporting Countries.

G. Factors involved in any choice between systems

It is not possible on the basis of the data in Table A to state that a given product should automatically lend itself to an agreement of a particular type.

The most that can be said is that:

essential foodstuffs should be covered by agreements involving a system of minimum and maximum prices together with a stock-building policy in order to achieve the harmonious development of prices, ensure continuity of supplies and facilitate the implementation of food aid programmes;

it is not possible in the case of perishable products to establish actual physical stocks;

products produced over a wide geographical area would seem to need to be controlled by the system with the strictest discipline, namely the buffer stock system;

products, the prices of which are difficult to determine, should not be controlled by a financial mechanism which presupposes a certain degree of price precision.

IV. Summary and conclusions

To conclude this first overall examination of the problem of product-by-product agreements, the Commission feels it is useful to sum up as follows:

1. It finds that the existing agreements have not always functioned satisfactorily.

One of the possible reasons for these operating difficulties is the fact that these agreements were designed with the particular objective of defending the producers' interests in periods of surplus and that the conception and management of the agreements has not been guided by the desire to achieve an appropriate balanced policy.

The Commission feels that, with a wider and balanced political vision, an improvement in the functioning of the agreements could be obtained, and it is in this spirit that the Commission recently put forward proposals in GATT for the conclusion of various agreements in the field of temperate agricultural products.

2. The Commission, which has often affirmed the desirability of extending product agreements to raw materials in appropriate cases, considers that the time has come to specify the studies which would enable a definitive position to be adopted on the various cases.

The Commission considers that, where the conclusion of such agreements seemed appropriate, they should be designed in such a way as to take account of the mutual interests of producers and consumers, with all that this implies from the angles of participation in the expenses, advantages and management of the agreements.

3. The Commission has carried out an initial examination of the conditions which products must fulfil if they are to be considered as possible candidates for such agreements.

These conditions are numerous and no product corresponds to them in an ideal way.

However, copper, zinc, lead, cotton and wool fulfil a number of these conditions and therefore appear to be the products on which studies could concentrate at the present stage.

4. The methods of operation of existing and possible agreements are many and varied. In the light of past experience and of the existing structures of external trade, it seems useful however to concentrate on:

- agreements with buffer stocks administered jointly by exporters and consumers, with or without rigid maximum and minimum prices, this probably being the least hazardous solution;
- the agreements based on a financial mechanism, since this is probably the least expensive solution and is very flexible and can be combined with other mechanisms.

5. In any event, it is necessary to carry out thorough technical and economic studies in cooperation with private firms before definitive conclusions can be reached. These studies should cover both the products and operating methods under the systems, the balance of advantages and disadvantages in the various possible cases and the financing arrangements. In each case, these studies should enable the limitations of the systems to be pinpointed.

6. As far as financing is concerned, it should be noted first of all that the requirements vary very widely according to the systems and operating methods chosen.

In numerous cases, however, large-scale financing will be necessary, particularly while the agreements are being started up.

Various arrangements can be considered, either in isolation or in combination, in particular:

i. financing by the producers and consumers, who share the costs;

ii. the intervention of international financial bodies representing the general interest, in particular the IMF;

iii. levies on transactions.

TABLE B

INTERNATIONAL COMMODITY AGREEMENTS

Products	Validity	Machinery of the agreement	Participants
TIN	First international agreement signed in 1954. Currently fourth agreement (1 July 1971 - 30 June 1976). Renegotiation in progress.	Buffer stock (20 000 t), namely approximately $140 million and a little more than one month's consumption. Possibility of fixing export quotas (first time in January 1973). Financing of the buffer stock by contributions from the producer countries, by the proceeds of sales from the stock and by voluntary contributions from the importing countries (France, Netherlands).	Principal exporters except China. Principal importers except USA. All EEC Member States. EEC member (1970) USA no USSR yes Japan yes
COCOA	"1972" agreement: 1 October 1973 - 30 September 1976.	Export quotas. Buffer stock (maximum 250 000 t) financed by a tax of US 1 cent per pound. Quotas and buffer stocks not functioning because of the level of world prices.	17 exporters = 90% of trade. 29 importers. All EEC Member States. EEC member (1972) USA no (25% of world imports) USSR yes Japan yes
COFFEE	First agreement in 1962. Renewed in 1968 and extended from 1973 to 30 September 1976: economic provisions (quotas, prices, diversification fund and promotion fund) frozen.	Export quotas to maintain prices within a certain bracket. Diversification fund } sizeable Propaganda fund } sizeable No stock.	41 exporters = 99% of world exports. 21 importers = 90% of world imports. EEC observer USA yes USSR no Japan yes

TABLE B (cont.)

INTERNATIONAL COMMODITY AGREEMENTS

Products	Validity	Machinery of the agreement	Participants
SUGAR	First agreement signed in 1974. Since renegotiated, although its economic clauses have not operated for a number of years.	1968 agreement: export quotas. 1973 agreement: does not contain any economic clauses.	In 1970: 34 exporters (42% of total sugar exports). 15 importers. The agreement applies only to trade other than that within the context of: the Commonwealth Sugar Agreement, the USA Preferential Agreement the USSR – Cuba Agreement. EEC observer UK yes URSS yes USA no Japan yes
WHEAT	1962 International Wheat Agreement. 1967 International Grains Agreement (with two conventions). 1971 International Wheat Agreement extended until 30 June 1975 with: – Wheat Trade Convention, – Food Aid Convention.	The 1971 Wheat Trade Convention does not contain any fundamental economic provisions: exchange of information. The Food Aid Convention involves a commitment on the part of each member to supply a fixed quantity of cereals in the form of aid to the developing countries.	EEC yes USA yes USSR yes Japan yes EEC yes USA yes USSR no Japan yes
OLIVE OIL	First agreement in 1963, since renewed, extended for 5 years from 1 January 1974.	No economic provisions. Exchange of information and export promotion.	(EEC observer) USA no Japan no