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Friedman Presidential Chron files / Commodity Problem, Jan. 1970

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Members of the President's Council

DATE: January 21, 1970

FROM: Irving S. Friedman

SUBJECT: Commodity Problem

Mr. McNamara has suggested that the paper on the Commodity Problem, distributed to you on January 20, be discussed at a forthcoming meeting of the President's Council.

ISF

cc: Mr. Christoffersen

FORM NO. 57

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

Ack. to Mr. Friedman

OFFICE MEMORANDUM

A first-class paper. Please distribute to members of the President's Council for discussion at a Monday meeting. RSMcN

TO: Mr. Robert S. McNamara

DATE: January 20, 1970

FROM: Irving S. Friedman

SUBJECT: Commodity Problem

JAN 21 1970
11:56

You will recall our discussion about preparing a paper on the commodity problem which would try to take a new look at the problem and what the Bank might do. We are also committed to do something on this subject as part of our Pearson review. The attached paper goes beyond what might be done for the Pearson review but hopefully will also serve this purpose. The paper tries to restate the problem and suggest what the Bank might do including a suggestion on financing of international buffer stocks and a proposal for a new approach to the commodity problem within the Bank, referred to herein as "commodity programs" which would be related to our 5-year programs on developing countries.

We have benefited from comments received from Mr. Demuth.

ISF

Attachment

cc: President's Council

Mr Fishman:

Please also send me a copy Lee 1/21

JAN 2 1 1970 11:55

Mr. Robert S. McNamara

January 20, 1970

Irving S. Friedman

Commodity Problem

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cc: President's Council

Copy sent to Prof. Frank 1/20
Mr. [illegible] 1/21

January 16, 1970

THE WORLD BANK AND THE COMMODITY PROBLEM

A number of questions have arisen about the nature of the commodity problem and the role of the Bank with respect to it. In particular, the question has been raised as to whether the Bank should stand ready to provide more direct support for international buffer stock operations than is implied in the decision taken last June by the Executive Directors. The purpose of this paper is to deal briefly with these issues and to indicate where the future emphasis of Bank policy should be with respect to the commodity problem.

I. Nature of the Commodity Problem

The commodity problem consists of two related but separate aspects: adverse long-term trends in prices and export earnings and wide short-term swings in these same variables. The Rio Resolution, which prompted the Bank decision of last June, is entitled "Stabilization of Prices of Primary Products," but it actually is addressed to both aspects of the problem since it refers to the need for a "remunerative level" of prices as well as to the need for stabilization.

Although we speak of the "commodity problem" in general, not all primary commodities produced and exported by the developing countries can be placed in the problem category. The commodities posing the main difficulties are for the most part agricultural and are characterized by sluggish growth in export markets as well as by short-term instability.

The basic cause of fluctuations lies in the interaction between, on the one hand, an inelastic demand with respect to price and, on the other hand, unplanned changes in supply due to natural causes such as weather and pests. This interaction induces wide fluctuations in prices and earnings in a direction inverse to the changes in production. Changes in demand in the industrial countries can also trigger market fluctuations but for agricultural commodities, as opposed to metals, these are generally of lesser importance. Even for metals the severity of demand-induced instability is less than it was prior to the second World War because the amplitude of business fluctuations in the advanced countries has been substantially moderated.

The basic cause of adverse longer-term trends in certain primary commodities is the slow growth in world demand relative to the ease with which output can be increased at existing prices. While a variety of forces underlies the sluggish growth in demand, competition from synthetics affects some of the most difficult cases such as rubber, cotton, jute and abaca.

Ignoring for the moment the interconnections between short-term instability and longer-term trends, it is fair to say that by far the more important of the two problems is that of adverse longer-term trends. For those countries lucky enough to be exporting commodities, such as petroleum and most of the metals, with favorable recent and prospective trends in prices and earnings, the fact that these earnings are subject to wide short-term fluctuations is a secondary problem. Similarly, those countries whose exports are concentrated in commodities with adverse long-term trends in prices and earnings are primarily concerned about the fact that their export earnings are not growing at an adequate rate rather than about the fact that, whatever the trend in those earnings, the latter are realized in widely varying amounts from year to year.

It is true that highly unstable prices may to some extent accentuate adverse longer-term trends in commodity markets. Instability in prices may exert a depressant effect on the demand for natural products when close synthetic substitutes are available with more stable and predictable price behavior. On the supply side, temporary high prices due to natural phenomena, such as drought or pests, may induce uneconomic investment in new productive capacity for commodities with long gestation periods (e.g., coffee, cocoa). When the new production ultimately comes onto the market, it accentuates the underlying adverse longer-term trend.

It is generally agreed, however, that instability is only contributory to the major problem of adverse trends and that, in order to deal with the latter, the forces determining the trends need to be dealt with more directly.

II. Role of Buffer Stocks and Commodity Agreements

For many years prior to the first UNCTAD Conference in 1964 the conventional wisdom in the Western world was that, if commodity arrangements were to be undertaken, they should be designed simply to moderate price fluctuations but should seek to avoid interfering with longer-term trends.

The rationale for this distinction was that excessive price fluctuations serve no economic purpose and could even impart the wrong economic signals as when temporary high prices stimulate excessive investment in new production. Both importing and exporting countries could agree on the objective of stabilization since they had an identity of interest in lopping off the peaks and troughs in prices. No transfer of real income from one group to the other over the long-term was implied in pure stabilization arrangements.

What was generally taboo, however, was any arrangement which through conscious interference with free market forces would attempt to alter the long-term trend of prices from what it would have been in the absence of an agreement. In this line of thinking, the trend in prices was simply a reflection of the underlying conditions of supply and demand, which in time would change and establish a new equilibrium. Importing countries might be willing to cooperate in measures to assist the process of orderly adjustment to the new conditions. But they were generally unwilling to conceive of commodity arrangements as devices to alter over an extended period of time the terms of trade of the primary producing countries and thereby to accomplish through the market a real transfer of resources to the developing countries.

Given the traditional negative attitude of the industrialized countries toward commodity arrangements of the latter variety, the question may nevertheless be raised as to why greater success was not achieved in negotiating more limited price-stabilization agreements whose objectives, after all, commanded general support. The answer is well put by Gerda Blau of the FAO in a study prepared for the first UNCTAD Conference: "The fact that the conclusion of price-stabilizing commodity agreements has proved so difficult in practice appears to indicate that neither exporters nor importers were prepared to pay a substantial premium for this kind of insurance ... And as to the interests of exporters, their main concern, of course, has been with the prospects for their total export proceeds (depending on volume as well as price) and with the average level of export proceeds over a number of years, measured in terms of import purchasing power, not merely with short-term fluctuations in money terms."1/

International buffer stocks are one device for moderating short-term fluctuations in prices and earnings from commodity exports and do not, by themselves, alter longer term trends and earnings. Therefore, where a buffer stock exists (tin) or has been seriously discussed (cocoa), it has been as

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1/ Gerda Blau, "International Commodity Arrangements and Policies," Proceedings of 1st UNCTAD Conference, Volume III, page 142 (1964) part of a broader attempt to improve the longer-term prospects for the commodity through controlling supplies offered on the world market. For the latter purpose, export quotas have been the principal instrument, and buffer stocks the subsidiary instrument. Since the main impetus for international action in the commodity field arises from structural disequilibrium between production and demand, it is unlikely that international buffer stocks can be negotiated in the future except in the context of more comprehensive arrangements for dealing with the disequilibrium through export quotas and diversification programs. Without such arrangements, moreover, a buffer stock would not be a practicable proposition since its financial resources would be quickly exhausted as it attempted to maintain a floor price in the face of unlimited supplies thrown on the market.

From what has been said above, it follows that a major limitation on the prospects for establishing international buffer stocks is the willingness and ability of the international community to negotiate commodity agreements which encompass the longer-term objective of achieving, in the words of the Rio resolution, a "remunerative level" of prices for exports of primary products. Or stated another way, the main interest of the developing countries is in improving their terms of trade and thereby accomplishing a transfer of resources from the rich importing countries to the low-income countries.

Since supply limitation is the key to achieving this objective, international buffer stocks could even work at cross-purposes to it by relieving individual countries of some of the pressures to reduce production. With export quotas but without <u>international</u> buffer stocks, the necessity to carry and finance large <u>national</u> stocks operate as a powerful lever to induce producing countries to curtail investment and output. This consideration is undoubtedly among those that account for the absence of a buffer stock arrangement in the coffee and sugar agreements.

Another consideration points toward possible conflict between buffer stocks and the achievement of the longer-term goals of commodity policy. The problem arises from the fact that, when a buffer stock is included as an integral part of a commodity agreement, ceiling and floor prices must be included in the agreement in explicit terms. This can prevent widely desired international commodity agreement from coming into being. It was the protracted controversy surrounding the negotiation of a price range as a basis for buffer stock operations that prolonged the negotiation of a cocoa agreement to the point where the market situation had undergone important changes so that some of the principal participants were no longer willing to go ahead on the previously agreed basis. By way of contrast, the price objective in the 1962 coffee agreement, which does not provide for an international buffer stock, could be stated in more general terms since it was to be achieved entirely through export quotas without the need for market intervention. Given the enormous difficulties of negotiating a commodity arrangement even under favorable circumstances, it is hard to escape the conclusion that such difficulties are accentuated when specific prices must be agreed upon in advance of the arrangement coming into effect. Experience under the coffee agreement has also demonstrated that, without recourse to an international buffer stock, export quotas are capable of yielding a substantial degree of price stabilization in addition to an orderly growth of export earnings in excess of what would have taken place in the absence of the agreement.

III. Buffer Stocks and the World Bank

Nevertheless, well-designed international buffer stocks could in certain cases make a contribution to the stabilization and strengthening of primary commodity markets when part of a comprehensive international commodity arrangement. It is natural therefore that the World Bank and the IMF should have attempted to facilitate their establishment as part of the affirmative response of the two institutions to the call of the less developed countries for additional mechanisms to deal with the commodity problem.

In the discussion which preceded the Rio Resolution, however, the importance of buffer stocks *per se* tended to escalate and eventually took on an almost symbolic character as indicative of the willingness of the international community to do something tangible about the commodity problem. Somehow the idea took hold that, if only adequate sources of finance were available, a major obstacle to the establishment of buffer stocks would be eliminated and the way would then be cleared for the negotiation of broader commodity agreements.

As already explained, the true sequence runs the other way. The main constraint on the prospects for establishing international buffer stocks lies in the complex of obstacles that stand in the way of commodity arrangements involving limitations on exports and production. Among such obstacles are conflicts between producers and consumers as to the long-run price objectives underlying the size of total quotas; conflicts among producers as to the basis for allocating country quotas; the need to reconcile the desire for higher prices with the threat of encouraging substitution; the need to build into the agreement strong incentives for diversification and disincentives for perpetuating overproduction; and a variety of negotiating and enforcement problems.

It is doubtful, moreover, that, if the other conditions were satisfied, finance would turn out to be a serious obstacle to the inclusion of buffer stocks as part of international commodity agreements. In the cocoa negotiations, for example, the plan was to finance the buffer stock through an export levy of one cent per pound. To the extent that, over the relevant price range, demand is less elastic than supply, the incidence of such a tax would fall mainly on the importing countries. Where such self-financing is contemplated, the need for outside funds would arise primarily to pre-finance the buffer stock in order to enable it to buy in the market prior to the build-up of internal funds. For this purpose medium-term commercial financing might well be available, but the new financial facility established by the recent IMF decision provides greater assurance and cheaper access to funds, while the Bank decision takes care of the exceptional cases in which the Fund decision may not cover.

Whatever inhibition may have been imposed in the past by the absence of an established source of financing for international buffer stocks, the problem has been largely dissipated. This view has been confirmed in a statement made in July 1969 by the Advisory Committee to UNCTAD: "The Committee felt that the provision of pre-finance was no longer the most important obstacle to the setting up of a buffer stock scheme."1/

Although the pressure for new international machinery to finance buffer stocks has been relieved, the question has, nevertheless, been raised as to whether the Bank's contribution could not have been more forthcoming, particularly in willingness to provide financing directly for international buffer stocks either to countries or international agencies or both. In order to place this matter in perspective, something needs to be said about the relationship between the IMF and the Bank in the financing of buffer stocks and about the possible magnitude of calls upon the Bank for this purpose.

1/ UNCTAD, "Report of the Advisory Committee to the Board and to the Committee on Commodities on its Third session," 25 July 1969.

International stocking operations should be envisaged strictly for cushioning short-term disturbances. Any long-term holding of stocks for the purpose of facilitating the structural adjustment of production to demand under international commodity agreements should be primarily the responsibility of national governments on whom the cost of stockholding will exert additional leverage to hasten the adjustment. If this premise is accepted, it follows that the burden of financial assistance to international buffer stocks should properly be carried mostly by the IMF, the agency primarily concerned with short-term stabilization, and that the Bank's role should be supplementary as explained below.

Under the recent Fund decision, a member may draw up to 50 per cent of its quota in order to meet obligations assumed under an international buffer stock scheme. This amount may be drawn in a single year, but will be subject to an overriding limit of 75 per cent of quota governing drawings under the IMF's compensatory financing facility and buffer stock scheme together. As in the case of drawings for compensatory finance, drawings under the buffer stock scheme will not be charged against a member's ceiling on regular fund drawings. (Unlike the former, however, drawings under the buffer stock scheme will affect the degree of automacity of the availability of regular drawings.) When IMF quotas are increased in January 1971, drawing rights under the buffer stock scheme will be enlarged proportionately.

Given the sizable resources which will be available through the Fund, particularly after the proposed quota increases, the question arises as to what role the World Bank might play in the financing of international buffer stocks. Two possibilities may be envisaged. One would be to assist countries in cases where their drawing rights under the Fund's buffer stock scheme prove insufficient in relation to their need to contribute to international buffer stocks. The other would be to refinance Fund drawings if, when repurchase becomes due at the end of three to five years, the buffer stock has not yet been able to liquidate its stock and repay member countries.

Let us look at the refinancing loan first. The purpose of such a loan would be to relieve the buffer stock agency of the need to sell when the market for the commodity is depressed. The loan should not, however, encourage the agency to hold stocks over an excessively long period of time since a reasonably rapid turnover of stocks is of the essence of efficient buffer stock operations. If the stocks were not to be liquidated for as long as say ten years, it would signify that the agency was not conducting a buffer operation designed to smooth out short-term price fluctuations and that its market intervention rules should have been adjusted. On the assumption that proper intervention rules are followed, it would be rather the exception for a buffer stock agency to hold stocks for more than even five years. To the extent that the IMF would be prepared to roll over its drawings, the likelihood of a need for World Bank refinancing would be reduced, and the amounts involved for the balance likely to be small.

This conclusion is reinforced, moreover, to the extent that future international buffer stock schemes provide for internal financing such as the export tax that was accepted in principle and included in the draft cocoa agreement. Such internal financing could substantially eliminate the need for outside assistance beyond a build-up period of five years. As a matter of fact, had the draft cocoa agreement been in effect during the period 1960-68, the hypothetical proceeds of the export levy would have been more than sufficient to finance both the acquisition of stocks and their carrying costs without any external assistance from the IMF or from any other source. Even if the Agreement had come into force in 1965 when there would have been an immediate need to make large stock purchases, the export levy would have obviated the need for short-term assistance beyond two years.1/

1/ IMF, "Some Aspects of Fund Liquidity and Buffer Stock Financing," 28 March 1969.

While the foregoing considerations suggest a probable minimal need for World Bank refinancing of IMF drawings, one cannot be certain that the Fund will in fact roll over its buffer stock drawings, nor that future international buffer stocks will necessarily provide for internal financing, nor that such self-financing, if provided, would fully satisfy the need for funds. If we assume no roll-overs by the Fund and no self-financing, what is the extent of possible claims on Bank resources for refinancing fund drawings? And what additional claims would arise from countries whose buffer stock drawing rights under the IMF scheme prove insufficient from the start.

An assessment of the magnitude of these potential demands for Bank assistance over a future period can in the nature of the case only be highly speculative. Among the relevant variables are: the probability of international agreements being negotiated for particular commodities; the prospect that such agreements would provide for the establishment of buffer stocks; the size of the buffer stock; the width of the agreed price range; the relative emphasis placed in the agreement on buffer stock operations as against other stabilization techniques; the extent to which only partial payment would be made upon the acquisition of buffer stocks (e.g. the half-payment provision in the cocoa agreement); the degree to which countries' drawing rights under the IMF buffer stock scheme may have been reduced through prior drawings under the compensatory financing scheme in excess of 25 per cent of quota; the lag of disbursements behind commitments (the timing of the former depending on the precise state of the market, while the latter become effective when the agreement enters into force).

An enumeration of the foregoing factors is perhaps sufficient to convey the high degree of uncertainty that necessarily attaches to any effort to estimate possible calls for Bank assistance in the financing of buffer stocks. Nevertheless such an attempt has been made by the Bank staff in a quantitative analysis covering fourteen commodities identified by the UNCTAD Secretariat as candidates for international buffer stocks: coffee, cocoa, tea, sugar, pepper, lauric oils and seeds, rubber, jute and allied fibers, hard fibers, copper, tin, lead, zinc and tungsten.[1] The principal assumptions underlying the analysis concern the probability of a buffer stock agreement being signed for each of the commodities by 1972; the most likely size of the buffer stock for each commodity; and the probability distribution of disbursements expressed as a fraction of commitments. In order to safeguard against understatement, it was assumed that the recent commodity stabilization decisions of the Fund and the Bank would encourage international commodity agreements involving buffer stocks.[2]

The findings of the study point to an exceedingly modest residual role for the Bank in financing capital contributions to international buffer stocks. Among the members of the Bank, 61 developing countries are exporters of the commodities for which international buffer stocks either exist or may conceivably be established. If the IMF did not roll over its drawings and if the IBRD decided to refinance them, the magnitude of net cumulative disbursements for refinancing purposes by the Bank over the period 1973-77 would be of the order of $100 million and would be unlikely to exceed $200 million.[3]

1/ In the case of tin an international buffer stock exists, but serious consideration has been given to increasing its size from 12 per cent to perhaps 18 per cent of world exports.

2/ IBRD, "Financing of International Buffer Stocks", Part Two, draft dated November 28, 1969.

3/ The quantitative analysis indicated that the mean disbursement would be $162 million and that, with 90% probability, disbursements would not exceed $326 million (line 1, Table 1, page 39, draft November 28, 1969, op. cit.). As noted in para. 69 of the cited paper, these figures provide an upper limit of the amount which the Bank might have to disburse. However, some of the buffer stocks would have liquidated their holdings in less than five years and reimbursed the member countries. The latter would therefore be in a position to pay back the Fund, thus reconstituting their drawing rights. Bank disbursements would therefore be substantially lower than the figure shown in Table 1.

When account is taken of the prospective increase in IMF quotas, the 61 countries will have access to drawings under the Fund's buffer stock facility amounting to \$3.2 billion. Nevertheless, the required net cumulative disbursements of some countries over the period 1973-77 could, according to the study, exceed their drawing rights under the IMF's facility, but only to a maximum extent of \$62 million, and the maximum number of "problem countries" requiring assistance supplementary to their IMF buffer stock tranches would be six. These small figures define the probable extent of the total net call upon Bank resources over the five-year period on the assumption that no Bank refinancing of Fund drawings takes place.

In sum, if the Bank undertook both to refinance buffer stock drawings from the Fund and to assist the "problem countries", the net cumulative call upon the Bank resources in the period 1973-77 would be unlikely to exceed about \$250 million, and the most probable figure would be of the order of \$100 million. While the full amount could conceivably be requested in a single year, the average annual call upon Bank resources for both purposes over the five-year period would probably amount to about \$20 million per year.

The foregoing estimates are predicated on the assumption that the full 50 per cent of IMF quotas would be available for buffer stock financing. Up to half of this amount, however, could be used up if full prior access had been had to a country's drawing rights under the Fund's compensatory financing facility. But actual use of the latter facility has been modest: outstanding drawings are approximately \$200 million and have never exceeded \$300 million. Nevertheless, if consideration is given to the possibility that half of the IMF buffer stock financing might have been used up, a few additional countries might need recourse to Bank financing, but the amounts involved would still remain small.

Despite the modest role anticipated for the World Bank in the financing of international buffer stocks, its willingness to cooperate in this field has taken on a certain additional significance of a symbolic character. It might therefore be desirable to remove the ambiguities in the present Board decision which would permit the Bank, "while maintaining its normal lending standards", to take into account additional borrowing needs of members arising from participation in appropriate international buffer stock arrangements. The decision has been construed by some to mean that the vehicle for Bank assistance for buffer stocks would only be its normal project loans. While this interpretation is unduly restrictive, it might nevertheless be helpful to state simply that the Bank is ready to lend to member countries directly for the purpose of assisting them to participate in international buffer stocks. Confirmation by the Executive Directors of this interpretation of their decision would be helpful.

IV. Diversification and the World Bank

The traditional western view that international commodity arrangements should moderate short-term fluctuations in prices and earnings but should not disturb long-term trends has in the last half-dozen years given way to the more activist view that the improvement of long-term trends is in itself a legitimate and indeed, a more compelling, objective of international cooperation. Whether or not the vehicle consists of commodity agreements, an essential element of such broader cooperation is the diversification of developing countries' economies away from primary commodities with unfavorable export prospects to other activities with a more favorable outlook. Part of the rationale for diversification is that it will improve the price trends for less developed countries exports and thereby bring about a transfer of resources from developed to developing countries.

Diversification occupied a central place in the Board's discussion of the commodity problem, and a decision was taken to give special consideration to projects which restrain or reduce over-production of primary products. The discussion did not, however, explore fully the possible implications of a more activist role in the commodity field for the Bank's normal techniques of project evaluation.

Normally, when the Bank considers a commodity project for country A, it calculates a rate of return by comparing the opportunity cost of production in that country with an estimated future world price. The project's impact on countries other than A would ordinarily be ignored. Although account is taken of the impact of the project on world markets, this is done only as it affects country A itself by lowering world prices. Since the project's exportable output is usually small in relation to the volume of world exports, the impact of country A's project on world prices remains generally well within the margin of error of the projected world price. Consequently, this correction factor is unimportant for country A, but for country A only. The accumulated losses of all developing countries other than A can be many times greater than the gain to country A.

There are circumstances, however, when the Bank <u>does</u> take into account the impact of an investment in country A on other developing countries. If there were a commodity agreement, for example, the Bank might well hesitate to finance a project in a country that had not signed the Agreement even if the rate of return were high. In this case the Bank realizes that by financing the project it would be undermining the Agreement and thereby damaging the interests of other developing countries.

Similarly, even in the absence of a commodity agreement, the Bank would hesitate to lend to increase the production of a commodity anywhere when a sharp decline in price has taken place. Although this policy may be destabilizing in the case of commodities with long gestation periods, it does provide another illustration of Bank policy being governed implicitly by a concern for the repercussions of its operations beyond the country in which the project may be located.

In general, however, the Bank's approach to project evaluation is still highly country-oriented, with little attention ordinarily given to the interaction between countries. This tendency can perhaps be explained by the traditional heavy concentration of Bank lending in the power and transport sectors, both of which produce non-tradeable goods. With the expansion of Bank operations into other fields, and particularly into primary commodities, it becomes essential to take account of the impact on other countries of policies adopted toward a given country.

The distinction drawn between national and international effects is analogous to the distinction between private and social rate of return. Government subsidies are legitimate where private returns are low but social returns are high, e.g., conservation and pollution. Similarly international financing should stimulate activities, such as research on improved grain varieties, which yield high international rates of return even though the returns may be modest to the country where the research is carried out. Contrariwise, an international institution whose function is assisting developing countries should not provide a loan for research on synthetic cocoa, regardless of how high the return to the recipient country or to high-income consuming countries might be.

By affirming its support last June for projects which would help restrain overproduction of primary products, the Bank has implicitly recognized the importance of an improvement in the terms of trade for the developing countries. As a source of additional resource transfers, more favorable export price trends may be of greater significance than an increased volume of aid. In order to pursue this objective in a more systematic way, however, it would be necessary for the Bank to develop and articulate an overall commodity strategy that clearly recognized the importance of maximizing the "social rate of return" for the developing world as a whole.

V. A New Role for the World Bank

A new role for the Bank in the commodity field can be envisaged by analogy with its role in assisting individual countries in their development efforts.

Following a country-by-country approach, the Bank is now preparing, subject to annual revision on the basis of full-scale country economic missions, five-year country programs of probable developments in each country, an indication of the direction along which these developments should be modified, and an outline of the actions to be taken by the Bank to facilitate the modifications. Formulation of such programs does not mean that the Bank believes that it should or could control the development policies of any given country. It simply reflects the Bank's conviction that, if it wishes to exert some leverage on a country's development policy, it must have a development strategy for that country.

Following a commodity-by-commodity approach, the Bank could also prepare and revise at yearly intervals "commodity programs" for the major primary commodities. The"commodity programs" could be established in three steps:

1. Perspectives would be established of the most likely developments in demand, production and prices for those commodities of importance to developing countries. Particular attention would be given to the projection of production, which is generally the weakest element in commodity forecasts. This would require a review of production policies and investment plans and an analysis of the response of production to prices. This first step should lead to a picture of what would be most likely to occur in the different commodity markets in the absence of any Bank action.
2. An analysis would then be made of how the most likely evolution could be improved. In making this assessment the Bank would take into account both demand and supply elasticities as well as opportunity costs in the various producing countries.
3. The Bank would define its strategy for the commodity concerned on a global basis. It would be expressed both in terms of overall policies and in terms of specific investment targets for Bank lending in individual countries.[1/]

The country and the commodity approaches are not independent but are only two different ways of looking at the same problem. By using the two approaches simultaneously and by insuring consistency between them, an optimum Bank strategy can be developed which takes account of the interaction between countries throughout world commodity markets as expressed in a social rate of return for the developing world as a whole.

1/ For a draft technical paper on this subject see "Diversification Benefits and Criteria for Project Selection," 25 September 1969.

To carry out its "commodity programs," the Bank could exert leverage in a number of ways: through its lending operations and, in particular, through the conditions stipulated in Bank loans; through its general policy advice either directly or through consultative groups chaired by the Bank; through the role it may be asked to play in commodity diversification funds; through advice to international commodity councils, particularly with respect to relative opportunity costs as a basis for the reallocation of quotas;1/ and, where appropriate, by suggesting to the competent U.N. body that a conference be called on a particular commodity and by presenting suggestions as to the nature of desirable arrangements.

None of these actions would be in conflict with the Board decisions on commodities. Within those guidelines the Bank could play a leading role in influencing world commodity trade if it wished to do so. The prerequisite, however, would be for the Bank to establish "commodity programs" along the lines proposed in this paper.

In view of the novelty of this approach, it is suggested that it be done initially for a few commodities on an experimental basis.

I. S. Friedman
I. Frank
L. Goreux

1/ For example, if Burundi could export nothing but coffee, while Brazil had a choice between coffee and something else, the relative opportunity cost would be lower in Burundi than in Brazil, even if market costs were higher. Under such conditions, the Bank could make a case for revising Burundi's quota upward.

January 16, 1970

THE WORLD BANK AND THE COMMODITY PROBLEM

A number of questions have arisen about the nature of the commodity problem and the role of the Bank with respect to it. In particular, the question has been raised as to whether the Bank should stand ready to provide more direct support for international buffer stock operations than is implied in the decision taken last June by the Executive Directors. The purpose of this paper is to deal briefly with these issues and to indicate where the future emphasis of Bank policy should be with respect to the commodity problem.

I. Nature of the Commodity Problem

The commodity problem consists of two related but separate aspects: adverse long-term trends in prices and export earnings and wide short-term swings in these same variables. The Rio Resolution, which prompted the Bank decision of last June, is entitled "Stabilization of Prices of Primary Products," but it actually is addressed to both aspects of the problem since it refers to the need for a "remunerative level" of prices as well as to the need for stabilization.

Although we speak of the "commodity problem" in general, not all primary commodities produced and exported by the developing countries can be placed in the problem category. The commodities posing the main difficulties are for the most part agricultural and are characterized by sluggish growth in export markets as well as by short-term instability.

The basic cause of fluctuations lies in the interaction between, on the one hand, an inelastic demand with respect to price and, on the other hand, unplanned changes in supply due to natural causes such as weather and pests. This interaction induces wide fluctuations in prices and earnings in a direction inverse to the changes in production. Changes in demand in the industrial countries can also trigger market fluctuations but for agricultural commodities, as opposed to metals, these are generally of lesser importance. Even for metals the severity of demand-induced instability is less than it was prior to the second World War because the amplitude of business fluctuations in the advanced countries has been substantially moderated.

The basic cause of adverse longer-term trends in certain primary commodities is the slow growth in world demand relative to the ease with which output can be increased at existing prices. While a variety of forces underlies the sluggish growth in demand, competition from synthetics affects some of the most difficult cases such as rubber, cotton, jute and abaca.

Ignoring for the moment the interconnections between short-term instability and longer-term trends, it is fair to say that by far the more important of the two problems is that of adverse longer-term trends. For those countries lucky enough to be exporting commodities, such as petroleum and most of the metals, with favorable recent and prospective trends in prices and earnings, the fact that these earnings are subject to wide short-term fluctuations is a secondary problem. Similarly, those countries whose exports are concentrated in commodities with adverse long-term trends in prices and earnings are primarily concerned about the fact that their export earnings are not growing at an adequate rate rather than about the fact that, whatever the trend in those earnings, the latter are realized in widely varying amounts from year to year.

It is true that highly unstable prices may to some extent accentuate adverse longer-term trends in commodity markets. Instability in prices may exert a depressant effect on the demand for natural products when close synthetic substitutes are available with more stable and predictable price behavior. On the supply side, temporary high prices due to natural phenomena, such as drought or pests, may induce uneconomic investment in new productive capacity for commodities with long gestation periods (e.g., coffee, cocoa). When the new production ultimately comes onto the market, it accentuates the underlying adverse longer-term trend.

It is generally agreed, however, that instability is only contributory to the major problem of adverse trends and that, in order to deal with the latter, the forces determining the trends need to be dealt with more directly.

II. Role of Buffer Stocks and Commodity Agreements

For many years prior to the first UNCTAD Conference in 1964 the conventional wisdom in the Western world was that, if commodity arrangements were to be undertaken, they should be designed simply to moderate price fluctuations but should seek to avoid interfering with longer-term trends.

The rationale for this distinction was that excessive price fluctuations serve no economic purpose and could even impart the wrong economic signals as when temporary high prices stimulate excessive investment in new production. Both importing and exporting countries could agree on the objective of stabilization since they had an identity of interest in lopping off the peaks and troughs in prices. No transfer of real income from one group to the other over the long-term was implied in pure stabilization arrangements.

What was generally taboo, however, was any arrangement which through conscious interference with free market forces would attempt to alter the long-term trend of prices from what it would have been in the absence of an agreement. In this line of thinking, the trend in prices was simply a reflection of the underlying conditions of supply and demand, which in time would change and establish a new equilibrium. Importing countries might be willing to cooperate in measures to assist the process of orderly adjustment to the new conditions. But they were generally unwilling to conceive of commodity arrangements as devices to alter over an extended period of time the terms of trade of the primary producing countries and thereby to accomplish through the market a real transfer of resources to the developing countries.

Given the traditional negative attitude of the industrialized countries toward commodity arrangements of the latter variety, the question may nevertheless be raised as to why greater success was not achieved in negotiating more limited price-stabilization agreements whose objectives, after all, commanded general support. The answer is well put by Gerda Blau of the FAO in a study prepared for the first UNCTAD Conference: "The fact that the conclusion of price-stabilizing commodity agreements has proved so difficult in practice appears to indicate that neither exporters nor importers were prepared to pay a substantial premium for this kind of insurance ... And as to the interests of exporters, their main concern, of course, has been with the prospects for their total export proceeds (depending on volume as well as price) and with the average level of export proceeds over a number of years, measured in terms of import purchasing power, not merely with short-term fluctuations in money terms."[1/]

International buffer stocks are one device for moderating short-term fluctuations in prices and earnings from commodity exports and do not, by themselves, alter longer term trends and earnings. Therefore, where a buffer stock exists (tin) or has been seriously discussed (cocoa), it has been as

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1/ Gerda Blau, "International Commodity Arrangements and Policies," Proceedings of 1st UNCTAD Conference, Volume III, page 142 (1964) part of a broader attempt to improve the longer-term prospects for the commodity through controlling supplies offered on the world market. For the latter purpose, export quotas have been the principal instrument, and buffer stocks the subsidiary instrument. Since the main impetus for international action in the commodity field arises from structural disequilibrium between production and demand, it is unlikely that international buffer stocks can be negotiated in the future except in the context of more comprehensive arrangements for dealing with the disequilibrium through export quotas and diversification programs. Without such arrangements, moreover, a buffer stock would not be a practicable proposition since its financial resources would be quickly exhausted as it attempted to maintain a floor price in the face of unlimited supplies thrown on the market.

From what has been said above, it follows that a major limitation on the prospects for establishing international buffer stocks is the willingness and ability of the international community to negotiate commodity agreements which encompass the longer-term objective of achieving, in the words of the Rio Resolution, a "remunerative level" of prices for exports of primary products. Or stated another way, the main interest of the developing countries is in improving their terms of trade and thereby accomplishing a transfer of resources from the rich importing countries to the low-income countries.

Since supply limitation is the key to achieving this objective, international buffer stocks could even work at cross-purposes to it by relieving individual countries of some of the pressures to reduce production. With export quotas but without <u>international</u> buffer stocks, the necessity to carry and finance large <u>national</u> stocks operate as a powerful lever to induce producing countries to curtail investment and output. This consideration is undoubtedly among those that account for the absence of a buffer stock arrangement in the coffee and sugar agreements.

Another consideration points toward possible conflict between buffer stocks and the achievement of the longer-term goals of commodity policy. The problem arises from the fact that, when a buffer stock is included as an integral part of a commodity agreement, ceiling and floor prices must be included in the agreement in explicit terms. This can prevent widely desired international commodity agreement from coming into being. It was the protracted controversy surrounding the negotiation of a price range as a basis for buffer stock operations that prolonged the negotiation of a cocoa agreement to the point where the market situation had undergone important changes so that some of the principal participants were no longer willing to go ahead on the previously agreed basis. By way of contrast, the price objective in the 1962 coffee agreement, which does not provide for an international buffer stock, could be stated in more general terms since it was to be achieved entirely through export quotas without the need for market intervention. Given the enormous difficulties of negotiating a commodity arrangement even under favorable circumstances, it is hard to escape the conclusion that such difficulties are accentuated when specific prices must be agreed upon in advance of the arrangement coming into effect. Experience under the coffee agreement has also demonstrated that, without recourse to an international buffer stock, export quotas are capable of yielding a substantial degree of price stabilization in addition to an orderly growth of export earnings in excess of what would have taken place in the absence of the agreement.

III. Buffer Stocks and the World Bank

Nevertheless, well-designed international buffer stocks could in certain cases make a contribution to the stabilization and strengthening of primary commodity markets when part of a comprehensive international commodity arrangement. It is natural therefore that the World Bank and the IMF should have attempted to facilitate their establishment as part of the affirmative response of the two institutions to the call of the less developed countries for additional mechanisms to deal with the commodity problem.

In the discussion which preceded the Rio Resolution, however, the importance of buffer stocks *per se* tended to escalate and eventually took on an almost symbolic character as indicative of the willingness of the international community to do something tangible about the commodity problem. Somehow the idea took hold that, if only adequate sources of finance were available, a major obstacle to the establishment of buffer stocks would be eliminated and the way would then be cleared for the negotiation of broader commodity agreements.

As already explained, the true sequence runs the other way. The main constraint on the prospects for establishing international buffer stocks lies in the complex of obstacles that stand in the way of commodity arrangements involving limitations on exports and production. Among such obstacles are conflicts between producers and consumers as to the long-run price objectives underlying the size of total quotas; conflicts among producers as to the basis for allocating country quotas; the need to reconcile the desire for higher prices with the threat of encouraging substitution; the need to build into the agreement strong incentives for diversification and disincentives for perpetuating overproduction; and a variety of negotiating and enforcement problems.

It is doubtful, moreover, that, if the other conditions were satisfied, finance would turn out to be a serious obstacle to the inclusion of buffer stocks as part of international commodity agreements. In the cocoa negotiations, for example, the plan was to finance the buffer stock through an export levy of one cent per pound. To the extent that, over the relevant price range, demand is less elastic than supply, the incidence of such a tax would fall mainly on the importing countries. Where such self-financing is contemplated, the need for outside funds would arise primarily to pre-finance the buffer stock in order to enable it to buy in the market prior to the build-up of internal funds. For this purpose medium-term commercial financing might well be available, but the new financial facility established by the recent IMF decision provides greater assurance and cheaper access to funds, while the Bank decision takes care of the exceptional cases in which the Fund decision may not cover.

Whatever inhibition may have been imposed in the past by the absence of an established source of financing for international buffer stocks, the problem has been largely dissipated. This view has been confirmed in a statement made in July 1969 by the Advisory Committee to UNCTAD: "The Committee felt that the provision of pre-finance was no longer the most important obstacle to the setting up of a buffer stock scheme."[1/]

Although the pressure for new international machinery to finance buffer stocks has been relieved, the question has, nevertheless, been raised as to whether the Bank's contribution could not have been more forthcoming, particularly in willingness to provide financing directly for international buffer stocks either to countries or international agencies or both. In order to place this matter in perspective, something needs to be said about the relationship between the IMF and the Bank in the financing of buffer stocks and about the possible magnitude of calls upon the Bank for this purpose.

1/ UNCTAD, "Report of the Advisory Committee to the Board and to the Committee on Commodities on its Third session," 25 July 1969.

International stocking operations should be envisaged strictly for cushioning short-term disturbances. Any long-term holding of stocks for the purpose of facilitating the structural adjustment of production to demand under international commodity agreements should be primarily the responsibility of national governments on whom the cost of stockholding will exert additional leverage to hasten the adjustment. If this premise is accepted, it follows that the burden of financial assistance to international buffer stocks should properly be carried mostly by the IMF, the agency primarily concerned with short-term stabilization, and that the Bank's role should be supplementary as explained below.

Under the recent Fund decision, a member may draw up to 50 per cent of its quota in order to meet obligations assumed under an international buffer stock scheme. This amount may be drawn in a single year, but will be subject to an overriding limit of 75 per cent of quota governing drawings under the IMF's compensatory financing facility and buffer stock scheme together. As in the case of drawings for compensatory finance, drawings under the buffer stock scheme will not be charged against a member's ceiling on regular fund drawings. (Unlike the former, however, drawings under the buffer stock scheme will affect the degree of automacity of the availability of regular drawings.) When IMF quotas are increased in January 1971, drawing rights under the buffer stock scheme will be enlarged proportionately.

Given the sizable resources which will be available through the Fund, particularly after the proposed quota increases, the question arises as to what role the World Bank might play in the financing of international buffer stocks. Two possibilities may be envisaged. One would be to assist countries in cases where their drawing rights under the Fund's buffer stock scheme prove insufficient in relation to their need to contribute to international buffer stocks. The other would be to refinance Fund drawings if, when repurchase becomes due at the end of three to five years, the buffer stock has not yet been able to liquidate its stock and repay member countries.

Let us look at the refinancing loan first. The purpose of such a loan would be to relieve the buffer stock agency of the need to sell when the market for the commodity is depressed. The loan should not, however, encourage the agency to hold stocks over an excessively long period of time since a reasonably rapid turnover of stocks is of the essence of efficient buffer stock operations. If the stocks were not to be liquidated for as long as say ten years, it would signify that the agency was not conducting a buffer operation designed to smooth out short-term price fluctuations and that its market intervention rules should have been adjusted. On the assumption that proper intervention rules are followed, it would be rather the exception for a buffer stock agency to hold stocks for more than even five years. To the extent that the IMF would be prepared to roll over its drawings, the likelihood of a need for World Bank refinancing would be reduced, and the amounts involved for the balance likely to be small.

This conclusion is reinforced, moreover, to the extent that future international buffer stock schemes provide for internal financing such as the export tax that was accepted in principle and included in the draft cocoa agreement. Such internal financing could substantially eliminate the need for outside assistance beyond a build-up period of five years. As a matter of fact, had the draft cocoa agreement been in effect during the period 1960-68, the hypothetical proceeds of the export levy would have been more than sufficient to finance both the acquisition of stocks and their carrying costs without any external assistance from the IMF or from any other source. Even if the Agreement had come into force in 1965 when there would have been an immediate need to make large stock purchases, the export levy would have obviated the need for short-term assistance beyond two years.[1/]

1/ IMF, "Some Aspects of Fund Liquidity and Buffer Stock Financing," 28 March 1969.

While the foregoing considerations suggest a probable minimal need for World Bank refinancing of IMF drawings, one cannot be certain that the Fund will in fact roll over its buffer stock drawings, nor that future international buffer stocks will necessarily provide for internal financing, nor that such self-financing, if provided, would fully satisfy the need for funds. If we assume no roll-overs by the Fund and no self-financing, what is the extent of possible claims on Bank resources for refinancing fund drawings? And what additional claims would arise from countries whose buffer stock drawing rights under the IMF scheme prove insufficient from the start.

An assessment of the magnitude of these potential demands for Bank assistance over a future period can in the nature of the case only be highly speculative. Among the relevant variables are: the probability of international agreements being negotiated for particular commodities; the prospect that such agreements would provide for the establishment of buffer stocks; the size of the buffer stock; the width of the agreed price range; the relative emphasis placed in the agreement on buffer stock operations as against other stabilization techniques; the extent to which only partial payment would be made upon the acquisition of buffer stocks (e.g. the half-payment provision in the cocoa agreement); the degree to which countries' drawing rights under the IMF buffer stock scheme may have been reduced through prior drawings under the compensatory financing scheme in excess of 25 per cent of quota; the lag of disbursements behind commitments (the timing of the former depending on the precise state of the market, while the latter become effective when the agreement enters into force).

An enumeration of the foregoing factors is perhaps sufficient to convey the high degree of uncertainty that necessarily attaches to any effort to estimate possible calls for Bank assistance in the financing of buffer stocks. Nevertheless such an attempt has been made by the Bank staff in a quantitative analysis covering fourteen commodities identified by the UNCTAD Secretariat as candidates for international buffer stocks: coffee, cocoa, tea, sugar, pepper, lauric oils and seeds, rubber, jute and allied fibers, hard fibers, copper, tin, lead, zinc and tungsten.[1] The principal assumptions underlying the analysis concern the probability of a buffer stock agreement being signed for each of the commodities by 1972; the most likely size of the buffer stock for each commodity; and the probability distribution of disbursements expressed as a fraction of commitments. In order to safeguard against understatement, it was assumed that the recent commodity stabilization decisions of the Fund and the Bank would encourage international commodity agreements involving buffer stocks.[2]

The findings of the study point to an exceedingly modest residual role for the Bank in financing capital contributions to international buffer stocks. Among the members of the Bank, 61 developing countries are exporters of the commodities for which international buffer stocks either exist or may conceivably be established. If the IMF did not roll over its drawings and if the IBRD decided to refinance them, the magnitude of net cumulative disbursements for refinancing purposes by the Bank over the period 1973-77 would be of the order of $100 million and would be unlikely to exceed $200 million.[3]

1/ In the case of tin an international buffer stock exists, but serious consideration has been given to increasing its size from 12 per cent to perhaps 18 per cent of world exports.

2/ IBRD, "Financing of International Buffer Stocks", Part Two, draft dated November 28, 1969.

3/ The quantitative analysis indicated that the mean disbursement would be $162 million and that, with 90% probability, disbursements would not exceed $326 million (line 1, Table 1, page 39, draft November 28, 1969, op. cit.). As noted in para. 69 of the cited paper, these figures provide an upper limit of the amount which the Bank might have to disburse. However, some of the buffer stocks would have liquidated their holdings in less than five years and reimbursed the member countries. The latter would therefore be in a position to pay back the Fund, thus reconstituting their drawing rights. Bank disbursements would therefore be substantially lower than the figure shown in Table 1.

When account is taken of the prospective increase in IMF quotas, the 61 countries will have access to drawings under the Fund's buffer stock facility amounting to \$3.2 billion. Nevertheless, the required net cumulative disbursements of some countries over the period 1973-77 could, according to the study, exceed their drawing rights under the IMF's facility, but only to a maximum extent of \$62 million, and the maximum number of "problem countries" requiring assistance supplementary to their IMF buffer stock tranches would be six. These small figures define the probable extent of the total net call upon Bank resources over the five-year period on the assumption that no Bank refinancing of Fund drawings takes place.

In sum, if the Bank undertook both to refinance buffer stock drawings from the Fund and to assist the "problem countries", the net cumulative call upon the Bank resources in the period 1973-77 would be unlikely to exceed about \$250 million, and the most probable figure would be of the order of \$100 million. While the full amount could conceivably be requested in a single year, the average annual call upon Bank resources for both purposes over the five-year period would probably amount to about \$20 million per year.

The foregoing estimates are predicated on the assumption that the full 50 per cent of IMF quotas would be available for buffer stock financing. Up to half of this amount, however, could be used up if full prior access had been had to a country's drawing rights under the Fund's compensatory financing facility. But actual use of the latter facility has been modest: outstanding drawings are approximately \$200 million and have never exceeded \$300 million. Nevertheless, if consideration is given to the possibility that half of the IMF buffer stock financing might have been used up, a few additional countries might need recourse to Bank financing, but the amounts involved would still remain small.

Despite the modest role anticipated for the World Bank in the financing of international buffer stocks, its willingness to cooperate in this field has taken on a certain additional significance of a symbolic character. It might therefore be desirable to remove the ambiguities in the present Board decision which would permit the Bank, "while maintaining its normal lending standards", to take into account additional borrowing needs of members arising from participation in appropriate international buffer stock arrangements. The decision has been construed by some to mean that the vehicle for Bank assistance for buffer stocks would only be its normal project loans. While this interpretation is unduly restrictive, it might nevertheless be helpful to state simply that the Bank is ready to lend to member countries directly for the purpose of assisting them to participate in international buffer stocks. Confirmation by the Executive Directors of this interpretation of their decision would be helpful.

IV. Diversification and the World Bank

The traditional western view that international commodity arrangements should moderate short-term fluctuations in prices and earnings but should not disturb long-term trends has in the last half-dozen years given way to the more activist view that the improvement of long-term trends is in itself a legitimate and indeed, a more compelling, objective of international cooperation. Whether or not the vehicle consists of commodity agreements, an essential element of such broader cooperation is the diversification of developing countries' economies away from primary commodities with unfavorable export prospects to other activities with a more favorable outlook. Part of the rationale for diversification is that it will improve the price trends for less developed countries exports and thereby bring about a transfer of resources from developed to developing countries.

Diversification occupied a central place in the Board's discussion of the commodity problem, and a decision was taken to give special consideration to projects which restrain or reduce over-production of primary products. The discussion did not, however, explore fully the possible implications of a more activist role in the commodity field for the Bank's normal techniques of project evaluation.

Normally, when the Bank considers a commodity project for country A, it calculates a rate of return by comparing the opportunity cost of production in that country with an estimated future world price. The project's impact on countries other than A would ordinarily be ignored. Although account is taken of the impact of the project on world markets, this is done only as it affects country A itself by lowering world prices. Since the project's exportable output is usually small in relation to the volume of world exports, the impact of country A's project on world prices remains generally well within the margin of error of the projected world price. Consequently, this correction factor is unimportant for country A, but for country A only. The accumulated losses of all developing countries other than A can be many times greater than the gain to country A.

There are circumstances, however, when the Bank does take into account the impact of an investment in country A on other developing countries. If there were a commodity agreement, for example, the Bank might well hesitate to finance a project in a country that had not signed the Agreement even if the rate of return were high. In this case the Bank realizes that by financing the project it would be undermining the Agreement and thereby damaging the interests of other developing countries.

Similarly, even in the absence of a commodity agreement, the Bank would hesitate to lend to increase the production of a commodity anywhere when a sharp decline in price has taken place. Although this policy may be destabilizing in the case of commodities with long gestation periods, it does provide another illustration of Bank policy being governed implicitly by a concern for the repercussions of its operations beyond the country in which the project may be located.

In general, however, the Bank's approach to project evaluation is still highly country-oriented, with little attention ordinarily given to the interaction between countries. This tendency can perhaps be explained by the traditional heavy concentration of Bank lending in the power and transport sectors, both of which produce non-tradeable goods. With the expansion of Bank operations into other fields, and particularly into primary commodities, it becomes essential to take account of the impact on other countries of policies adopted toward a given country.

The distinction drawn between national and international effects is analogous to the distinction between private and social rate of return. Government subsidies are legitimate where private returns are low but social returns are high, e.g., conservation and pollution. Similarly international financing should stimulate activities, such as research on improved grain varieties, which yield high international rates of return even though the returns may be modest to the country where the research is carried out. Contrariwise, an international institution whose function is assisting developing countries should not provide a loan for research on synthetic cocoa, regardless of how high the return to the recipient country or to high-income consuming countries might be.

By affirming its support last June for projects which would help restrain overproduction of primary products, the Bank has implicitly recognized the importance of an improvement in the terms of trade for the developing countries. As a source of additional resource transfers, more favorable export price trends may be of greater significance than an increased volume of aid. In order to pursue this objective in a more systematic way, however, it would be necessary for the Bank to develop and articulate an overall commodity strategy that clearly recognized the importance of maximizing the "social rate of return" for the developing world as a whole.

V. A New Role for the World Bank

A new role for the Bank in the commodity field can be envisaged by analogy with its role in assisting individual countries in their development efforts.

Following a country-by-country approach, the Bank is now preparing, subject to annual revision on the basis of full-scale country economic missions, five-year country programs of probable developments in each country, an indication of the direction along which these developments should be modified, and an outline of the actions to be taken by the Bank to facilitate the modifications. Formulation of such programs does not mean that the Bank believes that it should or could control the development policies of any given country. It simply reflects the Bank's conviction that, if it wishes to exert some leverage on a country's development policy, it must have a development strategy for that country.

Following a commodity-by-commodity approach, the Bank could also prepare and revise at yearly intervals "commodity programs" for the major primary commodities. The"commodity programs" could be established in three steps:

1. Perspectives would be established of the most likely developments in demand, production and prices for those commodities of importance to developing countries. Particular attention would be given to the projection of production, which is generally the weakest element in commodity forecasts. This would require a review of production policies and investment plans and an analysis of the response of production to prices. This first step should lead to a picture of what would be most likely to occur in the different commodity markets in the absence of any Bank action.
2. An analysis would then be made of how the most likely evolution could be improved. In making this assessment the Bank would take into account both demand and supply elasticities as well as opportunity costs in the various producing countries.
3. The Bank would define its strategy for the commodity concerned on a global basis. It would be expressed both in terms of overall policies and in terms of specific investment targets for Bank lending in individual countries.[1/]

The country and the commodity approaches are not independent but are only two different ways of looking at the same problem. By using the two approaches simultaneously and by insuring consistency between them, an optimum Bank strategy can be developed which takes account of the interaction between countries throughout world commodity markets as expressed in a social rate of return for the developing world as a whole.

1/ For a draft technical paper on this subject see "Diversification Benefits and Criteria for Project Selection," 25 September 1969.

To carry out its "commodity programs," the Bank could exert leverage in a number of ways: through its lending operations and, in particular, through the conditions stipulated in Bank loans; through its general policy advice either directly or through consultative groups chaired by the Bank; through the role it may be asked to play in commodity diversification funds; through advice to international commodity councils, particularly with respect to relative opportunity costs as a basis for the reallocation of quotas;[1/] and, where appropriate, by suggesting to the competent U.N. body that a conference be called on a particular commodity and by presenting suggestions as to the nature of desirable arrangements.

None of these actions would be in conflict with the Board decisions on commodities. Within those guidelines the Bank could play a leading role in influencing world commodity trade if it wished to do so. The prerequisite, however, would be for the Bank to establish "commodity programs" along the lines proposed in this paper.

In view of the novelty of this approach, it is suggested that it be done initially for a few commodities on an experimental basis.

I. S. Friedman
I. Frank
L. Goreux

1/ For example, if Burundi could export nothing but coffee, while Brazil had a choice between coffee and something else, the relative opportunity cost would be lower in Burundi than in Brazil, even if market costs were higher. Under such conditions, the Bank could make a case for revising Burundi's quota upward.

FORM No. 57 INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman DATE: 9 January 1970

FROM: Isaiah Frank

SUBJECT:

I suggest the following sentence to be added to the end of the paper on commodity policy:

> "This could be done initially for a few commodities ~~and~~ on an experimental basis ~~without entailing any sizeable additional staff requirements."~~

FORM NO. 57 INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

DATE: 9 January 1970

FROM: Isaiah Frank IF

SUBJECT:

JAN 9 1970

JAN 9 1970
12 noon

Attached is a copy of the paper, "The World Bank and the Commodity Problem". It includes all your suggested revisions as well as those of Dick Demuth. In addition, I now have Louis Goreux's concurrence for all references to the results of the quantitative study on buffer stocks.

I am sorry it has not been possible to get the paper retyped by today, but I thought you would nevertheless want to have it in this form.

cc: Mr. Demuth
Mr. Goreux

DRAFT Copies to: Mr. McNamara, Mr. van der Tak 1/13

RALPH FRANK
Louis Goreux
~~Isaiah Frank~~
~~30 December, 1969~~
Draft
9 January 1970

THE WORLD BANK AND THE COMMODITY PROBLEM

A number of questions have arisen ~~A great deal of confusion exists~~ about the nature of the commodity problem and the role of the Bank with respect to it. In particular, the question has been raised as to whether the Bank should stand ready to provide more direct support for international buffer stock operations than is implied in the decision taken last June by the Executive Directors. The purpose of this paper is to deal briefly with these issues and to indicate where the future emphasis of Bank policy should be with respect to the commodity problem.

I. Nature of the Commodity Problem

The commodity problem consists of two related but separate aspects: adverse long-term trends in prices and export earnings and wide short-term swings in these same variables. The Rio Resolution, which prompted the Bank decision of last June, is entitled "Stabilization of Prices of Primary Products", but it actually is addressed to both aspects of the problem since it refers to the need for a "remunerative level" of prices as well as to the need for stabilization.

Although we speak of the "commodity problem" in general, not all primary commodities produced and exported by the developing countries can be placed in the problem category. The commodities posing the main difficulties are for the most part agricultural and are characterized by sluggish growth in export markets as well as by short-term instability.

The basic cause of fluctuations lies in the interaction between, on the one hand, an inelastic demand with respect to price and, on the other hand, unplanned changes in supply due to natural causes such as weather and pests. This interaction induces wide fluctuations in prices and earnings in a direction inverse to the changes in production. Changes in demand in the industrial countries can also trigger market fluctuations but for agricultural commodities, as opposed to metals, these are generally of lesser importance. Even for metals the severity of demand-induced instability is less than it was prior to the second World War because the amplitude of business fluctuations in the advanced countries has been substantially moderated.

The basic cause of adverse longer-term trends in certain primary commodities is the slow growth in world demand relative to the ease with which output can be increased at existing prices. While a variety of forces underlies the sluggish growth in demand, competition from synthetics affects some of the most difficult cases such as rubber, cotton, jute and abaca.

Ignoring for the moment the interconnections between short-term instability and longer-term trends, it is fair to say that by far the more important of the two problems is that of adverse longer-term trends. For those countries lucky enough to be exporting commodities, such as petroleum and most of the metals, with favorable recent and prospective trends in prices and earnings, the fact that these earnings are subject to wide short-term fluctuations is a secondary problem. Similarly, those countries whose exports are concentrated in commodities with adverse long-term trends in prices and earnings are primarily concerned about the fact that their export earnings are not growing at an adequate rate rather than about the fact that, whatever the trend in those earnings, the latter are realized in widely varying amounts from year to year.

It is true that highly unstable prices may to some extent accentuate adverse longer-term trends in commodity markets. Instability in prices may exert a depressant effect on the demand for natural products when close synthetic substitutes are available with more stable and predictable price behavior. On the supply side, temporary high prices due to natural phenomena, such as drought or pests, may induce uneconomic investment in new productive capacity for commodities with long gestation periods (i.g. coffee, cocoa). When the new production ultimately comes onto the market, it accentuates the underlying adverse longer-term trend.

It is generally agreed, however, that instability is only contributory to the major problem of adverse trends and that, in order to deal with the latter, the forces determining the trends need to be dealt with more directly.

II. Role of Buffer Stocks and Commodity Agreements

For many years prior to the first UNCTAD Conference in 1964 the conventional wisdom in the Western world was that, if commodity arrangements were to be undertaken, they should be designed simply to moderate price fluctuations but should seek to avoid interfering with longer-term trends.

The rationale for this distinction was that excessive price fluctuations serve no economic purpose and could even impart the wrong economic signals as when temporary high prices stimulate excessive investment in new production. Both importing and exporting countries could agree on the objective of stabilization since they had an identity of interest in lopping off the peaks and troughs in prices. No transfer of real income from one group to the other over the long-term was implied in pure stabilization arrangements.

What was generally taboo, however, was any arrangement which through conscious interference with free market forces would attempt to alter the long-term trend of prices from what it would have been in the absence of an agreement. In this line of thinking, the trend in prices was simply a reflection of the underlying conditions of supply and demand, which in time would change and establish a new equilibrium. Importing countries might be willing to cooperate in measures to assist the process of orderly adjustment to the new conditions. But they were generally unwilling to conceive of commodity arrangements as devices to alter over an extended period of time the terms of trade of the primary producing countries and thereby to accomplish through the market a real transfer of resources to the developing countries.

Given the traditional negative attitude of the industrialized countries toward commodity arrangements of the latter variety, the question may nevertheless be raised as to why greater success was not achieved in negotiating more limited price-stabilization agreements whose objectives, after all, commanded general support. The answer is well put by Gerda Blau of the FAO in a study prepared for (and do not, by themselves, alter longer term trends and earnings.

the first UNCTAD Conference: "The fact that the conclusion of price-stabilizing commodity agreements has proved so difficult in practice appears to indicate that neither exporters nor importers were prepared to pay a substantial premium for this kind of insurance ... And as to the interests of exporters, their main concern, of course, has been with the prospects for their total export proceeds (depending on volume as well as price) and with the average level of export proceeds over a number of years, measured in terms of import purchasing power, not merely with short-term fluctuations in money terms." 1/

International buffer stocks are one device for moderating short-term fluctuations in prices and earnings from commodity exports. Therefore, Where a buffer stock exists (tin) or has been seriously discussed (cocoa), it has been as part of a broader attempt to improve the longer-term prospects for the commodity through controlling supplies offered on the world market. For the latter purpose, export quotas have been the principal instrument, and buffer stocks the subsidiary instrument. Since the main impetus for international action in the commodity field arises from structural disequilibrium between production and demand, it is unlikely that international buffer stocks can be negotiated in the future except in the context of more comprehensive arrangements for dealing with the disequilibrium through export quotas and diversification programs. Without such arrangements, moreover, a buffer stock would not be a practicable proposition since its financial resources would be quickly exhausted as it attempted to maintain a floor price in the face of unlimited supplies thrown on the market.

From what has been said above, it follows that a major limitation on the prospects for establishing international buffer stocks is the willingness and ability of the international community to negotiate commodity agreements which encompass the longer-term objective of achieving, in the words of the Rio resolution,

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1/ Gerda Blau, "International Commodity Arrangements and Policies", Proceedings of 1st UNCTAD Conference, Volume III, page 142 (1964) a "remunerative level" of prices for exports of primary products. Or stated another way, the main interest of the developing countries is in improving their terms of trade and thereby accomplishing a transfer of resources from the rich importing countries to the low-income exporting countries.

Since supply limitation is the key to achieving this objective, international buffer stocks could even work at cross-purposes to it by relieving individual countries of some of the pressures to reduce production. With export quotas but without <u>international</u> buffer stocks, the necessity to carry and finance large <u>national</u> stocks will operate as a powerful lever to induce producing countries to curtail investment and output. This consideration is undoubtedly among those that account for the absence of a buffer stock arrangement in the coffee and sugar agreements.

Another consideration points toward possible conflict between buffer stocks and the achievement of the longer-term goals of commodity policy. The problem arises from the fact that, when a buffer stock is included as an integral part of a commodity agreement, ~~a price~~ ceiling and floor prices must be included in the agreement in explicit terms. This can prevent a ~~far~~ widely desired international commodity agreement from coming into being; It was the protracted controversy surrounding the negotiation of a price range as a basis for buffer stock operations that prolonged the negotiation of a cocoa agreement to the point where the market situation had undergone important changes so that some of the principal participants were no longer willing to go ahead on the previously agreed basis. By way of contrast, the price objective in the 1962 coffee agreement, which does not provide for an international buffer stock, could be stated in more general terms since it was to be achieved entirely through export quotas without the need for market intervention. Given the enormous difficulties of negotiating a commodity arrangement even under favorable circumstances, it is hard to escape the conclusion that such difficulties are accentuated when specific prices must be agreed upon in advance of the arrangement coming into effect. Experience under the coffee agreement has also demonstrated that, without recourse to an international buffer stock, export quotas are capable of yielding a substantial degree of price stabilization in addition to an orderly growth of export earnings in excess of what would have taken place in the absence of the agreement.

The need for international buffer stocks as an adjunct of broader commodity agreements is significantly lessened today by the existence of the IMF's compensatory financing facility. ~~In effect the latter may be viewed as~~ an ~~international buffer fund~~. Whereas buffer stocks are designed to reduce instability in export earnings by moderating price fluctuations through market intervention, compensatory financing can ~~accomplish a similar objective more directly by offsetting shortfalls~~ offset the balance of payments impact of falling prices resulting in declines in export earnings through the equivalent of virtually automatic three-to-five-year loans. Under compensatory financing, a country can draw up to 50 per cent of its IMF quota (although normally not more than 25 per cent in any 12 months) without such drawings affecting its access to regular Fund drawings either with respect to their amount or conditions of availability. From the beginning of the scheme in 1963 to mid-1969, 17 countries had drawn a total of about $ 378 million under the compensatory arrangement.

III. Buffer Stocks and the World Bank

~~Despite the existence of compensatory financing,~~ Nevertheless, well-designed international buffer stocks could in certain cases make a ~~valuable~~ contribution to the stabilization and strengthening of primary commodity markets when part of a comprehensive international commodity arrangement. It is natural therefore that the World Bank and the IMF should have attempted to facilitate their establishment as part of the affirmative response of the two institutions to the call of the less developed countries for additional mechanisms to deal with the commodity problem.

In the discussion which preceded the Rio Resolution, however, the importance of buffer stocks per se tended to escalate and eventually took on an almost symbolic character as indicative of the willingness of the international community to do something tangible about the commodity problem. Somehow the ~~sense of proportion got distorted, and the~~ idea took hold that, if only adequate sources of finance were available, a major obstacle to the establishment of buffer stocks would be eliminated and the way would then be cleared for the negotiation of broader commodity agreements.

As already explained, the true sequence runs the other way. The main constraint on the prospects for establishing international buffer stocks lies in the complex of obstacles that stand in the way of commodity arrangements involving limitations on exports and production. Among such obstacles are conflicts between producers and consumers as to the long-run price objectives underlying the size of total quotas; conflicts among producers as to the basis for allocating country quotas; the need to reconcile the desire for higher prices with the threat of encouraging substitution; the need to build into the agreement strong incentives for diversification and disincentives for perpetuating overproduction; and a variety of negotiating and enforcement problems.

It is doubtful, moreover, that, if the other conditions were satisfied, finance would turn out to be a serious obstacle to the inclusion of buffer stocks as part of international commodity agreements. In the cocoa negotiations, for example, the plan was to finance the buffer stock through an export levy of one cent per pound. To the extent that, over the relevant price range, demand is less elastic than supply, the incidence of such a tax would fall mainly on the importing countries. Where such self-financing is contemplated, the need for outside funds would arise primarily to pre-finance the buffer stock in order to enable it to buy in the market prior to the build-up of internal funds. For this purpose medium-term commercial financing might well be available, but the new financial facility ~~facilities~~ established by the recent IMF ~~and World Bank~~ decision provides greater assurance and cheaper access to funds, while the Bank decision takes care of the exceptional cases in which the Fund decision may not cover.

Whatever inhibition may have been imposed in the past by the absence of an established source of financing for international buffer stocks, the problem has ~~now~~ been largely dissipated. This view has ~~in a sense been internationally~~ been confirmed in a directly for international buffer stocks either to countries or international agencies or both.

~~ratified in an overly cautious~~ statement made in July 1969 by the Advisory Committee to UNCTAD: "The Committee felt that the provision of pre-finance was no longer the most important obstacle to the setting up of a buffer stock scheme."[1/]

Although ~~the recent IMF and World Bank decisions relieve~~ has been relieved, the pressure for new international machinery to finance buffer stocks, the question ~~may~~ has been ~~be~~ raised as to whether the Bank's contribution could not have been more forthcoming, particularly in willingness to provide financing ~~In order to place this matter in perspective,~~ something needs to be said about the relationship between the IMF and the Bank in the financing of buffer stocks and about the possible magnitude of calls upon the Bank for this purpose.

International stocking operations should be envisaged strictly for cushioning short-term disturbances. Any long-term holding of stocks for the purpose of facilitating the structural adjustment of production to demand under international commodity agreements should be primarily the responsibility of national governments on whom the cost of stockholding will exert additional leverage to hasten the adjustment. If this premise is accepted, it follows that the burden of financial assistance to international buffer stocks should properly be carried mostly by the IMF, the agency primarily concerned with short-term stabilization, and that the Bank's role should be supplementary as explained below.

Under the recent Fund decision, a member may draw up to 50 per cent of its quota in order to meet obligations assumed under an international

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1/ UNCTAD, "Report of the Advisory Committee to the Board and to the Committee on Commodities on its Third session," 25 July 1969.

(particularly after the proposed quota increases,

buffer stock scheme. This amount may be drawn in a single year, but will be subject to an overriding limit of 75 per cent of quota governing drawings under, the IMF's compensatory financing facility and buffer stock scheme together. As in the case of drawings for compensatory finance, drawings under the buffer stock scheme will not be charged against a member's ceiling on regular fund drawings. (Unlike the former, however, drawings under the buffer stock scheme will affect the degree of automacity of the availability of regular drawings.) When IMF quotas are increased ~~by 25 per cent~~ in January 1971, drawing rights under the buffer stock scheme will be enlarged proportionately.

Given the sizeable resources ~~now~~ which will be available through the Fund, the question arises as to ~~whether there is a ... significant~~ ~~what residual~~ what role ~~might be conceived for~~ the World Bank might play ~~in the~~ financing of international buffer stocks. Two possibilities may be envisaged. One would be to assist countries in cases where their drawing rights under the Fund's buffer stock scheme prove insufficient in relation to their need to contribute to international buffer stocks. The other would be to refinance Fund drawings if, when repurchase becomes due at the end of three to five years, the buffer stock has not yet been able to liquidate its stock and repay member countries.

Let us look at the refinancing loan first. The purpose of such a loan would be to relieve the buffer stock agency of the need to sell when the market for the commodity is depressed. The loan should not, however, encourage the agency to hold stocks over an excessively long period of time since a reasonably rapid turnover of stocks is of the essence of efficient buffer stock operations. If the stocks were not to be liquidated for as long as say ten years, it would signify that the agency was not conducting a buffer operation designed to smooth out short-term price fluctuations and that its market intervention rules should have been adjusted. On the assumption that proper intervention rules are followed, it would be rather the exception for a buffer stock agency to hold stocks for more than even five years. To the extent ~~In such exceptional cases the presumption is~~ that the IMF would be prepared to roll over its ~~credit so that~~ drawings, the likelihood of a need for World Bank refinancing would be ~~minimal.~~ reduced, and the amounts involved for the balance likely to be small.

~~The foregoing~~ this conclusion is reinforced, moreover, to the extent that future international buffer stock schemes provide for internal financing such as the export tax that was accepted in principle and included in the draft cocoa agreement. Such internal financing could substantially eliminate the need for outside assistance beyond a build-up period of five years. As a matter of fact, had the draft cocoa agreement been in effect during the period 1960-68, the hypothetical proceeds of the export levy would have been more than sufficient to finance both the acquisition of stocks and their carrying costs without any external assistance from the IMF or from any other source. Even if the Agreement had come into force in 1965 when there would have been an immediate need to make large stock purchases, the export levy would have obviated the need for short-term assistance beyond two years.[1]

Insert A (page 10-A)

~~Given the probable minimal need for World Bank refinancing of IMF drawings, what about the claims on Bank resources in cases of countries whose buffer stock drawing rights under the IMF scheme prove insufficient from the start.~~ An assessment of the magnitude of ~~this residual~~ these potential demands for Bank assistance over a future period can in the nature of the case only be highly speculative. Among the relevant variables are: the probability of international agreements being negotiated for particular commodities; the prospect that such agreements would provide for the establishment of buffer stocks; the size of the buffer stock; the width of the agreed price range; the

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1/ IMF, "Some Aspects of Fund Liquidity and Buffer Stock Financing", 28 March, 1969.

Insert A

While the foregoing considerations suggest a probable minimal need for World Bank refinancing of IMF drawings, one cannot be certain that the Fund will in fact roll over its buffer stock drawings, nor that future international buffer stocks will necessarily provide for internal financing, nor that such self-financing, if provided, would fully satisfy the need for funds. If we assume no roll-overs by the Fund and no self-financing, what is the extent of possible claims on Bank resources for refinancing Fund drawings? And what additional claims would arise from countries ...

relative emphasis placed in the agreement on buffer stock operations as against other stabilization techniques; the extent to which only partial payment would be made upon the acquisition of buffer stocks (e.g. the half-payment provision in the cocoa agreement); ~~the extent to which the arrangement is self-financing, as through an export tax, and the rapidity of the build-up of such funds~~; the degree to which countries' drawing rights under the IMF buffer stock scheme may have been reduced through prior drawings under the compensatory financing scheme in excess of 25 per cent of quota; the lag of disbursements behind commitments (the timing of the former depending on the precise state of the market, while the latter become effective when the agreement enters into force).

An enumeration of the foregoing factors is perhaps sufficient to convey the high degree of uncertainty that necessarily attaches to any effort to estimate possible calls for Bank assistance in the financing of buffer stocks. Nevertheless such an attempt has been made by the Bank staff in a quantitative analysis covering fourteen commodities identified by the UNCTAD Secretariat as candidates for international buffer stocks: coffee, cocoa, tea, sugar, pepper, lauric oils and seeds, rubber, jute and allied fibers, hard fibers, copper, tin, lead, zinc and tungsten.1/ The principal assumptions underlying the analysis concern the probability of a buffer stock agreement being signed for each of the commodities by 1972; the most likely size of the buffer stock for each commodity; and the probability distribution of disbursements expressed as a fraction of commitments. In order to safeguard against understatement, it was assumed that the recent commodity stabilization decisions of ~~existence of the new facilities in~~ the Fund and the Bank would encourage international commodity agreements involving buffer stocks.2/

1/ In the case of tin an international buffer stock exists, but serious consideration has been given to increasing its size from 12 percent to perhaps 18 percent of world exports.

2/ IBRD, "Financing of International Buffer Stocks", Part Two, draft dated 28 November, 1969.

Insert B

If the IMF did not roll over its drawings and if the IBRD decided to refinance them, the magnitude of net cumulative disbursements for refinancing purposes by the Bank over the period 1973-77 would be of the order of $100 million and would be unlikely to exceed $200 million. 1/

1/ The quantitative analysis indicated that the mean disbursement would be $162 million and that, with 90% probability, disbursements would not exceed $326 million (line 1, Table 1, page 39, draft 28 November 69, op. cit.). As noted in para. 69 of the cited paper, these figures provide an upper limit of the amount which the Bank might have to disburse. However, some of the buffer stocks would have liquidated their holdings in less than 5 years and reimbursed the member countries. The latter would therefore be in a position to pay back the Fund, thus reconstituting their drawing rights. Bank disbursements would therefore be substantially lower than the figures shown in Table 1.

Insert C

the probable extent of the total net call upon Bank resources over the five-year period on the assumption that no Bank refinancing of Fund drawings takes place.

In sum, if the Bank undertook both to refinance buffer stock drawings from the Fund and to assist the "problem countries", the net cumulative call upon Bank resources in the period 1973-77 would be unlikely to exceed about $250 million, and the most probable figure would be of the order of $100 million. While the full amount could conceivably be requested in a single year, the average annual call upon Bank resources for both purposes over the five-year period would probably amount to ~~between~~ about $20 million ~~and $50 million~~ per year.

The findings of the study point to an exceedingly modest residual role for the Bank in financing capital contributions to international buffer stocks. Among the members of the Bank, 61 developing countries are exporters of the commodities for which international buffer stocks either exist or may conceivably be established. ¶ When account is taken of the prospective ~~25 per cent~~ increase in IMF quotas, the 61 countries will have access to drawings under the Fund's buffer stock facility amounting to $ 3.2 billion. Nevertheless, the required net cumulative disbursements of some countries over the period 1973-77 could, according to the study, exceed their drawing rights under the IMF's facility, but only to a maximum extent of $ 62 million, ~~At the 98 per cent probability level this figure contracts to only $ 32 million. Even under the extreme assumption that buffer stock agreements were signed by 1972 for each of the fourteen commodities, the comparable figures would be $112 million and $100 million, respectively,~~ and the maximum number of "problem countries" requiring assistance supplementary to their IMF buffer stock tranches would be ~~eight~~ six. These small figures define

Insert B (page 12-a)

Insert C (page 12-b)

The foregoing estimates are predicated on the assumption that the full 50 per cent of IMF quotas would be available for buffer stock financing. Up to half of this amount, however, could be used up if full prior access had been had to a country's drawing rights under the Fund's compensatory financing facility. But actual use of the latter facility has been modest: outstanding drawings are approximately $200 million and have never exceeded $300 million. Nevertheless, if consideration is given to ~~this~~ the possibility that half of the (IMF) buffer stock financing might have been used up, a few ~~of a reduction in the availability of IMF buffer stock financing, a few~~ additional countries ~~would~~ might need recourse to Bank financing, but the amounts involved would still remain small.

1/ The quantitative study on which these results are based assumed that any refinancing of buffer stock drawings from the Fund would also be accomplished through Bank loans. As explained earlier, however, we are assuming in the present paper that this need would be fully met either by a roll-over of Fund drawings or by self-financing through, for example, an export tax. The figures cited in the text above do not, therefore, make any allowance for refinancing.

While this interpretation is unduly restrictive, it might nevertheless be helpful

Despite the ~~exceedingly~~ modest role anticipated for the World Bank in the financing of international buffer stocks, its willingness to cooperate in this field has taken on a certain additional significance of a symbolic character. It ~~would~~ might therefore be desirable to remove the ambiguities in the present Board decision which would ~~merely~~ permit the Bank, "while maintaining its normal lending standards", to take into account additional borrowing needs of members arising from participation in appropriate international buffer stock arrangements. ~~The implication is~~ The decision has been construed by some to mean that the vehicle for Bank assistance for ~~this~~ buffer stocks ~~purpose~~ would only be its normal project loans. ~~Rather than to deal with the matter in this circuitous way,~~ to state simply that the Bank ~~should stand~~ is ready to lend to member countries directly for the purpose of assisting them to participate in international buffer stocks. Confirmation by the Executive Directors of this interpretation of their decision would be helpful.

IV. Diversification and the World Bank

The traditional Western view that international commodity arrangements should moderate short-term fluctuations in prices and earnings but should not disturb long-term trends has in the last half-dozen years given way to the more activist view that the improvement of long-term trends is in itself a legitimate and indeed, a more compelling, objective of international cooperation. Whether or not the vehicle consists of commodity agreements, an essential element in such broader cooperation is the diversification of developing countries' economies away from primary commodities with unfavorable export prospects to other activities with a more favorable outlook. Part of the rationale for diversification is that it will improve the price trends for LDC exports and thereby bring about a transfer of resources from developed to developing countries.

Diversification occupied a central place in the Board's discussion of the commodity problem, and a decision was taken to give special consideration to projects which restrain or reduce over-production of primary products. ~~At no point, however, did~~ The discussion did not, however, explore fully the possible ~~come to grips with~~ the implications of a more activist role in the commodity field for the Bank's normal techniques of project evaluation.

Normally, when the Bank considers a commodity project for country A, it calculates a rate of return by comparing the opportunity cost of production in that country with an estimated future world price. The project's impact on countries other than A would ordinarily be ignored. Although account is taken of the impact of the project on world markets, this is done only as it affects country A itself by lowering world prices. Since the project's exportable output is usually small in relation to the volume of world exports, the impact of country A's project on world prices remains generally well within the margin of error of the projected world price. Consequently, this correction factor is unimportant for country A, but for country A only. The accumulated losses of all developing countries other than A can be many times greater than the gain to country A.

There are circumstances, however, when the Bank does take into account the impact of an investment in country A on other developing countries. If there were a commodity agreement, for example, the Bank ~~would not~~ might well hesitate to finance a project in a country that had not signed the Agreement even if the rate of return were high. In this case the Bank realizes that by financing the project it would be undermining the Agreement and thereby damaging the interests of other developing countries.

(Start here)

Similarly, even in the absence of a commodity agreement, the Bank would hesitate ~~refrains from~~ lend~~ing~~ to increase the production of a commodity anywhere when a sharp decline in price has taken place. Although this policy may be destabilizing in the case of commodities with long gestation periods, it does provide another illustration of Bank policy being governed implicitly by a concern for the repercussions of its operations beyond the country in which the project may be located.

In general, however, the Bank's approach to project evaluation is still highly country-oriented, with little attention ordinarily given to the interaction between countries. This tendency can perhaps be explained by the traditional heavy concentration of Bank lending in the power and transport sectors, both of which produce non-tradeable goods. With the expansion of Bank operations into other fields, and particularly into primary commodities, it becomes essential to take account of the impact on other countries of policies adopted toward a given country.

The distinction drawn between national and international effects is analogous to the distinction between private and social rate of return. Government subsidies are legitimate where private returns are low but social returns are high, e.g. conservation and pollution. Similarly international financing should stimulate activities, such as research on improved grain varieties, which yield high international rates of return even though the returns may be modest to the country where the research is carried out. Contrariwise, an international institution where production [illegible] developing countries should not provide a loan for research on synthetic cocoa, regardless of how high the return to the recipient country or to high-income consuming countries might be.

By affirming its support last June for projects which would help restrain overproduction of primary products, the Bank has implicitly recognized the importance of an improvement in the terms of trade for the developing countries. As a source of additional resource transfers, more favorable export price trends ~~can~~ may be of greater significance than an increased volume of aid. In order to pursue this objective in a more systematic way, however, it would be necessary for the Bank to develop and articulate an overall commodity strategy that clearly recognized the importance of maximizing the "social rate of return" for the developing world as a whole.

V. A New Role for the World Bank

A new role for the Bank in the commodity field can be envisaged by analogy with its role in assisting individual countries in their development efforts.

Following a country-by-country approach, the Bank is now ~~issuing~~ preparing, a ~~series of "country economic programs"~~ "program papers" subject to annual revision on the basis of ~~a~~ full-scale country economic missions. ~~The programs are intended~~ Papers ~~to provide a five-year perspective~~ five year country programs of probable developments in each country, an indication of the direction along which these developments should be modified, and an outline of the actions to be taken by the Bank to facilitate the modifications. Formulation of such programs does not mean that the Bank believes that it should or could control the development policies of any given country. It simply reflects the Bank's conviction that, if it wishes to exert some leverage on a country's development policy, it must have a development strategy for that country.

Following a commodity-by-commodity approach, the Bank could also prepare and revise at yearly intervals "commodity programs" for the major primary commodities. The commodity programs" could be established in three steps:

1. Perspectives would be established of the most likely developments in demand, production and prices. Particular attention would be given to the

for those commodities of importance to developing countries.

projection of production, which is generally the weakest element in commodity forecasts. This would require a review of production policies and investment plans and an analysis of the response of production to prices. ~~The latter would be based on time-series analysis of both aggregate and project data supplemented by a technical analysis of cost data for individual projects.~~ This first step should lead to a picture of what would be most likely to occur in the different commodity markets in the absence of any Bank action.

2. An analysis would then be made of how the most likely evolution could be improved. ~~from the Bank's point of view.~~ In making this assessment the Bank would take into account both demand and supply elasticities as well as opportunity costs in the various producing countries.

3. The Bank would define its strategy for the commodity concerned on a global basis. It would be expressed both in terms of overall policies and in terms of specific investment targets for Bank lending in individual countries. 1/

The country and the commodity approaches are not independent but are only two different ways of looking at the same problem. By using the two approaches simultaneously and by insuring consistency between them, an optimum Bank strategy can be developed which takes account of the interaction between countries throughout world commodity markets as expressed in a social rate of return for the developing world as a whole.

1/ For a draft technical paper on this subject see "Diversification Benefits and Criteria for Project Selection", 25 September, 1969.

To carry out its "commodity programs", the Bank could exert leverage in a number of ways: through its lending operations and, in particular, through the conditions stipulated in Bank loans; through its general policy advice either directly or through ~~consortia~~ consultative groups chaired by the Bank; through the role it may be asked to play in commodity diversification funds; through advice to international commodity councils, particularly with respect to relative opportunity costs as a basis for the reallocation of quotas;[1/] and, where appropriate, by ~~requesting~~ suggesting to the competent U.N. ~~bodies to call~~ body that a conference be called on a particular commodity and by presenting suggestions as to the nature of desirable arrangements.

None of these actions would be in conflict with the Board decisions on commodities. Within those guidelines the Bank could play a leading role in influencing world commodity trade if it wished to do so. The prerequisite, however, would be for the Bank to establish "commodity programs" along the lines proposed in this paper.

In view of the novelty of this ~~suggestion~~ approach it is suggested that it be done initially for a few commodities on an experimental basis.

I.S. Friedman
I. Frank
L. Goreux

1/ For example, if Burundi could export nothing but coffee, while Brazil had a choice between coffee and something else, the relative opportunity cost would be lower in Burundi than in Brazil, even if market costs were higher. Under such conditions, the Bank could make a case for revising Burundi's quota upward.