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Contribution from the World Bank to the G20 Commodity Markets Sub Working Group

Reducing Distortions in International Commodity Markets:

An Agenda for Multilateral Cooperation

April 2012

CONTRIBUTION TO G20 COMMODITY MARKETS SUB WORKING GROUP [1]

Reducing Distortions in International Commodity Markets: An Agenda for Multilateral Cooperation*

April 2, 2011

World commodity markets—and particularly the markets for agricultural commodities—remain highly distorted despite the wave of liberalization that has swept world trade since the 1980s. Some markets for commodities are characterized by imperfect competition. Where monopolies or oligopolies in trade arise either because of government regulation or through other barriers to entry, distortions may arise that call for the application of antitrust law and other forms of pro-competitive policy action. Commodity markets are distorted on both the export and the import sides, with serious implications for world prices and their volatility.

Very few of the price distortions found in commodity markets can be justified as dealing with market failures. Rather, most policies that affect prices of commodities are designed to transfer resources to favored groups by raising or lowering prices. Policy may target the level and/or the volatility of prices, and the pursuit of one type of policy objective may have unintended consequences in generating further distortions. The negative spillovers for other countries that arise from national policies or the exercise of market power give rise to an incentive to cooperate and negotiate reciprocally binding disciplines on the use of specific policies.

Agricultural and commodity market distortions

Many agricultural commodities tend to be heavily protected in industrial countries for reasons including that:(i) food tends to be a small share of consumers' expenditures in these countries; (ii) the number of farmers tends to be small, making it relatively easy for them to coordinate in order to apply political pressure; and (iii) farmers in sell virtually all of their output, and use substantial amounts of purchased inputs—increasing the leverage of output prices on their net returns. Conversely, historically, agricultural products in developing countries have tended to be taxed because: (i) food expenditures are frequently a large share of the income of most people; (ii) the number of farmers is large, making it hard for them to organize; (iii) urban consumers are a relatively small group, able to organize against rising food prices; (iv) farmers are mainly subsistence-oriented—selling only part of their output and having little leverage between food prices and their net returns.

A recent comprehensive multi-country study of agricultural distortions shows that agricultural distortions in the industrial countries remain large but have declined from the high levels in the mid-1980s (Anderson, 2009). In developing countries, the average rate of taxation of agriculture declined sharply, as shown in Figure 1, and has switched to positive assistance on average. The changes in these rates of assistance reflect a sea-change in the pattern of agricultural distortions in developing countries, perhaps related to the high rates of economic growth in developing countries in the latter period of the sample, and the sharp shift away from dependence on exports of commodities towards greater reliance on exports of manufactures. Within developing-country agriculture, there is a sharp difference in the rates of protection provided to import-competing agriculture and to export-oriented agriculture (Figure 2). The almost complete elimination of

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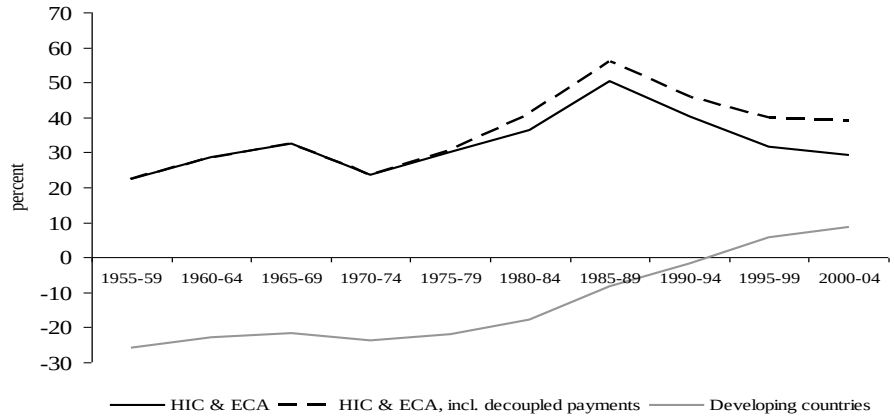
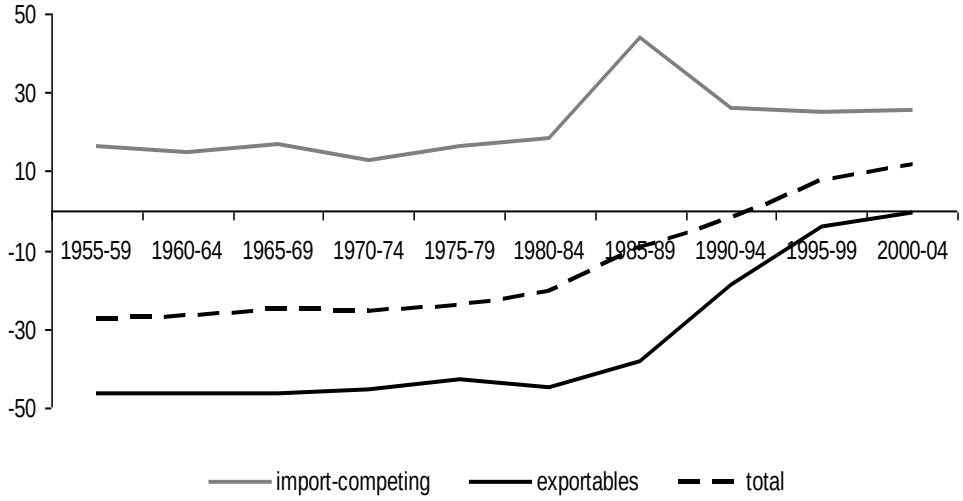
taxation of agriculture has sharply reduced the cost of distortions on export-oriented agriculture in developing-countries. The rise in protection to import-competing agriculture is likely to be particularly costly to the poor, who spend a large share of their incomes on food.

Figure 1. Average nominal rates of assistance to agriculture, 1955-2004



Source: Five year averages from Anderson (2009) and www.worldbank.org/agdistortions

Fig. 2. Nominal Rates of Assistance to Developing Country Agriculture (%)



Source: Five year averages from Anderson (2009) and www.worldbank.org/agdistortions

For a number of staple foods, governments intervene to reduce the volatility of domestic prices relative to world prices. Such measures have a long history and were also used in high-income countries to stabilize domestic prices prior to the Uruguay Round. Insulating policies are heavily used for key staples such as rice and wheat. While they help individual countries reduce domestic price volatility, there remains a serious collective-action problem. As more countries

stabilize their domestic prices, world prices become more volatile, and the policy is completely ineffective if all countries use it to the same degree. Martin and Anderson (2012) found that almost half the increase in the world price of rice in 2008 could be explained by countries' attempts to insulate themselves from the primary shocks causing the world price of rice to rise. While some countries were relatively successful in insulating themselves against the increases in world prices, domestic prices in low income countries in Africa rose almost as much as world prices did, suggesting that price volatility may have been greater given the use of insulating policies than it would have been otherwise.

Governments also have a long history of intervening in markets for other natural resources, both renewable and non-renewables. Imperfect competition, market power, and high levels of concentration characterize some commodities markets and may result in price distortions. Political uncertainty and risk that precludes efficient investment and generates inefficient forms of trade can also generate important costs (Collier and Venables, 2010; WTO, 2010). In the case of natural resources, the focus of producers has been much more on export restrictions designed either to lower domestic prices or to raise export prices—including through the creation of producer cartels. Export restrictions are predominantly used by developing countries (WTO, 2010). Export taxes on natural resources account for about one-third of all export taxes imposed—some 11 percent of world trade in natural resources is covered by such taxes, with timber, iron, copper, pearls and gemstones being among the most frequently affected.[2] Countries may also use other instruments that have similar effects as export restrictions on international prices, such as efforts to agree on joint production limitations (quotas), as in the case of OPEC members.

Protection rates for imports of non-agricultural natural resources are generally low because of pressure from user industries. However, importing countries confronting exporters of resources with market power and thus the ability to affect world prices may seek to use import tariffs or excise taxes to lower demand and shift rents away from supplying nations. In practice most efforts by producers to form a commodity cartel and improve their terms of trade by restricting supply have not been successful. An exception is OPEC. Instruments used by many oil and energy importing countries to transfer resource rents from producers are (nondiscriminatory) domestic taxes, not import tariffs. In addition, tariff escalation is often used to increase the effective rate of assistance to domestic processing industries.

In sum, a wide mix of policy instruments is used by countries to influence the level and volatility of domestic prices for commodities. Countries also pursue policies that may affect international prices, either indirectly or directly, if they are large suppliers or importers. The pursuit of such policies, even if welfare-enhancing for the countries concerned, may lower welfare for the world as a whole by generating negative spillover effects on trading partners and inducing governments to put in place measures in turn that are aimed at offsetting such effects, in the process generating further distortions and inefficiencies.

Rule-making Implications and Priorities

Many of the policies that affect commodity markets are subject to multilateral rules under the WTO. But a number of the major policy instruments that are used by governments are not

[2] Export restrictions on natural resource products accounted for one-third of the 7,328 notified export restrictions in the time period covered by WTO (2010).

subject to effective disciplines. In practice domestic policy measures may be used that have an equivalent effect to trade policies that are subject to disciplines – e.g., excise taxes or output quotas. The multilateral trading system has focused primarily on lowering and making import barriers less variable. WTO disciplines are much less comprehensive on export measures and policies that reduce output or restrict supply. Article XI of the GATT prohibits the use of quantitative restrictions, whether on imports or on exports, but permits temporary quantitative trade restrictions to prevent critical shortages of food or other goods. It leaves open the possibility of a country imposing production quotas or using excise taxes that primarily affect imports. Export taxes are also unconstrained unless a country has made specific commitments in this regard—which most have not.

There has been a recent upsurge in the use of export barriers in response to rising world prices of food staples and strong demand for scarce natural resources (Datt, Hoekman and Malouche, 2011). Countries depending heavily on the world market for food and resources feel vulnerable to export controls or taxes imposed by supplying nations. Proposals to discipline export barriers have been made in the Doha round negotiations—the draft Modalities of May 2008 (WTO 2008) included some quite specific disciplines on the use of export prohibitions and restrictions under GATT Article XI. Even if such proposals were to be adopted, they would need to be complemented by disciplines on the use of export taxes. In addition, in order to more fully address policy-induced distortions on commodity markets it will be necessary to focus as well on domestic fiscal (tax/subsidy) instruments that may be used to affect demand in countries that do not produce the resources concerned, and supply in resource dependent countries that export most of their output.

The agenda on import protection is well understood and is already squarely on the agenda of the WTO and on the table in Doha. Making progress in further disciplining the scope to use import barriers is important – the estimated welfare gains from lowering applied levels of protection and bringing down tariff bindings are significant. But extending the effort to agree on disciplines on export restrictions is equally important, not least because the greater freedom of countries to use export restrictions is likely to have a direct bearing on the willingness of many importing countries to accept greater disciplines on their import policies. An immediate priority is to agree on a code of conduct to exempt food aid from export restrictions.

As has been argued by Collier and Venables (2010), multilateral efforts to agree on policy disciplines that will reduce distortions of international commodity markets need to span not only export and import trade policy and domestic substitutes for trade policy instruments, but also policies that determine the extent to which the most efficient firms are permitted access to resources. Uncertainty regarding the conditions of competition for contracts and leases, and uncertainty as regards the future operating and tax regime that will affect extraction activities and rates of return on investment generates various distortions that may result in reductions in supply, excess costs and inefficiencies, and lower revenues for host governments. An implication is that rule-making efforts need to extend to issues that affect conditions of access to resources through foreign direct investment (FDI) and transparency of contracting (government procurement).

While the WTO is clearly the institution through which to pursue further international cooperation as regards policies that affect the operation of global commodity markets, it is equally clear that extending the trading regime to cover all of the major policies that do so will be a complex endeavor. However, the case for a concerted focus on the set of policies that distort

agricultural and natural resource markets is strong. Distorted price levels and excess price volatility are detrimental to both producers and consumers, and agreement to discipline the use of policies that generate distortions would benefit all countries. In order to do so the focus must be comprehensive and address all policies that result in distortions, not just a subset.

There has been much analysis and discussion of why the Doha round negotiations have proven so difficult to conclude successfully. One argument that has been made is that one reason may be that the way the negotiations (and thus prospective agreements) were structured made them less relevant to international business and the concerns of citizens. In the case of commodities the DDA has focused primarily on agricultural products and a subset of the relevant policies. This significantly reduces the potential global welfare payoffs from any agreement. Given the social importance of food prices and access to food and the impact of increasing demand and competition for other natural resources, renewable and non-renewable, a concerted multilateral effort to agree to disciplines on the use of the major policies that distort global commodity markets should be a priority.

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