PAMUN XVIII RESEARCH REPORT— MEASURES TO PROMOTE THE DIVERSIFICATION OF ECONOMIES IN CDDCs

Introduction of Topic

Commodity Dependent Developing Countries (CDDCs) are developing countries whose economies are heavily dependent on commodity exports. About two-thirds of all developing countries are CDDCs, whose economies are predicted to do worse than diverse economies in terms of socio-economic development. Policies pursued by many CDDCs have been largely ineffective in mitigating the impact of price fluctuations on their economy or achieving social development, and this raises concerns about these countries' ability to accomplish the Sustainable Development Goals (SDGs).

Economic diversification is the process of manufacturing different goods and investing in a variety of profitable sectors so that the economy of the country as a whole does not collapse if one sector or business fails. It is imperative that economies in CDDCs diversify in order to achieve stable economic growth. Economic diversification is necessary for CDDCs to achieve the 2030 Agenda for Sustainable Development. As a matter of fact, commodity dependence and commodity-related policies are correlated with numerous SDGs, such as SDG 2, which aims to end hunger; SDG 7, which calls for the use of clean energy; SDG 9, which urges sustainable industrialization; SDG 12, which requires responsible consumption and production; and SDG 15, which calls upon countries to preserve terrestrial ecosystems. Terms-of-trade shocks and volatility, along with loss of income and purchasing power, frequently occur in economies of CDDCs, which reduces growth rate and public spending on social programmes or infrastructure. Therefore, it is necessary that CDDCs reform their policies and diversify their economies in order to achieve inclusive growth over the next decade.

Definition of Key Terms

Commodity Dependent Developing Countries (CDDCs)

Generally, a developing country is a country that does not have adequate industrial strength, ranks low on the Human Development Index (HDI), and has a relatively low gross national product (GDP).

According to UNCTAD, Commodity Dependent Developing Countries are developing countries whose commodity export incomes constitute more than 60% of their total export revenue. CDDCs mainly exist in tropical regions, and economies in these countries are dependent on commodities such as rice, soybeans, sugar, cotton, oil, and cocoa beans. A majority of developing countries are dependent on single commodity exports, and according to UNCTAD's "State of Commodity Dependence Report" in 2016 (Appendix II), approximately 46 CDDCs exist in Africa, 17 in the Americas, 18 in Asia, and 10 in Oceania, bringing the total number of CDDCs to 91 in 2015.

Commodity

A commodity is a raw material that can be bought and sold. Commodities include agricultural raw materials, food, minerals, and fuels. In general, commodities are prone to price volatility unlike manufactured goods, and economic uncertainty is very normal in economies in CDDCs. Different CDDCs are dependent on different commodities. For example, Argentina and Brazil are dependent on soybeans, Bangladesh on rice, Burkina Faso on cotton, and Nigeria on oil.

Price Volatility

Price volatility describes fluctuations in commodity prices, which are sudden variations in the commodity prices. Highly fluctuating prices are an effect of commodity dependence, and this price volatility leads to income uncertainty and a decline in producers' earnings.

Oversupply/Overproduction

Oversupply or overproduction refers to an excess of supply over the quantity demanded of the commodity. This phenomenon causes a reduction in commodity prices, which in turn leads to a decrease in producers' income and higher unemployment.

Export Processing Zones (EPZs)

Export-processing zones (EPZs), as defined by the International Labor Organization (ILO), are "industrial zones with special incentives set up to attract foreign investors, in which imported materials undergo some degree of processing before being exported again". EPZs normally offer incentives such as tax and tariff breaks and exemptions from business regulations to export-oriented enterprises.

Dutch Disease

The Dutch Disease describes the effect of the economic growth of a specific sector. According to the Dutch Disease, this growth causes the country's other sectors to become less important and less competitive on the export market, which in turn leads to their decline. For example, in the early 2000s, Canada's Athabasca oil sands grew in dominance due to the increased foreign demand for its natural resources and helped appreciate the nation's currency. The growth of the natural resources sector hindered the growth of Canada's manufacturing sector, making it less competitive.

International Commodity Agreement (ICA)

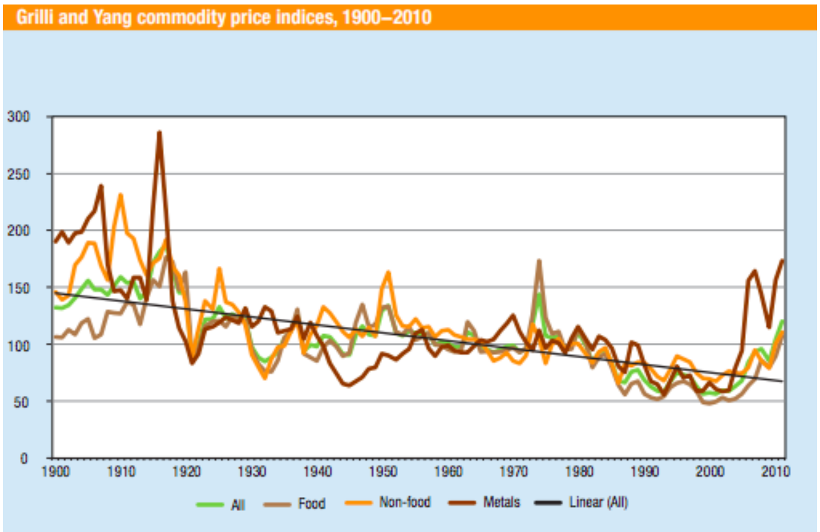
An International Commodity Agreement (ICA) is a form of active intervention in commodity markets. It is an agreement by a group of countries to stabilize commodity prices, trade, and supplies. Since the mid-1980s, the number of ICAs drastically reduced as the supply of commodities significantly increased.

Terms-of-trade shocks

The Economist defines terms-of-trade as the “the weighted average of a country's export prices relative to its import prices”. A shock, on the other hand, is defined as an “unexpected event that affects an economy”. Terms-of-trade shocks in the context of CDDCs are sudden price drops in international commodity markets, which in turn leads to output shocks that adversely affect growth prospects.

Background Information

Following a depression in commodity prices in the late 1900s, commodities saw sudden rises and falls in prices in the 2000s. Between 2000 and 2011, prices tripled, and as a result, export earnings of CDDCs increased. However, this trend has slowed down, and prices of most agricultural and non-agricultural commodities have secularly declined, causing many poor countries dependent on single commodity exports to suffer.



The graph, a part of UNCTAD’s Commodities and Development Report in 2017 (Appendix I), has a main commodity price index that consists of 24 commodities: aluminium, bananas, beef, cocoa, coffee, copper, cotton, hides, jute, lamb, lead, maize, palm oil, rice, rubber, silver, sugar, tea, timber, tin, tobacco, wheat, wool and zinc, which are divided into 3 sub-indices: agricultural food commodities, non-food commodities, and metals.

The graph supports the Prebisch-Singer hypothesis, which states that “the price of primary commodities declines relative to the price of manufactured goods over the long term”, and it reveals a similar decline in prices for different types of commodities, be they agricultural, non-agricultural, or metal. Various analysts have found a significant downward trend of between -0.3% and -1% per year in commodity prices, with an average estimate of approximately -0.6% per year.

Policy changes during the late 1900s and their impact on commodity prices

Policies regarding commodity markets have transformed during the last 50 years in both developed and developing countries. From the end of the Second World War until the mid-1980s, countries were obliged to stimulate their war-torn economies. Thus, in the 1970s and 80s, marketing boards were present in developed and developing countries, and International Commodity Agreements (ICAs), such as the International Coffee Agreement and the International Tropical Timber Agreement greatly helped the developed economies (consumers) and developing economies (exporters) to maintain favorable prices for both parties.

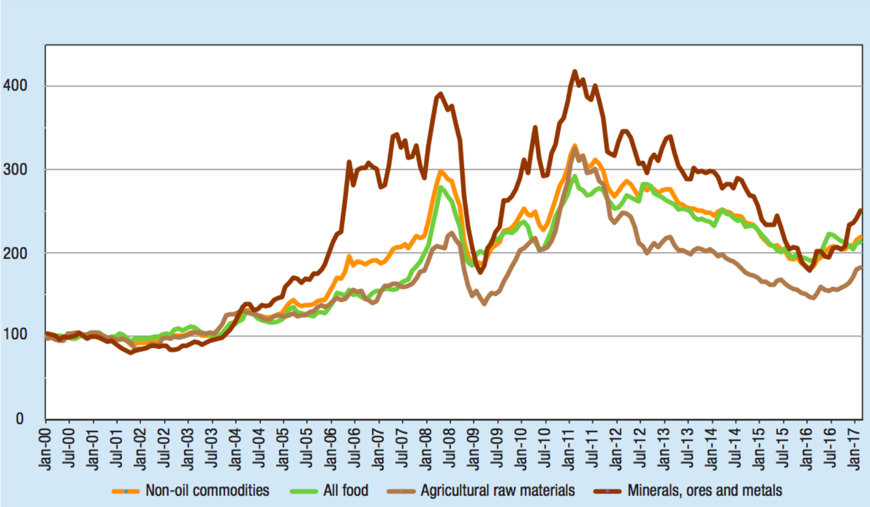
Nevertheless, laissez-faire and deregulation became the norm in the mid-80s. As commodities greatly increased in supply since the mid-1980s and economies were in much better shape, developed countries, the primary consumers of commodities, advocated for the nullification of ICAs and interventionary programmes as it causes commodity prices to fall, which is beneficial for these countries as these commodities become cheaper for them to buy. In 1989, the term “Washington Consensus” was coined, which included several economic policy recommendations that decreased government spending, increased interest rates, and lifted state restrictions on imports and exports. These ideas were implemented through structural adjustment programmes in developing countries that comprised deregulation and non-interventionist measures in commodity markets, which led to increased competition. Consequently, this overemphasis on export based policies caused a significant oversupply of commodities, which led to a large decrease in world prices of commodities. This is known as the “Great Commodities Depression of the 1980s and 1990s”.

As a whole, policies in regards to commodity markets in the late 1900s changed from active intervention to liberalization. This transformation in policies not only led to a surplus of commodities and a drastic reduction in commodity prices, but it also made developing countries vulnerable to price fluctuations and instabilities. The removal of marketing boards, in particular, weakened developing countries’ ability to deal with national and international commodity shocks and decreased their control over prices of commodities.

The 2000s commodities boom

In the early 2000s, after the establishment of the World Trade Organization (WTO) in 1995, trade liberalization continued to be the norm, and countries continued to lower trade barriers. In the late 1900s, due to low demand in developed countries and oversupply, the Great Commodities Depression occured. However, in the early 2000s, economies of emerging and developing countries grew at an unprecedented rate, and as a result, demand for commodities surged. Although demand for commodities in advanced economies continued to decline, the dramatic growth of developing economies that relied heavily on commodities led to an increase in global demand. This is the main cause for the commodity boom that took place in the early 2000s, especially between 2003 and 2008. In fact, according to the WTO, commodity prices rose by about 75% in real terms on average during mid-2008-.

Commodity price indices, Jan. 2000–Feb. 2017 (2000=100)



As seen in the graph, also a part of UNCTAD's Commodities and Development Report in 2017, there was a sudden decline in prices in 2008 as a result of the financial crisis of 2007-2008; nevertheless, prices again began to rise from late 2009 as demand recovered. However, by the end of 2011, global commodity prices decreased and stabilized at a lower level, as seen in the graph.

During the commodities boom, most CDDCs adopted procyclical fiscal policies: these countries increased spending and lowered taxes when the commodity prices were high, and export revenues and economic growth rates both increased during the commodities boom. However, when prices went back down in 2011, CDDCs faced economic declines, achieving only short term economic growth.

Major impacts of commodity export dependence

Overproduction and low demand

The decrease in world commodity prices led to sustained oversupply of numerous commodities, especially in the late 1900s. Normally, overproduction results in short term imbalance, which can be automatically rectified according to economic principles. However, this is not the case with CDDCs, as the rate at which a form of equilibrium is achieved is very slow in these countries' economies. As commodity prices drop, producers in commodity dependent countries increase output in order to preserve their income. The increase in supply is not followed by an increase in demand, which further decreases the prices of the commodities and leads to more oversupply. Technological advancements also play a role, as the increased efficiency in the production of commodities increases the supply.

Finally, another reason for the sustained overproduction in CDDCs was slower demand growth in developed countries, which is very important given that developed countries are the main consumers of the commodities that the CDDCs export. The population of European developed countries is growing slowly, and as a result, demand is not growing fast. This increasing disequilibrium between supply and demand leads to income uncertainty.

Price volatility

Price volatility is a distinguishable feature of economies in CDDCs because of numerous reasons. Economies in CDDCs are very dependent on the demand for their commodities in countries consuming the commodities, and these prices either rise or fall based on the economic performance and demand in these countries. Other reasons for the volatility of commodity prices include political instability, price speculation, and changing weather patterns. As a result, in CDDCs, there are sudden rises and falls in commodity prices, leading to economic uncertainty.

Secular decline of commodity prices

Between 2003 and 2011, commodity prices increased and was beneficial for many CDDCs, which experienced a large rise in export earnings and rates of economic growth. However, this was only a short lived phenomenon. According to the Prebisch-Singer hypothesis, CDDCs fail to keep up with the import costs and cannot maintain a favorable balance of trade in the long term because the price of primary commodities, which they export, declines relative to the price of manufactured goods, which they import, over the long term.

Declining terms of trade

Overproduction of commodities, especially foodstuffs, leads to export dumping, which is the sale of commodities by CDDCs below the cost of production in developed countries. This causes trade barriers such as tariffs, which decreases the export revenues of the CDDCs. Moreover, when a country produces and depends on the export of commodities that cannot be consumed, such as metal and oil, the country is obliged to import basic goods, which is not beneficial for the economy. In addition, CDDCs are prone to terms of trade shocks and terms of trade volatility, which can heavily affect these countries’ chances of growth and human development.

Income uncertainty

Income uncertainty is a major problem in CDDCs. This is primarily because economies in CDDCs are prone to price fluctuations. Price volatility directly leads to income volatility because a drop in prices causes earnings of the producers to slump. Due to so many price fluctuations, producers are unable to make a decision as to how much to produce, what to produce and whether it is beneficial to increase productivity. Similarly, the overall decline in commodity prices decreases the income of producers, and even though producers have the ability to produce more and maintain their income in the short-term, the prices only drop more. Furthermore, often the production of non-agricultural commodities like oil is not very labor intensive and cannot employ many people, which leads to a rise in unemployment.

Major Countries and Organizations Involved

United Nations Conference on Trade and Development (UNCTAD)

UNCTAD is a United Nations intergovernmental body that aims to give developing countries the advantages of a globalized economy and support these countries when they face issues regarding trade, investment, finance, and technology. UNCTAD publishes the “State of Commodity Dependence” report and the “Commodities and Development” report every 2 years and recommends solutions to CDDCs in order to achieve inclusive and sustainable growth.

World Trade Organization (WTO)

The WTO is an international organization under the United Nations that has 164 members. The organization, established in 1995, deals with the rules of trade between nations and aims to further trade liberalization and lower trade barriers. This organization gathers information on the nature of commodity prices and terms of trade issues in CDDCs and intends to promote the diversification of economies in CDDCs.

United Nations Development Programme (UNDP)

UNDP is a global development network that works in approximately 170 countries in order to promote democracy and peace, and achieve inclusive and sustainable growth. In an age of economic uncertainty, UNDP gathers information regarding development in CDDCs and aims to find reasons and solutions to the recurrent issues of price volatility and commodity price decline.

Food and Agriculture Organization of the United Nations (FAO)

FAO is a United Nations agency that works toward international food security and ending hunger in the world. Since economic and social development is one of the departments of the FAO, the organization plays an important role in dealing with the issue of commodity dependence, given that this issue has a big impact on human development. In fact, FAO jointly produced the Commodities and Development Report in 2017 with UNCTAD in order to determine the connection between commodity dependence and human development.

Timeline of Events

Date	Description of Event
2 September, 1945	End of Second World War
1962	International Coffee Agreement
1964	Formation of UNCTAD
Mid-1980s	Deregulation of the commodity market and change to free market policies

1983	International Tropical Timber Agreement
1989	Economist John Williamson first used the term “Washington Consensus” that describes the growing trade liberalization
1995	WTO established
2003 - 2011	The 2000s commodities boom took place, which was characterized by sudden rises and falls in commodity prices
2015	Total number of CDDCs increases to 91, about two thirds of all the developing countries in the world

Relevant UN Treaties and Events

- International Coffee Agreement 1983 (with annexes), 16 September 1982 (**No. 22376**)
- International Tropical Timber Agreement 1983, 18 November 1983 (**No. 23317**)
- Commodities : resolution / adopted by the General Assembly, 30 January 1995 **(A/RES/49/104)**
- Diversification of Production and Exports in Commodity-Dependent Developing Countries, 25 July 2002 (**TD/B/COM.1/50**)
- Multi-year Expert Meeting on Commodities and Development, 22 January 2013 (**TD/B/C.I/MEM.2/21**)
- Policy Actions for Mitigating the Impact of Price Volatility in Commodity Markets, 4 February 2015 (**TD/B/C.I/MEM.2/30**)
- Commodity Dependence and the Sustainable Development Goals, 3 August 2017 (**TD/B/C.I/MEM.2/37**)

Main Issues

As previously stated, it is becoming more and more challenging for CDDCs to achieve the SDGs and achieve stable economic growth due to five major impacts of commodity export dependence (explained in the Background Information section): overproduction and low demand, price volatility, the secular decline of prices, declining terms of trade, and income uncertainty. Governments of CDDCs are not practicing beneficial policies and are not effectively managing revenues; as a result, inclusive and sustainable growth has become a challenge.

Procyclical fiscal policies

Many CDDC governments practice procyclical fiscal policies, which means that the government spending rises and taxes drop during commodity price booms, while the government spending falls and taxes increase during economic slowdowns. Political pressure to increase spending during times of high commodity prices is the main reason for such policies. These policies lead to immediate economic growth when commodity prices increase; however, these economic booms are followed by economic declines and even recessions when prices go down because of the decreased government spending and increased taxes. These policies lead to unstable, short-term economic growth, which is a major issue given that stable economic growth for long periods of time is indispensable in order to achieve human development.

Lower spending on necessities and social programmes

The various challenges posed by commodity export dependence hinders the government's ability to spend enough money on basic needs that are integral to sustainability. In CDDCs, due to price volatility, producers do not have a consistent form of income, which in turn causes the government to receive lower tax revenues. Lower tax revenues translates to lower spending on in-kind goods and services and on fundamental aspects of the society, such as health care, education, and food. Furthermore, given the decline of commodity prices, the government often must take measures to keep production efficient through subsidies or tax breaks, which can prove to be expensive for the government. This leads to lower spending on government initiatives in order to improve the living standards of the people.

Insufficient mechanisms for inclusive growth

According to a case study on Zambia in UNCTAD's Commodities and Development Report in 2017, rising export earnings contributed to high GDP growth rates during the commodity price boom of the 2000s. However, progress in terms of poverty alleviation and inequality reduction was limited inspite of high GDP growth. The poverty headcount ratio increased from 49.4% in 2002 to 64.4% in 2010, and inequality also increased between 2003 and 2011. Hence, the Zambian case study reveals that although economic growth is extremely important, it does not necessarily lead to inclusive growth, given that issues such as poverty and inequality persisted even though GDP growth rates were high in Zambia. Inclusive growth can only be achieved if government revenues are used for social protection mechanisms, and many governments of CDDCs lack such policies.

Previous Attempts to solve the Issue

A variety of policy strategies have been used in the past in order to combat the issues of commodity dependence and achieve human development. Some countries such as Ghana and

Botswana have achieved to maintain a relatively stable economy through beneficial policies and strong institutions. Costa Rica, in particular, is a great example of a CDDC that really diversified its economy by making sound changes to its policies regarding the export of commodities. It succeeded in facilitating economic growth and improving the living standards of their citizens.

Costa Rica was very dependent on the export of agricultural commodities, particularly coffee and bananas, in the period after the Second World War. In fact, agriculture constituted 41% of the GDP and 55% of the employment in the country, and bananas and coffee accounted for 90% of the country's total exports. However, in response to the falling prices and the country's high vulnerability to shocks, Costa Rica diversified its exports over time as shown by the much lower volatility in the terms of trade from the 1980s onward. It not only expanded its agricultural exports beyond bananas and coffee, but it also developed advanced export-oriented manufacturing firms. Thus, the overall economy became less dependent on coffee and banana prices, as it diversified horizontally and vertically.

In order to achieve this export diversification, the country granted many export incentives including subsidies and tax exemptions. The government also established EPZs, which incentivized export-oriented enterprises through tax breaks and reduced tariffs on imports. This encouraged a lot of Foreign Direct Investment (FDI) inflows from manufacturing and technology companies such as Intel. In fact, computer parts comprised 40% of Costa Rica's exports in 2000, overtaking exports from traditional commodities.

The establishment of EPZs alone is responsible for 26,000 jobs and encouraged the growth of non-traditional exports in Costa Rica. Moreover, the country also prepared its workforce for the transition to a more diversified economy because of its commitment to education. The high literacy rate made it much easier for the workforce to leave coffee and banana production. As a whole, the reform in the country's public policies along with FDI involvement not only facilitated economic growth and stability, but it also improved the living standards of the workforce through poverty reduction and better education.

Possible Solutions

In this year's PAMUN conference, delegates are expected to write specialized clauses, which should later amount to a coherent resolution with each of them addressing a specific aspect of the topic. When writing their clauses, delegates are to focus on a specific aspect or a "specialized topic" of the general issue that are outlined by 'major issues' and 'possible solutions' of this report. During your conference, chairs will deliver their delegates with more specific instructions. However, please keep in mind that these ideas do not in any way set restrictions for debate. Moreover, each solution has both its benefits and disadvantages that delegates should thoroughly consider.

After years of following conventional development policies based on free trade, CDDCs are no closer to diversifying their economies, and it is imperative that these countries reform their policies in order to build a stable, resilient and diverse economies so that these countries achieve the SDGs.

Securing and effectively managing government revenues

Governments of CDDCs need to secure sufficient export revenues, without which governments cannot promote wider development, carry out diversification policies, or establish relevant institutions. To accomplish this, governments should strive for a balance between public and private interests through the implementation of policies that give the governments an adequate portion of commodity export earnings and that help sustain government budgets. Policies should also aim to curb tax evasion and the illicit misinvoicing of commodity export and transfer pricing, so that governments secure funds that are otherwise funneled abroad.

Governments should also ensure that the funds secured are effectively managed. A large portion of government revenues should be devoted to diversification policies and social protection mechanisms (explained below). Governments should ensure that markets function well, but at the same time, it is important to incentivize commodity producers and give them a fair share of global prices in order to sustain production and drive investment.

Countercyclical fiscal policies

As previously stated, procyclical fiscal policies cause unstable economic growth. Thus, in order to promote a steadier economic growth rate that is not solely dependent on the increase of commodity prices and demand, governments should implement countercyclical fiscal policies and deal with political pressure. These policies are characterized by the accumulation of savings during periods of high commodity prices and demand, and increased spending when commodity prices fall. Stabilization funds, which mitigate the effect of commodity price fluctuations, should be enacted in order to keep a consistent level of government revenue, which in turn can be spent on helpful social programmes to diversify the economy and social protection mechanisms.

Attracting private enterprises to invest in different sectors

The phenomenon described in the Dutch Disease shows that the dependence on the export of one or two commodities causes other sectors of the economy decline, which leads to a less diversified economy. Hence, it is very important for CDDCs to work towards diversification away from primary commodity exports and towards manufacturing exports. In order to achieve this diversification, governments should provide incentives to private enterprises from manufacturing and technology sectors to invest in the country through exemptions on taxes, tariffs, and business regulations. The creation of an EPZ has the potential to attract foreign investment and facilitate the growth of different sectors. If managed well, EPZs can diversify the economy and also create many new jobs. In addition, CDDCs should also ensure that the workforce is ready for a transition to a more diversified economy through better education and training facilities.

Expanding the commodity sector

Economic diversification should not only include the investment in other sectors of the economy, but it should also expand the commodity sector. Countries should export a range of commodities and not solely depend on a few commodity exports. Costa Rica, for example, expanded its agricultural sector, which used to be dependent on only coffee and bananas, by exporting a variety of new tropical fruits. Moreover, countries could also expand linkages between the commodity sectors and manufacturing and services by investing in subsequent stages of production and relevant facilities. This expansion could reduce the country's dependence on a few exports, open up new markets, and create a variety of jobs which are not completely dependent on the commodity prices.

Social protection mechanisms

As previously stated, economic growth, though necessary, is an insufficient condition for achieving inclusive growth. Thus, social protection policies that target the poor and vulnerable should be put in place. These mechanisms should promote social inclusion and seek to reduce poverty and inequality, and achieve food security through means such as safety net programs (welfare, unemployment benefit, universal healthcare...etc.). Stabilization funds can also help gain access to necessities such as food and water in times of commodity price shocks. Export revenues, especially when commodity prices increase, can be allocated to infrastructure development, investments in education and health, and other social protection mechanisms that contribute to food security for the poor.

For further inquiry

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Appendices

I. UNCTAD's Commodities and Development Report 2017: http://unctad.org/en/PublicationsLibrary/suc2017d1_en.pdf
This report comprises an overview of the topic with relevant statistics and explanations, numerous case studies on CDDCs, and detailed recommendations for policymakers.

II. UNCTAD's State of Commodity Dependence Report 2016: http://unctad.org/en/PublicationsLibrary/suc2017d2.pdf
This is the most recent overview of CDDCs, and includes vital information on the state of commodity dependence in each of these countries.

III. South Centre's TRADE Analysis on CDDCs: https://www.southcentre.int/wp-content/uploads/2013/07/AN_COM1_Problems-and-Policy-Challenges-Faced-by-CDDCs_EN.pdf
This document explains in detail issues faced by CDDCs, causes of the problem, and policy approaches to tackle the problem.

IV. Economics A-Z Terms by the Economist: https://www.economist.com/economics-a-to-z/a
This is a dictionary of relevant economic terms provided by the Economist.