

WHY IS THE DEBATE ON COMMODITIES SO CRUCIAL FOR LATIN AMERICA?
Alicia Bárcena, Executive Secretary of the Economic Commission for Latin
America and the Caribbean (ECLAC)

I would like to express my particular thanks to the Government of Argentina for organizing this interesting debate and for inviting the Economic Commission for Latin America and the Caribbean to participate in it.

It is remarkable that the French presidency of the Group of Twenty (G20) has made the issue of agriculture, in general, and matters relating to the volatility of commodity prices, in particular, priorities for its tenure.

This provides a unique opportunity to provide leadership on this critical issue, which requires unified global action, particularly to address commodity price volatility and its determinants.

In the case of agricultural commodity markets, the debate on whether volatility comes out of changes in global demand and supply or out of an increasing role of speculators in commodity markets (“financialization”) is probably a false opposition, as both variables may be at work. Yet, the real challenge is to connect the short-term with a longer-term vision and to work beyond the succession of short-term urgencies: probably this is the main task of the G20—to see the world through this transition from the financial crisis to the longer-term challenge of global climate change. For our region it is still a priority to reduce volatility. But we have learned that this, though necessary, is not sufficient, if the priority is to move towards growth with equity – an inclusive process of economic development.

Since 2003 Latin America has made significant progress on several fronts. Some of them are related to achieving growth with low inflation, low debt ratios and small current deficits (macroeconomic prudence); others, no less remarkable, have to do with fighting inequality, which has declined for the first time in decades.

Latin America needs to consolidate growth and move faster in the effort to reduce inequality—which is still the highest in the world—and

improve welfare. And it is in this context that we should assess current trends in commodity prices and volatility.

This workshop has produced a fruitful debate, especially regarding the upward trend in agricultural prices and the question of whether price volatility can be explained by speculation or by fundamental, structural forces that could give rise to a long-term boom in the terms of trade of primary goods.

Some of you have emphasized structural factors (fundamentals) related to food supply and demand, including changing patterns of demand and the impact of climate change; others stress the growing role of commodity speculation, particularly the interpenetration of the agricultural, financial and energy markets.

Whether structural factors¹ or speculative factors² are responsible, both need policy action in which the role of States and international cooperation is crucial.

Special attention should be paid to improving knowledge and data on the increasing integration between the agricultural and energy markets (supported by the use of agricultural crops for the production of biofuels), which implies that fluctuations in oil prices tend to be transmitted to the agricultural markets.

- On the one hand, higher commodity prices may bring about serious macroeconomic problems, both for financial markets and for the real economy. Indeed, the variety of goods affected by the ongoing boom is impressive (energy, metals and agriculture, and so forth) when

¹ (i) Changes in consumption patterns in certain large developing countries (although there is insufficient evidence that the increase in supply has failed to match the surge in demand seen in recent years); and (ii) Variability in climate conditions: since 1980 a larger number of severe floods and droughts have damaged agricultural production. Extreme climate events have become more frequent and are expected to increase with climate change.

² Speculative forces are a key part of the story, associated with closer integration between the financial and the agricultural markets. Indeed, the global jump in the value and number of financial contracts in agricultural markets during the past decade contrasts sharply with the relatively stable real production in these markets, and this has led to the financialization of agricultural commodity markets.

compared with historical precedents—even though commodity prices have not yet reached the levels of the 1970s in real terms.

- The rise in agricultural prices has been accompanied by a notable increase in price volatility. This instability is compounded and reinforced by instability in the energy market.
- High volatility affects both producers, especially small farmers, and consumers. For producers, volatility makes it more difficult to estimate rate of return on investment, due to the strong linkage of foodstuffs and fertilizer prices (since prices at harvest time may turn out not to make up for fertilizer costs);
- Impacts are stronger for smaller producers, as they do not have broad access to financial hedging instruments;
- Consumers are affected through the (direct or indirect) significance of agricultural goods in the wage basket, particularly at the low end of the income distribution spectrum.

Volatility constitutes a major hindrance to investment and the sustained accumulation of technological and productive capabilities.

These two obstacles both have a differentiated impact in our region:

The escalating path of most commodity prices has affected the region in a differentiated manner because prices have risen more steeply for minerals and energy than for agricultural goods.

Net importers such as the Central American and most Caribbean countries have been badly affected and net exporters, mostly in South America, have benefited greatly. Mexico is a special case.

- Therefore, exporters of minerals or energy, like Chile, Peru and the Bolivarian Republic of Venezuela, have obtained larger benefits from the surge in commodity prices than traditional agricultural exporters like Argentina and Uruguay.
- For net exporters, improved trade balances may lead to exchange-rate appreciation, which may in turn prompt an increase in capital inflows

(foreign short-term inflows are typically stimulated by expectations of further appreciation), reinforcing the initial exchange-rate momentum.

- With few exceptions, exporting economies' local currencies appreciated nominally against the dollar between December 2008 and December 2010: 41.2 % in Brazil, 36.7 % in Chile, 22.4 % in Uruguay, 17.1 % in Colombia and 10.1 % in Peru.
- With regard to the impact on inflation, while exchange-rate appreciation offsets the domestic impact of rising international food prices in the short run, it tends to diminish competitiveness in non-traditional tradable sectors, with serious potential damage to capabilities in the medium and long run.
- In importing or exporting economies alike, small, less sophisticated producers in the agricultural sector have not necessarily benefited from higher international prices, as there is often a large gap between the price they receive and consumer prices, related to market concentration in the agricultural value chain. In contrast, they tend to be negatively affected when fertilizer prices rise, as observed in recent agricultural price booms.

On the financial side:

- Exchange-rate appreciation may result in excessive current account deficits, nurturing the upward phase of a boom-bust cycle in the domestic asset prices, thus over-exposing the economy to international liquidity cycles (“sudden stops”).
- On the real economy or development side, exchange-rate appreciation and volatility tend to hurt investment spending in the non-traditional tradable sectors of the economy—those that do not benefit from the improvement in terms of trade.
- Indeed, the fact that real exchange rate appreciation fosters deindustrialization is already a matter of concern in several Latin American countries, as it harms technological capabilities and reduces diversification in exporting countries.

- Short-term success in containing exogenous, “imported” inflation may compromise long-run growth driven by knowledge-intensive sectors.
- The implications, however, depend on structural conditions (e.g. whether countries are net exporters or net importers). In the case of net importers, price increases tend to reduce food consumption by the poorer segments. The price hike of 2007-2008, for instance, reduced the food intake of the poorest 20% of the population by 9% in Guatemala and by 19% in Peru.
- Current account tensions may also arise as a result of terms-of-trade downturns, especially when rising food prices are coupled with escalating oil prices, as has been the case in some Central American and Caribbean economies. In these cases growing pressure tends to be exerted on the capital and financial accounts, and therefore standard (trade-related) balance-of-payments problems are likely to emerge.
- Tensions associated with macroeconomic management also tend to affect Latin American and Caribbean countries across the board, irrespective of their positions as commodity exporters or importers.
- Higher volatility significantly affects monetary, fiscal and exchange-rate policies: in the absence of offsetting mechanisms (such as Peru’s removal of import tariffs for several key agricultural products), the rise in international food prices is passed through to domestic inflation.

Why is it so crucial to understand the forces underlying volatility?

The forces driving volatility form very different scenarios, especially with regard to long-term development objectives and the avoidance of short-termism.

If speculative forces are the prevailing cause of volatility, we cannot count on a long period of rising prices and rising demand which would, in turn, allow for higher growth with stability on the external front. If, conversely, the boom is related to fundamentals, we may be more optimistic about the future.

The evidence so far tends to suggest that both forces are at work in the present circumstances and we need to be cautious and remain very alert to future developments in commodity markets, especially in the agricultural markets.

And yet, although this is a very important point for discussion, there are other, long-run topics that cannot be neglected.

As stated in Boianovsky (2009), the original concept of Dutch disease developed in the 1970s “referred to fears of deindustrialization in the Netherlands in the wake of the appreciation of the Dutch guilder following the discovery of natural gas deposits in the North Sea in the 1960s”³. This author also argues that the effect of resource booms on the economic structure was investigated as part of the theory of international trade by Cairnes, Wickseil and Furtado decades before the term “Dutch disease” was coined by *The Economist*. In Furtado’s analysis of the case of oil in Venezuela, he concluded that “deindustrialization” was a likely outcome.

Prebisch (1949)⁴ and Singer (1950)⁵ base the case for industrialization in underdeveloped countries on the dynamic importance of the phenomenon as such and not only on the falling terms of trade thesis. For Prebisch and Singer, manufacturing is the main driver of technological learning and demand growth and this is why it plays such a critical role in the development process.

The Prebisch-Singer thesis warned us about the risks of a continuous, long-term decline in the terms of trade for commodities. The evidence has so far tended to confirm this; we do not know if it will be so in the future. But this was not the key point of Prebisch’s structuralist perspective. Prebisch was principally concerned with the accumulation of productive and technological capabilities, with a denser productive matrix, in which activities with higher technological intensity increase their share in total

³ Boianovsky, Mauro (2009), *Commodities, Natural Resources and Growth: A Survey Through the History of Economics* (September 2009). Available at SSRN: <http://ssrn.com/abstract=1601969>.

⁴ Prebisch, Raúl (1949), *El desarrollo económico de la América Latina y algunos de sus principales problemas*, E/CN.12/89, CEPAL, Santiago de Chile. Published in English in 1950: Prebisch, Raúl (1950), *The Economic Development of Latin America and its Principal Problems*, reprinted in *Economic Bulletin for Latin America*, Vol. 7, No. 1, 1962, 1-22.

⁵ Singer, Hans W. (1950), *The distribution of gains between investing and borrowing countries*. *American Economic Review*. 40: 473-85.

production. For this reason, Prebisch considered that the centre-periphery system had been formed as a result of the “slow and unequal” international diffusion of technology, which permeated the productive structure of the peripheral regions in too localized and too limited a manner.

In other words, there seem to be two variants to Prebisch’s thesis: first, what I would call the “terms of trade variant”, the well-known thesis that terms of trade for primary good exporters tend to fall in the long term. This variant of Prebisch’s thesis has been under intense scrutiny lately on account of rising commodity prices, but there are no empirical grounds to reject it thus far. But there is also a second, less acknowledged variant of Prebisch’s approach, which I would call the “evolutionist”, “structuralist” or “industrialist” variant, concerned with the accumulation of productive and technological capabilities.

At ECLAC we are currently working on how to achieve gains in productivity beyond the two or three successful export-led commodity sectors and move towards the transfer of the workforce from subsistence and informal sectors to those with higher productivity. Several studies have shown that generating employment in high-productivity sectors is a form of attaining more productivity growth and more equality at the same time, a point that Prebisch stressed in his pioneer work (Prebisch, 1949). Poverty cannot be defeated solely with social policies, however necessary they may be. The only solution for the employment problem is structural change in which the unemployed or underemployed find higher-quality jobs. For this, we need productive and technological convergence with the developed world and within our economies. Development is not just a problem of terms of trade; rather, is the challenge of closing the technology, productivity and income gaps that exist in the international and domestic economies. This is one of the main themes of *Time for Equality: closing gaps, opening trails*.

Of course, the abundance of natural resources can help in this process. But if instability and high prices jeopardize investment in technology-intensive activities, that sounds very much like a natural resource curse. We should not forget that the countries that have created this entirely

new situation in the international economy —the Asian countries and particularly China— are precisely those that chose to dramatically transform their productive structure. This is why they are now reshaping the whole system of global trade and finance: because they sought and implemented the industrial and technological policies demanded by structural change. We should also choose a new role in this global system compatible with the aim of economic development.

The dogmatic confidence in the rationality of economic agents (which prevailed before the Great Recession) has been abandoned, hopefully for good. This dogmatic stance formed part of what Paul Krugman labeled the “Dark Ages” of macroeconomics —a period in which important teachings of the pioneers were forgotten. We should recover these ideas and use them to be more courageous in devising the new policies of the future.

Lastly, Latin America needs to reflect on what it needs from international governance, no longer as policy-takers but now as policymakers together with other emerging economies.

Briefly, policies should be implemented at least in three areas to reduce the negative impacts of rising commodity prices and marked instability:

1. Trade

- There is a clear need for more international coordination to avoid food shortages in importing countries and to curb instability in both exporting and importing countries. For this, institutions must be designed with a medium- and long-term perspective and better international coordination.
- In the meantime, as long as the current price volatility persists, developing countries may need to enhance their defensive policy instruments—not remove them. These measures should also be complemented with longer-term policies relating to income distribution, the productive structure, public finances (including subsidies), and so forth.

2. Policies supporting production and consumption

- Policies directed at enhancing agricultural productivity, particularly of small local producers, may help to reduce vulnerability to food crises, especially if they are complemented by policies to reduce vulnerability arising from consumption demands.
- As long as the spectre of rising and highly volatile food prices remains, it will be necessary to maintain existing income support programmes set up to help poor families to cope with increasing food prices.

3. Macroeconomic policy management

- Regarding macroeconomic policy management, to paraphrase Stiglitz: “we need to develop a wider range of instruments for broader goals”.
- A wider range of instruments are needed to preserve non-traditional industrial competitiveness (prevent reprimarization) and boost employment and competitiveness while keeping inflation in check and reducing price volatility.
- The boom in the external sector —especially for South America— certainly provides renewed opportunities in the quest for development, but poses serious policy challenges regarding short-run macroeconomic management.
- The surge in inflation rates, stemming primarily from the rise in international prices for agricultural goods, and the associated tendency for real exchange rates to appreciate, force policy makers to tread a very narrow path, balancing internal equilibrium (growth and price stability) with external equilibrium. The ever-present risks associated with external sector imbalances have by no means been lessened by the favourable international prices and abundant international liquidity. On the contrary, they may be exacerbated by profound real exchange-rate misalignments and domestic asset bubbles.
- The overvaluation of domestic currencies resulting from the combination of improved terms of trade, higher domestic policy rates and rising international liquidity has given major grounds for concern for many countries in the region, notwithstanding the fact that it has helped to deal with inflation. Symptoms of Dutch disease abound.
- One of the greatest challenges ahead is, therefore, related to the management of rents or quasi-rents originating in the exploitation of

natural resources, and the need to devise fiscal and monetary instruments to avoid the loss of industrial competitiveness and the excessive primarization of exports as observed in recent years.

- So, as we have noted, the need to broaden policy goals —aside from targeting inflation— to include, for instance, employment, competitiveness and the reduction of price volatility, may in fact require a wider range of policy instruments, including the regulation not only of cross-border capital inflows —which has recently regained acceptance in policy circles— but also of domestic financial markets and commodity markets.
- Besides short-term measures, policies for long-term, structural change are required if the aim is to reduce the region's vulnerability to international price shocks and volatility.
- Technological capabilities will become ever more critical to avoid Dutch disease in the current international context.

As the current governance stands, we still respond as national entities to the global markets. Hence the importance of multilateral forums and cooperation in arming ourselves better against the threat of volatility, instability and climate insecurity.

Connecting the short term with the long term requires decisions to be taken in the present (Keynes).

The structural trends that are in evidence today are so deep as to signal a genuine change of era: climate change; technological change, particularly in ICTs, which are creating a different society; and cultural change (including transparency for both the markets and society), inasmuch as deregulation or self-regulation can be harmful and dangerous when projected onto certain areas of global life. The system itself should provide the means to strengthen regulation in some areas of global life, precisely because the lack of oversight is likely to lead to global crises, be they economic, production-related, environmental or world-security-related.

A historic opportunity now exists to make every effort to build a model of globalization that breeds greater collective awareness of global public goods and awakens democracy across the planet. We need policies with a long-term vision in order to remain one step ahead of the climate, taking into account different technological, demographic and cultural scenarios.