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Secretary of State for Trade and Industry

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25 April 1986

The Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON
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Dear Geoffrey,

The second session of the Conference to renegotiate the Natural Rubber Agreement will start in Geneva on 5 May. The first session was held in April last year but proved to be inconclusive.

Officials here have looked carefully at the operation of the existing Agreement and have consulted your officials as well as those in MAFF and the Treasury. As you are well aware, in the light of our experiences with the International Tin Agreement, we have argued that we must take a more rigorous view of Commodity Agreements. The inter-Departmental review of commodity policy has not yet completed its work but the general view emerging is that, among other things, Commodity Agreements should include the following key elements: a wide and representative membership including the major producers and consumers; automaticity of price adjustments which are veto-proof; a ceiling to the size of the Buffer Stock; and the absence of futures trading, as well as a series of other points which are detailed in the attached paper prepared by my officials. I understand that an earlier version of this paper was seen by your officials but that the final version has not.

It can be argued that the INRA compares quite favourably with other Agreements and possesses some important features that have been identified as highly desirable in any Commodity Agreement. At an earlier stage one might have been content to renegotiate something along similar lines. But the position has changed with the collapse of the ITA and Commodity Agreements must now undergo more rigorous scrutiny. There are a number of improvements that can

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and should be made to the Agreement, if a new one is negotiated. The proposed negotiating position as outlined in paragraphs 11 and 12 of the paper is a tough one, without fallback and will no doubt prove difficult to achieve. However I believe the approach is the right one.

We will of course have to carry our Community partners with us and I suspect that we will face some resistance to our proposals from them as well as expected reactions from the producer countries. At this stage at least we need to take a hard line if we are to get an Agreement which does not fly in the face of economic realities. On the other hand, our industry and trade support the view that we could manage without a new Agreement. And even at this stage it is not clear what the attitude of the major producers, Malaysia, Thailand and Indonesia will be. They may indeed decide that a new INRA is not in their interests and our negotiators will not of course seek to influence them otherwise.

The ITA lessons have clearly had some influence on producing countries as well as other consumers. At the Committee on Commodities in UNCTAD last December both groups adopted a decision which gave support to Agreements being more market-related where possible. This should strengthen our hand.

I would be grateful if you could let me know fairly quickly if you have any comments on our proposed negotiating package. In the event of difficulties, particularly with the Community, the negotiators will of course need to report back to us.

Copies of this letter go to the Prime Minister, Nigel Lawson, Michael Jopling and to Sir Robert Armstrong.

Yours

Paul

PAUL CHANNON

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ANNEX

RENEGOTIATION OF THE INTERNATIONAL NATURAL RUBBER AGREEMENT (INRA)

1 Current Ministerial Position

(i) Ministers approval to enter into a renegotiation of the INRA was obtained in November 1983. Their endorsement of the UK and EC (see paragraph 10 below) objectives for the Renegotiation Conference the first session of which was held in Geneva last April was obtained at that time.

(ii) A second session of the Conference is to held in Geneva on 5 - 23 May 1986. In view of developments in commodity agreements, particularly the collapse of the International Tin Agreement (ITA) since last consulting Ministers, we have reviewed carefully the negotiating mandate in relation to the coming session and are now seeking Ministerial approval for new objectives.

2 Background to the INRA

(i) INRA was the first new commodity agreement negotiated under the UNCTAD Integrated Programme for Commodities (IPC). Its main objective is to reduce price fluctuations by means of a buffer stock. It came into force provisionally on 23 October 1980 and definitively on 15 April 1982. It was due to expire in October 1985 but a decision to extend it for a final 2 years was taken in June 1985.

(ii) All the major producers and consumers were prepared to join the first INRA, including the EC Member States. The UK also felt that membership could offer the following:

(a) greater price stability for an important industrial commodity to assist industrial planning and help to ensure continuity of supply.

(b) strategic value of buffer stocks stored in the West and that

(c) buffer stock dealings would provide business for the London rubber market.

At that time there was a political view that we should confirm our commitment to the UNCTAD Integrated Programme for Commodities.

(iii) INRA provides that the buffer stock is the sole mechanism for intervention in the natural rubber (NR) market. The Buffer Stock Manager (BSM) is allowed to operate by buying and selling within established price zones. There are zones for both discretionary and compulsory buying and selling, with an intermediate neutral zone. The mechanism also features semi-automatic provisions for price adjustment with no powers of veto.

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(iv) In the life of the Agreement there have been periodic downward trends in the price of NR and in November 1981 the buffer stock buying mechanism was triggered. There was a recovery of prices in 1983 but in 1985 the BSM was obliged to enter into the market again when prices weakened. As a consequence of this activity the stock has grown to 360k tonnes (the maximum size of the normal buffer stock is 400k tonnes but there is also provision for a contingency stock of 150k tonnes). This amount of NR represents less than 1 month's world consumption. This compares with almost 4/5 months' consumption being held off the market by the ITA at the time of the collapse.

(v) The first renegotiation session was inconclusive. The UK/EEC view and that of all major consumers at that time was that the original Agreement had worked reasonably well and that no major changes needed to be made. Producers took a different view. They argued for a higher price range and reduced automaticity for price adjustment.

3 Assessment of the INRA

(i) UK industry and trade representatives have worked closely with officials in the construction of the existing Agreement and in its management. This has helped to ensure that the Agreement met its principal objectives in the best way achievable. But the benefits have to be balanced against costs.

(ii) The principal objective of the Agreement was to reduce the degree to which NR prices fluctuated in the short-term whilst at the same time ensuring that prices continued to follow a path consistent with long term market clearing. As regards short term price fluctuations, average monthly prices have varied less during the period of the Agreement than they did in the 1970s (though this could reflect factors other than the Agreement). However the BSM has only purchased NR and an accumulated buffer stock of 360k tonnes might suggest that any element of increased price stability has been bought at the expense of providing an element of price support.

(iii)a) Benefits

It can be argued that the UK, as a consumer would have derived benefits from any greater stability of NR prices. Consumers would have been better able to undertake their long-term industrial planning. Additionally, they may also have benefited from a perceived reduction of producers' risks feeding through into greater security of supply or even a lower supply price.

b) <u>Costs</u>

The UK's participation in INRA has inevitably imposed costs on the Exchequer. To date, the UK has contributed £5.75m to the INRA and although the UK's share of the buffer stock is presently valued at about £5m opportunity cost arguments apply since the resources invested in rubber could have been invested elsewhere.

(iv) The maximum liability for the UK is limited to the cash requirements of financing the Buffer Stock (which has a defined ceiling) and the nominal costs of administering the Agreement. At current prices, the maximum additional call on the UK Exchequer is approximately £2.25m.

(v) In addition to the Exchequer costs of financing the UK's contribution to the buffer stock, the INRA may also have imposed some other economic costs. If the Agreement has resulted in the price of NR being higher in the long term than it otherwise would have been, this will have resulted in economic costs in consuming countries. Relatively inefficient producers may have been protected and consuming industries will have purchased rather less NR than would be appropriate if the NR price had not been distorted. However, since the size of the buffer stock is small relative to world consumption any economic costs will have been correspondingly small.

(vi) Though the above does not reflect all the benefits to the UK (there have, for example, been gains from trading on the London market, shipping freight charges, insurance placed in London, and UK warehousing) it is clear that such stability as has been achieved has been at some cost. But the fact remains that INRA is a much better agreement than the ITA and may well be the most effective of all commodity agreements.

4 <u>Prospects for Natural Rubber Supply and Demand</u>

(i) It is always difficult to make accurate projections of NR supply and demand since there is a wide range of factors which influence both. However, with recent movements in oil prices the present position is more uncertain than usual. As synthetic rubber (SR) is an oil based product it has been suggested that the fall in oil prices will result in some substitution of NR by SR. The extent of any substitution depends, however, on expectations about the future level of oil prices and the technical possibilities that exist: overall, it seems unlikely that there will be any <u>major</u> switch from NR to SR, especially in the short term.

(ii) The fall in oil prices is, however, expected to lead to a higher level of economic activity, particularly motoring activity from which much demand for NR derives, and this should strengthen

NR demand, and offset any weakening through substitution.

(iii) On the supply side, it is believed that as recent plantings of rubber trees come to maturity so the overall level of NR supply will rise steadily in the next few years. It is not clear whether the growth in supply of NR will outstrip that of demand but it seems unlikely that there will be any marked strengthening of the NR price in the foreseeable future.

5 INRA Price Range

We have considered carefully the question of the existing price levels in the INRA against the supply demand position outlined above and past experience of their operation. Though minimal buffer stock activity has taken place since September 1985, the price of NR has recently slipped back into the Agreement's discretionary purchasing zone, having been in the neutral price zone for the previous two months. Since the Agreement came into effect low NR prices and buffer stock buying have meant that the INRA price range has been revised downwards on two occasions (by 1% in 1982 and 3% in 1985) in accordance with INRA's semi-automatic price revision mechanism.

(ii) In view of the current depressed prices for NR in the world market and the agreement's history there is an argument for reviewing the price range downwards in the coming session. We will seek to do so. But the uncertainty as to the supply/demand position and considerable political resistance will make it difficult to achieve. There is, however, no case at all for revising INRA's current range upwards and we should firmly resist this.

6 UK Commodity Policy

(i) In the past the UK has expressed a willingness to join commodity agreements where they were seen to be feasible, cost effective and beneficial to producers and consumers alike. These considerations are still valid.

(ii) Following the collapse of the ITA, and with an eye to UNCTAD VII, officials are carrying out an interdepartmental review of commodity policy. The core view emerging from discussion is that we should look harder at individual commodity agreements with economic provisions. Ideally, such agreements should include the following elements;

(a) Wide participation of producer and consumer countries.

(b) Veto-proof automaticity in the adjustment of the price range to accord with longer term market trends.

(c) A clearly defined limit on the size of the Buffer Stock.

(d) The Agreement should be seen to be financially viable ie adequate cash funding, no forward dealing and no borrowings, and

(e) Transparency of buffer stock operations.

(iii) In addition officials have also said that any Agreement should have provisions for neutralizing currency fluctuations.

7 Key Elements of the Present INRA

Unlike the ITA the present INRA has features which come close to the above. In particular:

(a) All major producers (c.93% of exports) and consumers (c.82% of imports) are members.

(b) The Agreement has semi-automatic veto-proof provisions for price adjustment around longer term market trends which have operated.

(c) The present INRA has an absolute maximum Buffer Stock level of 550k tonnes.

(d) Administration and Buffer Stock activity has been financed by cash contributions. The Buffer Stock Manager is expressly precluded from dealing in the futures market. Borrowing powers are also clear, limited and triggered only with Council approval (which has not been done).

(e) Full details of Buffer Stock transactions are sent to members in clear monthly reports after a 60 day period, and

(f) Financial holdings in the Buffer Stock Account are managed in accordance with advice provided by Rothschilds to limit exposure to exchange rate fluctuations. The world price for rubber is determined on a basket of four currencies which reflect the dominant trading currencies in NR markets.

In addition the liabilities associated with the collapse of the ITA have focused attention on possible contingent liabilities arising from other commodity agreements. In the case of the INRA, DTI Solicitors have concluded that the arguments suggesting that there may be a contingent liability are academic in the extreme. We will ensure that the non-exposure to liabilities is maintained in any new Agreement.

8 **Political Considerations**

(i) The major producers of NR are three ASEAN countries, Malaysia, Indonesia and Thailand. When the Agreement was first negotiated there was general support for the concept of International Commodity Agreements and the producers had no doubts that INRA was in their general interest. Recent developments in the commodities field have prompted a number of producer as well as consumer countries to re-appraise their assumptions about ICA's.

(ii) We do not know current ASEAN producer thinking about INRA and its successor. But they may still be seeking some increase in the reference price and less automaticity in the revision of the price range, since they regard this as having operated against them in the present agreement. All three countries and in particular Malaysia, remain sensitive to any action by developed countries which they view as running counter to their interests. The South East Asian economies are under considerable pressure at present. Any action by the UK which could be interpreted as adding to their problems could have adverse political and economic repercussions for us.

(iii) These considerations need to be borne closely in mind in both our strategic and our tactical approach to the INRA negotiations. There is therefore a balance to be struck between our desire to ensure that the terms of the new INRA reflect the negotiating objectives set out below and the desirability of not being blamed by the producers for any failure of the negotiations.

(iv) All major participants have expressed support for the current agreement at one stage or another. On the consumer side even the USA, often antipathetic to such agreements, has been supportive. US officials recently affirmed their willingness to participate in a new agreement provided it was similar to the existing one. The position of the USSR and Japan is understood to be similar.

(v) We consider that both producers and consumers have a much clearer perception, as a result of the ITA experience, of the dangers of defending unreal prices and the costs that this involves. At a meeting of the Committee on Commodities in UNCTAD last December both producers and consumers adopted a decision which gave broad support to the need for prices to be market related, and for a degree of automaticity for price adjustments where possible. This should provide scope for consumers to take a tougher line in future negotiations.

9 **Community Regime**

(i) The Council and the Commission agreed in 1981 that all the IPC commodity agreements should be mixed agreements, negotiated and concluded by the Community and the Member States on the basis of a common position. In negotiating, the Community and Member States are represented by a common delegation which expresses the joint position. If there is no agreement on a joint position, the Community remains silent. There is, however, an ability in principle for Member States to make in exceptional circumstances national statements on matters of fundamental national concern.

(ii) This arrangement is without prejudice to the legal position on the respective spheres of competence of the Community and the Member States over any particular community agreement. In the case of the INRA, however, the Court of Justice has upheld the "mixed" formula which recognises Community competence under Article 113 of the EEC Treaty (common commercial policy) and the competence of Member States to the extent that they are responsible for financing the buffer stock.

(iii) It is the practice that, in the event of failure to reach a common position during negotiations, the matter is referred first to COREPER and then, if necessary, to the Foreign Affairs Council. If, in the next Session on the INRA, the United Kingdom refused to support a position agreed by the Commission and the other Member States, recourse would be had to this mechanism for resolving the difficulty. It is possible that no solution might be reached at the Foreign Affairs Council, but, as a matter of practical procedure, unanimity is required, and compromise solutions have generally been found.

10 EC Negotiating Objectives

The agreed principal EC objectives for the renegotiation conference are as follows:

(a) to encourage the conclusion of a viable agreement whose economic and financial provisions allow it to operate efficiently and take account of market realities;

(b) to help achieve stability of natural rubber prices by preventing excessive price fluctuations without distorting long-term market trends, and

(c) to seek to guarantee adequate and regular supplies of natural rubber on reasonable terms for Community industries.

Apart from some administrative changes the Member States agreed in April 1985 that the existing Agreement reflected the above objectives, and that a new Agreement which was along the same lines as the existing Agreement would be acceptable, subject to a high constituency of membership.

11 **Objectives for the forthcoming session of the Renegotiation**

In the light of our recent experiences with Commodity Agreements, particularly the ITA, we now need to review the UK position for the renegotiation in order to strengthen it. In all the circumstances, we would propose the following UK objectives:

(a) The existing key elements of the INRA which meet the desirable elements (listed in 6(ii) above) for UK Commodity policy should not be diluted or eroded.

(b) The existing Buffer Stock should be transferred to any new Agreement and the current ceiling on size maintained.

(c) All references to "borrowing" should be removed from the text of the Agreement; (although noting that such powers are already highly constrained).

(d) The UK should seek even greater automaticity for reviewing the price range by reducing the interval for such reviews. At present the reference price is reviewed every 18 months. We will seek to reduce this interval in order to reflect more quickly market movements. Other ways of improving the automaticity provisions such as removing discretion as to the percentage change should also be pursued in the course of the negotiation, and

(e) the UK should explore the possibilities for a lowering of the current price range in the agreement and should not settle for a higher range.

12 Recommendations

Eventual failure to achieve a new Agreement could carry political risks if the producers are keen to get an INRA II and if they feel that consumers, or more particularly the UK, carried responsibility for the failure. Moreover, in the event that no new Agreement emerges from the negotiation, for whatever reason, the buffer stock from the existing INRA should be sold onto the market over a period of 3 years after October 1987. This could put the BSM in the role of distressed seller and could thus affect the value of our existing investment. But we nevertheless believe that the UK can live with or without a new agreement. This view is supported by industry and trade. What is quite clear is that the UK should not negotiate a new Agreement which is less than satisfactory. Accordingly, we recommend ministerial endorsement of the line that UK negotiators, whilst seeking to minimize exposure to the political risk, should:

(i) seek improvements to the existing Agreement through the EC joint position in line with the proposed negotiating objectives at 10 above.

(ii) seek to persuade other Member States to an EC joint position to withdraw in the event of a withdrawl from the renegotiation session of a major producer or consumer (US, USSR, Japan or any of the three ASEAN producers).

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