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CONFIDENTIAL

Prime Minister
Paragraphs 12 - 14 of the paper by officials attached to this minute are well worth reading.
DEW 8/5

JU198

PRIME MINISTER

INTERNATIONAL NATURAL RUBBER AGREEMENT

1 The attached paper has been prepared by my officials in consultation with other interested Departments in response to the request in your Private Secretary's letter of 1 May. In view of the importance of the legal issues involved I have, as suggested by the Chief Secretary, referred them to the Law Officers for an opinion. I understand that the Attorney General will be present at the meeting arranged for this Friday and will be prepared to give an opinion then. The attached paper is therefore based upon the advice of Departmental legal advisers.

2 A new INRA would be of little or no benefit to the United Kingdom and I would be content to see the present agreement lapse without renewal. We shall therefore need to consider our future course of action principally in the light of the Law Officers' advice on the legal obligations under Community law and on the wider considerations which would apply if we were to decide to act contrary to our Community obligations.

3 Subject to the views of the Law Officers, the advice from officials is that our freedom of action is severely constrained

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by Community Law. It is doubtful whether we can unilaterally withdraw from the present INRA, nor, since we are legally bound by a negotiating mandate agreed in April 1985, can we withdraw from the renewal negotiations. Were we to attempt to act unilaterally we might well provoke a damaging row on the eve of the UK Presidency. Legal action against the UK by the Commission would be inevitable and could result in an unwelcome extension of Community competence. Officials conclude that in the circumstances the most effective course would be to press the Community to take a tough line in negotiations within the existing mandate in the hope that this will be unacceptable to the producing countries, though there is a risk that we might not be able to prevent an eventual compromise leading to a new INRA. However, we could not afford to be seen to be aiming for the failure of negotiations since this would undoubtedly jeopardize our chances of maintaining the support necessary for a tough Community line. While we could in theory seek to change the negotiating mandate the chances of our succeeding are remote.

4 I am copying this minute to the Secretary of State for Foreign and Commonwealth Affairs, the Chief Secretary, the Attorney General, the Minister for Agriculture, Fisheries and Food and to Sir Robert Armstrong.

MRL

PP PAUL CHANNON

8 May 1986

Department of Trade & Industry

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The International Natural Rubber Agreement

Paper by the Department of Trade and Industry

This paper has been prepared by officials of the Department of Trade and Industry in consultation with officials from the Cabinet Office, Treasury, Foreign and Commonwealth Office, and the Ministry of Agriculture, Fisheries and Food.

2 The conclusions presented below are based upon the advice of Departmental legal advisers but are subject to the views of the Law Officers whose advice has been sought.

The Issues

3 How best to secure the withdrawal of the United Kingdom from the International Natural Rubber Agreement (INRA) bearing in mind existing legal obligations and the size of the outstanding stock.

4 If this is not possible, what negotiating line should the UK Delegation be instructed to take in the current negotiations.

Options

5 There are four possible approaches to the problem:

(i) To withdraw from the present INRA. But it is very doubtful whether the United Kingdom can unilaterally withdraw consistently with Community law.

(ii) To seek the agreement of Community partners to annul the existing European Community mandate for the negotiations. In April 1985 EC and Member States decided to enter negotiations on the basis of a common position (supported by the UK) couched in broad terms (see para 9 below), within which detailed positions would have to be formulated.

(iii) To stiffen the Community position within the existing mandate to the point where it becomes unacceptable to producing countries. This will require the UK to enlist the support of its EC and consumer partners but offers the best chance of success.

(iv) Unilaterally to withdraw from the renewal negotiations. But Community law, because of the mandate, constrains the UK's freedom of action.

Constraints

6 (i) Withdrawal from the Present INRA.

The present Agreement expires at the beginning of October 1987. The 12 months' notice of withdrawal required means that the UK would only be outside the Agreement for a maximum of 5 months (assuming that Community law would allow unilateral withdrawal).

(ii) Annulment of the EC mandate.

Annulment of the mandate would require EC partners formally to decide that they did not wish to negotiate a new INRA contrary to the objectives endorsed by the Council in April 1985. Such a decision would have political implications going beyond INRA, and amounting to general EC opposition to International Commodity Agreements (ICAs). Whatever the reservations of some of our Comunity partners about ICAs, the majority is unlikely to be willing to adopt such a course before the Community has thoroughly reviewed existing policy on commodities in general.

(iii) Stiffening the EC Mandate.

There is a reasonable chance of mustering sufficient support within the Community for a tough line. Member States however would be reluctant to agree to such a line if the UK revealed that its ultimate objective was the failure of the Conference. Tactically, we should therefore press to the maximum the point that the UK's specific requirements are essential if the provisions of the mandate are to be fulfilled and the Community is to avoid concluding an Agreement which is not in line with market realities. But this line carries with it the danger either that the UK will be unable to muster sufficient support to prevent an eventual compromise solution which has the faults of INRA 1, (ie a tendency to support the price) or that the producing countries will accept what ever tough line the EC proposes.

(iv) Unilateral withdrawal from the negotiations.

Unilateral withdrawal would be contrary to the spirit, and probably to the legal obligations, of the April 1985 mandate. Non-participation would make it impossible for us to influence Community priorities in the negotiations, and would reduce our influence on other consumers. It would also make it very much more difficult to muster a blocking minority of EC member states to prevent the Council taking a decision contrary to our interests. At the end of the day, we might still find ourselves obliged by a Council decision taken by qualified majority to join a new Agreement. Most other EC member states are in favour of continuing the negotiations. Unilateral withdrawal from the negotiations would inevitably expose the UK's isolated position and lead to major disagreement in the Community on the eve of the UK Presidency.

Legal aspects

7 UKREP Brussels advise that the Commission would probably welcome the opportunity of seeking a ruling from the Court on the issues of Community competence raised. There are three aspects.

(i) A unilateral UK withdrawal from the current Agreement would be likely to be challenged by the Commission in the European Court of Justice.

(ii) As regards withdrawal from the current negotiations, the UK is bound by the terms of the mandate agreed by the Council in April 1985, unless the UK succeeds in having it changed. Unilateral withdrawal from the negotiations which carried an implication that UK would not participate in any eventual Agreement might also be challenged by the Commission before the Court.

(iii) Finally, and most important, if a Council Decision were to be taken under Articles 113 and 116 obliging the Community and Member States to sign and provisionally apply a new Agreement, the UK would be bound to comply with its terms and would undoubtedly be taken to the court by the Commission if it did not do so.

8 Subject to the views of the Law Officers the UK is thought unlikely to succeed in any action brought against it under (i) to (iii). Furthermore, if any case on commodity agreements is brought before the Court, we risk a Court judgment which extends Community competence, with serious implications for external agreements in other fields eg environment.

Renegotiation of the INRA

9 The first renegotiation session of the INRA was held in Geneva in April/May 1985. The European Community and its Member States entered the renegotiation, with Ministerial endorsement, on the basis of a Council decision agreed in April 1985. The principal EC objectives were 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 and

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

This mandate is fairly broad in its terms but it assumes implicitly that the INRA is worth renewing.

10 Given the broad terms of the mandate there is a fine balance between what is referrable back to Council and what is an acceptable adjustment to the mandate by Member State consensus. The EC Working Grouping preparing the current session was developing a tough position which strengthened the mandate without recourse to Council. A radical change such as seeking to block any new Agreement would, however, result in a reference back to Council.

Other countries' views

11 The current Geneva session represents the second session of the renegotiation for a possible second INRA and by precedent it would not be the last such session. As at present known, the

divergence between the consumer and producer positions in such that the most likely outcome of the present session is either disagreement or breakdown. Initial reports suggest that the producers are seeking to ensure that the price mechanism under any new INRA pays regard to production costs, whereas the consuming countries are opposed to this. A tough Community position should further stiffen consumer resistance.

12 In the EC working group there is substantial support for a tough line. All accept that the key elements of the present agreement (as set out in para 7 of the paper annexed to the Secretary of State's letter of 25 April) should be maintained without dilution. There is also support for many of the ideas for strengthening INRA as set out in para 11 of the same paper. (The texts of these two references are repeated for convenience at Annex A to this paper). There is support for the maintenance of the present ceiling on the size of the buffer stock and the removal of all references to borrowing. The areas of difficulty relate to the need for greater price automaticity (where there is broad agreement on the principle but not on the frequency proposed by the UK) and on price levels (where there would be difficulty in getting support for a tough stance). No member state, however, is thought to contemplate a price range above the market level at the time that any new agreement might enter into force. Support will be easiest to obtain from the Federal Republic and Belgium. The smaller and newer member states may well become more supportive as may the Netherlands. France and Italy may be unwilling to come alongside. On the question of EC withdrawal in the event of a major producer or consumer withdrawing Italy and the Netherlands may be the most recalcitrant. For a variety of reasons others may well agree to the proposed UK line. In the event, however, of the UK seeking to adopt wrecking tactics or to change the mandate and seek withdrawal, the movement towards our position could well be reversed.

13 At the present time, all other members of the agreement, representing all major consumers and producers, are prepared to negotiate. The US in particular, normally anti-pathetic, is willing to contemplate renewal as are the Japanese and other consumers. The UK, therefore, although possibly able to bring its EC partners alongside would be seen as pushing the toughest individual line. On the producer side, despite expressed doubts, the Malaysians may be willing to join a new agreement, but probably only on terms which would be unacceptable to consumers. There remains some risk of political conflict and commercial repercussions if they identify the UK as the wrecker. Thailand and Indonesia who are the other two major producers seem to be seeking a successor agreement.

Economic Committee

14 The UK has the chair of the key Economic Committee for the duration of the Conference. Whilst the UK adopts the position of a tough negotiating stance, this can be viewed as a negotiating asset. If Ministers were to decide, however, on a withdrawal course, the Chairman's position would become difficult and of no UK benefit. Withdrawal from the Chair would however flag up the United Kingdom's intentions.

The current INRA

15 INRA was the first new Commodity Agreement negotiated under the UNCTAD Integrated Programme for Commodities. It came into force provisionally in 1980 and definitively in 1982. The present Agreement is due to expire in October 1987.

16 The principal objective of INRA is to reduce price fluctuations by means of a Buffer Stock. All major producers and consumers of natural rubber (NR) are members. To date the Buffer Stock has accumulated over a four year period 360k tonnes of rubber (about one month's world consumption) which represents 90% of the

normal buffer stock limit of 400,000 tonnes (on top of which there is the contingency of 150,000 tonnes). There have been no purchases of rubber during the past 6 months because the market price has been sufficiently high. There have been no sales from the stock. The direct cost to the UK has been £5¾m but we estimate that on current prices we have about £5m worth of stock share. The INRA is generally regarded as having worked satisfactorily, though it is not of significant benefit to the United Kingdom. The Agreement is a cash Agreement. Borrowing powers are clear and limited and can be used only with the Rubber Council's agreement which has not been given. The Buffer Stock Manager is not permitted to operate on the futures market. DTI lawyers advise that, as a result of the requirement on the buffer stock manager to trade only in physical rubber, the transparency attaching to his trading operations, and the Council's very limited borrowing powers, there is little likelihood of unfunded contingent liabilities arising. They have, however, prepared amendments, for use in negotiations on a new Agreement, to restrict the Council further, and to reduce the likelihood that members could incur additional liabilities (including liabilities of the kind which creditors of the ITC may allege have been incurred by members of the ITC).

17 In the event of there being no further INRA the stock existing at the close of the current agreement should be sold over a maximum period of 3 years from October 1987. This would probably put the Buffer stock manager in the role of a distressed seller and thereby adversely affect the value of the UK share of the stock.

Economic aspects

18 Annex B contains background information on the market. To date, under INRA, natural rubber costs have probably been higher than if there had been no Agreement. For the UK, as a consumer, the support of prices provided by past Buffer Stock operations represents one of the principal costs of participating in the present Agreement.

However, any greater stability of prices resulting from the Agreement may have produced benefits for UK consumers which, at least, partly offset the costs. If at the end of the day the UK cannot prevent renewal of INRA we need to ensure that any future Agreement remains viable and able to stabilise rubber prices whilst removing the likelihood that prices can be supported. The conditions set out at Annex A would need to be included.

19 There is no case for any increase in the price range. Indeed, there is a overwhelming case for arguing that the reference price should be significantly reduced in any new Agreement. It is relevant here that under the existing Agreement, prices are likely to be further reduced in a review due in October 1986. However, in assessing the need for adjustments in the reference price consideration needs to be given to the prospects for natural rubber prices. Whilst the recent fall in oil prices will undoubtedly have led to a reduction in the cost of producing synthetic rubber, and in turn some limited substitution of natural rubber with synthetic rubber, the extent of this shift will be dependent on technical possibilities as well as expectations about future relative prices, and hence future oil prices. Moreover, the fall in oil prices is expected to give a boost to overall levels of economic activity and hence to demand for natural rubber. The overall effect on natural rubber demand is thus ambiguous. Given the prospects for natural supply as recently planted trees mature, there must be uncertainty as to the movement of natural rubber prices in the immediate future.

Conclusions

Subject to the views of the Law Officers:-

a) The course offering the best chance of ensuring that there is no further INRA is to persuade EC partners to adopt and maintain a tough line in negotiations.

b) Officials should be instructed to seek to ensure that the points set out in Annex A to this paper are included in the EC negotiating position. Officials should refer back for instructions if there is opposition on any particular issue.

CTPS Division
Department of Trade and Industry
May 1986

Extract from the paper annexed to the Secretary of State for Trade and Industry's letter of 25 April as referred to in para 12.

Key Elements of the Present INRA

(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 future 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.

(Reference should be made here to para 16 of the covering paper on the question of contingent liabilities).

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.

ANNEX B

INRA

A. Market Facts

1. Production: In 1984 world production of natural rubber was 4.26 million tonnes (3.71 million tonnes in 1987). The main producing countries are Malaysia (36% of production in 1984), Indonesia (26%) and Thailand (15%).

2. Consumption: World consumption in 1984 was 4.24 million tonnes (3.7 million tonnes in 1981). The USA (18% of consumption in 1984), EC(15.4%) and Japan (12.4%) are the three main consumers. The UK consumed 2.8 per cent of world consumption in 1984.

3. Stocks: Estimated world stocks of natural rubber amounted to 1.7 million tonnes in October 1985 of which INRA stocks were less than one quarter (360,000 tonnes). World stocks increased by 30,000 tonnes between 1981 and October 1985.

4. Price Levels: From the start of INRA there has been a downward trend in the price of natural rubber and in November 1981 the buffer stock buying mechanism was triggered for the first time. Subsequently there have been two small reductions in the reference price and a third may be necessary in October 1986.

5. Substitutes: The main substitute for natural rubber is synthetic rubber which accounts for about two-thirds of total rubber consumption.

B. Costs and Benefits of the Present Agreement

6. Costs: So far the UK has contributed £5.74 million towards the purchase of buffer stocks. This is equivalent

to a payment of about £7.8 million today. Additionally, the UK has made a contribution of nearly £100,000 to the administration of INRA. If the UK continues to participate in the present agreement it could be called upon to contribute a further £2 million towards the purchase of its share of the contingency stock. In the event of the UK withdrawing from INRA or not participating in a new Agreement, the UK would take 9,000 tonnes (2.5 per cent)from the buffer stock together with its share of any cash reserves. At present prices, this rubber (together with the share of any cash reserves held by the Buffer Stock Manager) would be valued at £5½-6 million. However, in the event of there being no successor Agreement it would be unlikely that present prices would be obtained and accordingly the value would be lower. These calculations exclude any contingent liabilty arising from buffer stock operations.

7. The ageement,through its buffer stock purchases, will have sustained natural rubber prices above long-term market clearing levels and so have added to industrial costs. However, since the size of the buffer stock is small relative to world consumption of natural rubber these economic costs will have been correspondingly small.

8. Benefits: To the extent that INRA has produced greater assurance of supply for consumers, UK industries may have derived some benefits from INRA to set against the UK's costs of memberships. These are, however, likely to be small relative to costs.

9. Costs and Benefits of Possible Membership of a Successor Agreement: The economic costs to the UK of membership of a successor Agreement will depend on the particulars of the Agreement. If the reference price can

be suitably revised downwards, and the automatic price adjustment mechanism improved in line with the UK's proposals in Annex A, the costs to the UK from membership of a future Agreement should be reduced compared to the present Agreement. Provided that there is little scope for increasing the size of the buffer stock, a successor Agreement would not be able to sustain prices above market clearing levels for long.

10. If the maximum size of the buffer stock is not increased from its level in the present Agreement, the economic costs of membership should be limited to the opportunity costs of the resources tied up in the buffer stock plus a share of management charges.