Prime Minister 2

To be aware that the review of commodity policy is now in. It looks a sensible piece of work. I suggest await the comments of others before you intervene. DRN 4/7.

PRIME MINISTER

4 July 1986

Para 1.15 of the report sets out the preferred option (flagged).

EEC would go the way we say not

UK COMMODITY POLICY

1. The DTI proposals on UK Commodity Policy represent a major shift in policy to introduce the Government's general principles of free market operation into international commodity trading. We believe this change is essential to avoid building another hugh CAP-type problem and, while recognising the international aspects, would urge you to resist the Foreign Office desire to fudge the issue at this stage.

2. The essence of the DTI proposals are to persuade our EEC partners to join us in withdrawing support for UNCTAD's Integrated Programme for Commodities (IPC). The main programmes under IPC are:

(1) Operation of price stabilisation programmes for certain commodities, including the purchase of 'buffer stocks' or operation of export quotas. (Agreements to date have covered only Rubber, Cocoa, Tin and Coffee - the last without buffer stocks.)

(2) Financing of research and development programmes aimed at expanding markets for commodities.

(3) Provision of compensating finance for shortfalls in export earnings (as distinct from prices).

3. Recent experience with Tin as well as with the CAP makes it evident that, from an economic viewpoint, such agreements are dangerous and unworkable. Rather than stabilising prices, they inevitably lead to prices being fixed above the market clearing level, and create a situation where producers are encouraged to overproduce - building up a surplus stockpile which sooner or later forces painful and costly adjustment. Furthermore, the high reward for commodity production will tend to focus resources in these countries even more on commodities - inhibiting the needed diversification of their economies into other areas. These agreements are therefore certainly not in the interests of consuming countries and neither are they in the long-run interest of producing countries. The development of financial markets offering futures contracts provides a far more effective way of providing near term price security, while ensuring long-term market adjustment.

4. A shift in position on commodity agreements must recognise, however, that the LDCs will view the price guarantee element of these schemes as an implicit form of aid. For many countries which are heavily dependent on commodity earnings, these agreements have a very high economic and political significance. Furthermore, as the paper itself and Geoffrey Howe's note both point out, the current low price of most commodities means that many of these countries now have significant debt burdens.

5. As with the CAP, however, the answer is not to fudge the issues or seek meaningless consensus language; unless we get the issue on the table, we may find ourselves drawn into agreements we do not want - or find ourselves having to back down on recently agreed commitments. Instead, we should make clear our objectives and seek the co-operation of the EEC and the LDCs in working towards better solutions. Put crudely, if the developed countries are agreed that it is desirable to financially assist commodity-dependent LDCs there are more direct, efficient - and probably less corrupt - ways of doing it than through subsidising commodity cartels.

6. We recommend, therefore, that the Government should make clear its view on the need to deregulate commodity markets but - to avoid a backlash - should ensure that it presents this as 'part of a consistent approach to the Third World'. One way to achieve this could be to pursuade the EEC to set up a working group to make recommendations on actions the EEC could take to assist these countries outside of commodity market intervention. In particular, this group would need to consider:

We should need to ensure that this could not turn into an aid lobby. It seems a dubious idea.. Z

- the effectiveness of the futures markets as a primary trading vehicle;

- the links between deregulation on commodities and general tariff reductions in GATT;

- direct ways of assisting these countries in achieving structural adjustment to reduce their dependence on commodities.

In this way we could preserve a helpful but more rational approach to the problems of LDCs, while avoiding the pitfalls of further commodity agreements.

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