Commodities and market failure

In investigating how any market works, the big questions revolve around the price system: how prices change, what signals they give to supply and demand, and how those signals are transmitted to producers and consumers. These essential mechanisms are deficient on many commodity markets. This will not be resolved by removing obstacles to the markets' free operation: it was recognised long ago that the markets themselves have inherent features which prevent them from performing their functions effectively. Wherever that leads to harmful consequences, policy should seek a way to remedy it.

A well-known feature of many commodity markets lies in the volatility of prices. This can take two forms: short-term fluctuations during the course of the year, resulting from changes in the weather or forecasts of the supply and demand balance; and medium-term disturbances over the business cycle. The former can occur very suddenly, for example when there is news of a frost in Brazil which might affect the coffee harvest, or a strike in an important mine.

Price fluctuations are frequently exacerbated by a time-lag between initial changes in price and consequential adaptations of supply or demand. With tree crops such as coffee, cocoa and rubber it can take several years for supply to expand or contract sufficiently in response. The same applies to the metals and mining industries, which require expensive, "lumpy" investments that take many years to develop; and they can be equally slow to cut back or close when demand falls off. As long as such adaptations do not occur, the market remains out of balance and prices will be excessively high or excessively low. Where futures markets or other arrangements facilitate it, price movements in either direction can be further exaggerated by speculative buying and selling; futures exchanges welcome speculative activity as it increases liquidity.

The most unstable markets of all have been pepper and sugar; and among minerals, crude petroleum. Other unstable prices include those for coffee, copra, nickel and silver, while among the most stable are soybeans, tobacco, phosphates and iron ore. The last two operate with long-term price agreements between buyers and sellers, which do not exist on most international commodity markets.

There can be serious macroeconomic consequences for a country which relies on an unstable market for its foreign revenues. For example, Ethiopia is renowned for the quality of its arabica coffees and in the late 1990s up to 70 per cent of its merchandise exports were accounted for by that crop. It exported US$420m worth in 1997-98. But three years later, Ethiopian coffee exports fetched just US$175m. This was partly caused by a fall in volume but mostly by the collapse in price. It may reasonably be asked how any country can make rational economic plans when its foreign trade is so unpredictable.

Now, if a freely operating market does not perform its functions properly it is said to exhibit "market failure." Where the linkages between supply, demand and price are so slow as to prevent timely responses, then some degree of failure must exist. This is the first of three price issues to be addressed in the functioning of commodity markets: sharp fluctuations in the price over the short or medium term.

The second was identified by Prebisch and Singer: the secular tendency of commodity prices to decline vis-à-vis other prices. This is the long-term price issue. According to Prebisch/Singer, the price will decline eventually even if the market retains a balance between supply and demand. But a chronic oversupply will exacerbate any decline in prices. It indicates a market that is not making demand increase or supply decline sufficiently when prices have fallen, and so is also not doing its job properly.

These difficulties with commodity markets have been widely discussed for more than 60 years. But a third price issue – especially relevant to agricultural markets - has come to the fore only in recent years. It is not only declining prices overall but the farmers' declining share of final retail prices which has led to crisis. Response on the demand side to price signals can be even slower than on the supply side, at least when those prices fall. This is the third issue of commodity market structure that needs to be addressed. It is the result of an imbalance in market power which arises from growing market concentration among the processors and distributors of agricultural commodities, be they grain-trading companies, dairies, coffee roasters or supermarkets.