Number 7/2006/p.113-119 www.CAFRI.org

Current Agriculture, Food & Resource Issues

A Journal of the Canadian Agricultural Economics Society

The Role of State Trading Enterprises and Their Impact on Agricultural Development and Economic Growth in Developing Countries

George N. Vlontzos
Contract Lecturer, University of Thessaly, Volos, Greece

The Issue

The role of state trading enterprises (STEs) is significant for international trade, especially since the Uruguay Round. They account for large shares of world trade in certain products: about 40 percent for wheat and 30 percent for dairy products (WTO, 2000). This article examines the influence of STEs on the development of the agricultural sector in developing countries. During both the Uruguay Round and Doha Round negotiations, there have been serious complaints from developing countries that the operation of STEs is trade distorting and creates serious obstacles to agricultural development.

Implications and Conclusions

Through application of the five forces competitive model (FFCM) of Michael Porter, the competitive environment is examined, and special attention is given to STEs that have a considerable distorting effect. During the Doha Round of WTO negotiations the role of STEs is again under consideration, the target being to decrease or eliminate their trade-distorting operational practices. At this point there are proposals, on a modalities level, that can promote the above target and help developing countries to establish modern and profitable agricultural sectors.

State Trading Enterprises

The GATT Agreement of 1994, Article XVII, defines STEs as follows:

> Governmental and non-governmental enterprises, including Marketing Boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports. (WTO, 1994)

STEs vary in terms of structure, operation, power and function. Attempts to classify STEs until now have used criteria that measure market contestability, market concentration, trade shares, price differences and rents. According to this approach to classification, there are three types of STEs. Type I STEs are characterized by low potential to distort trade. Type II STEs have the ability to distort trade flows, but in a way that contestability can be retrieved without serious changes in the way they operate. Type III STEs have adverse impacts on contestability and distort trade (WTO, 1996). The latter category includes all import STEs (those that operate as monopolies for import of goods into a country); this type gives rise to the most strongly worded protests against STEs. The usual objectives of STEs are domestic price stabilization, market regulation and control and promotion of exports. The issues surrounding STEs are not new for the WTO. In order to monitor the operation of STEs, the GATT itself established the International Trade Organization (ITO) in 1948. An entire chapter was created under the title "Restricted Trade Policies". During that period, the trading environment was not mature enough to put obstacles in the way of developed-country STEs. STEs functioned as one of the most effective means by which developed countries enlarged their market shares on an international level. This was especially true for the United States, where the pressure not to make changes to the operation of STEs was so strong that President Truman withdrew the "Restricted Trade Policies" chapter (Veeman, Fulton and Larue, 1999). In 1957 the issue of STEs arose again under Article XVII of the GATT: reporting requirements represented an attempt to monitor and evaluate the degree of distortion of international trade that could be attributed to STEs.

STEs and the Competitive Environment

One of the most useful tools for evaluating the competitive environment in a market is Michael Porter's "five forces competitive model," or FFCM (Day, 1984). The five parameters the model examines are

- the threat of new entrants;
- the bargaining power of suppliers;
- the bargaining power of consumers;
- the threat of substitute products; and
- the intensity of rivalry amongst competing firms.

Threat of New Entrants

STEs that focus on exports face threat from new entrants because on a global level there are no monopolies. This threat can be minimized by using various contracting methods that do not allow new firms to claim market share. Such methods include direct contracts between exporting and importing STEs, and tariff rate quotas (TRQs) administered by the "historical importers" and "state traders" methods. Under these methods no new entries are possible, the level of competition is very low and the market is monopolistic or oligopolistic.

In the case of STEs that focus on imports, no new entries into the market are possible. There is no competition in the internal market, which is monopolistic.

Bargaining Power of Suppliers

The bargaining power of suppliers in markets where STEs focus on exports is quite important, because usually the quantities being traded are very large and can give traders the opportunity to claim better prices and enlarge their market share.

In the case of STEs that focus on imports, the bargaining power of suppliers is absolute; they have the ability to set any price they wish by using political targets as criteria, ignoring the existing market balances on an international level.

Bargaining Power of Consumers

The bargaining power of consumers in the case of exporting STEs is not very strong, because the quantities being traded are very large and the number of such enterprises is quite low. This leads to the conclusion that there are not many alternative choices for consumers, and the market is oligopolistic.

The trading environment that is created where STEs focus on imports leaves no choice to consumers, and thus no bargaining power to consumers. In most cases, such a situation has positive effects for the consumers of developing countries and negative effects for the consumers of developed countries. This occurs because the aim in developing countries is to satisfy demand with low-priced agricultural products, while in developed countries the aim is to protect internal production from international competition.

The operation of an importing STE is the most effective way to stabilize prices at a level high enough to cover production costs and create a satisfactory profit for producers.

Threat of Substitute Products

The threat of substitute products is not strong, because agricultural products being traded by STEs are usually cereals or dairy products, which are irreplaceable and are characterized by inelastic demand. This lack of substitute products becomes the most important reason to establish market conditions that will create competition and decrease trade distortions.

Intensity of Rivalry amongst Competing Firms

Intensity of rivalry amongst competing firms is not high in the case of exporting STEs and does not exist at all in the case of importing STEs. This lack is due to advance deals arrived at between countries on the political level; such deals do not allow market forces to operate.

From the above analysis it is obvious that the most trade-distorting type of STE is the type that focuses on imports. Exporting STEs are not alone in the international context, and they operate in a competitive environment; however, when they have to negotiate with importing STEs they are victims of the distortion that characterizes the operation of importing STEs. Since the last GATT agreement, the operation of STEs has been under increased monitoring and evaluation. Article XVII of the GATT 1994, Paragraph 1 of the Understanding, obliges all members of the WTO to submit annual notifications of their state trading activities. Unfortunately, for the year 2003 only 12 members submitted their reports (WTO, 2003a). There is deep concern among members of the WTO about the reporting periods for notifications and updates. The common belief tends to be that the current timetable is too tight. The failure of so many members to submit reports creates a serious lack of information and gives rise to concerns about the ways in which STEs affect or even distort international trade. These concerns take on a further dimension due to the fact that the Doha Round has not yet been completed (WTO, 2003b).

STEs in Relation to Food Aid and Export Credits

During the previous GATT negotiations there were additional topics of interest that, under more intense study, show another dimension to the role of STEs. Many developing countries protested the food aid and export credit systems, and during the current negotiations they have argued for structural changes to these systems at the operational level. Food aid is a mechanism for providing, among other things, crucial agricultural products to least-developed or developing countries. For developed countries, which provide the food products, this mechanism allows the opportunity to manage both their stocks and prices. The usual status for food aid operations is that when stocks are at high levels, the quantities granted as food aid are high as well, and the international prices of these products tend to decline. When stocks are at low levels, the quantities granted as food aid are low, and the international prices tend to increase. There are several estimates claiming that this way of managing stocks is a secret price stabilization mechanism that uses the lack of production infrastructure in developing countries to continue to give production incentives to agricultural producers in developed countries. Usually the quality of the products concerned is low and the trading parties that the operational tasks fall to are STEs focused on exports (IATRC, 2001).

The other parameter mentioned above that affects trade is the export credit system. Export credits include

> … direct financing support, comprising direct credits/financing, refinancing and interest rate support; risk cover, comprising export credit insurance or reinsurance and export credit guarantees; government-to-government credit agreements covering the imports of agricultural products exclusively from the creditor country under which some or all of the risk is undertaken by the government of the exporting country; and any other form of governmental export credit support, direct or indirect, including deferred invoicing and foreign exchange risk hedging. (WTO, 2003c)

It is obvious that a variety of bank products and services are included under the term, and each one has its own positive or negative impact on trade, prices and market share. One of the most distorting ways of applying export credits is to establish trade agreements that depute exclusively the exporting rights to the creditor. In many cases the creditor is an exporting STE from the developed world. All the other forms of financing aim to manage and minimize the operational risk included in a trade act, or to motivate structural adjustment of the agricultural sector. When a STE has exclusive rights for exports through an export credit agreement, every market force is ignored. The importing country does not have the ability to negotiate the price or quality of the product; the STE can reduce its stock through a closed agreement and create revenue with what is usually a low-quality commodity; and the STE can also create more profit, as a side effect, through the interest rates. Export credits that are granted to meet short-term consumer needs in developing countries can satisfy the demand for the products in question, but when this practice is the common route chosen to solve such problems, the long-term prospects for internal production are not auspicious (Canadian Committee on Agriculture, 2006).

Developing countries facing food shortage problems – even, in some cases, famine problems – cannot act as equal members of the WTO when they are being used by developed countries as part of a diffusion mechanism to balance their production and trading systems. The argument the developed countries make, especially the United States, is that export credits, STEs and export subsidies are mechanisms that keep prices of agricultural commodities low in order that developing countries will be able to acquire such products without worsening their debts and trade deficits. The U.S. Department of Agriculture maintains that elimination of these mechanisms would, because the agricultural market is characterized by imperfect competition, increase market prices on an international level, thus reducing the ability of developing countries to acquire the agricultural products they need (USDA, 1998). This argument has two weak points with regard to the developed countries, one internal and one external. The first is that it ignores the fact that the primary sector is not competitive and appears feasible only through the

subsidization system each country has established. In 1994 the WTO began attempting to liberalize agricultural trade and decouple subsidies from production. The continuation of this attempt, through the new Doha Round, will result in the minimization of the gap between internal and international prices, with the former to decrease and the latter to increase. The use of export subsidies and export credits in order to meet consumer needs has totally adverse outcomes with regard to the WTO liberalization strategy and, hopefully, will be eliminated.

The second weak point of the argument is a continuation of the first, but on an international level. The new opportunities being created though freer market access and increased prices create the most suitable environment for structural adjustment and development and/or establishment of production wherever there is competitive advantage for the developing countries. This shift allows the population of such countries to gain two very important things, income and partial satisfaction of demand with their own products. The liberalization strategy stabilizes the world market, creates income and wealth and creates opportunity for improvement in any production channel, be it in a developed or a developing country.

It is a common belief that the step-by-step procedure of reducing tariffs and liberalizing agricultural trade will lead to an increase in international prices and the establishment of new producing and trading opportunities for developing countries. The products of developing countries can have two marketing channels, one to meet domestic needs and the other to gain market share on an international level. Both these channels can boost the economies of these countries and reduce their dependence on food aid programs and the inefficient operation of exporting and importing STEs. The interrelationship will force both developed and developing countries to improve STEs and to minimize their role and importance, thus allowing market forces to establish a less distorting marketing environment.

Finally export credits must in the future be used from a more development-oriented perspective, having as their target the financing of investment projects, rather than operating as a mechanism to meet consumer needs over the short term. According to this way of thinking, the WTO must cease to accept the ability of the creditor to have exclusive exporting rights, because such a situation is highly distorting and does not lead to economic growth for the recipients. On the contrary, this way of satisfying consumer needs intensifies misallocation of resources, enlarges external debt and trade deficit and postpones the establishment of market oriented production channels.

Discussion and Conclusions

The above analysis intends to examine the ways STEs operate in both developing and developed countries and the effects they have on economic growth, from a strictly market oriented point of view and according to the current WTO spirit. It is obvious that more steps need to be taken at both structural and operational levels, and these steps must be

analyzed one by one. Liberalization of agricultural trade is a process that does not accept statutory or constitutional rights, which totally ignore market forces. Experience to date proves that the status quo helps the economies of the developed world to grow while depriving developing countries of opportunities for domestic and international growth. Among the other measures being proposed to improve the economies of the developing countries, significant steps need to be taken with regard to STEs; such decisions can create free space and permit developing economies to move and grow in a less distorting trade environment.

Bibliography

Canadian Committee on Agriculture. 2006. Canada's comments on the revised consolidated reference paper on possible modalities on export competition: Export credits, export credit guaranties or insurance programmes. Job (06) 202 (20 June).

Day, G. S. 1984. Strategic Market Planning: The Pursuit of Competitive Advantages. St. Paul, MN: West.

International Agricultural Trade Research Consortium (IATRC). 2001. Agriculture in the WTO. The current WTO agricultural negotiations: Options for progress (synthesis). Commissioned Paper Number 18 (November).

Josling, T. 1999. State trading enterprises in a global context: Recent developments in Australia and New Zealand. Workshop on State Trading in North America.

U.S. Department of Agriculture (USDA). 1998. Agriculture in the WTO. Economic Research Service. International Agriculture and Reports. *State Trading Enterprises in World Agricultural Trade,* pp. 43-47.

Veeman, M., M. Fulton, and B. Larue. 1999. International trade in agricultural and food products: The role of state trading enterprises. Economic and Policy Analysis Directorate. Agriculture and Agrifood Canada (April).

WTO (World Trade Organization). 1994. Understanding the interpretation of Article XVII of the General Agreement of Tariffs and Trade. MTN/FA II-AIA-1(b).

WTO (World Trade Organization). 1996. Operations of STEs as they relate to international trade. Background paper by the Secretariat, G/STR/2.26 (October).

WTO (World Trade Organization). 2000. European Communities Proposal, Export Competition. Committee on Agriculture, Special Session, G/AG/NG/W/34 (18 September).

WTO (World Trade Organization). 2003. Draft recommendation on the frequency of notifications. Working Party on State Trading Enterprises C/STR/W/40/Rev.1 (27 October).

WTO (World Trade Organization). 2003. Negotiations on agriculture. First draft of modalities for the further commitments. Committee on Agriculture. Special Session TN/AG/W/1 (17 February). Attachment 2 p.12.

WTO (World Trade Organization). 2003. Negotiations on agriculture. First draft of modalities for the further commitments. Committee on Agriculture. Special Session TN/AG/W/1 (17 February). Attachment 4 p.15.