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International Wheat Agreements

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THE JUSTIFICATION OF COMMODITY AGREEMENTS

IT has nearly become a commonplace that a peculiarity attaches to the pricing process of agricultural commodities, which makes it necessary, or at least highly desirable, to interfere with the free trade and pricing of these goods even in an economy otherwise based on the equilibrating forces of the price system.

Thus the I.T.O. charter, adopted at Havana in 1948, which in its general outlook is an instrument for the maintenance and promotion of a free international economy, states in Chapter VI the desirability of government interference in the case of so-called primary commodities, and deals with the rules which should be observed in carrying out such interference. It is further worth noting that this chapter was inserted and ardently defended by the U.S.A. Government, which otherwise has been the main champion of a liberalistic economic order in the post-war world, as opposed to the rather socialistic tendency of the rest of the world and especially Europe. The very idea of the I.T.O. has, so to speak, been forced on a reluctant and sceptical Europe by U.S.A. in connexion with the great credit granted to Great Britain in 1946.

The reason normally given for the deviation from the general principle of leaving the adaptation of consumption and production to the market forces as far as these commodities are concerned is that demand and supply are so extremely inelastic that equilibrium can hardly be brought about by the free pricing process. It is held that a fall in price does not lead to a decrease in production nor an increase in demand sufficient to arrest the price fall at a reasonable level, but may even lead to an increase in production with a further fall as a consequence. Nor does a rise in price necessarily peter out because of increased supply and decreased demand; on the contrary, producers may within certain limits reduce production and thus accelerate the rise in prices. In other words the fluctuations in price caused by *exogenous* disturbances are not of the damped, but rather of the explosive type or, at least, the cumulative forces may be at work within wide limits, and prices may for long intervals diverge positively or negatively from the opportunity cost of the factors involved, injuring the consumer in the one case and ruining the producer in the other.

It is considered necessary or desirable, therefore, at least within certain limits, to fix the price by international agreement so that it 'is fair to the consumers and provides a reasonable return to producers, having regard to the desirability of securing long-term equilibrium between the forces of supply and demand'.[1]

The idea seems to be that a price should be so fixed that the opportunity cost of the productive factors employed is covered at a quantity equal to demand at that price; for if that is not the definition of a fair price to consumers and producers it seems to me difficult to attach any meaning to the term at all.

IS THERE ANY EMPIRICAL BASIS FOR THE ASSUMED PECULIARITY OF THE PRICE FORMATION?

As far as I know there is no empirical basis for these assumptions, either for agricultural or for other commodities. In the following I shall limit myself to foods.

In collaboration with Mr. Strange Petersen I have made a study of a great number of commodities during the period from 1855 to 1913, a period in which there was no interference with prices and production. This study[2] shows that, during that period, prices of cereals and animal products did not exhibit any peculiarity as compared with other prices of the flexible type. We find long-term movements, such as the generally falling tendency from about 1875 to 1897, and the generally rising tendency during the rest of the period, but these movements could not be taken as evidence of the theory of the absence or extreme weakness of the equilibrating forces. The falling price tendency was plainly due to technical changes, especially in transport facilities. Thus according to David Wells[3] the marginal producer of wheat, i.e. the producer of the U.S.A. middle-west, experienced a reduction in cost of transport to the European market of 19 shillings per quarter during the period 1870–87. The very same improvements in transport facilities that cheapened the movement of grain from the western plains to the eastern markets facilitated the movement of people from the east to the west to increase the production of grain, so that the fall in prices could continue after its initiating cause had spent most of its force.

The fall in the price of grain on the European market during this period was about 35 per cent., but animal products fell much less,

[1] Chap. vi of the I.T.O. charter, Art. 57 *c*.

[2] Jørgen Pedersen and Strange Petersen: *An Analysis of Price Behaviour*, Copenhagen, 1938, pp. 28–34, 156–221.

[3] *Recent Economic Changes*, New York, 1898, p. 168.

and some of them began to rise long before the fall in grain prices had ceased. The fall in grain prices, therefore, was kept in check by the ability of the people to absorb increasing quantities of animal products even at rising prices.

The rising tendency of grain prices after 1897 was due partly to the

The Grain Cycle.

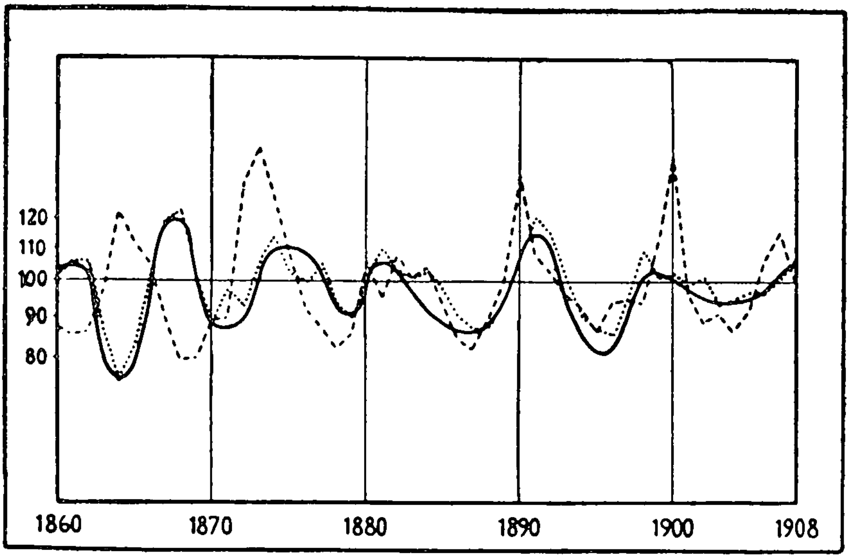


CHART 1.

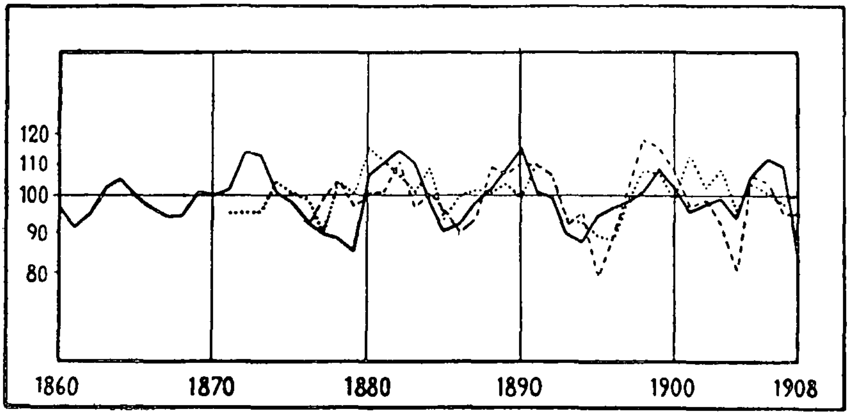
fact that the law of decreasing return in U.S.A. slowed down the expansion of production, and partly to a gradual rise in money wages that elevated the whole level of prices.

It will easily be realized that these trend movements are not of the kind which, according to the programme of the I.T.O., should be interfered with by means of commodity agreements; on the contrary, they are the kind of movements which should be the guide to the prices determined in such agreements.

Superimposed on these long-term movements we find cyclical fluctuations of the type found in other flexible prices such as pig-iron and other metals; cf. the adjoining chart, which is taken from the above-mentioned work, Jørgen Pedersen and Strange Petersen, p. 158.

Those cycles are clearly demand cycles. During the upswing of the business cycle purchasing power increases because of increasing employment. The formerly unemployed or partly employed who now get normal wages increase their consumption of bread, and start to buy meat. Prices of meat go up, farmers increase their herds as speedily as possible, and the demand for grain for feeding purposes is increased and there is a rise in grain prices. It is not true, therefore, that demand is very inelastic, income-, as well as price-elasticity for animal

Wheat Area.



——— World Iron Production
------ Wheat Area (Gr. Britain)
.... » » (U. S. A.)
Deviation from trend

CHART 2.

products is of a considerable magnitude, and as demand for cereals is derived from that of animal products, demand for the former also becomes considerable.

Next we turn to the question of supply. Is it true that supply is extremely inelastic? Let us take a look at Chart 2, where iron production is correlated to the wheat area in Great Britain and U.S.A.

It will be seen from the chart that the sown area of this cereal fluctuates almost as the production of iron, and as we know that iron production is positively correlated with iron prices, we also know that the wheat area is positively correlated with wheat prices. This means that during the business cycle, when employment goes up and prices of grain rise, agriculture responds by increasing production although not sufficient to prevent a rise in prices.

The conclusions drawn here from the data of the period 1875–1913 could be verified also by the development in U.S.A. during and after the Second World War: demand for foods has proved to be very elastic, it has increased enormously, and production has responded to a considerable extent in spite of high costs.

WHAT IS THE ORIGIN OF THE THEORY OF THE INELASTICITY OF DEMAND AND SUPPLY?

That theory is a child of the great depression. The experience of that period has been unduly generalized. There is, however, no difficulty in explaining what happened without resort to theory.

It must be admitted that supply did not respond much to the enormous fall in prices, owing to the falling off of demand caused by the great depression. But that was not to be expected, for it must be remembered that opportunity costs fell nearly to the same extent. On account of the large permanent unemployment, the farming population had no choice but to stay in agriculture; their substitution income was next to zero, there was even an influx into agriculture. If minimum prices had been fixed internationally by commodity agreements, it would only have led to a larger influx into agriculture, greater production, and accumulation of stocks. Nothing short of an international control of production could have prevented such a development. This in turn would only have aggravated the evil which it was intended to cure, for, apart from the question whether it would have been possible to carry out such a policy, it would have led to further unemployment and a further impoverishment of the whole society. The only proper remedy would of course have been to increase general demand and thereby employment and income.

Since the war it has been the declared policy of all the co-operating countries of the world to maintain a state of full employment. In fact, the very same document, viz. the Havana Charter, which claims the necessity of commodity agreements, is based on the assumption that the policy of full employment is successfully carried out. This is very illogical for, as I have tried to show, in a fully employed world—yes, even in a world with moderate fluctuations in economic activity, such as we experienced prior to the First World War—the problem of preventing excessive price fluctuations by commodity agreements does not exist. Experience has proved that in a state of full employment productive factors are very mobile. This is only what should be expected, for when everybody can obtain work at normal rates of pay outside of agriculture, they certainly will not work for lower pay in agriculture. This has been amply demonstrated by the fact that the great gap between wages in agriculture and other trades, which existed prior to the war in all countries in the western world, has disappeared. If prices of agricultural products are too low to pay normal wages, production will have to be reduced, and if prices are higher than necessary to pay ruling wages, profits in agriculture will be above normal, and agriculture will attract labour, and production will be expanded.

It may be argued that the alleged high mobility of factors may apply to hired labour, but certainly not to the farmers. They do not move speedily. When prices go down and lower their income below the normal level, they stay on and probably increase their work. This may be true, but it is not a question of the whole farming population leaving, but whether there is a sufficient influx and efflux at the margin to keep fluctuations in prices within tolerable limits. According to all historical evidence there is a sufficient marginal mobility for that purpose. The mobility does not come solely from hired labour and the sons and daughters working on the farm, but also from the new generation deciding on future vocations. Those people will as a rule not go into farming if greater earnings can be obtained elsewhere.

The conclusion of the above reasoning is that, in a fairly fully employed economy or an economy subject to moderate cyclical fluctuations, there is no need to take special measures for agricultural products, in order to avoid exceptional hardship to producers or exorbitant prices to consumers. The adaptation to changes in costs and demand, it is true, may take considerable time and may for a number of years cause the income of the farmers to be above or below normal, but if prices are authoritatively fixed so as to prevent this, the process is merely retarded and the evil aggravated. It is worth noting that nobody has in fact proposed to take such measures. As has been stated, the I.T.O. charter mentions expressly the long-term equilibrium price as the norm for the price-fixing. It may be, however, that the parties to the charter or people in general have no, or only little, faith in the realization of a fully employed free economy, or that what the charter has in view is not to eliminate structural price fluctuations, but fluctuations of shorter duration. I shall examine, therefore, first the possibility and consequences of price-fixing by international commodity agreements in the case of a permanently depressed economy such as prevailed in the thirties, next I shall consider the stabilization of prices in a world of cyclical fluctuations of the pre-First-World-War type, and finally I shall make a few comments on the question of elimination of price fluctuations due to variations in the size of the crop.

THE COMMODITY AGREEMENTS OF THE THIRTIES

Limiting ourselves to foods, we have only two cases to consider, viz. sugar and wheat. In neither of these cases was the attempt made to stabilize prices successful. Both agreements involved curtailment of production, which in itself was a very difficult task to undertake, for even if an individual country succeeded in reducing its acreage of the commodity in question, the farmers might increase the production of other crops, thus creating a surplus elsewhere. Secondly, there is the circumstance that it has never so far been possible to negotiate an agreement which included all countries, and in that case the outsiders would increase their production to an extent that increases with the success of the regulating countries in curtailing production and exports. As a result it is possible in fact to end up with a larger area and surplus than the one started with. That is probably what happened to the attempts to regulate the price of sugar and wheat in the thirties. To the extent in which the participating countries succeeded in reducing production, they reduced employment and the real income of the people.

ELIMINATION OF CYCLICAL FLUCTUATION

It is probably rather academic to discuss questions arising out of cyclical fluctuations of the type known in the nineteenth century and up to the First World War, for it is very unlikely that such fluctuations will ever again appear. But if they did recur, to keep prices of essential foods from rising during an upswing, rationing would certainly be necessary in order to avoid chaos in the market. This in turn would divert demand to other goods, and cause an acceleration of the expansion there. In the same manner the establishment of minimum prices in the downswing would require control of production, or it would lead to accumulation of stocks. In both cases it would most probably aggravate the general situation. To this should be added that nothing in historical experience suggests that such cyclical fluctuations have caused serious hardship to producers. They have certainly in most cases been able to accumulate reserves during the upswing to spend during the downswing, so that they have been able to maintain fairly stable consumption.

There is, however, one way in which prices could be stabilized over the cycle without these unfavourable effects. Whenever prices, e.g. of butter, hogs, and eggs, rose above a certain level a tax could be imposed on the commodity so as to prevent the rise. The proceeds of that tax could be accumulated and used to finance a subsidy sufficient to keep the price from falling below that level during depression. In that manner consumption and production as well would be kept fairly stable, and the accumulation of funds during the upswing and their spending during depression would tend to stabilize the economy as a whole.

ELIMINATING FLUCTUATIONS DUE TO CROP VARIATIONS

It is clear that if one of the two more ambitious stabilization policies mentioned above is carried out, fluctuations due to crop variations are *eo ipso* eliminated too. If the programme of general stabilization of economic activity is realized, the question arises if it would be worth while to take measures against these price fluctuations.

A study of these fluctuations shows that as a rule they are not large. There is no doubt that private speculation has kept them within moderate bounds. Of course they could be kept within still narrower limits by the speculation of some national or international authority, buying and selling the commodity in question at a price, either absolutely fixed or fixed within very narrow limits, but it is difficult to see that much would be gained thereby. On the contrary it is easy to detect some disadvantage which would follow from such a policy. It is true that a wiping out of these fluctuations would tend to stabilize the production of animal products, especially hogs and eggs, which would clearly be beneficial. But on the other hand it would de-stabilize farming income, which would be a disadvantage. In addition the stabilization agency might make mistakes by not giving due attention to the normal market forces, and thus accumulate stocks, which it could not get rid of without causing great disturbance in the market.

BUYING AND SELLING AS A LINK IN A POLICY OF GENERAL STABILIZATION OF ECONOMIC ACTIVITY

In the *Journal of Political Economy*, December 1946, Dr. W. W. Riefler advanced a proposal for an international buffer-stock agency as a device for the stabilization of economic activity. I shall not make any comments on the proposal in general, except to remark that little is likely to be gained by including agricultural commodities in such a scheme. It would assume that fluctuations in employment largely originate in agriculture, so that it would be important for the control activity to stop a fall in agricultural income in its initial stages. There is no evidence, however, that these assumptions are justified. On the contrary, there is evidence that farmers do not react speedily to income variations in reducing their purchases. As far as one can see, variations in stocks of finished goods and in investment demand are the main initiating factors in general business fluctuations.

The conclusion arrived at is, therefore, that none of the cases presented above justifies international commodity agreements for the stabilization of prices. The theories on which the claim for such measures is based are very ill founded in experience. They are mostly based on a misinterpretation of the development during the thirties. It is regularly forgotten that most of the problems which it is intended to solve by means of commodity agreements do not exist in a fully employed world. If the policy of full employment is realized it is not necessary to resort to such measures and, if it is not, they do not seem to be any more effective.

THE WHEAT AGREEMENT

The following remarks on the International Wheat Agreement negotiated in Washington D.C. in the spring of 1948 are made in the light of the above discussion. The main feature of the Agreement was to limit the price fluctuations, not by authorizing the International Wheat Council to buy all the wheat offered at the minimum price and sell all that may be demanded at the maximum price, but by guaranteeing that the exporting countries would deliver certain quantities to each importing country at the maximum price, and that these countries would buy the same quantities at the minimum price. The duration of the Agreement was to be 5 years, and the maximum price $2.00 per bushel No. 1 Manitoba Northern at Fort William/Port Arthur and equal for the whole period, whereas the minimum price decreased by 10 cents a year from $1.50 to $1.10. It thus appears that a downward trend in prices was expected by the importing countries. Whether that expectation will come true is rather doubtful. As has been shown in the preceding discussion, the extremely low prices in the thirties were possible only because of the general depression, segregating the agricultural population from the rest of the economy, and forcing it to take almost any income, as there was no other substitute than unemployment benefit. Since then wages in agriculture expressed in dollars have in most countries more than trebled and they have thereby reached a parity with wages in other trades. If the high level of employment is maintained, there is no reason why agricultural wages should not stay at parity, and it is unlikely that wheat prices should fall below \$2.00. Thus it would seem that the importing countries have made the better deal, for the chances that true market prices will rise above \$2.00 are greater than that they fall below the minimum figures. This, again, is on the assumption of full employment and, of course, expressed in stable currency.

Let us consider a little more closely the implications of the scheme. Suppose the parties to the Agreement did not pass on the loss and gain, occurring when the market price crossed the limits fixed in the Agreement, either to the producer or to the consumer, but financed the loss out of a revolving fund, fed by the gain, then the scheme would affect neither production nor consumption. In that respect, it is not only harmless but also worthless. If, on the other hand, the importing country passed its gain, when the price was above the maximum, on to the consumer, there will be less inducement to economize with wheat and an expansive tendency in the economy as a whole. Further, if in the case of a market price below the lower limit, the exporter passed the gain on to the producer, and the importer charged the loss to the consumer, we would get in the exporting country a shifting of production towards wheat and a general tendency to an expansion in grain production, and in the importing country we would get a decrease in consumption. In all cases where there was an effect, it would run counter to the automatic forces of the price system and serve to de-stabilize rather than to stabilize the economy. In the case of the Agreement under consideration, however, its scope was so limited that the effects would be very small, but, of course, to the same extent its usefulness was insignificant.

In the preceding comments we have assumed that prices oscillated equally above the upper and below the lower limits during the period covered by the Agreement. If that did not happen there would be a pressure on the part of the losing party to get the terms of the Agreement changed before its expiration. By normal interpretation there was hardly any provision for such a revision during the term of the Agreement, but then, of course, a revision would be a condition for a renewal of the Agreement.

CONCLUSION

The particular Agreement here considered was a rather insignificant measure, but its foreseeable effects, so far as it had any, were harmful to good world economy. Of course, if wheat prices during the period persistently ran above or below the limits fixed in the Agreement one of the parties would gain at the cost of the other, and consequently it would be worth while for that party to enter into it, but such a state of affairs could not last long.

As for more ambitious schemes of commodity agreements, aiming at stabilizing the price of a commodity in general, they would have a disturbing effect on the economy as a whole, and should be avoided. The limitation of price fluctuations in general and the acceleration of the processes of adaptation are no doubt highly desirable ends, but these objects could not be attained by measures which in their effect run counter to the self-regulating forces of the economic system instead of supporting them.