SUGAR MARKETS IN DISARRAY

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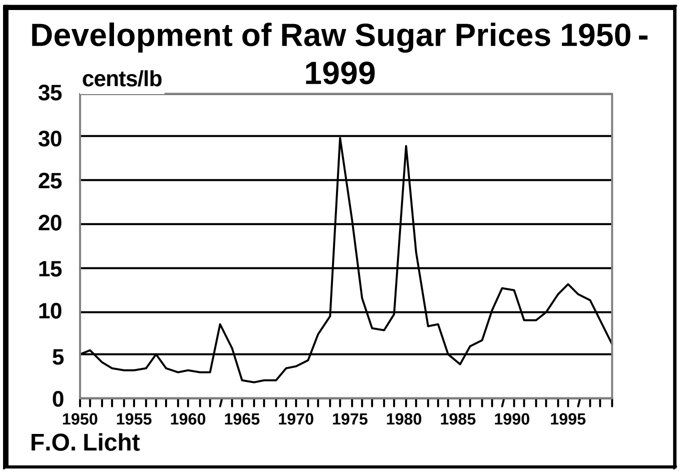
Much has been said in recent years about the greater stability of world sugar market prices, resulting from the structural changes since the mid-1980s. Deregulation has increased the number both of producers and users that are exposed to movements in world market prices. Hardly any large state entities remain which are prepared to sell surpluses to the world market regardless of price. The tendency is for surpluses to be withheld and stored when returns from the world market fail to meet the costs of production. Moreover, developing countries with higher income and price elasticities now play the leading role on the import side. Those that are exporters lack the resources to subsidise the dumping of surpluses on the world market. All this makes for more stable global prices and helps avoid a prolonged price depression.



And yet, the Daily Price of the International Sugar Organization fell from 13.28 cents/lb in 1995 to 8.92 cents/lb in 1998 and further to a low of 5.42 cents/lb in April 1999. This is a decline of 59 percent in nominal values and nearly 62 percent in 1995 money. That does not look like a stable market, although prices have recovered to some extent.

Notwithstanding such gyrations, it cannot be denied that the structure of the world market has changed and that today's price response differs markedly from that before the mid-1980s. Without going into details, it is obvious that one of the consequences of these changes is greater price stability than in the past. But it would be equally wrong to assume that fundamentals no longer matter and that market behaviour is unrelated to supply and demand.

ECONOMIC TURMOIL, PRICES, CONSUMPTION AND TRADE FLOWS

So what has gone wrong? Were there exceptional circumstances which caused the steep fall in world market prices?

The first thing coming to mind is the recent economic turmoil in Asia, Latin America and Russia. The collapse of the Thai baht in July 1997 marked the beginning of the financial crisis in Asia. Within weeks, Thailand's difficulties turned into a regional problem. Soon, Indonesia, the fourth most populous country in the world, and South Korea, the world's eleventh largest economy, were engulfed in crisis. Until then vibrant Asian economies were plunged into steep recession. And not only emerging economies were hit - look at Japan - nor were the repercussions confined to Asia. The trouble reverberated around the world.

Table 1: Growth rate of real GDP per cent per annum

Net Sugar Importers	1997	1998	1999	2000
Indonesia	4.7	-13.7	-0.8	2.6
India	5.5	5.8	5.7	5.5
Japan	1.4	-2.8	1.0	1.5
S.Korea	5.0	-5.8	6.5	5.5
Malaysia	7.7	-6.7	2.4	6.5
Philippines	5.2	-0.5	2.2	3.5
China	8.8	7.8	6.6	6.0
Net Sugar Exporters				
Pakistan	1.2	3.3	3.1	4.0
Thailand	-1.3	-9.4	4.0	4.0
Source: IMF				

Russia's economy again weakened, after some modest growth in 1997 and early 1998, the first since the transition began. Although Russia plays only a limited role in the world economy, it heightened fears of a global slowdown.

Latin America came under pressure in January 1999, when Brazil abandoned its crawling currency peg. Given that Brazil accounts for almost a third of the region's output and that the Brazilian GDP is set to decline by an estimated 1.2 percent in 1999, Latin America as a whole was bound to be affected.

Fortunately, the crisis remained confined to parts of the world, and it would be wrong to speak of a global economic crisis. But as this brief review indicates, several major sugar importing and exporting countries were at the epicentre of the turmoil. Currencies were drastically devalued, and it is reasonable to think that this should have impacted on the sugar market.

Table 2: Exchange Rates Currency Units Per Dollar

Country	Currency	1995	1996	1997	1998
Brazil	Real	0.9162	1.0051	1.0779	1.1605
China	Yuan	8.3700	8.3389	8.3193	8.3008
India	Rupee	32.42	35.51	36.36	41.36
Japan	Yen	93.96	108.78	121.06	130.99
S.Korea	Won	772.69	805.00	950.77	1400.40
Singapore	Dollar	1.4171	1.4100	1.4857	1.6722
Thailand	Baht	24.921	25.359	31.072	41.2620
Source: Federal Reserve Bank					

Assuming no change in the world sugar price, a currency depreciation raises the local sugar price, while an appreciation will lower the price. Intuitively, the devaluations of several major Asian sugar importers could have been expected to have led to higher internal prices and, together with the fall in per capita incomes, should have lowered sugar demand.

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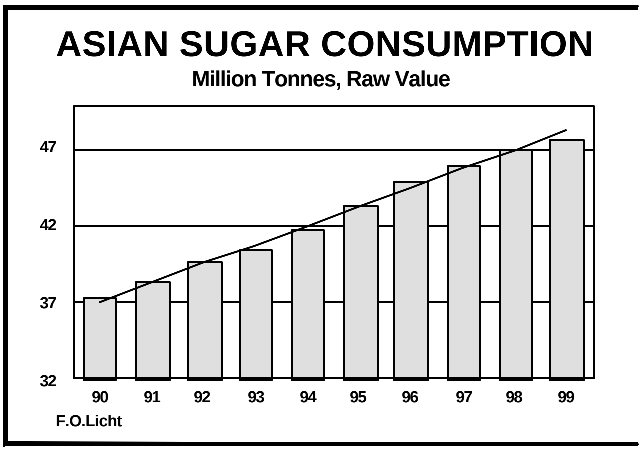


As things turned out, the crisis does seem to have had some impact on demand growth. But the effect was less than might be supposed (see graph). In no year was there an absolute decline in Asian sugar offtake. True, a few countries saw an absolute decline, but the effect was too small to pull down the overall figure. The impact on net imports was also muted, which was even more surprising.

With hindsight, this turn of events is easily explained. In the first place, the precipitous fall in the world market price for sugar over the last couple of years partially or wholly offset the effect of the currency devaluations. Moreover, we must not forget that sugar is a politically sensitive commodity which tends to have a relatively high import priority.

Indonesia is a case in point. Production fell sharply in 1998/99. Despite the devaluation of the local currency, the government imported large amounts of sugar to ward off any supply problem. Indeed, tempted by the fall in world market prices, it imported more than was needed to cover demand, creating a noticeable build-up in stocks.

In India, the glut on the domestic market following the sharp rise in 1998/99 production did not stop importers bringing in huge amounts, given the differential between world and domestic prices, and low import tariffs. Following protests by the domestic industry, the government stepwise raised the import duty. But imports continued because of the sharper fall in world market prices.

Even Malaysia, the government of which took steps to control domestic demand to stem the outflow of foreign exchange, kept imports at reasonable levels. The same is true of South Korea, where net imports dipped only slightly in 1998, while a modest rise is forecast for 1999.

In the Philippines, careful economic management, together with liberal import rules to augment domestic supplies after the 1998/99 crop shortfall, prevented a fall in sugar consumption. As a result, imports in 1998/99 were noticeably above those of the previous year.

The very high support levels for sugar that form part of the stabilization regime in Japan have for years impacted on that country's sugar consumption and imports. While Japan has been affected by the economic crisis in the Far East, the long-term declining trend of imports and demand has hardly varied in the past two years.

The Chinese economy has remained largely untouched by the Asian financial crisis, although GDP growth has slowed to single digits. But an expected growth of more than 6 percent in 1999 can hardly be called a disaster. What has affected China's demand growth is not so much the slowdown of the economy but the large usage of high-intensity sweeteners, mainly saccharin. And that has nothing to do with Far Eastern economic problems.

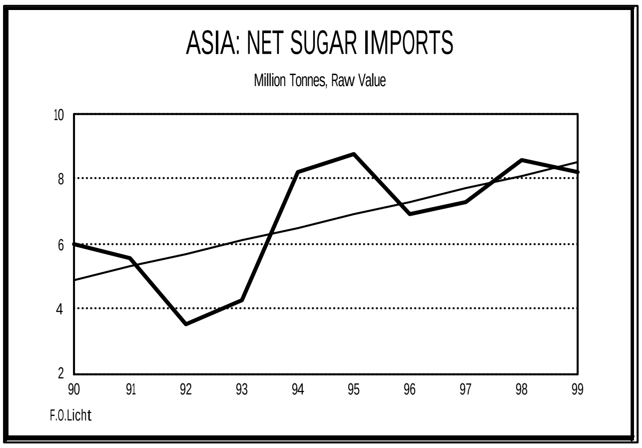


Table 3: Sugar Consumption - 1000 Tonnes, Raw Value

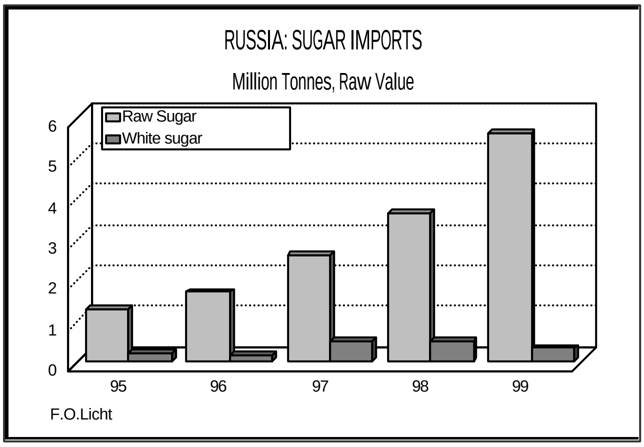
Net Sugar Importers	**1996**	**1997**	**1998**	**1999**
Indonesia	3320	3167	2976	3083
India	14463	15328	16171	16397
Japan	2579	2471	2427	2524
S.Korea	1106	1113	986	1050
Malaysia	1096	1018	948	1000
Philippines	1956	1959	1958	1962
China	8142	8180	8484	8485
Net Sugar Exporters				
Pakistan	3070	3135	3178	3260
Thailand	1706	1829	1834	1760
Source: F.O. Licht				

Table 4: Net Sugar Imports/Exports - 1000 Tonnes, Raw Value

Net Sugar Importers	1996	1997	1998	1999
Indonesia	1593	1223	972	1806
India	-863	-487	971	470
Japan	1656	1702	1557	1578
S.Korea	1099	1151	1009	1030
Malaysia	987	1003	879	885
Philippines	427	-172	180	302
China	656	421	54	58
Net Sugar Exporters				
Pakistan	453	526	-766	-290
Thailand	-4628	-4234	-2370	-3571
+ Net Imports; - Net Exports				
Source: F.O. Licht				

To sum up: The evidence indicates that the economic turmoil in the Far East had only minor impact on sugar consumption and import demand. The reason is that the economic difficulties and currency devaluations were outweighed by the drastic fall in global sugar prices and political considerations.

What about Russia, the largest importing country? It was assumed that the rouble devaluation in August 1998 and declining per capita incomes would take their toll on sugar consumption. However, here, too, things did not turn out so badly. Helped by the fall in world market prices, Russia imported much more than western observers had thought possible. One explanation is that, due to the lower value of the rouble, imports of sugar-containing products virtually stopped and domestic products took over. Moreover, it is believed that the use of sugar for illegal distilling was significantly greater than in 1998 due to a ban on alcohol imports, which came into effect on January 1, 1999. Even financing more than 5 mln tonnes of sugar imports was not a problem. Ironically, the financial crisis greatly facilitated sugar import financing. Before the crisis, private banks seldom engaged in import financing, as gambling with treasury bonds was more attractive. But after the August devaluation, the banks turned to the real economy. According to Russian trade sources, the August crisis made investment in raw sugar and tolling uncommonly profitable, and imports were mainly financed from domestic funds.

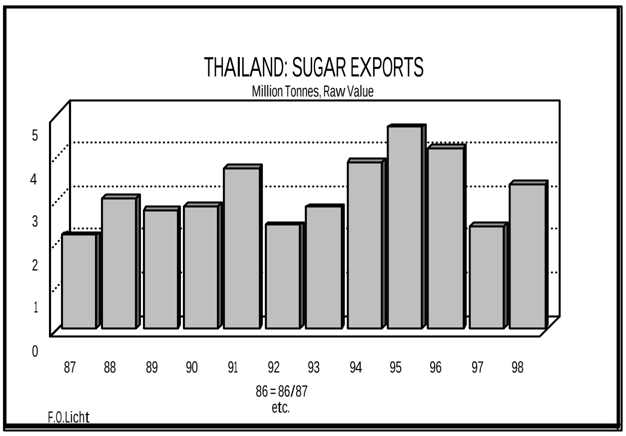


Thus neither the economic turmoil in the Far East nor in Russia offers a satisfactory explanation for the fall of world market prices. Abundant supplies and low import prices helped to keep demand fairly buoyant in those domestic markets that are free to shadow world prices, despite devaluations against the dollar. In addition, it is evident that even in times of economic hardship, sugar consumption does not suffer correspondingly. The slowdown in global demand may have been a contributory factor, but it is not the main reason for the current plight of sugar exporters. The explanation must lie on the supply side.

EXPANSION OF PRODUCTION CAPACITIES THE ROAD TO SURPLUS

Any study of long-run trends in sugar production costs reveals that one of the key determinants of a country's international cost competitiveness is the value of that country's currency. A devaluation in real terms boosts the country's international cost competitiveness, because it has the effect of lowering local costs when expressed in other currencies.

Lax financial discipline forced Brazil to freely float the real from January 1999. Between March 1998 and March 1999, the real devalued by more than 60 percent, which greatly increased Brazil's competitiveness and the attractiveness of the export market relative to the domestic market for the country's sugar producers. The devaluation of the real has undoubtedly drawn significantly more sugar into the international arena. To a large extent, the devaluation cushioned the effect of the fall in world market prices and helped Brazil to pump out enormous amounts of sugar, facilitated by the diversion of cane from alcohol to sugar production. Greater competitiveness and low freight rates made Brazilian sugar appear in markets as far afield as South Korea, Malaysia and Indonesia. The growth of Brazilian sugar exports must be regarded as one of the main factors behind the fall in world prices.



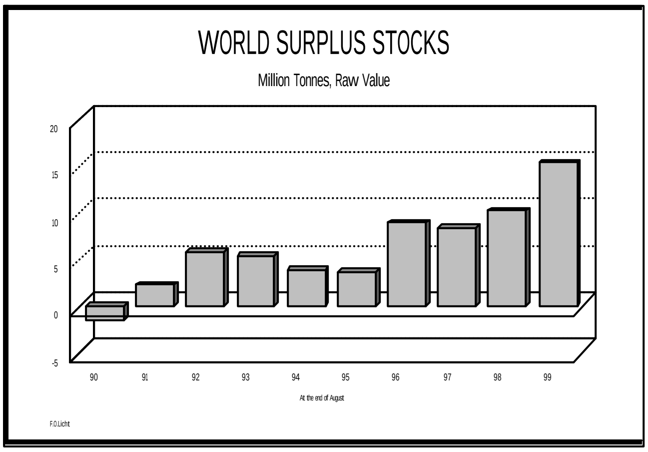
Asian exporters have also contributed to weak prices, albeit to a far lesser extent. Thailand's sugar industry was plunged into financial difficulties by the country's economic problems and poor returns from the world market. Many mills had to put sugar up as collateral against bank loans. The creditors in turn were unwilling to release the sugar at rock-bottom prices, which restricted legal exports in 1998/99, despite a recovery of production. The reduced value of the baht also made the domestic market far less attractive, although internal prices are fixed by the government. In effect, the slide of the baht reduced domestic sugar prices to the point of encouraging smuggling to neighbouring states. However, even assuming that more sugar left the country than the official figures show, the Thai factor is insignificant compared with the weight of Brazil.

Pakistan has increased its production capacity in recent years until it is now far beyond domestic needs, giving rise to large exports. High production costs and low world market prices mean that these have to be subsidized. But financial constraints forced the government to limit subsidized exports to half a million tonnes, not enough to make much difference to the market.

Brazil shows that the problem lies more on the production than on the demand side. This view is supported by the evolution of the surplus stock situation. From zero at the beginning of the decade, surplus stocks –that is, stocks over and above pipeline requirements –reached an unprecedented 15 mln tonnes at the end of August 1999. This will have to be absorbed to restore a balance between overall supply and demand. Despite the build-up of surplus stocks, especially after 1995, prices held up in 1996 and 1997. This was because a large part of the surplus was held in India and unlikely to come onto the world market, as neither government nor industry had enough funds to subsidize sales. Elsewhere, the advent of El Niño opened the possibility of weather-induced production shortfalls, but in the event El Niño had minimal effect. A buying spree by Russia in the last quarter of 1997 sustained prices until the early months of 1998. They started to weaken in the second half of 1998, and after the Brazilian devaluation, fundamentals reasserted themselves with a vengeance.

The root of the problem is excess capacity. There have been numerous warnings in recent years that the continuing build-up of export capabilities in Latin America and the Pacific Rim would lead to overcapacities and low global prices. These warnings were not heeded, and the expansion process continued unabated.

But is the situation really as serious as world prices might suggest? Some will recall that the International Sugar Agreement of 1977 aimed to stabilize prices in the range of 11 to 21 cents/lb. The Australian sugar industry, one of the most efficient in the world, argued at the time that 12 cents/lb was needed to ensure the viability of the industry.



Yet less than twenty years later, in the mid-1990s, nominal prices of 12-13 cents/lb were evidently sufficient to prompt efficient producers, such as Brazil, Thailand, Australia and Guatemala, to greatly expand export production. This suggests that the equilibrium price, at which supply and demand are in balance, is much lower now than in the days of the 1977 agreement.

Behind the fall in the equilibrium price are technological advances that allow producers to operate more efficiently. The movement towards privatization and market liberalization has done its bit to motivate producers to invest and adopt new technology.

But although the equilibrium price is now much lower than it was in the days of the 1977 agreement, it is clear that current prices are unsatisfactory for sugar exporters. Many industries, especially those largely dependent on world market prices, face serious financial problems. This has spurred the search for solutions, and various proposals, including the revival of export and production restrictions, have been advanced to cope with the problem.

FREE MARKETS VERSUS MARKET MANAGEMENT

The low level of sugar prices has breathed new life into discussions of sugar policy. In some quarters the current state of affairs is seen as confirmation of the need for greater regulation of the market.

So, can international restriction schemes, such as export quota arrangements, offer a way out? Highly unlikely. A review of the achievements of past International Sugar Agreements with economic clauses is sobering, as are the experiences with other commodity agreements, such as tin and coffee. The ISAs did not curb national protectionist policies encouraging production, nor did they succeed in maintaining the world price within the negotiated ranges.

Looking at the economic and social effects of the agreements, one must ask what would have happened without them. Would average prices have been significantly lower, and fluctuations greater? Did the economies of developing countries – a primary ISA concern – benefit on balance? A detailed study by Albert Viton has concluded that the agreements did not eliminate large price fluctuations and that the costs exceeded the benefits.

The problem with all such agreements, whether they use buffer stocks, export quotas or any other control mechanism, is that they only treat the symptoms of oversupply and often give the wrong signals to producers, leading to even greater price swings. The truth is that one cannot eat one's cake and have it too. Remunerative prices cannot be enjoyed without adapting production to demand.

In any event, it would now be much harder to negotiate an agreement because of the changed structure of the world market. An added complication arises from the fact that it is now possible for sucrose to lose market share to other sweeteners.

Of even greater importance is the change in economic thinking since the collapse of communism in eastern Europe. Significantly, this is most pronounced in Latin America and Asia, where the mystique of national and international government planning and management ruled until the mid-1980s. Political and economic liberalism, private enterprise and competition have emerged as the dominant trend. Not one of the four major intergovernmental bodies for commodity market management – tin, coffee, cocoa, and sugar – which loomed so large in progressive economic thought during the 1960s and 1970s, has fully survived into the 1990s.

However, while a formal market management agreement is neither economically desirable nor politically feasible, producers do not have to sit on their hands. There are informal or semi-formal ways of cooperation and influencing the market. For instance, it has been suggested that the major exporters should reduce production across the board by 10 percent. This, it was argued, would reduce production by 6 mln tonnes and, if continued over two years, would rebalance supply and demand and more or less eliminate the surplus stocks. That proposal was a non-starter from its very conception, as there was neither the will nor the institutional framework to put it into practice. Proposals of loose cooperation between exporters to impose export targets, such as exist in the coffee market, found no acceptance either. As a result, producing countries have been left to their own devices and have acted unilaterally.

Unhappily, experience suggests that resort to the usual regulatory instruments to shield domestic industries from the vagaries of the world market – that is, tariffs and quotas to restrict the inflow of imports, and export incentives to get rid of domestic surpluses – is actually counterproductive in the present situation. This is because it puts off the necessary and inevitable adjustment of supply and demand. As prices stay in the doldrums, the worry is that the proponents of intervention will win over the advocates of freer trade, to the detriment of the industry in the long run. Sadly, in calling for government to come to its aid when the going gets tough, the sugar industry can be its own worst enemy.

It is a curious commentary on politics that it admits the prescription of old-style remedies that give merely temporary relief. No medical doctor would get away with prescribing three-hundred-year-old nostrums to cure modern ailments. The arguments in favour of protectionism and against free trade have their origin in 17th century mercantilist concerns with the relationship between a country's wealth and its balance of foreign trade. Specifically in respect of sugar, it all goes back to the differential duties and export refunds, with their hidden bounty, introduced by Jean Baptiste Colbert, the chief minister to Louis XIV. Lurking in the background is the ethical notion that exporting is virtuous, relying on imports a sign of moral turpitude.

At one time, sugar tariffs were a major source of government revenue in various countries. As a protectionist device, they served to promote infant industries. Over the years, protectionist measures have been advanced for reasons of food security, safeguarding jobs, foreign exchange constraints, as a counter to dumping, and in retaliation against other countries' restrictions. They are without question useful in these respects. That accounts for their survival from the days when bullion was transported in galleons to the digital age when billions of dollars are transferred electronically at a keystroke.

The trouble with protectionist remedies, however, is that they are addictive, easy to take up and hard to quit when no longer needed. Moreover, they tend to have side-effects which require antidotes, so what starts out as a little pillbox ends up as a big medicine chest. And they interfere in unforeseen ways with natural restorative processes.

The road to hell is paved with good intentions. Policy-makers ought to remember Dr. Samuel Johnson's warning as they go about their regulatory duties.

Let's say, a government aims to help the domestic sugar industry to survive in the face of low world market prices. Import tariffs are imposed or those already in place are raised. In effect, the domestic sugar price is fixed above the cost of world market sugar. Unless the authorities are uncommonly nimble in adjusting the tariff to changing circumstances, this is what is liable to happen:

- The consumer pays over the odds – or put more elegantly in the jargon of economists: income is transferred from the consumer.
- High sugar prices may reduce demand, directly and by encouraging resort to substitutes.
- Insulated to a greater or lesser degree from market forces, the industry puts out more sugar, unless prohibited from doing so by production quotas.
- Since it is very difficult to fine-tune the tariff so that it shields only the more efficient producers, necessary restructuring of the industry to reduce costs is delayed and resources are misallocated.

- Output will tend to grow beyond domestic demand. Then the government will be pressed to provide export subsidies to get rid of the surplus.

Production quotas, the setting of which is open to political pressure, are prone to be overly generous and conducive to the generation of surpluses and excess profits for favoured producers. Export subsidies, in turn, at the end of the day have to be paid for by somebody, whether it is the taxpayer or the consumer. The international fallout from the whole protectionist bag of tricks is the distortion of trade flows, structural petrification and increased world market price volatility.

Some of these consequences also attend the levying of duties for the purpose of increasing government revenues, rather than protecting the industry. Nor is government intervention on behalf of the consumer immune to the risk of untoward effects. Freezing domestic sugar prices over long periods makes sugar progressively cheaper in real terms, but is apt to put a damper on investment in the industry and eventually on its production capacity, quite apart from creating a climate for smuggling to less controlled markets. Requiring the sugar industry to deliver a good part of its produce to the state at an unremunerative price can be equally discouraging to the industry's development.

Nothing I have said should be construed to suggest that the sugar industry should be totally unregulated, or that market forces can cure all ills. But policy-makers must keep in mind that there is probably no kind of government intervention that over time does not engender costs as well as benefits. Politicians and industry representatives need to weigh very carefully how much is gained and lost by administrative remedies. The safest approach is to keep regulations to the absolute minimum necessary to ensure the stability of the industry. Moreover, government interference in the market has to be reviewed at regular intervals to make sure that it is still necessary. For the general good, it is to be hoped that even in the current phase of low world market prices the overall inclination remains towards dismantling existing barriers to trade rather than erecting new ones. The chances for this to happen are not too bad. There are indications that fundamentals will improve and that prices will rise in the not too distant future.

WHAT CRISIS?

Last autumn, the spectre of a global recession loomed over the world economy. Asia's crisis appeared set to deepen. Russia had defaulted. European banks, currencies, and stock markets were affected and the euro area was seen to be faltering. Contagion was threatening Latin America with the Brazilian real under siege. Fears that even the United States economy would not withstand the downturn in other parts of the world engendered visions of world-wide depression.

Concerted policy responses by OECD member countries and strong reflationary policies in the crisis-affected Asian economies averted a meltdown. Synchronized interest rate cuts and fiscal stimuli laid the basis for an upturn in the global economy at the beginning of 1999, and the gloom began to lift. Stability was restored to Asian currency and financial markets. The euro area withstood the Russian crisis, and the Brazilian infection was effectively contained. Estimated GDP growth rates suggest the worse is over. True, there are still danger areas, such as Indonesia and Russia. The fears that the US economy might be heading towards a hard landing have not been entirely banished. But overall the situation is much brighter than it was a year ago.

This will stimulate sugar consumption, which can be expected to grow at a healthier rate than in 1998/99. Exporters have reason to hope for better prices. The EU will be forced to reduce output in 2000/01, and Brazil also expects to produce less. Indian sugar production could be sharply down next season due to the effects of previous oversupply. As a result, there could be an absolute decline in production next season. The long-awaited draw-down of stocks could become reality in 2000/01.

That will take the wind out of the sails of protectionists, who already have sleepless nights because of the impending World Trade Organization negotiations. These are likely to bring further cuts in support, increased market access thanks to lower tariffs, and further reductions of export refunds and quantities. The overall objective is continuing trade liberalization. That makes cost-cutting the name of the game, in order to survive in a more liberal economic environment.

SUGAR IN THE NEXT CENTURY

Looking towards the next century, we need have no fears about the future of sugar demand. On any estimate of world population growth, a great deal more sugar will be needed. Can the additional sugar be produced and which countries will be the main suppliers?

Technological advances already under way in the areas of genetic engineering; ground-based and satellite-borne sensor and positioning systems for precision field and transport management; juice filtration; combined heat and power generation and so on promise that the ever greater productivity achieved in this century will continue in the next. The wide range of unit sizes and performance still existing within most national sugar industries, as well as between countries, indicates the vast production and efficiency reserves not yet exploited. There will also be new developments in the field of alternative sweeteners. These new products will contribute to still the world's hunger for sweetness, but, at the same time, will impose a ceiling on the price expectations sugar producers can entertain in the longer run, without opening the gate to competitors.

Structural changes on the supply side are the daily bread of the market. At the beginning of the 19th century, Jamaica was the world's leading sugar exporter; at the end, it was Germany. From 1904 onwards, Cuba was for decades firmly installed in first place. On the eve of the 21st century, Brazil is the greatest sugar exporter.

There is circumstantial evidence that with the devaluation of the real Brazil can make money, or at least break even, at 5-6 cents/lb. If true, this could completely change the face of the supply side, unless the Brazilian cost structure changes markedly for the worse. None of the other efficient producers (Australia, Guatemala, Thailand) are profitable at this price.

Brazil already controls 25 percent of the market and still has enormous potential for expansion. In a few years, perhaps, the world sugar market will mirror that for coffee, and adverse weather in Brazil will send shock waves through the global sugar market.

Alongside the challenges posed by the ongoing process of liberalization, the call to the world's sugar industries in the 21st century is to devise strategies of sustainable development in order to avoid the dangers of an excessive concentration of production and associated price fluctuations.