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COMPETITIVE SUGAR OR COMPETITIVE CURRENCIES?

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Having served as Director of Strategy for Saint Louis Sucre for over 20 years, Patrick Chatenay gained valuable experience in the sugar and ethanol industry world-wide. In particular, he was closely involved with operations in France, Spain, Brazil and Chile. Agricultural and trade regulations, both domestic and international are key factors in the industry's development, and Patrick continues to carefully monitor their evolution. It is in this context that he comments upon World Trade Organization multilateral liberalization efforts. Currently, he is available to advise firms interested in the strategic analysis of the sugar and ethanol industry.

The number of sugar and ethanol companies that bill themselves "efficient", "a market leader" or "competitive" in their annual reports, press releases and appeals to investors is truly wondrous. Whole sugar industries often do the same. Why there remains so much resistance to open international trade in sugar and ethanol can therefore seem rather puzzling.

Often, Brazil is said to be the most competitive source of sugar and ethanol – after all, today it does supply nearly half of internationally-traded sugar, up from zilch in the 1970's. Many – including many Brazilians – believe Brazil would, if trade was truly liberalised, take over the world. But, when one looks at productivity data, whether in the fields or at the mills and distilleries, most often Brazil does not stand out as exceptional. And Brazilian logistics are horrid.

So, why the angst?

In large part, the answer is "price" or, rather, the uncertainty of the world market price. Part of that uncertainty is due to cyclical supply and demand mismatches which come with the business, but part of it is due to exchange-rate fluctuations which are unrelated to the industry.

With its current dominance of the world market and cut-throat competition at home, when the Brazilian currency exchange-rate with the US dollar falls, world market prices fall too, without any change in Brazilian physical productivity.

For most commodities indeed, if you tell me what your exchange-rate is, I will tell you if you are competitive. This illustrates a general and substantive problem of international trade rules.

Since 1947, multilateral trade negotiations have sought to facilitate international trade in goods, services and capital. The principle driving these agreements is that free trade improves economic efficiency. Ultimately, demand will be satisfied by the most efficient sources, wherever they are.

Traditionally, import tariffs have been seen as the main barrier to free trade and World Trade Organization members regularly launch negotiation "rounds" through which, after years of complex, tough and expensive discussions, achieve agreement on import tariff reductions.

Thus, if successful, the current "Doha Development Round" would cut the EU's tariffs on sugar by some 70%.

Is this reasonable?

The method is based on a model – David Ricardo's law of comparative advantage – which works so well in practise that today it would seem quite bizarre, if not outrageous, to advocate import tariffs between Wales and Scotland, between Bavaria and Brandenburg or between Vermont and Massachusetts.

It is, however, worth noting that these areas share a single currency, as the model requires. Trade flows between them are unaffected by exchange-rate uncertainty. Indeed, the eminent role given to import duty reductions by the GATT took place in a world of fixed exchange-rates. GATT members were fully conscious of this: in its article II, paragraph 6, the 1947 agreement recognises the logic of adjusting tariffs when currencies move.

Setting fixed import duties without regard for exchange-rates is pure nonsense: how can one determine the effects of a given tariff when sudden and large variations in currency values change its true level? Since the end of the 70's, however, reductions in tariffs are agreed by WTO members in a world of floating exchange-rates …

This is not just a theoretical issue: whole industries are irreparably damaged by monetary fluctuations. Challenged by the devaluation of the currency of a major competitor, which industry can find productivity improvements in the order of 15 to 25%, or more, within a few months? Even industries fully integrated in international trade suffer from the uncertainty of currency fluctuations: A 10 cent move in the Euro to US Dollar rate changes Airbus' operating result by 1 billion Euros. That cannot help good planning.

Many economists will say that exchange-rate fluctuations do not matter much as, in the longrun, they should reflect productivity and inflation differentials exactly. But private commercial considerations rarely operate beyond 7 to 8 years, so the "long-run" really doesn't matter for market decisions. Among other negative consequences, the added risk from currency fluctuations makes private investors require higher rate of return or commit less resources.

Whether high or low with respect to the Euro, the Brits love their Pound Sterling without realising that a single market – that Holy Grail of British European Union policy – without a single currency is economic nonsense: if it was efficient to have many currencies in a single market, Texas and California would each have their own. Come to think of it, Bristol and Leeds too. Supporters of the Pound often mention the "adjustments" allowed by currency fluctuations to justify not joining the Euro zone. But one does not need another currency for prices to adjust: salaries and rents in Detroit are different from those in San Francisco, as they are in Brest compared to Munich, or in London compared to Birmingham.

In such a capital-intensive industry as sugar and ethanol, it is totally unreasonable to expect investors to bet correctly on currency fluctuations. To expect a rational supply system – based on physical productivity differentials – in a market where steep price changes caused by external shocks can ruin perfectly well-managed operations is ridiculous. Chile recognises this in "la banda", a tariff system through which, when import prices for sugar escape a range based upon the latest 4 years of world market prices, the tariff is adjusted up or down to bring them back into the target range. Sudden, brutal and large currency fluctuations are thus neutralised and their effects spread over time.

These considerations do not plead against free trade. They support re-introducing economic common sense in multilateral trade negotiations so that free trade works as it should. For the WTO to be relevant and for its success in reducing trade barriers to be legitimate, it is high time currency fluctuations were clearly and automatically accounted for in import tariff determination. Only then will sugar and ethanol producers be able to measure truly how competitive they are.

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