

# **Commodity Income Management: Selected Southeast Asian Economies**

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### **Tackling Commodity Price Volatility**

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## Acronyms

ACE	ASEAN Centre for Energy
ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
CEO	Chief Executive Officer
CMLV	Cambodia, Myanmar, Laos and Vietnam
CP	Charoen Pokphand
EU	European Union
FELDA	Federal Land Development Authority
GATT-AoA	General Agreement on Tariffs and Trade – Agreement on Agriculture
ICA	International Coffee Agreement
MPOB	Malaysian Palm Oil Board
MYR	Malaysian Ringgit
NFA	National Food Authority
NGO	non-governmental organization
PIPOC	International Palm Oil Congress
QR	quantitative restrictions
R&D	research and development
RISDA	Rubber Smallholder Development Authority
TNB	Tenaga Nasional Berhad
UNCTAD	United Nations Conference on Trade and Development
VBARD	Vietnamese Bank for Agriculture and Rural Development
VND	Vietnam Dong
WTO	World Trade Organization

## 1. Introduction

Commodity prices have been soaring due to high demand from both developed and developing countries. This has benefited developing countries, typically the suppliers of these commodities. However despite the recent spike, the long-term price trend for commodities continues to be unfavourable for producers, with declining prices over time. When added to short-term volatility, these commodity price fluctuations continue to wreak havoc on producer incomes and federal budgets, and in some cases can lead to economic and social unrest.

In Southeast Asia, as in other developing regions, this problem is exacerbated by the fact that there are high levels of economic reliance on commodities, and that the price and income elasticities associated with these goods tend to be very sensitive to market fluctuations. To address these challenges, each country must respond with unique policies for managing and planning the exploitation and sale of their specific commodities. Lessons can be gleaned from other commodities, however; success in Malaysia's palm oil sector can provide insights for other commodity-producing countries in managing price and revenue fluctuations.

This paper will focus on the commodities considered most crucial to two economies in the ASEAN region: coffee in Vietnam and palm oil in Malaysia. These two examples were chosen to reflect both successes and failures in stabilizing commodity incomes; it is hoped that recommendations can be drawn from each to improve current revenue management policies in the region. The Malaysian palm oil sector is long-established, with a tradition of success in cultivation and primary production. Vietnamese coffee, on the other hand, represents a newly-emerging industry which has aggressively engaged the international market to become a global leader in recent years.

In the following section of the paper, we will present the two case studies on commodity dependence. In Section 3, we will present national approaches used by these countries to manage their commodity revenues, and in Section 4, we will recommend future courses of action, addressing the failures and gaps in past policies for our focus countries and some of their neighbours.

## 2 Commodity Dependence in Vietnam and Malaysia

### 2.1 Vietnamese dependence on coffee

While the French colonial administration introduced coffee to Vietnam in the 1850s, it was only after reunification in 1975 following the Vietnam War that the government set up special economic zones for coffee-growing.<sup>1</sup> The sector grew quickly, and by 2002 Vietnam had become the world's second largest grower, after Brazil.<sup>2</sup> At its peak, the industry was the country's second largest export earner after rice, and employed on average 600,000 workers (reaching a high of 800,000 at one point, or 2.93 per cent of the agricultural workforce).<sup>3</sup> This growth has relied heavily on international markets: 92 per cent of Vietnam's beans are now exported overseas,<sup>4</sup> making the exposure to international prices severe and acute.

#### **The nature and impact of price volatility of Vietnamese coffee**

One of the reasons that coffee prices have fallen since the mid-1990s is that the average costs of production have declined. Ironically, one of the reasons for this decrease is the entry of Vietnam into the coffee market; its efficiency and low-cost labour in producing Robusta<sup>5</sup> put tremendous price pressures on other coffee-growing countries. The challenge to incumbent coffee-growers is even more aggressive given that Vietnam's low-cost advantage appears to be sustainable,<sup>6</sup> and that Vietnam is poised to cultivate even more coffee. Furthermore, the country's Robusta cultivation has been boosted by technological advancements such as improved steam-cleaning technologies, which allow greater use of this lower-quality bean in blends.<sup>7</sup>

Coffee prices dropped in 1999, and the slump continued until 2002. From revenues of US\$601 million before the crisis, Vietnam watched its returns drop every year, bottoming out at US\$300 million in 2002.<sup>8</sup> Revenues have since rebounded, with export earnings increasing on the back of strong prices despite volumes trending downwards since 2005. Coffee worth US\$404 million was exported in the first four months of 2006, down 23.4 per cent in volume but up 20.8 per cent in value against the same period in 2005.<sup>9</sup> 2005 had improved upon 2004, with 885,000 tonnes of coffee exported for a total of US\$725 million, down 9.2 per cent in volume, but up 13.1 per cent in value over 2004.<sup>10</sup>

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<sup>1</sup> de Fontenay, P. and S. Leung (undated) "Managing Commodity Price Fluctuations in Vietnam's Coffee Industry," National Centre for Development Studies, Australian National University, p.1

<sup>2</sup> Nash, J., B. Lewin and H. Smit (2002) "Vietnam: Agricultural Price Risk Management," *Phase I Reports*, Washington D.C., World Bank, p.48

<sup>3</sup> *ibid*, p.48

<sup>4</sup> de Fontenay, P. and S. Leung (undated) "Managing Commodity Price Fluctuations in Vietnam's Coffee Industry," National Centre for Development Studies, Australian National University, p.2

<sup>5</sup> Robusta and Arabica are the two primary coffee beans; Robusta is considered lower in quality, and is cheaper to produce (McKinsey, 2003).

<sup>6</sup> *ibid*

<sup>7</sup> *ibid*

<sup>8</sup> Doan, T.N. (2005) "Vietnamese Coffee Industry after 5 Years' Crisis and its Future Orientation," International Coffee Organization, [www.ico.org/event\\_pdfs/wcc2/presentations/nhan.pdf](http://www.ico.org/event_pdfs/wcc2/presentations/nhan.pdf) accessed in 2007, p.2

<sup>9</sup> People's Daily (2006) "Vietnam coffee industry still ailing: report" [http://english.peopledaily.com.cn/200605/09/eng20060509\\_264116.html](http://english.peopledaily.com.cn/200605/09/eng20060509_264116.html) accessed in 2007

<sup>10</sup> *ibid*

### **Lack of social and financial safety for minority and small-time growers**

The 1999–2002 drop in coffee prices had severe economic implications for Vietnam’s vulnerable Robusta farmers. The Vietnam News Agency suggested in December 2001 that Central Highland coffee farmers had lost 2.6 trillion Vietnam Dong (VND) between 2000 and 2001,<sup>11</sup> an amount roughly equivalent to US\$173.3 million.<sup>12</sup> In the Central Highlands province of Dak Lak—where 60 per cent of Vietnam’s coffee is grown—household dependence on coffee is enormous; the crop accounts for over 95 per cent of the local incomes.<sup>13</sup>

The hardships caused by falling prices have led to tensions and unrest between ethnic minorities and ethnic Vietnamese throughout the Central Highlands since February 2001.<sup>14</sup> Ethnic minorities feel slighted, given that much of the coffee is grown on their land with their labour power but with increasingly smaller profits coming to them in return. They are unable to switch to other crops in time to stop declining revenues from coffee. As many of these farmers are small-hold growers, they have insufficient lines of credit, inadequate technical and management skills, and have a very poor business and legal infrastructure to help them re-adjust to other commercial crops to hedge against declining coffee prices.

During the crisis, the Ministry of Agriculture and Rural Development’s offer of extra funding and exemption from paying land-use taxes failed to appease the growers in Dak Lak. It seemed the industry’s problems could only be solved if bean prices rose above production costs.<sup>15</sup> Vietnam, which initially prospered on the lower value-added Robusta coffee beans, will therefore have to look for other strategies to cope with global changes in the coffee industry.

Small-holder farmers in Dak Lak continue to grow more beans in the hope that revenue shortfalls can be overcome through scale, or in the hope that coffee prices will turn around some day. However, an oversupply could then force the government to reduce the acreage allocated for Robusta cultivation, precipitating more social unrest. All of these factors would reduce the amount of funds available to Vietnamese government for creating social safety nets and supporting diversification among small-hold minority farmers in Dak Lak.

### **State control**

The state monopoly over coffee exports prior to 1999 had a dismal record, as state-owned coffee enterprises frequently failed to meet their contractual export obligations, damaging Vietnam’s reputation and reliability internationally.<sup>16</sup> The Vietnamese coffee industry is still partially under state control, with policies that do not necessarily work to

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<sup>11</sup> Greenfield, G. (2002) “Vietnam and the world coffee crisis: Local coffee riots in a global context,” *Urban Renaissance Institute*, <http://www.urban-renaissance.org/urbanren/index.cfm?DSP=content&ContentID=10057>

<sup>12</sup> Nash, J., B. Lewin and H. Smit (2002) “Vietnam: Agricultural Price Risk Management,” *Phase I Reports*, Washington D.C., World Bank, p.61

<sup>13</sup> de Fontenay, P. and S. Leung (undated) “Managing Commodity Price Fluctuations in Vietnam’s Coffee Industry,” National Centre for Development Studies, Australian National University, p.2

<sup>14</sup> Nash, J., B. Lewin and H. Smit (2002) “Vietnam: Agricultural Price Risk Management,” *Phase I Reports*, Washington D.C., World Bank, p.49

<sup>15</sup> Tran, D. T. L. (2002) “Vietnam’s Coffee Growers See Hope,” *World Press Review*, Vol. 39, No. 12, <http://www.worldpress.org/Asia/802.cfm#down> accessed in 2007

<sup>16</sup> de Fontenay, P. and S. Leung (undated) “Managing Commodity Price Fluctuations in Vietnam’s Coffee Industry,” National Centre for Development Studies, Australian National University, p.15

the benefit of Dak Lak's ethnic minorities. For example, the state-controlled coffee industry in Dak Lak encouraged the internal migration of ethnic Vietnamese (Kinh) into the coffee-growing New Economic Zones of this region<sup>17</sup> after reunification, in an effort to move more manpower to regions where soil and climatic conditions were suitable for coffee-growing.<sup>18</sup> Coffee-growing was simultaneously taken up by the indigenous ethnic minorities, who were looking for stable incomes.<sup>19</sup> This lay the foundation for tension as both groups competed for land, tension which only increased when Kinhs began moving into Dak Lak autonomously, without state control.<sup>20</sup>

## 2.2 Malaysian dependence on palm oil

Malaysia is the biggest grower and exporter of palm oil globally, accounting for 30 per cent of the world's traded edible oils & fats supply.<sup>21</sup> The palm oil industry is one of the main pillars of Malaysia's economy, contributing MYR27 billion (approximately US\$7.9 billion) or more in exports annually since 2003,<sup>22</sup> a figure equivalent to 6.79 per cent of total Malaysian exports in 2003 (MYR397.88 billion).<sup>23</sup> The crop now covers 40 per cent of cultivated land in Malaysia (3.88 million hectares),<sup>24</sup> and in 2004 produced 14 million tonnes of the oil.<sup>25</sup> This provides jobs to more than half a million Malaysians and livelihoods to an estimated one million.<sup>26</sup>

### The nature and impact of the price volatility of Malaysian palm oil

Palm oil prices have fallen in recent years, from US\$700 per tonne in 1998 to US\$350 per tonne in 2001. This has placed them below their average price of US\$455 per tonne.<sup>27</sup> One of the reasons for this decline is oversupply; strong prices before the 1997 Asian economic crisis led to a surge in palm planting, and as it takes three years for the saplings to mature, recent years have seen a glut in palm oil supply from these young trees.<sup>28</sup>

Socio-political unrest and an unstable currency in Indonesia have added to Malaysia's woes, as Indonesia is the second largest palm oil producer in the region and its instability

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<sup>17</sup> Nash, J., B. Lewin and H. Smit (2002) "Vietnam: Agricultural Price Risk Management," *Phase I Reports*, Washington D.C., World Bank, p.49

<sup>18</sup> de Fontenay, P. and S. Leung (undated) "Managing Commodity Price Fluctuations in Vietnam's Coffee Industry," National Centre for Development Studies, Australian National University, p.1

<sup>19</sup> *ibid*, p.49

<sup>20</sup> *ibid*, p.49

<sup>21</sup> Malaysian Palm Oil Council (undated) "The Palm" *Malaysian Palm Oil Council*, [http://www.mpoc.org.my/main\\_palmoil\\_01.asp](http://www.mpoc.org.my/main_palmoil_01.asp)

<sup>22</sup> Chin, Fah Kui Peter (2004) "2004 MPOB National Seminar on green and renewable biofuel," Speech by Y.B. Datuk Peter Chin Fah Kui Minister of Plantation Industries and Commodities, Malaysia, <http://www.kppk.gov.my/index.php?option=comcontent&task=view&id=92&Itemid=29&lang=malay> accessed in 2007

<sup>23</sup> Malaysia External Trade Development Corporation (2006) "Malaysia Trade Information: Trade Statistics," *Malaysia External Trade Development Corporation*, [www.matrade.gov.my/foreignbuyer/Msiatradestats.htm](http://www.matrade.gov.my/foreignbuyer/Msiatradestats.htm) accessed in 2007

<sup>24</sup> Department of Agriculture (undated) "Agribusiness and Marketing Assistance Service," Republic of the Philippines, [www.da.gov.ph/agribiz/palm\\_oil.html](http://www.da.gov.ph/agribiz/palm_oil.html) accessed in 2007

<sup>25</sup> Malaysian Palm Oil Council (undated) "The Palm" *Malaysian Palm Oil Council*, [http://www.mpoc.org.my/main\\_palmoil\\_01.asp](http://www.mpoc.org.my/main_palmoil_01.asp)

<sup>26</sup> *ibid*

<sup>27</sup> Segal, P. (2000) "Palm Oil Shares Seemed Poised for Rise," *International Herald Tribune*, [www.ihrt.com/articles/2000/02/19/mpalm.t.php](http://www.ihrt.com/articles/2000/02/19/mpalm.t.php) accessed in 2007

<sup>28</sup> *ibid*



makes palm oil supplies and stock sales unpredictable.<sup>29</sup> Currency speculation in commodity markets has also tended to accentuate commodity price instability. Malaysia's own currency peg and the constant questions over its re-pegging intentions have both worried investors<sup>30</sup> and prompted speculation in palm oil stocks, adding to the volatility.

### **The Malaysian palm oil industry's social safety net challenge in 1998**

One of the greatest challenges to the otherwise resilient Malaysian palm oil industry came in 1998, when adverse climatic conditions (primarily dry weather) hurt the crop and caused declines of 8.3 per cent in crude palm oil production.<sup>31</sup> This also affected the biological yield cycle of the oil palm trees,<sup>32</sup> and the revenue decline presented a strong challenge for health and education funding, both of which had made gains in recent years.<sup>33</sup> Coinciding with the Asian financial crisis, the Malaysian government decided to deal with their revenue shortfall by borrowing from the Asian Development Bank (ADB) and the Japanese Bank for International Cooperation.<sup>34</sup> This dual crisis emphasized the need for economic diversification away from palm oil, a strategy addressed later in the paper.

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<sup>29</sup> *ibid*

<sup>30</sup> *ibid*

<sup>31</sup> Asian Development Bank (1999) "Country Assistance Plan (2000–2002) Malaysia"  
<http://www.adb.org/Documents/CAPs/mal.pdf> accessed in 2007, p. 9

<sup>32</sup> *ibid*

<sup>33</sup> *ibid*, p.10

<sup>34</sup> *ibid*, p.13

### 3 National Approaches to Managing Commodity Revenues

With price instability largely an outcome of the forces of supply, demand and speculation, governments often intervene with policies aimed at achieving greater stability in commodity prices and predictability in revenues. While at times these policies can add to market distortions (through subsidies, for example), there are a variety of tools that states use to stabilize prices.

Governments rarely opt for extreme measures that expose producers to either full protectionism or to market forces; states instead typically opt for policies which lie in between the two extremes. This section will look at the ways that producers and governments have faced the challenge of volatile commodity prices and incomes, and the successes and failures of these schemes, in particular supply management, compensatory finance mechanisms, national revenue management and market-based risk management.

#### 3.1 Supply management

##### Developing stockpiles

Developing countries often produce a narrow range of primary commodities which they depend on for foreign exchange and state revenues, and for which they have limited access to shipping outlets for sale to global end-user markets.<sup>35</sup> To offset these disadvantages, developing countries often rely on national stockpiles, where state entities collect supplies from both small and large producers across the country to regulate and manage the supply of the commodity for export.<sup>36</sup>

This can be done through marketing boards. Using this mechanism, the state would typically set an annual price at which it would purchase the commodity through intermediaries (e.g., cooperatives or licensed traders) who were then given a fixed margin for profits.<sup>37</sup> *Caisse de stabilisation* systems differ in the sense that, while they controlled export contracts, they do not handle, export or acquire physical ownership of the commodity in question.<sup>38</sup> Instead, primary processing, marketing and exporting are carried out by cooperatives, private traders or state enterprises.<sup>39</sup>

Marketing boards and *caisses de stabilisation* guarantee that farmers know the price they will receive at harvest, and by aggregating the output of a large number of small producers, they strengthen their bargaining power relative to buyers.<sup>40</sup> But not all stockpiling programs work. Vietnam's experience with the coffee sector provides a good example, where success proved to be a double-edged sword. Vietnam has benefited from its enhanced export capabilities for the commodity but has also become more dependent on coffee exports, exposing it to fluctuations in world prices. When global coffee prices fell in 2001, the government began a stockpile program of 90,000 tonnes of Robusta beans, in the hopes of decreasing global supply and thereby favourably influencing prices. This

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<sup>35</sup> Page, S. and A. Hewitt (2001) "World Commodity Prices: Still a Problem for developing countries?" *Overseas Development Institute*, [www.odi.org.uk/IEDG/Publications/commodities.pdf](http://www.odi.org.uk/IEDG/Publications/commodities.pdf) accessed in 2007, p.23

<sup>36</sup> *ibid*, p.23

<sup>37</sup> Agriculture and Natural Resources Team of the UK Department for International Development (DFID) in collaboration with Ian Gillson, Steve Wiggins and Nilah Pandian of the Overseas Development Institute (ODI) (2004) *Rethinking Tropical Agricultural Commodities*, London, DFID/ODI, p.11

<sup>38</sup> *ibid*, p.11

<sup>39</sup> *ibid*, p.11

<sup>40</sup> *ibid*, p.11

new stockpile boosted its existing stock of 60,000 tonnes, and was funded by an Export Supporting Fund, financed by the Vietnam Bank for Agriculture and Rural Development.<sup>41</sup>

However despite the stockpile, prices continued to fall, leading to US\$15.45 million in losses for the Vietnamese Ministry of Trade.<sup>42</sup> The stockpile was subsequently abandoned in favour of free market determination. It failed because Vietnam did not have a world monopoly for Robusta coffee. Thus stockpiling attempts to reduce global supply of the beans to increase prices had no effect—other producing countries simply increased their quotas to make up for the shortfall. Without a cartel or monopoly in place, free market forces will overpower efforts at stockpiling. The Vietnamese government should have remembered its own experiences with the International Coffee Agreement (ICA), to which it was not party when it entered the market in the 1990s. By selling above ICA quotas, Vietnam contributed to market forces overpowering the agreement and its eventual collapse. Vietnam is therefore proof that not all cartel-imposed measures such as quotas or (unilateral/multilateral) stockpiles work in all cases.

### 3.2 Compensatory finance mechanism

Eventually, Vietnamese coffee incomes could only be stabilized by debt financing with the government. Compensation for producer losses came in the form of tax relief, eliminating land and export taxes for coffee growers, subsidies (officially termed as ‘bonuses’) of 60 000 VND/tonne,<sup>43</sup> interest-free loan programs and removing the need on the part of companies to dispense social insurance payments.

The government’s Vietnamese Bank for Agriculture and Rural Development (VBARD) is typically the agency that dispenses such financing to farmers. It has used debt write-offs and rescheduling and interest rate reductions as a safety net to respond to farmers’ problems, including adverse price movements.<sup>44</sup> In the case of the coffee crisis, however, it is not publicly known precisely how VBARD’s funding was distributed.

### 3.3 Protectionism

The Philippines and South Korea are the only countries in the WTO that have quantitative restrictions (QRs) on rice imports. The Filipino government sought exemptions for rice under the General Agreement on Tariffs and Trade – Agreement on Agriculture (GATT-AoA) of the WTO.<sup>45</sup> As “token recognition of its niche in the lives and livelihood of [the] majority of its people,” the Philippine government sought protection for rice under the AoA and negotiated for the exemption of rice by lifting the QRs until 2004 through the Special Treatment Clause or “Rice Clause” of the AoA, which was intended to protect sensitive commodities and staple foods.<sup>46</sup> In other words,

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<sup>41</sup> de Fontenay, P. and S. Leung (undated) “Managing Commodity Price Fluctuations in Vietnam’s Coffee Industry,” National Centre for Development Studies, Australian National University, p.4

<sup>42</sup> *ibid*, p.4

<sup>43</sup> Nash, J., B. Lewin and H. Smit (2002) “Vietnam: Agricultural Price Risk Management,” *Phase I Reports*, Washington D.C., World Bank, p.61

<sup>44</sup> *ibid*, p.8

<sup>45</sup> Intal Jr., P. and M. Garcia (2005) “Rice and Philippine Politics” *Discussion Paper Series No. 2005-13*, Philippine Institute for Development Studies, <http://www3.pids.gov.ph/ris/dps/pidsdps0513.pdf> accessed in 2007, p.8

<sup>46</sup> *ibid*, p.9

given rice's status as a main source of food for the Filipino people and its importance to the livelihood of many within the country, the Filipino government negotiated for its exemption from WTO requirements for the liberalization of protected industries.

Having exempted rice from its GATT commitments upon signing the agreement in 1979, the Philippines has been consistently reluctant to open its rice market, and since the mid-1980s has seen a marked decline in export rates. This has turned the country into a net rice importer over time. The failure of price controls accentuated the difficulties of implementing them through a monopolistic state agency like the National Food Authority (NFA), the agency that determined rice prices for the entire country.

Given the complexities of commodity prices, the NFA was unable to react effectively and speedily to the dynamics of global, regional and domestic factors that affect rice prices. Inefficient management of rice prices resulted in two outcomes: high domestic prices (a burden to consumers) and exaggerated price fluctuations (a burden to both consumers and producers).<sup>47</sup> The protection tariff rate for Filipino rice increased significantly from 16 per cent in the 1980s to 41 per cent in the 1990s while price stabilization declined.<sup>48</sup> As a result, the Philippines were unable to manage their own domestic supply well, much less attempt to export the commodity overseas.

### **3.4 Vertical and horizontal diversification**

Diversification is a common strategy for commodity-based economies to move out of overdependence and lessen vulnerabilities to boom-bust cycles. The problem for developing countries is that they are often caught in the middle when embarking on their industrial upgrading activities. They want to graduate from labour-intensive primary production activities, but are unable to engage in overly-sophisticated manufacturing. Their solution is often to opt for industrialization with moderate technical requirements (such as the apparel industry).

Successful diversification is an important platform for strengthening the position or place of a primary producer in a value chain, so that more of the added value is retained in the country.<sup>49</sup> While it is generally agreed that diversification is helpful in achieving this, improved stability of prices will help the process by reducing risks to producers and allowing them to invest in diversification.<sup>50</sup>

Diversification ultimately has to be the result of decisions taken on the level of individual producers. The state can help this, by formulating policies that enable producers to make informed choices and supporting the process through its own or international agencies, taking into account both current and prospective world market conditions.<sup>51</sup> The dynamic nature of the process has to be recognized, with diversification not an end in itself but rather an element of larger development strategies—it should not simply be followed for its own sake. Competitive commodity producers need not diversify out of

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<sup>47</sup> Nash, J., B. Lewin and H. Smit (2002) "Vietnam: Agricultural Price Risk Management," *Phase I Reports*, Washington D.C., World Bank, pp.19-20

<sup>48</sup> *ibid*, p.8

<sup>49</sup> ul Haque, I. (2004) "Commodities as a Development Issue" *Informal hearings of civil society on financing for development*, United Nations Headquarters, 22 March 2004, <http://www.un-ngls.org/cso/cso2/004%200304-Hearings-CS-ulhaque.pdf> accessed in 2007, p.6

<sup>50</sup> *ibid*, p.6

<sup>51</sup> *ibid*, p.6

commodity production just because of market distortions, such as those introduced by subsidies.<sup>52</sup>

Historically, palm oil was an alternative crop for Malaysia and its solution to a dependence on rubber, the dominant crop during Malaysia's First (1961–1965) and Second five-year Plans (1966–1970).<sup>53</sup> During Malaysia's rubber era, poverty was chiefly attributed to a lack of access for farmers to productive assets, namely land and capital. The early strategy of the government to redress this involved the provision of land and capital to the rural poor and the formation of new government agencies such as RISDA (Rubber Smallholder Development Authority), which provided replanting funds to rubber smallholders who wished to switch to oil palm. Subsequently, the cultivation of oil palm has played a dominant role in reducing dependence on rubber, stabilizing and enhancing the income of the rural population, and in alleviating poverty among agricultural smallholders.<sup>54</sup>

After income was stabilized and the transition was made from rubber to palm oil, further value-added processes were initiated. One successful policy was Malaysia's vertical diversification into oil processing and value-adding processes to reduce income volatility and move forward on industrialization. Because of the tendency for non-food crop-based commodities to be associated with heavy or light industrial applications, there are greater possibilities for upgrading the industry's capacity for higher value-added processing activities that will benefit the country's industrialization. In other words, crops that are associated with industrial applications (e.g., palm oil) typically require more demanding processing technologies and processes, which are in turn useful for catalyzing industrialization. Malaysia has done well in this respect. The British, whose development during the colonial area depended upon commodity imports, sparked a light industrialization in the country to draw on Malaysia's deposits of tin and rubber. Since then, Malaysia has been largely successful in managing its non-food crop commodities—particularly with palm oil, a sector it now dominates.

As early as the 1960s, the government recognized the need to expand the narrow base of the economy and vertically diversify into other economic activities to generate growth for the palm oil industry.<sup>55</sup> The Federal Land Development Authority (FELDA) was one of the main state agencies in charge of vertically diversifying palm oil into value-added processes. The opening up of new land for cultivation and production of palm oil offered more diversified processing services/functions for FELDA to explore, allowing the agency to move from the core upstream sector into downstream portfolios like milling, refining, kernel crushing, marketing, engineering, transport, trading and security processes.<sup>56</sup>

Malaysia's rudimentary structure for commodity processing facilities in turn helped its transition into light industrialization, which is far more effective in reducing the economy's dependence on commodities as it moves the country away from being a producer of commodities to being a consumer of commodities. Malaysia's

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<sup>52</sup> *ibid*, p.7

<sup>53</sup> Simeh, A. and T. M. A. T. Ahmad (2001) "The Case Study on the Malaysian Palm Oil" *Regional Workshop on Commodity Export Diversification and Poverty Reduction in South and Southeast Asia*, Bangkok, UNCTAD [www.unctad.org/infocomm/diversification/bangkok/palmoil.pdf](http://www.unctad.org/infocomm/diversification/bangkok/palmoil.pdf) accessed in 2007, pp.4-5

<sup>54</sup> *ibid*, p.5

<sup>55</sup> *ibid*, p.1

<sup>56</sup> *ibid*, p.11

industrialization has followed this pattern with electrical and electronic manufacturing, successfully developing both non-agricultural commodities and light manufacturing industries in tandem.

One advantage of diversification into light manufacturing is that as workers' incomes rise from such economic development, there is less pressure to continue price protection that deliberately caps prices; higher incomes allow workers to buy commodities at market rates or near market rates, thus relieving the government of the burden to artificially depress prices to ensure affordability. In Malaysia's case, its export-led economic development in light manufacturing and subcontracting industries, and early diversification away from an over-reliance on tin and rubber have been successful enough for the country to be relieved of inward-looking protectionism in its commodities industries.

### 3.5 Transition schemes

Aiding vertical diversification is the fact that Malaysia has also successfully applied transition schemes for its palm oil industry. National revenue management approaches within Malaysia include a levy on palm oil production in times of high prices, which is then used when prices fall to subsidize the use of palm oil in non-traditional ways, namely for electricity generation.<sup>57</sup> The key element in the Malaysian case is that the subsidy is mainly applicable for palm oil electricity generation,<sup>58</sup> meaning that it does not lure the industry into dependence but indirectly spurs the industry into higher value-added research and development activities.

Vertical diversification is also technology-based, as Malaysia's palm oil mills are self-sustaining and draw their fuel from palm fibres and shells. Thus, Malaysia already has a platform for the usage of palm oil bio-fuels, fuels it is going to produce. The two main products that Malaysia will be developing are palm methyl ester (or palm diesel), a diesel substitute usable in engines and industrial burners, and palm oil itself, which can be burned in diesel engines.

Malaysia has noted that the use of methyl ester has successfully placated price fluctuations in the rapeseed industries in France, Italy, Germany, Australia, Slovakia and the Czech Republic, as surplus production is used in the bio-fuel sector and therefore does not contribute to price fluctuations.<sup>59</sup> Advantageously, the yield of palm oil per unit area is five and 10 times higher than rapeseed.<sup>60</sup> Thus there is great potential for Malaysia to achieve the same benefits through the palm oil commodities. Even in its current infancy stage, Malaysia's palm oil sector is already yielding benefits, as it is burned for

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<sup>57</sup> Green, D (2005) "Conspiracy of silence: old and new directions on commodities," *Oxfam*, [www.dgroups.org/groups/cgiar/MarketAfrica/docs/bitter\\_coffee.pdf](http://www.dgroups.org/groups/cgiar/MarketAfrica/docs/bitter_coffee.pdf) accessed in 2007, p.32 and Agriculture and Natural Resources Team of the UK Department for International Development (DFID) in collaboration with Ian Gillson, Steve Wiggins and Nilah Pandian of the Overseas Development Institute (ODI) (2004) *Rethinking Tropical Agricultural Commodities*, London, DFID/ODI, p.17

<sup>58</sup> Agriculture and Natural Resources Team of the UK Department for International Development (DFID) in collaboration with Ian Gillson, Steve Wiggins and Nilah Pandian of the Overseas Development Institute (ODI) (2004) *Rethinking Tropical Agricultural Commodities*, London, DFID/ODI, p.17

<sup>59</sup> Chin, Fah Kui Peter (2004) "2004 MPOB National Seminar on green and renewable biofuel," Speech by Y.B. Datuk Peter Chin Fah Kui Minister of Plantation Industries and Commodities, Malaysia, [http://www.kppk.gov.my/index.php?option=com\\_content&task=view&id=92&Itemid=29&lang=malay](http://www.kppk.gov.my/index.php?option=com_content&task=view&id=92&Itemid=29&lang=malay) accessed in 2007

<sup>60</sup> *ibid*

fuel in mills, reducing stocks of palm oil and helping to stabilize and enhance palm oil prices.

The effectiveness of this price stabilization mechanism was tested in 2001 when palm oil prices fell sharply. The decline was stopped when Malaysian power generation started burning crude palm oil together with Medium Fuel Oil at Tenaga Nasional Berhad (TNB)'s power station in Butterworth, helping the recovery of crude palm oil prices.<sup>61</sup> According to Y.B. Datuk Peter Chin Fah Kui, Minister of Plantation Industries and Commodities, such government-driven demand will help reduce excess stocks of palm oil and as such help to stabilize and enhance palm oil prices.<sup>62</sup>

To buffer against volatility in palm oil and biofuel prices, ASEAN Ministers agreed in Vientiane in July 2006 to improve cooperation and the exchange of experience in promoting biofuel production and use, including relevant fiscal incentives, funding facilities and regulatory infrastructure.<sup>63</sup> This is to be implemented through the ASEAN Centre for Energy (ACE), which provides assistance for ASEAN project preparation, coordination and facilitation, as well as in forging technical and financial partnerships for palm biofuels, among other energy sectors.

Indonesia and Malaysia, which currently account for 85 per cent of the world's supply of crude palm oil, earn more than US\$6 billion a year from palm oil,<sup>64</sup> and thereby have a decisive impact on the world supply of palm oil and bio-fuels. It is not surprising, therefore, that ASEAN initiatives in palm oil biofuel are garnering a considerable amount of international attention, a large portion of which comes from the EU, one of the sector's largest customers.<sup>65</sup> The EU already supports ASEAN initiatives in palm oil, and in November 2006 came together with ASEAN countries to establish a National Association for Cogeneration and De-centralised Energy Systems.<sup>66</sup> This initiative will complement and operate in conjunction with the 2006 Vientiane agreement, which by itself seeks foreign partners in an attempt to guard against excessive commodity price volatility.

The abundance of palm oil and the potential for cooperation between ASEAN and the EU on biofuel generation holds great potential for stabilizing palm oil prices in the world. Combined the two regions account for one billion consumers, and with greater coordination and information-sharing (e.g., road shows), this could stabilize or reduce volatility in the palm oil market. Volatility in prices arises from uncertainties about the supply or consumption of the resources, and greater information exchange would mitigate such uncertainties.

That said the initiative is in its infancy, and still has a number of details to work out; for example, it is not clear whether it will depend solely on excess palm oil supply. Ultimately, the initiative will probably increase demand for the resource, since its goals are to

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<sup>61</sup> *ibid*

<sup>62</sup> *ibid*

<sup>63</sup> ASEAN Secretariat (2006) "Joint Media Statement of the 24th ASEAN Ministers on Energy Meeting Vientiane, 27 July 2006," <http://www.aseansec.org/18582.htm> accessed in 2007

<sup>64</sup> Guerin, B. (2007) "European blowback for Asian bio-fuels," *Asia Times*, [http://www.atimes.com/atimes/Southeast\\_Asia/IB08Ae01.html](http://www.atimes.com/atimes/Southeast_Asia/IB08Ae01.html) accessed in 2007

<sup>65</sup> *ibid*

<sup>66</sup> Europe-ASEAN Energy Facility (EAEF) (2006) "Summary of Project Implemented Under EAEF Co-financing." Indonesia: EAEF, p.1

diversify energy resources for ASEAN/EU countries and to find new markets for ASEAN energy resources such as palm oil. The project also aims to make energy supply more efficient and enlarge its capacity for both the export and domestic markets.



## 4 Conclusions and Recommendations.

Vietnam and Malaysia each share a legitimate need to stabilize their commodity incomes. Past policies in both countries attempting to tackle the problems associated with volatile prices have met with varying degrees of success; the countries remain to a large degree dependent on coffee and palm oil crops, respectively, and state and producer incomes continue lack the stability and predictability that would otherwise accompany less volatile prices. This section will focus on recommendations for addressing existing policy gaps and the reasons for past failures.

### **Information-sharing in the global commodities market**

To cope with commodity price fluctuations, any initiative needs to be global, comprehensive and realistic about market forces. It cannot be managed unilaterally by individual governments, trading companies or producers. A matrix of information that connects all these parties is therefore needed to establish a common stakeholder position.

Information-sharing is important in trying to eliminate ignorance among ill-informed policy-makers who believe that protectionism is the only way to protect their commodity industries from price fluctuations. Similarly, it would be highly difficult and potentially dangerous for a country like Indonesia to fully liberalize its commodities industry overnight, given its high rates of poverty; unprepared farmers may not be able to cope with a sudden exposure to global market forces. As such, commodity-dependent countries should move towards a model that lies between the two extremes, one that works with industry and provides the tools necessary to empower producers to stabilize their own incomes. Policymakers in commodity-dependent economies need the right information from the international community on how to best manage the transition towards a degree of market liberalization.

Information-sharing can also prevent excessive speculation on the price of a given commodity. By reducing information asymmetries, countries can help reduce the amount of unhealthy speculation which goes on in the market, and thus reduce the swings in price which can result from speculation. Information exchange helps to filter the relevant information from the rumours and inaccurate information known as “noise” in the trade, and facilitates a positive relationship between buyers and sellers, to help calibrate trading volumes more accurately. This in turn can mitigate large price volatility shocks.

### **Technological coping mechanisms**

The Vietnamese government, to address its dependence on coffee, decided to look at vertical diversification through technological upgrades in the hopes of capturing more added-value through new products like canned soluble liquid coffee. Investing in technology therefore offers commodity-dependent countries the opportunity to move up the supply chain towards greater industrialization and revenues. Supporting producers and providing them with the means to access similar technologies is essential.

If funding has to come from the government, market-based loans are preferred. Instead of direct state subsidies, market-based loans issued by the state tend to have less fiscal cost to the government, are less likely to involve risky behaviour and would give farmers the ability to invest in productivity-enhancing technology in the long run.<sup>67</sup> Other than

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<sup>67</sup> Nash, J., B. Lewin and H. Smit (2002) “Vietnam: Agricultural Price Risk Management,” *Phase I Reports*, Washington D.C., World Bank, p.8

funding from national governments, it may be possible to introduce technological enhancement programs through World Bank projects—for instance agricultural technology development projects in the northern coffee growing regions of Vietnam, where poverty alleviation work is already focused.<sup>68</sup>

Technology is a key component to the sustainable development of agricultural commodities. The adoption of sustainable production technology is particularly important for ensuring that commodities like coffee can go on being produced in those areas now highly dependent on it.<sup>69</sup> Beyond production technologies, information technologies should be harnessed, especially in the information collection and marketing functions, to make information more accessible to coffee exporters.<sup>70</sup>

Organizations and networks are needed to collect and disseminate knowledge on the technologies available and how they can be implemented. Some have suggested the use of co-operatives for the transfer of advanced technologies to production and for helping farmers approach and access the market.<sup>71</sup> Advocates of this approach believe that the government should sponsor programs combining the application of new technologies with the building of specialty co-operatives.<sup>72</sup> In terms of assistance, the government can provide farmers with the needed resources on a sizable scale (financial resources, technical know-how, access to state resources) and therefore the leadership of the government is sought after for the creation of the co-operatives.

### **Taking the fight to social movements**

For many commodity-dependent countries in the region, poverty alleviation and income stabilization initiatives for the affected sectors have to be taken up in political circles. In the Philippines, for example, farmers have been receiving a declining share of the retail price of rice, and many analysts see this as a result of the market power of rice traders. These traders are not only able to control and manipulate the inputs and processing functions of the rice market, but they also hold considerable sway over the market price of rice itself.<sup>73</sup> The government has so far not been successful in dismantling this “rice cartel,” which is composed of seven Chinese families and whose monopsonistic tactics are cited as the main reason for the high prices. With limited resources, access to finances and processing/warehousing facilities, farmers are compelled to sell their harvest at low prices, thus augmenting the trader/wholesaler control over prices.<sup>74</sup>

By stockpiling, wholesalers can artificially reduce supply by hoarding rice to increase price or conversely can flood the market with their supplies to reduce price.<sup>75</sup> This type

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<sup>68</sup> *ibid*, p.59

<sup>69</sup> *ibid*, p.63

<sup>70</sup> de Fontenay, P. and S. Leung (undated) “Managing Commodity Price Fluctuations in Vietnam’s Coffee Industry,” National Centre for Development Studies, Australian National University, p.15

<sup>71</sup> Doan, T.N. (2005) “Vietnamese Coffee Industry after 5 Years’ Crisis and it’s Future Orientation,” *International Coffee Organization*, [http://www.ico.org/event\\_pdfs/wcc2/presentations/nhan.pdf](http://www.ico.org/event_pdfs/wcc2/presentations/nhan.pdf) accessed in 2007, p.8

<sup>72</sup> *ibid*, p.8

<sup>73</sup> Intal Jr., P. and M. Garcia (2005) “Rice and Philippine Politics” *Discussion Paper Series No. 2005-13*, Philippine Institute for Development Studies, <http://www3.pids.gov.ph/ris/dps/pidsdps0513.pdf> accessed in 2007, p.10

<sup>74</sup> Intal Jr., P. and M. Garcia (2005) “Rice and Philippine Politics” *Discussion Paper Series No. 2005-13*, Philippine Institute for Development Studies, <http://www3.pids.gov.ph/ris/dps/pidsdps0513.pdf> accessed in 2007, p. 10

<sup>75</sup> *ibid*, p.10

of policy cannot be sustained in the long-run, as domestic rice prices out of line with world prices will inevitably lead to inefficiency and waste.<sup>76</sup> To prevent producers and the government from being subject to the forces of any commodity cartel, the government must work to specify the regulatory framework in which the actors work.<sup>77</sup> Social movements and the media are important here, as they can pressure traders to work for the benefit small farmers.

Political and social pressures must therefore be exerted through non-governmental channels, including the media, NGOs, social movements, long-term education, social campaigns and non-violent protest, the impetus for change being social rather than political/economic. This social pressure could in turn prompt future government policies on commodities to concentrate on supporting productivity-enhancing investments (such as irrigation, agricultural R&D and extension services) through increased public expenditure.<sup>78</sup>

### **Small farmer empowerment schemes**

In the long run, a good institutional infrastructure (from transportation and communications networks to education systems, sound and consistent laws and transparent banking practices) is crucial to producer success. This will empower small-scale farmers to cope with the risks and dangers of the commodities industry. It is also essential for small-scale farmers to have fair and ready access to financial institutions so that they have the tools to cope with the risks and dangers of local and global commodity markets.

Sometimes, however, the local or national banks and financial institutions may not be equipped to deal with the challenges faced by producers, which include ready and fair access, and capacity-building for small-scale farming enterprises. This is where international financial institutions can step in to educate and inform local and national banks as well as small-scale farmers on how to obtain loans and credits to manage their commodities businesses. Institutions such as the World Bank and the Asian Development Bank are particularly important for this function.

This cannot happen overnight. Even in a short period of time, it cannot be done by the private sector alone in the absence of official support both from state and international organizations related to the commodities industries. External help is especially crucial for improving general economic and social infrastructure, developing regulatory frameworks and financial institutions, and providing technical assistance and market access for new products. But any strategy has to be nation-wide in focus and driven by—if not at least supported by—state institutions. Trade policies have to be tailored to each country's needs, such as the country's level of dependence on a given commodity, the abundance of that commodity, the size of the country and its potential for moving beyond commodity dependence to industrialization.

Commodity consumers will play a large role here as well. Developed nations, as the primary consumers of commodities, have to treat suppliers in developing countries with the appropriate level of fairness and equality. This could extend to assistance provided by developed countries in areas such as technology, management skills and financial

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<sup>76</sup> *ibid*, p.11

<sup>77</sup> *ibid*, p. 21

<sup>78</sup> *ibid*, p.11

resources, which can all speed up the learning curve and ease poverty among small-scale farmers whose livelihoods are dependent on commodities.

For countries unable to make the transition to industrialization, support for horizontal and vertical diversification and for insurance schemes for small-scale farmers to buffer volatility risks are possible solutions to empower small-scale farmers to reduce their vulnerabilities. These options may be more useful in coping with short to medium term fluctuations and changes in the commodities industries.

Insurance schemes can be a market-based mechanism to help producers buffer risks beyond price floor guarantees. The World Bank proposed an international version of this system in 1999, and the challenge now is for the international community to come together to see the proposal through. If the burden is too big for the private sector to shoulder alone, aid dollars may be useful for this. A more drastic form of insurance against risks might involve actual compensation used under the most extenuating of circumstances. It is recommended that such compensation schemes not treat the poor (whether in terms of state entities or individual groups within the states) as a homogenous group.

Other possible short to medium term coping mechanisms include getting governments to develop a regulatory function and reduce their interventionist role in the economy. Local and international empowerment and capacity-building institutions, along with the private sector, can also help to provide training at all intermediary levels of the commodities hierarchy so that all elements can help to buffer against risks.

Schemes need to be commodity-specific and differentiate compensation according to the origins of the shock (whether natural or manmade, for example). Cost-sharing mechanisms can also be integrated, with risks and costs distributed among as many parties as possible to ease the burden on any one single participant in the scheme. Besides being commodity-specific, such schemes also need to clearly identify the groups that they apply to. These groups must have their idiosyncratic features sketched out accurately so that risks can be determined as precisely as possible. Eventually, this may have to become a global project, because in the most severe of storms, only international aid can fully finance buffer schemes of insurance and compensation. An international coordinating agency may be useful here.

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