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Soaring world food prices: causes and some important trade policy responses

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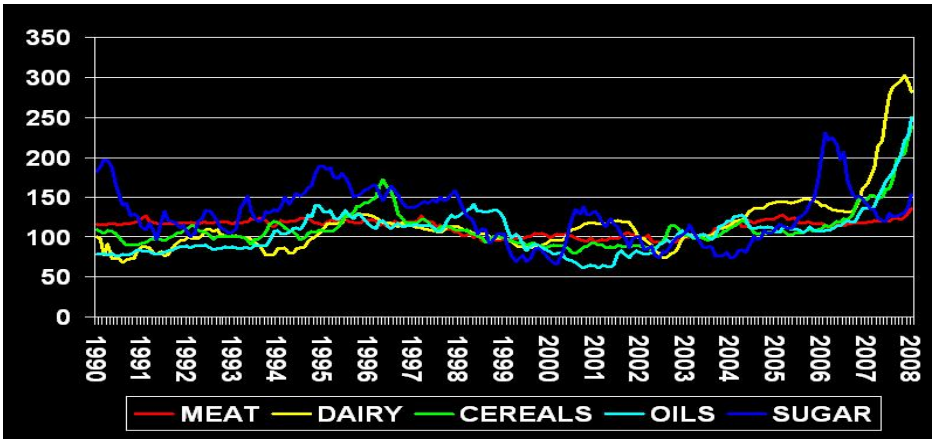
The issue of soaring food prices has already received considerable attention during this Conference, not least by the Secretary-General in his extensive remarks during the opening session of the Conference. The upward movement in prices started some 3 years ago but intensified during 2007 and much more so during recent months and weeks. Over the last 12 months US wheat export prices increased by 110%, the price of rice more than doubled and that of maize rose by nearly 40%[2]. For households in the poorest countries that already spent as much 80% of their income on food, such price increases have devastating effects on their capacity to feed themselves. Unless the problem is addressed soon, there is a great risk that more people would be added to the 800 million people already suffering from hunger and malnutrition in developing countries.



I will structure my comments under four main headings: first, on the causes of the problem leading to the present widespread increase in food prices; second, on whether the factors identified are likely to go away any time soon, thus relieving the pressure on food prices; third, policy responses needed at the national level; and finally, measures to be taken by the international community, in particular trade policy measures under the WTO reform process.

The causes

High price events, like low price events, are not rare occurrences in agricultural markets, although often high prices tend to be short lived compared with low prices, which persist for longer periods. What distinguishes the current situation is the concurrence of sharp price increase in nearly all food commodities and the complex set of factors behind these trends.

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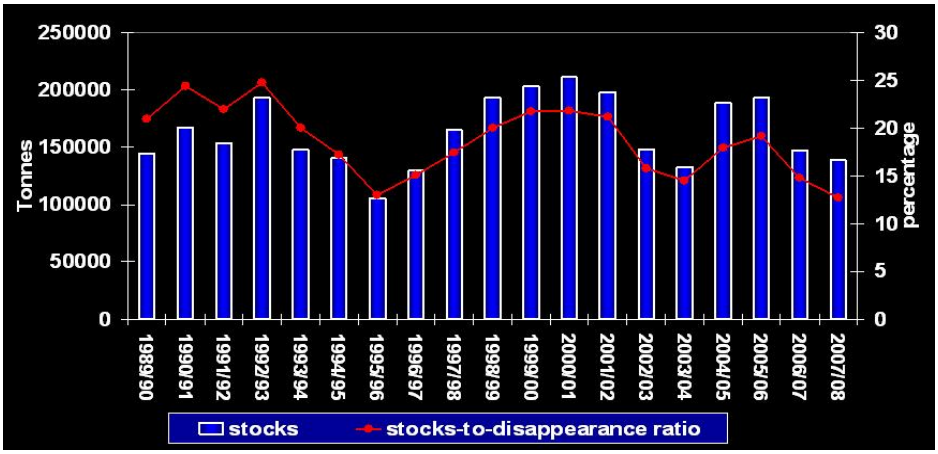
[1] The views expressed here are those of the author and do not represent official policy of the Food and Agricultural Organization.

[2] It may be noted that food prices increased faster and more pronounced during the 1973-74 world food crisis. Real prices (MUV deflated) for most agricultural products are still well below their 1974 levels (see Graph 1 in Annex).

Most analysts and commentators agree on the list of possible factors leading to soaring prices of basic foodstuffs, but there are different opinions as regards their relative effects and which factor is more dominant among them. The forces contributing to the present situation, originate in both the supply and the demand side of the food market, but also due to some other developments external to the food sector.

On the supply side, a critical trigger for the price hike has been **weather-related shortfalls** in cereal production (wheat) in major exporting countries beginning in 2005 and continuing in 2006 (by 4 and 7%, respectively). Although there was a significant increase in cereal output in 2007, prices remained high, as aggregate utilization of grains outpaced production. Since 2000, the world has been consuming more than it is producing. As a result, stock levels of cereals have declined continuously both in absolute and in relation to aggregate utilization.

By the end of crop seasons in 2008, world **cereal stocks** are expected to decline a further 5% from their already reduced level at the end of the 2007 crop seasons and reach their lowest levels in 25 years. The ratio of the major exporters' ending cereal stocks to their total disappearance is forecast to plunge to 12.8% at the end of the 2007/08 seasons compared to nearly 22% in 2000/01. Historically, there have been sharp increases in world prices and greater market volatility when this ratio drops to such low levels.



Another important factor on the supply side is **increasing fuel costs**. The increase in energy prices has been very rapid and steep, with the energy price index more than tripling since 2003. This has had a direct effect on the cost of all agricultural inputs. For example, prices of some fertilizers increased by more than 160% in the first two months of 2008, compared to the same period in 2007. Freight rates also rose sharply, nearly tripling in 2007.

But the most dominant factors contributing to the soaring food prices come from the demand side of the equation. The emerging **biofuels market** is a new and significant source of demand for some agricultural commodities such as sugar, maize, cassava, oilseeds and palm oil. These commodities, which have predominantly been used as food, are now being grown as feedstock for producing biofuels[3]. Significant increases in the price of crude oil allow them to become viable feedstocks in biofuel production such as ethanol. However, much of the diversion of food commodities to biofuel

[3] Among all major food and feed commodities, the additional demand for maize (a feedstock for the production of ethanol) and rapeseed (a feedstock for the production of biodiesel) has had the potential for the strongest impacts on prices. For example, out of the near 40 million tonnes increase in global maize utilization in 2007, almost 30 million tonnes were absorbed by ethanol plants alone, mostly in the United States, the world's largest producer and exporter of maize. Over thirty percent of the country's maize harvest in 2008 is forecast to be diverted to ethanol distilleries, which amounts to over 12 percent at the global level. In the EU, the biodiesel sector is estimated to have absorbed about 60% of member states' rapeseed oil output in 2007, which amounts to about 25% of global production and 70% of global trade in the commodity in 2007.

production is policy driven[4] and hardly justifiable from an economic perspective. It is also hardly justifiable from the additional net energy gained, or even from the alleged contribution to reducing green-house gases.

Yet another factor on the demand side is the changing **structure of food consumption** due to urbanization and income growth in many emerging economies. Diets are gradually moving away from starchy foods towards more meat and dairy products, which is intensifying demand for feed grains and strengthening the linkages between different food commodities.

Beyond strictly supply and demand factors, other forces are also at play. **Speculative trading** in food commodities has been on the increase as a means of spreading risk and pursuing more lucrative returns. Also, considering that the prices of most agricultural commodities are quoted in US dollars, **exchange rate swings**, that have been experienced in recent years, is another contributing factor. For those countries that experienced appreciation of their currencies against the US dollar, imports have become cheaper, thereby boosting demand. Finally, short-term **policy responses by Governments**, such as export bans and export taxes, to contain domestic prices for their own consumers, have exacerbated the price increases in the world market (more on this below).

Will these trends continue?

While there is general agreement that the confluence of the above factors contributed to the present price hike, another very pertinent question is whether prices are likely to return to more normal levels any time soon. Again on this issue, many analysts tend to agree that, as opposed to other instances of sharp increases in agricultural commodity prices in the past that have rapidly dissipated, in this instance the circumstances may not be the same.

As already mentioned cereal stocks are historically low and the stock to utilization ratio well below the comfort zone. The last time this ratio was as low was in 1995/96, when grain prices also peaked, although the price spike then was short-lived. The stock to utilization ratio recovered quickly, following a series of good harvests. Therefore, historically, world cereal production has the capacity to respond relatively quickly to situations of high prices and one would expect a similar reaction now. Already, early assessments of crop prospects for the current season point to a substantial increase in cereal output globally during the 2008 seasons[5]. But it would take more than one good year for the cereal market to find its new equilibrium and where that new equilibrium is likely to be is an open question.

Of major significance in this respect is the high demand for food commodities for use in the biofuel sector. Continuation of this trend would depend on a number of factors:

- continued increase in crude oil prices which would maintain the pressure on food prices both from increased input costs and continued use of food commodities in biofuel production;
- the speed of development of 2nd generation biofuel technologies, although these are likely to take some years before they become commercially viable to relieve the pressure on agricultural feedstocks[6];

[4] US processors and growers received support worth about US$6-7 billion in 2006, and those in the EU about US$4.7 billion.

[5] World cereal production in 2008 is forecast by FAO to increase 2.6% to a record 2,164 million tonnes. The bulk of the increase is expected to be in wheat following significant expansion in plantings in major producing countries. Coarse grains output is tentatively forecast to remain around the bumper level of last year. Rice production is foreseen to increase slightly reflecting production incentives in several Asian countries. However, much will depend on climatic conditions in the coming months.

[6] However, 2nd generation feedstocks do not offer a solution per se. It is irrelevant whether we produce food or non-food feedstocks if they compete for the same land, water and other resources. Only when such alternative feedstocks are grown with limited use of land/water and other resources they may offer a viable alternative to 1st generation feedstocks.

- continued subsidization of the production and use of biofuels in developed countries, considering that they can compete with fossil fuels only through substantial government support. If such support is maintained in the future, the pressure on demand for agricultural feedstocks will be maintained.

Reasonable expectations on all these factors make most analysts to conclude that the current high prices of basic foodstuffs and attendant market volatility may well persist for some years to come and hence justify urgent policy action now.

Policy responses at the national level

Faced with persistently high prices, many governments have tried to limit the increase in domestic food prices by lowering import tariffs, reducing consumer taxes, raising general food subsidies or providing direct food assistance to the needy and vulnerable. Some 20 countries have also resorted to export prohibitions or restrictions of different kinds in recent months. While the aim of all these interventions was to provide short-term relief to distressed consumers, there are possible adverse effects on other countries and on the prospects for improving longer-term food security. Export prohibitions and restrictions tend to exacerbate price increases in the world market, while excessive intervention in the domestic market would limit the transmission of higher prices to the farmer, thus discouraging the much needed supply response to cater for future market needs.

Food security will not improve in the long run unless farmers and rural economies benefit from the high price windfall that they presently experience. Unless the institutional environment in a country encourages investing in agriculture and rural development, high prices will have no permanent impact on agriculture and rural economies. Governments play a crucial role in this respect and policies need to be put in place to provide incentives to private agents and promote favourable economic conditions for saving and investment that would lead to long run sustained growth and poverty reduction.

National policy has to prioritise agriculture by allocating more resources from national budgets. Much more investment is required, particularly for water management, rural infrastructure, storage facilities, as well as research and extension. At the same time, policies conducive for private sector investment in agriculture need to be developed and implemented.

Policy responses at the international level

The international community has also a key role to play in responding concretely and urgently to the food crisis. Actions should include, inter alia, the following:

- increasing resources for food assistance and safety nets in developing countries,
- providing balance of payments support, food import financing, and budget support to help meeting soaring food and energy bills,
- supporting short-term programs that aim at improving poor farmers' access to much needed inputs in order to increase productivity[7], and
- increasing the share of ODA going to finance agriculture and rural development projects.

At the same time there is great need for improving policy coordination to maximize synergies in responding to the present crisis while avoiding situations whereby one country's intervention becomes another country's burden. Better regional and international coordination is needed in agricultural trade policy to ensure that national actions do not have harmful effects to other countries' food security.

[7] FAO has launched an Initiative on Soaring Food Prices in December 2007; and is working with other partners to offer countries short-term support and technical and policy advice to encourage a rapid supply response and an increase in productivity by ensuring that farmers have adequate access to inputs such as seeds and fertilizers.

Some of the needed policy responses have clear links to the reform process at the WTO and deserve due consideration in the on-going negotiations. I would like to elaborate on a few of them.

First, Article 12 of the Agreement on Agriculture (AoA). As demonstrated by the large number of countries that resorted to export restrictions of various kinds during the present food price hike, Article 12 is a rather weak provision of no real restraining value. Under para (a) of Article 12 "the Member instituting the export prohibition or restriction shall give due consideration to the effects of such prohibition or restriction on importing Members' food security". Also, under para (b) "it shall give notice in writing, as far in advance as practicable, to the Committee on Agriculture", etc.

It is not clear to what extent these provisions have been adhered to by any of the WTO Members that resorted to export prohibitions or restrictions during the recent past. The danger of a weak Article 12 is real, however, namely to raise doubts about the world market being a reliable source of food supplies. Strengthening Article 12 and making non-compliance actionable on the part of affected WTO Members should be a priority under the current Doha Round.

Second, of real concern, not only for contributing to the current food price hike, is the continued heavy subsidization of biofuel production which, as discussed, is the main drive in the substantial use of food commodities in the energy sector. Besides this amounting to indirect subsidization of agricultural commodities, something that the AoA tries to discipline, and raising ethical issues as some have pointed out, there are also questions about the coherence of the multilateral trading system as a whole and whether what is done in one agreement may not be as effective if there are loopholes elsewhere. This apparent incoherence of the trade rules would need to be corrected.

Third, the Marrakesh Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least Developed and Net Food Importing Developing Countries. The issue of possible difficulties in financing food imports has been of concern to NFIDCs and LDCs from the time the Uruguay Round was negotiated and the Marrakesh Decision was meant to respond to such difficulties. FAO and UNCTAD collaborated in the form of ideas and analytical work to come up with mechanisms that the international community could put in place to respond to the eventuality of high food prices. The most promising idea was the proposal for the creation of a Food Import Financing Facility (FIFF)[8]. The FIFF was supposed to be a market-based instrument to provide credit guarantees to importing agents/traders of LDCs and NFIDCs to meet the cost of excess food import bills.

While the present soaring food prices may not have anything to do with the implementation of the AoA, a functional instrument along the lines of the FIFF would have provided some relief to the affected countries and would have reassured them about the world market being an affordable source of food supplies. It is time to re-examine the rationale for this proposal and how it could be implemented in practice.

Finally, trade facilitation is one more issue of direct relevance to the present food crisis. The speed with which food supplies move in ports and across borders to reach the markets of importing countries is of great concern, especially for vulnerable landlocked countries. The longer it takes to move supplies, the greater the inventories have to be in the destination, the higher the storage and transaction costs for traders, and the higher the price paid by the final consumer. Grain in transit is grain that is not in the market! The implications are clear: much needs to be done to expedite the negotiations on trade facilitation and also in prioritising Aid for Trade resources in building and improving physical and institutional infrastructure necessary to expedite the delivery of food and other essential imports.

[8] FAO (2003). Financing Normal Levels of Commercial Imports of Basic Foodstuffs in the context of the Marrakesh Decision on least-developed (LDC) and net food importing developing countries (NFIDC).

Graph 1. Long term real cereal prices (1959-2008)