

Center for Global Development
Washington, D.C.

Roundtable on
“PREPARING FOR THE NEXT GLOBAL FOOD PRICE CRISIS”

Prepared Remarks

by

Justin Lin
Senior Vice President and Chief Economist
World Bank

October 6, 2008

Introduction

Thanks to Nancy and her team for organizing this event, and for the invitation to share my views on a very important topic. This is my second visit to the Center for Global Development. The first time was in April before I took the job of Chief Economist at the World Bank. I hope there will be many opportunities to come back again during my tenure.

I am sure I can speak on behalf of all my Bank colleagues if I say that we all have a lot of admiration and respect for the excellent work that CGD has been doing on a wide range of important development issues since it was established in 2001. I hope we can build, even more, on the strong collaboration that has developed between our two institutions.

When I last visited CGD in April, the headlines at that time focused mostly on rising commodity and oil prices. They generated a lot of anxiety, to the point that the recent G8 summit took the matter to heart and announced its intention to liaise better with UN and partners regarding the Comprehensive Framework for Action (CFA). In the G8 Summit food security communiqué, leaders requested that G8 agricultural ministers meet to deal with institutional and logistical challenges and report back.

As we meet today, the main headlines are about the crisis in international financial markets. Clearly, we should all be concerned about the current international situation; the negative impact of which will channel through the financial sector, the real economy, and its relative price effects to impact upon world growth. However, for those of us whose work is primarily on development issues, the food crisis will remain a key focus for the foreseeable future.

In my remarks here today, I would like to make four points:

- The food crisis should remain a matter of great concern; its impact upon the fight to reduce global poverty remains critical.
- The World Bank Group has been working closely with other development partners to respond effectively to the crisis.
- However, we need to acknowledge that the recent price fluctuations reflect a collapse in market confidence, and not just a temporary disequilibrium in supply and demand.
- This crisis highlights the need to explore innovative ways to improve the functioning of global grain markets.

1. A Matter of Great Concern

While the increase in global food prices has moderated in recent months, domestic prices remain much higher than in previous years and there are few signs of relief on the horizon. Grain prices have more than doubled since January, 2006, despite having declined substantially from their April highs.

High and volatile global food prices, along with rising energy prices, are contributing to macroeconomic instability in many countries. For net importers, the average impact on terms-of-trade can be very large and can exacerbate high current account deficits.

Whilst resource-rich/net exporters have been able to cushion the current-account impact of food and oil price increases, they now face the threat of inflation and the risk of Dutch disease stemming from appreciating real exchange rates. Furthermore, the sequential nature of the price increase also tends to feed inflationary expectations, and second-round inflationary effects through increases in wages and prices in other sectors.

In fact, the grain price spike has already caused a humanitarian crisis in a number of poor countries. The World Bank estimates that high and volatile food prices could result in more than 100 million additional people falling into poverty. This would threaten attainment of the Millennium Development Goals by 2015.

Higher food prices may also heighten inequality within countries. The effects of food prices on child malnutrition and the vulnerability of many children living in conditions of conflict, instability, and drought, is already visible. Forty countries have experienced social unrest and millions of poor households are now either skipping meals or switching to cheaper and lower quality cereals:

- In Liberia, the cost of the typical food basket for a typical household has increased by 25 percent since January, while in Sierra Leone rising food prices have raised the incidence of poverty by 3 percentage points to 69 percent.
- Increased malnutrition in India has resulted in 8 million more stunted children, according to UNICEF.

There are also major risks to schooling. Higher food prices tend to create pressure to pull children out of school. The loss of income in poor families often forces parents to difficult tradeoffs between food and education costs:

- This was already the case in Indonesia when the 1997 economic crisis was associated with significant declines in school enrolment among the poorest, particularly in rural areas.
- Evidence from a recent survey in Bangladesh also suggests that about half of the households surveyed reduced spending on education to cope with rising food prices.

- Longitudinal data from Brazil show that the sudden loss of job, of a household head, can increase by 50 percent the probability that a female youth leaves school to look for work.

2. The World Bank Response to the Crisis

The World Bank's call for a New Deal for Global Food Policy has been widely endorsed by development partners. On April 29, 2008, under the leadership of the Secretary-General, the Chief Executives Board (CEB) of the United Nations established a High-Level Task Force (HLTF) on the Global Food Crisis. This task force brought together the Heads of the United Nations specialized agencies, funds, and programs, Bretton Woods institutions and relevant parts of the UN Secretariat. The aim of the HLTF was to create a prioritized plan of action for addressing the current crisis and coordinating its implementation.

Drawing on needs expressed by government leaders, on national assessments, and on consultations with civil society organizations, the Comprehensive Framework for Action (CFA) was rapidly put into place. The CFA provides a framework for setting out the joint position of HLTF members on proposed actions to: 1) address the current threats and opportunities resulting from food price rises; 2) create policy changes to avoid future food crises; and 3) contribute to country, regional, and global food and nutritional security.

Consistent with the agreements reached at the *Accra High Level Forum on Aid Effectiveness*, donor agencies will move forward with supporting country level action through the country teams of UN and Bretton Woods institutions. A preliminary list of 27 countries for initiating this work was agreed, as were templates to enable Governments, bilateral agencies, and NGOs to identify: priorities, assistance committed to-date, remaining funding, and technical support gaps. Of these 27 countries, 22 countries are being supported by the GFRP (including approved and pipeline projects) either through grants or fast-track IDA or IBRD funding.¹ The World Bank is working with UN agencies in support of a coordinated, CFA-based approach in country level coordination that supports Government leadership and is inclusive in terms of bilateral agencies and civil society.

The Bank's rapid response is articulated around five main pillars: (i) Policy advice; (ii) Expedited financial support; (iii) The creation of a Multi Donor Trust Fund; (iv) Increased IFC investment in agribusiness supply chains; and (v) the use of financial market insurance products and risk management strategies.

¹ Note that the GFRP is also supporting other countries. As of September 30, total GFRP projects—either Board-approved or well along the pipeline for Board approval—from Bank funds amounted to \$851 million in 32 countries. In addition, since April 2008, the World Bank has also approved \$90 million in IDA funding in Africa for food crisis response projects beyond those processed under GFRP. This includes projects in Ghana, Burkina Faso, Eritrea, Malawi, Burundi, Togo and Madagascar.

3. Price fluctuations reflect a collapse in market confidence

In looking for long-term solutions to the food crisis, one must also address the root causes of the problem and carefully examine what really happened in the international grain and food markets over the past several years. Grain is often used as a proxy for food since more than half of the calories consumed in developing countries comes from grain. While there are many causes of the increase in grain prices, the most important were: the increase in production costs due to high fuel and fertilizer prices; the decline of the dollar, and the rapid increase in the demand of biofuels on food crops such as maize and edible oils. Other factors exacerbating the price increases include droughts in major producing countries and low stocks following policy changes in major producing countries. However, in addition to these factors there may have also been an element of market failure due to rising expectations, hoarding, speculation, and restrictions on grain exports. The substantial rise in global food prices has made it even more important to improve the functioning of the market, reduce price volatility, and enhance the effectiveness of humanitarian interventions.

Global grain stocks fell to 16.5 percent of production in the 2007/08 crop year according to the USDA - the lowest level since 1973. That earlier low point also led to a global food crisis in 1974. The difference between too little and adequate stocks is relatively small, but when stocks fall below some critical level, it can lead to large price increases and a breakdown of functioning markets. For example, in 2004/05, global stocks were 20 percent of consumption and grain prices were relatively stable, while in 2007/08 prices rose sharply indeed some prices (such as rice) tripled in a few months. The difference in global ending-year stocks in 2004/05 and 2007/08 was only about 60 million tons - only about 2.7 percent of global production.

In the short-term, consumption demand for grain is very inelastic, as people need a certain quantity of food to survive but, at the same time, they cannot consume much more than what is enough for them. Supply too is inelastic, as agricultural production follows the normal cycle of harvests. Grain production is also weather-sensitive. A drought or flood may reduce output significantly. Because of the inelasticity in demand, a supply shock in a country will lead to a sharp price spike which in turn may trigger hoarding by farmers. When the expected future price becomes higher than the cost of holding stock, farmers may stock their outputs to sell in the future², causing prices to increase further.

High grain prices in turn make food prohibitively expensive for the poor, putting some people at risk of hunger and even famine. This is likely to cause social unrest and political instability. Also, high prices may induce farmers to increase their production in subsequent harvest periods. Paradoxically, because of the inelastic consumption demand, the dynamics of higher production might eventually lead to a sharp price decline, which

² The cost of holding grain stocks is as high as 15-20 percent of the value of stock per year due to financing and storage costs. However, without the government's stabilization actions, the price of grain may increase sharply due to a small increase in demand or a small reduction in supply, which may trigger farmers to hoard their outputs.

in turn hurts farmers. In developing countries most farmers are poor and a fall in prices further impoverishes them and limits their ability to pay for other basic needs. In the end, low prices also reduce farmers' incentive to produce grain, causing shortages in subsequent periods.

If left to market forces alone, grain production and price will display large volatility, exposing a country to undesirable social and political consequences. A possible remedy is for a government to create a public reserve so as to stabilize the market and reduce price volatility. While such reserves are costly to hold and difficult to manage, the costs of holding a public grain reserve can be viewed as an expenditure for a public good—it mitigates the risks of social unrest and political instability.

Grain production is weather-sensitive in a single location but less so over a larger area, because drought or flood in a particular location are often compensated by higher production in other locations. The variance in global grain supply is therefore quite small, compared to that of individual countries. For example, the variance from the trend in annual grain production is 2.7% for the world, 4.6% for China, and 6.2% for a smaller country such as the Philippines. Therefore, international trade not only can improve resource allocation by allowing each country to produce according to its comparative advantage, but also is a cost-effective way to reduce the need for large public reserves at the national level. Global trade also reduces domestic price volatility.

In fact, the decline of global grain stock from 31.2 percent of total global grain production in 1999/2000 to 16.5 percent in 2007/2008 reflected the trend of reducing individual countries' public grain reserves by increasing global grain trade. However, the trouble is that when grain prices started to surge in 2007, most countries had reduced their public grain reserves to almost zero, and therefore the governments in those countries were deprived of the means to stabilize the grain market. Moreover, in a few countries with substantial public grain reserves, their governments for the purpose of protecting domestic consumers were unwilling to release the reserves to stabilize the global market even though a few million tons of grain would have sufficed to prevent the price surges. The situation was made worse, when seeing the price surge in the global market, the governments in a few exporting countries adopted various measures to restrict exports, including high taxes on exports and even export bans, for the sake of stabilizing their own domestic prices.

4. Innovative ways to improve the functioning of global grain markets

The end result of the recent grain crisis is the collapse of confidence in the international grain market, with many countries now trying to achieve grain self-sufficiency and rebuild their own public reserves. While the motivation of each country is justifiable, the result will be a very inefficient global production system and a very thin global grain market. In this case, if a country encounters an unexpected shock to its demand or supply which is larger than its public reserves, not only will its domestic price surge, but also any attempts to import grain from a thin global market will cause the global market price to surge. A food crisis akin to the recent one may not be avoidable by individual country

action alone. It is imperative, therefore, to find a way to coordinate each country's efforts and to restore confidence in international grain market.

Increased global food stockholding has been proposed as one measure, but stock building in the midst of a crisis is likely to increase, not reduce, the price pressures which have already undermined the accessibility of food for millions of people. Moreover broad-based stock programs present considerable logistical, financial, and political challenges and could undermine attempts to strengthen local grain markets and regional trade. Still, strong institutional infrastructure for coordinated action at the international level already exists. For example, the World Food Program (WFP) anticipates that its staff of more than 10,000 will feed 70 million people during 2008, distributing 4.3 million tons of food valued at US\$3.3 billion. Many donor countries manage sizable bilateral food aid programs, providing food or financial resources to dozens of needy countries, and there are numerous private agencies operating in the field as well.

With full awareness of the complexity of the architecture of food aid provision, there is nevertheless scope to do improve the effectiveness of existing humanitarian programs. This would require more stable financing for the WFP through agreement on multi-year support, by "earmarking" funding sources, or by utilizing commodity price hedging and weather risk management strategies which have the potential to protect WFP's budget from shocks; and the creation of contingent lines of finance to help humanitarian organizations cope with periods of unanticipated high demand (perhaps financed by major donors and subject to periodic review/replenishment).

There is also scope for other initiatives that would improve the ability of humanitarian organizations to deliver emergency food to vulnerable populations, and to help countries manage future supply/price volatility through policies that support—rather than undermine—private markets. While the specific features for a new international coordinated effort could be further discussed, I suggest a general framework as follows:

- There should be an agreement under the auspices of the United Nations that each country will hold a certain amount of public grain reserve in addition to the pipeline stock that the private sector holds for commercial operations. Although the exact amount of public reserve that each country holds is a subject for study, it will not be too large as a percentage of its domestic grain demand annually.
- There should be a mechanism for releasing individual countries' public reserves onto the global market when a shock in supply and/or demand causes the global grain price to increase more than a certain limit. This will stabilize the market and prevent further price surges due to hoarding and speculation.
- Exporting countries should pledge not to apply export bans or prohibitive taxes for exports under any situation.

Past efforts on stabilizing grain prices at a certain level by some individual countries have generally been unsuccessful. However, the purpose of this agreement is to avoid the excess price surges caused by hoarding and speculation. The above agreement will restore the confidence of global grain markets; allowing the market to perform well without prohibiting its function of guiding resource allocations in response to fundamental changes in supply, demand, and costs of production. Such an agreement is a win-win solution for both consumers and producers as well as for the exporting and importing countries.

The likely impacts of climate change on grain supply and demand in the coming years make action imperative! Now is the time to consider such a proposal, if we are to prevent the next global food price crisis.