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Global Food Crisis & Inflationary Pressures: Short and Medium to Long Term Policy Options

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ABSTRACT

The present paper is an initiative to pin down major factors behind exorbitant inflationary pressures in the global economy. The paper mentions that among other factors productivity shocks, external shocks, inflationary expectations and conversion of food crops into fuel generation are the major drivers of inflation (especially food inflation) in the present inflationary era. An attempt is also made to offer some short and medium to long term policy recommendations in this regard. Especially, the acquisition of internal growth momentum is emphasized to absorb the severity of imported inflation in the global economy as well as in Pakistan's economic scenario. Last but not the least, the paper highlights that inflationary pressures are more sensitive to the productivity shocks than the impact of monetary policy operations in the short run and therefore, supply side measures along with monetary policy operations are important to control inflationary stance in the emerging economies including Pakistan.

Section I: Lack of Internal Growth Momentum with Monetary Policy Operations

Pakistan joined the fast growing Asian economies in the region after the lost decade of late 1990's when the severity of financial crisis struck the GDP growth at 3.0 per cent which ultimately fell even to 2.0 per cent in FY-01. The economy continues to show robust and broad based growth at the average rate of almost 6.6 per cent per annum over the last six years. However, the present exorbitant surge of oil and food prices in international markets, the political turmoil, mismanagement of policies and domestic disequilibrium of supply and demand forces in the commodity market along with short fall in the growth of Large Scale Manufacturing & agriculture contributed to disturb all the major important macroeconomic fundamentals of the economy and, real GDP growth was recorded at 5.8 per cent in the fiscal year 2008. Though the economic spillovers of under-stressed advanced economies have also been realized in other emerging economies, they have successfully managed to show resilience in this behalf. The resilience is due to the strong internal growth momentum which has enabled these developing economies (especially China & India) to absorb the strokes of external shocks. However, Pakistan's economy despite satisfactory economic progress over the last seven years remains weaker or largely unable to absorb the severity of these external shocks. All this is due to the fact that economic growth during these happy years was not based upon strong economic pillars and as a result, the strong internal growth momentum could not be established during these periods. Therefore, the best domestic strategy to absorb the external shocks should be based upon strengthening the internal growth momentum over the medium to long term periods which also requires addressing all the downside risk to growth in the economy. In deed, this momentum can not be ensured with out the sustainable level of prices vis-à-vis the conduct of monetary policy and, above all, the contributing role of agricultural sector in the global economy as well as in Pakistan's context.

The famous monetarist proverb that “*Inflation is always and everywhere a Monetary Phenomenon*” offers the major reason of inflation for an economy. It recommends the proper conduct of monetary policy to arrest inflationary pressures in the economy. In this regard, State Bank of Pakistan (SBP) is continuously working with tight monetary policy operations to curb the existing higher inflationary pressures in the economy. SBP recommended the government to follow quarterly and annual ceilings on budget borrowings from SBP and adopt a balanced domestic debt strategy (i.e. with greater reliance on long term financing sources) in Monetary Policy Statement (MPS) for first half of FY-08. SBP also advised the government to reduce its borrowing from SBP and diversify its borrowing sources in FY-08. In addition, SBP introduced more stringent measures in Monetary Policy Statement for second half and, then in interim MPS of FY-08 which *inter alia* include raising the discount rate to 12 per cent from 10.5 per cent and raising CRR by 100 basis points to 9.0 per cent from 8.0 per cent for deposits of maximum one year maturity. The State Bank of Pakistan has also continued tight monetary policy stance with raising the discount rate to 13 per cent in the Monetary Policy Statement for the first half of FY-09. The monetary policy measures can help maintain the credibility of the central bank to overcome the second-round effects. However, these recent efforts to reduce inflationary pressures through the conduct of stringent monetary policy operations can show fruitful results if and only if the major share of inflation is coming out through the channels of monetary aggregates. This highlights the importance of searching out determinants of inflation before exercising monetary policy measures in inflation-stricken economies. Therefore, “there is no reason to expect that *regardless of the sources of inflation*, the best response is to increase interest rates” as inflation is of imported nature and “raising interest rates won’t have much impact on the international prices of grains or fuel” [Stiglitz (2008)]. Moreover, the causality of monetary aggregates to inflation for the time being also does not seem to be at all dominant whereby recent inflationary trends are productivity-related-shocks coupled with the cost push inflationary pressures owing to pass-through of oil prices. In this behalf, the internal exercise of tighter monetary policy will remain ineffective unless monetary policy operations are not supported by the sound supply side measures to counter the inflation pressures [Abbas (2008)]. Along with productivity shocks in the commodity market, the present paper also discusses a number of factors leading to accelerate inflationary pressures in the global economy as discussed below in Section II. Section III offers some short and medium to long term policy recommendations to control the severity of inflationary pressures in the global as well as in Pakistan’s context. The last section follows concluding remarks.

Sections II: Reasons for Rising International Food Prices

2.1 Inflationary Pressures to Productivity Shocks

The simple economic theory suggests that prices are determined by the forces of demand and supply conditions in the market. Generally, the price rise of essential food items is considered to be the result of widening imbalances between these two forces and price distortions will be observed either by the increase in demand or by decrease in supply in the commodity market. However, average demand for daily use food items does not change drastically in the short run and thus rise in prices of daily use food items is directly related to the supply shortages in the market. Therefore, the higher

food inflation pressures are also related to productivity shocks in the world market as well as in Pakistan's economy. In this behalf, the situation of all crops especially wheat, vegetables and pulses seems to be very discouraging over time in Pakistan. Also, the yield of commonly used pulses namely Mung, Mash and Masoor also remains volatile during the period of 2005-08 (see Table # 1). The poor production of various major and minor crops is not in line with the growing consumer's demand in the commodity market over these periods. Thus it has led to disturb demand and supply conditions and hence producing inflationary pressures in Pakistan.

Table # 1
Yield (Kgs/Ha) Achievements

	FY05	FY06	% Change	FY 07	FY 08	% Change
<i>Crops</i>	<i>Yield(Kgs/Ha)</i>	<i>Yield(Kgs/Ha)</i>	<i>Yield</i>	<i>Yield(Kgs/Ha)</i>	<i>Yield(Kgs/Ha)</i>	<i>Yield</i>
<i>Potato</i>	18079	13355	-26.13	18722	--	--
<i>Onion</i>	13810	13824	0.11	13824	--	--
<i>Mung</i>	577	546	-5.32	636	621	-2.4
<i>Mash</i>	491	477	-2.88	479	--	--
<i>Masoor</i>	597	528	-11.52	541	--	--
<i>Tomato</i>	10295	10132	-1.58	10665	--	--
<i>Wheat</i>	2586	2519	-2.59	2716	2585	-4.8
<i>Rice</i>	1995	2116	6.12	2107	2211	4.9
<i>Maize</i>	2849	2984	4.74	2784	3079	10.6
<i>Sugarcane</i>	48906	49246	0.70	53199	51507	-3.2
<i>Cotton</i>	760	714	-6.05	711	649	-8.7

Source: Economic Survey 2007-08

2.2 *The Hypothesis of Industrial-Led Growth*

The idea of industrial led growth was popularized to avoid the uncertainty of agriculture growth especially in the Asian region to ensure continuity in real GDP growth over time. This idea stimulated the Asian economies to prioritize industrial growth while little attention was paid to the agricultural sector during these years. Most of the emerging economies (especially China & India) remained successful to maintain industrial led growth but the volatility in agricultural growth was increased as well over these periods (see table # 2). In particular, Pakistan's economy remains unsuccessful to maintain either the agriculture or industry growth during these periods. The internal volatility in agricultural growth has increased the demand for food import items and ultimately leading to generate the severe inflationary pressures especially in the Asian economies.

2.3 *Inflation Expectations Further Produce Inflationary Pressures*

In the short run, demand and supply mechanism frequently does not seem to work in the commodity market. It is expectations rather than demand and supply forces which play an important role in price determination in the commodity market. It has been observed whenever inflationary expectations sets in economy consumers tend to buy more than their routine consumption demand on the one hand and sellers start charging more than competitive prices on the other in response to inflationary expectations. Thus availability of enough supply in the market does not push down price level in the

presence of inflationary expectations. This kind of market behavior has also contributed to the price rise of essential food items in the market economy.

Table # 2
Agriculture & Industry Growth Scenario

	<i>FY 01</i>	<i>FY 02</i>	<i>FY 03</i>	<i>FY 04</i>	<i>FY 05</i>	<i>FY 06</i>	<i>FY 07</i>
<i>Bangladesh</i>							
Agriculture (%)	3.1	0.0	3.1	4.1	2.2	4.5	3.2
Industry (%)	7.5	6.5	7.3	7.6	8.3	9.6	9.5
<i>China</i>							
Agriculture (%)	2.8	2.9	2.5	6.3	5.2	5.0	3.7
Industry (%)	8.4	9.8	12.7	11.1	11.7	12.5	13.4
<i>India</i>							
Agriculture (%)	6.3	-7.2	10	0.0	6.0	2.7	2.6
Industry (%)	2.7	7.1	7.4	9.8	9.6	10.9	8.9
<i>Indonesia</i>							
Agriculture (%)	4.1	2.6	3.8	2.8	2.7	3.0	3.5
Industry (%)	2.7	4.3	3.8	3.9	4.7	4.7	4.7
<i>Pakistan</i>							
Agriculture (%)	-2.2	0.1	4.1	2.4	6.5	1.6	5.0
Industry (%)	4.1	2.7	4.2	16.3	12.1	5.0	6.8

Source: Key Indicators 2007, ADB & Asian Development Outlook (2008)

2.4 Price Controls Lead to Disturb Market Mechanism

The production decisions depend upon previous prevailing prices of the produced and, if farmers do not receive *satisfactory returns* from last crop, they will switch over to other crops in the next coming season. In this way, the exercise of price controls to facilitate the domestic consumers hurts economic incentives of the producers and can also worsen supply conditions in the market. The option of ban on export of food-items exercised by some countries has created an artificial shortage of food items in the world economy.

2.5 The Higher Living Standards Drive Inflation

Another controversial argument frequently pointed out is that the average size of emerging economies has increased in view of continuous momentum in growth especially in the case of China and India. As a result, the income of people has also increased therefore they have managed to switch over to the superior food consumption items such as meat, fish etc. Thus the conversion of food crops to breed the animals has also increased over this period and, as a result, inflationary pressures have emerged in the world economy.

2.6 Conversion of Food Crops into Fuel Generation

The increasing demand for energy in both the developing and developed countries has led to exercise the conversion of food crops into fuel generation which has further worsened the availability of food related items in the world economy. In this behalf, governments have introduced subsidies to promote the use of bio-fuel and, as a result, the demand for bio-fuels material inputs (such as wheat, maize, palm oil etc.) has also increased the prices of food items in the international market.

In brief, all the above mentioned factors have contributed to accelerate the global productivity shocks and hence the severity of food inflationary pressures has been felt all over the world.

Section III: Policy Recommendations

We recommend some short and medium to long term policy measures which can help control the inflationary pressures as discussed below:

3.1 Short term Policy Measures:

3.1.1 Targeted Cash Transfers to Vulnerable Group

The best policy option to shield the vulnerable group from the severity of food inflationary pressures is to exercise the operation of targeted cash transfers to vulnerable group.

3.1.2 Targeted Distribution of Food Items to Vulnerable Group

Another alternative strategy can be the distribution of daily use food items to the vulnerable group or least poor class through mobile services at different points in the countries. This policy can work more effectively to target the poor people than the disbursement of cash transfers.

3.1.3 Reduction/Elimination of Tariffs & Taxes on Food Staples

There is need to reduce the cost of food staples which can be possible through elimination or at least reduction of the tariffs and other taxes on the imported food items as well as on locally produced food items.

3.1.4 Lift the Ban on Exports of Food Items

The exercise of this policy option has limited or largely no impact on the domestic prevailing prices in the commodity market rather it will lead to hurt economic incentives of the domestic producers and disturb further the global supply conditions around the world.

3.1.5 Easy Access to Markets

The major problem facing farmers is the delivery of the produced to the markets in the city. The proper transportation facility is not available which leads to the wastage of the crops before reaching markets. The special transportation facility should be provided to the farmers on special rates.

3.1.6 Best Utilization of the Available Produced

The supply of daily use food items can not be increased in the short run. Therefore, there is need of taking hectic measures to procure and utilize all the produced without wastage before utilization. It is estimated that up to 40 per cent of food harvested in developing countries is lost before it is consumed because of inadequate processing, storage constraints and other relevant problems.

3.1.7 Administrative Measures

It is equally important to build a mechanism through which daily use items may be available at reasonable prices as sometimes the higher level of production does not guarantee availability at lower prices (i.e. hoarding, black marketing etc.) to the consumers in the commodity market.

3.1.8 Build up the Strategic Grain Reserves

The availability of food supply items can be increased through building up the strategic grain reserves in the country.

3.1.9 Easy Access to Agricultural Credit

It is also important to ensure the easy access of agricultural credit to the farmers.

3.2 Medium to Long term Policy Measures

The medium to long term measures should be based upon the strategies to address major risks to agricultural productivity in the economy.

3.2.1 Elimination of Subsidies

It is a common practice to provide subsidies to the poor segment of the society around the world with the basic purpose to normalize and/or lessen the impact of imported or domestic inflation in the economy. The exercise of subsidies is considered to be an important part of policy formulation and political decision all around the world. Subsidies are commonly limited to three main areas namely fuel, electricity and food related items in developing countries as well as in Pakistan. The biggest share of subsidies goes to fuel prices in most of the developing countries like India, China, and Pakistan etc. However, a number of Asian countries have now decided to shift the impact of higher oil prices to the domestic consumers to improve the fiscal constraints. The notable example is of China who has raised prices of gasoline by 17 Per cent and diesel by 18 per cent in June 2008. This is the second price increase since November and biggest in four years. In Pakistan, the burden of total subsidized items has been estimated Rs407 billion against the budgetary estimate of Rs114 billion in FY-08. The amount of subsidies increased heavily against target of FY-08 because the government used the soft corner policies to pass on the increase of international prices of oil to the consumers. Contrarily, the government has now passed on the increase of oil price to the domestic consumers to correct the fiscal imbalances in the economy and reduce the burden of subsidies from Rs407 billion to Rs295 billion in the budget for FY-09.

The elimination of subsidies generates inflationary pressures in the short run in the economy. However, the provision of subsidies to defuse inflationary pressures in the economy is not a permanent, long term and reliable solution as it can disturb market mechanism; worsen fiscal and current account positions and ultimately leading to macroeconomic instability in the country.

3.2.2 Full Pass-through of External Prices to Domestic Market

The exercise of pass through of international prices to domestic consumers can defuse the inflationary pressures in the economy. The argument is based upon the proposition that pass-through decreases real income of the households and affects demand side factors while producers are encouraged to increase supply in the market. Therefore,

“Without the increase in supply and reductions in demand engendered by full pass through of world prices, the upward pressures on world prices will be exacerbated” (IMF 2008).

3.2.3 Provision of Basic Infrastructure and Logistic Arrangements

The medium to long term policy measures should be based upon providing the basic infrastructure and logistic requites to the farming sector.

3.2.4 Introducing Risk Management Instruments and Crop Insurance Policies

The initiatives should be taken to address the risk management and promote crop insurance policies for small farmers especially in the developing countries.

3.2.5 Addressing Mechanism of Cultivation and Harvesting Process

The promotion of agricultural sector is important to enhance agricultural productivity in the global economy. In this behalf, the mechanism of cultivation and harvesting process should be addressed through technological innovations in this sector.

3.2.6 Increasing Agricultural R & D Fund

It is important to promote the policy of investment in R&D in the agricultural sector to increase the yield per acre and improve the availability of supply over the medium to long term periods.

3.2.7 Promotion of Private Sector-led-Investment

The policies should be chalked out introducing the measures to stimulate private sector-led-investment in agri-business in the short to medium term policy.

3.2.8 Adopting Alternative Policies of Energy Generation

It is also important to find the alternative ways of energy generation and rethink the policies of conversion of food crops into fuel generation as the rush to produce energy at the expense of food items can exacerbate rising food prices across the world. It is estimated that around a fifth of US maize is used to produce ethanol while the European Union’s 10 per cent target for bio-fuel use in transport by 2010 can also worsen the availability of food items in the world.

3.2.9 Global Food Stocks Facility

There is a need of global cooperation to introduce global food stocks facility to cope with the emergency demand of food staples of countries facing severe food related problems in the world.

3.2.10 Miscellaneous Measures

The long term agri-policy should also address the problems of land leveling, water run off, soil erosion etc.

Conclusion

The recent global inflationary pressures are not a transitory phenomenon rather it is the outcome of limited supply of food staples in the commodity market. Therefore, it is anticipated that the food price surge will remain higher due to both demand pressures and further rise in the use of bio-fuel production in the global market at least in near future. In this context, the exercise of stringent monetary policy measures to control inflation especially in the emerging market economies can not show fruitful results as prevailing inflationary pressures are more sensitive to the productivity shocks than the impact of monetary policy operations in the short run. In particular, the demand for daily use items does not change drastically in the short run and therefore, the price rise of essential food items is largely the result of widening imbalances between demand and supply forces in the commodity market. The supply side steps along with monetary policy operations can overcome inflation pressures over the medium to long term periods. Moreover, the acquisition of internal growth momentum is extremely important to absorb the severity of imported inflation in the economy. Above all, the promotion of agricultural sector is also extremely important to achieve the sustainability of internal growth momentum as well as counter the productivity-related-inflation pressures around the global economy especially in Pakistan's context.

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