

The (Food) Price of Success

Higher global demand for calories brings inflationary pressure and more

AUSTRALIAN wheat, Chinese pork, U.S. corn. What do these three specific goods have to do with macroeconomics? Unfortunately, right now, a great deal, and in ways that are globally interconnected.

Over the past 12 months, the world has experienced a substantial inflationary shock in the form of higher food prices. This shock doesn't necessarily translate into higher sustained inflation; monetary policy in most countries appears to be responding appropriately. But it will have adverse effects, particularly on relatively poor urban residents in low-income countries.

There are also two potential silver linings: direct benefits for farmers in low-income countries and potential policy space for removing agricultural subsidies in rich countries.

The increase in food prices is a shock that originates largely in rich and middle-income countries. For some time now, commodity prices have been increasing, and this has been particularly apparent in fuels and metals. A major driver of these increases has been high rates of global growth—the last half decade has seen the world's best run in growth rates since the 1960s. Of course, a big part of what has sustained global growth is the strong performance of emerging markets.

Higher commodity prices should elicit a supply response, with some lag, and almost all developing countries have benefited on net from the increase in global economic activity. So part of what we're observing is perhaps an unavoidable side effect of rising prosperity worldwide.

And then there's the effect of weather. There've been serious droughts in some parts of the world, and animal disease has had an impact elsewhere.

It's also the biofuel policy

But more recently food prices have jumped sharply, at least in part because of an attempt

to encourage the use of so-called biofuels in industrial countries. Biofuels are a type of renewable energy source; that is, you make ethanol from corn, mix the ethanol with gasoline to drive your car, and also grow more corn. As an approach to energy security, this has some appeal—it's a diversification of energy sources.

Unfortunately, although the benefits of biofuels are sometimes exaggerated, their side effects have become all too apparent. Making ethanol from corn doesn't generate much net energy—you use almost as much oil producing and transporting the ethanol as you'd use to generate the equivalent amount of gasoline. It also doesn't significantly reduce carbon emission. But it does drive up the price of corn.

The surge in corn prices over the past two years has been remarkable—prices have roughly doubled both in the United States and worldwide (although they have fallen slightly in recent months). This then has knock-on effects on other crops, as land is switched from wheat on the margin, for example, into corn or, as has been most marked in Europe, out of dairy production and into crops used for biodiesel (for example, rapeseed, whose prices have also increased sharply). In the IMF staff's assessment, a significant part of the latest jump in food prices can be traced directly to biofuels policy.

A key part of this approach to biofuels is agricultural protectionism. A number of countries, including Brazil, can produce ethanol much cheaper, with a greater saving of nonrenewable energy and lower emissions, for example, by using sugar. But this sugar-based ethanol is subject to a prohibitive tariff in the United States (and there are similar barriers in Europe). In addition, production subsidies in rich countries, which are intended to encourage innovation in this sector, seem to have led to excessive entry into the U.S. ethanol distillery business. It's a good idea to encourage innovation—for example, the use of *Jatropha*



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trees in India shows great potential but needs considerable investment to become fully viable—but there are more effective ways to encourage research and development in this sector.

And the consequences are . . .

So if the food-price shock is driven in large part by bio-fuels policy in industrial countries, who faces the consequences? First of all, the industrial countries themselves are not immune from the effects of such a shock. The Federal Reserve does not include food prices in its measure of core inflation (which guides U.S. monetary policy actions), but this is because food prices are typically volatile. However, if there is a likely permanent rise in food prices, because of the shift to biofuels or for some other reason, there's a case for including these prices in core inflation (and they're already included by some industrial country central banks).

Nevertheless, the effect in rich countries will be limited for a simple reason. Food is a relatively small part of what people consume in most advanced economies—about 10–15 percent on average, and some of that relates to processing and distribution rather than the cost of the raw material—and is therefore a small part of the consumer price index.

Food is a much larger component of the consumer price index in many poorer countries. For example, in China and other emerging markets, food is about 30 percent of what consumers buy, and, in many low-income developing countries, it is 50 percent or more. This means that the same global increase in the prices of corn, wheat, milk, and meat immediately becomes higher inflation in poorer countries.

Still, the implication is that monetary policy in middle-income and developing countries will need to be tighter—with higher interest rates—than it would otherwise be (of course, there may also be non-market-based policies, such as price controls, that lead to distortions). This will tend to increase the interest rate differential between poorer and richer countries, which are tending toward lowering interest rates. This will, in turn, tend to increase the so-called global carry trade, in which people borrow in a currency with a relatively lower interest rate (for example, yen) and invest in a currency with a relatively higher interest rate (for example, developing country currencies).

There's nothing wrong with capital flowing from rich to poor countries—in fact, if it happens in the right form and with deliberate speed, it can definitely help development. But the IMF's work on financial globalization emphasizes a very important health warning: if you get too much capital, too fast, and in too footloose a fashion, there can be serious consequences for your economic stability and growth.

Now for the bad news

The really bad news is for poor people in urban areas. Quite aside from considerations of macroeconomic policy, the

impact of high food prices on these people is straightforward and downright painful. They need to pay more for what they eat. With population growth continuing in many poorer countries, rising food prices will put increasing pressure on the budgets of the very poorest. People who produce enough food for themselves and the market can benefit (depending on exactly what happens to the prices of what they produce and what they consume), but the urban poor and many of the rural poor are losing out.

So what about the silver linings?

The greatest potential gains are for farmers everywhere, including the rural sector of poorer countries. Of course, urban dwellers are likely to be hurt, so the net impact for each country will vary.

There is another potential opportunity in this rapidly developing difficult situation. Farm subsidies of various kinds in rich countries have long plagued the international trading system and currently make it difficult to move forward with further trade liberalization. Rich countries are reluctant to improve access to their most protected markets.

With high food prices, subsidies are less compelling and—depending on how they are structured—may not even pay out when prices are above a certain level. Industrial countries need to seize this moment and eliminate subsidies in such a way that it is hard to reimpose them later.

Even though the European Union is not always regarded as a model of agricultural reform, it has taken an impressive step forward in terms of export subsidies for milk. With milk

at record-high prices this year, these subsidies have been suspended. Given the nature of decision making over agricultural policy, reinstating such subsidies might be difficult.

But industrial country tariffs on ethanol should also come down. The rich world is constantly admonishing the poor to get serious about adding value in the agricultural sector. This is exactly what the rapid development of a global biofuels market could bring. But this will not happen unless and until tariffs on the import of biofuels into rich countries are eliminated. There is no panacea here, of course, but allowing freer trade in biofuels should generally help agricultural sectors everywhere and bring benefits to poor, rural societies. Opportunities to expand land use will be greater if all countries have a fair chance to produce biofuels. ■

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For more detail, see Boxes 1.1 and 1.6 in the October 2007 World Economic Outlook and our recent financial globalization paper: www.imf.org/external/np/res/docs/2007/0607.htm.