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Crisis Averted? How Government Actions Keep Food Prices High

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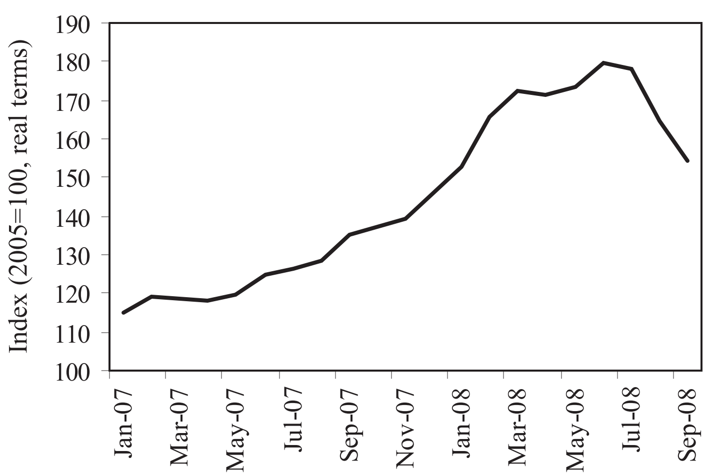
Although global food prices have fallen somewhat from their summer 2008 peaks, they are still high by historical standards. The best way to encourage moderation in food prices is to allow markets to function so that price signals can be transmitted efficiently. That should translate into less extreme fluctuations in commodity prices, as supply and demand will be able to adjust more quickly. In the longer term, reform and liberalization efforts through the World Trade Organization will allow markets to function more effectively.

In early 2008, before the subprime mortgage crisis caused financial upheaval, the "crisis" on everyone's mind was the rapid growth in food prices. The spike was fueled by a "perfect storm" of high oil and fertilizer prices, ethanol mandates that encourage the use of feedstuffs such as corn and soybeans in fuel production, adverse weather events in major food exporting countries, a downward trend in agricultural investment because of rich-world subsidies that depressed prices and closed markets, an increase in demand from rapidly growing developing countries, and depreciation of the dollar (in which most commodities are priced).[1] More than 40 countries experienced riots (and, in the case of Haiti, the downfall of a government) inspired by high food prices, and important agricultural exporting countries from Argentina to Ukraine introduced misguided policy responses ranging from export taxes to outright bans in an attempt to fix the problem. India, a huge global player in many commodity markets, extended bans on exports of rice, wheat, and other crops until April 2009.

Since the early months of 2008, when food prices were constantly front-page news, the world seems to have moved on. First, the global financial crisis and general economic slowdown is a greater threat, and certainly will have more impact on voters in rich countries than do food prices, which are a relatively small part of their household spending. Second, commodity prices, though still high by historical standards, have fallen from their June record highs (see Figure 1). Corn was then selling for about $7 a bushel and pushed toward $8 in midsummer, but has since fallen back to about $4. Similarly, soybeans are selling for just under $9 a bushel as of late October, well below the $16-plus price in June.

Figure 1
Global Food Prices, January 2007 to September 2008



Source: International Monetary Fund Indices of Primary Commodity Prices.

These dramatic declines have not yet translated into substantial falls in the prices that American consumers pay at the grocery store. The U.S. Bureau of Labor Statistics' index for food prepared at home (i.e., the prices that consumers pay at the grocery stores) had increased 7.6 percent during the year leading up to September 2008, although the pace of acceleration slowed to a 0.6 percent increase in the month of September, down from a 0.8 percent increase in August.[2] The general economic slowdown might see these increases decelerate somewhat, but the general consensus is that grocery prices are sticky downwards because firms are reluctant to be the first to cut prices in their category (ingredient prices are locked in months in advance). American consumers should not expect significant relief soon.

Likewise, international relief agencies and intergovernmental organizations insist that the crisis is still a major one, despite recent price falls. Indeed, Table 1 shows that global

Table 1
Global Ending-Stocks-to-Use Ratio of Major Grains

Crop	Average (2001–02 to 2005–06)	2007–08	Difference from average, %	2008–09, projected	Difference from average, %
Wheat	31.4	24.0	-23.6	29.0	-7.6
Coarse Grains	18.2	15.2	-16.5	15.6	-14.3
Rice	27.6	24.6	-10.9	25.9	-6.2
Total cereals	24.2	19.7	-18.6	21.6	-10.7

Source: Food and Agriculture Organization of the United Nations, "Crop Prospects and Food Situation no. 4, October 2008," http://www.fao.org/docrep/011/ai473e/ai473e07.htm.

stocks of many commodities are still low, and Oxfam estimates almost 120 million more people are at risk of starving than before the recent price surge. Although the FAO Food Price Index dropped 13 percent in October 2008 and by 6 percent over the year since October 2007, it was still 28 percent above its October 2006 level.[3] Food aid agencies' budgets are still stretched thin, and history suggests that "surplus disposal" of food stocks from developed countries will fall, too. On the other hand, agricultural exporters (potentially mainly developing countries, if comparative advantage was allowed to work its magic) will gain from higher prices.

To be sure, the historically low stocks of many food commodities suggest that food prices will remain above their historical averages for a time, even if stocks have rebounded somewhat since last year (see Table 1) and demand growth seems to have moderated. The slowing growth in demand for commodities is expected to continue, judging by recent falls in the Baltic Dry Index (more than 80 percent since early summer), which tracks prices for shipping bulk cargo and is considered a leading indicator of international trade activity. But there is much that governments can do—or refrain from doing—to ameliorate the price spikes and to allow the price signals to encourage farmers to invest in farming and increase production.

The WTO's Role?

Restrictions on exports of the type enacted by governments in the wake of this crisis may reduce their domestic price, but they also increase the world price of those commodities if the exporter is big enough to move the market. That harms importing countries and reduces agricultural investment and farmers' incentives to increase production (because the domestic price is held down artificially). Export restrictions therefore have the potential to exacerbate high food prices in the long run.

Can the WTO play a role in preventing the types of counterproductive export restrictions implemented by governments in the wake of soaring food prices? Certainly it is a problem that the WTO is unaccustomed to: when the Doha round of multilateral trade negotiations was launched in November 2001, the focus in agriculture was on long-run declines in commodity prices and the effect of high import barriers on poor farmers abroad and subsidies of rich-country governments that artificially depress prices.

Indeed, export restrictions were not explicitly part of the original Doha mandate at all, although Japan and other countries had expressed concern about them before the Doha round was launched.[4] Events have changed the emphasis, though: the problems facing the world at the current stage of the round are vastly different from those facing the global trading system when the round was launched: for example, food commodity prices increased by about 98 percent from 2001 to July 2008.[5] If prices remain relatively high, agricultural trade negotiators will be forced to address agricultural trade policies that seemed almost moot a few years ago. The likely resistance by some WTO members to new issues outside of the mandate will come up against pressure to do something for poor net food importers.

Unfortunately, the scope in the *existing* WTO rules to restrict the use of policies designed to keep domestic goods inside a border are not necessarily helpful, either; they are certainly less developed than those relating to (more common) policies to keep imports out or to promote exports. Article XI:2 of the General Agreement on Tariffs and Trade places a general prohibition on quantitative restrictions on imports and exports of goods, but makes an exception in subparagraph (a) for

> export prohibitions or restrictions **temporarily** applied to prevent or relieve **critical** shortages of foodstuffs or other products **essential** to the exporting contracting party

(emphasis added, to show the conditions that WTO members would need to satisfy in order to exercise this clause, and which would doubtless be subject to legal interpretation in the event of a dispute).

In order to set some rules for this relatively new terrain, net agricultural importing countries Japan and Switzerland proposed new rules on export restrictions in an informal (and not publicly available) document on April 30, 2008. They suggested that WTO members limit export restrictions "strictly to the extent necessary," notify other WTO members before instituting restrictions (the current draft language requires members to notify others within 90 days after the restrictions are implemented) and to give due consideration to the effect on importers and food aid. They also proposed time limits on restrictions (in an attempt to define the "temporary" condition in GATT Article XI:2(a)) and binding arbitration in the case of a dispute.[6] The current draft agriculture text in the Doha round contains a requirement to lift all current restrictions on exports within one year of a Doha deal coming into effect.[7] But these proposals are languishing with the rest of the Doha agenda.

Another way in which the WTO talks could influence food prices is by encouraging an increase in the amount of biofuels that can be traded under the "in-quota" tariff rate (many agricultural goods are traded according to tariff rate quotas, whereby a certain amount of trade is covered by one tariff level called the "in-quota tariff" and any trade above that quota is covered by a higher rate, the "out-of-quota tariff"). There is currently some uncertainty around trade in alternative fuels. Ethanol destined for use as a biofuel does not have a specific customs classification, but it tends to be classified by customs officials as an agricultural product. Biodiesel (diesel fuel made from vegetable oils), on the other hand, is classified as an industrial good and so it will be subject to the formula reductions agreed on as part of the negotiations on nonagricultural market access. Tariff reductions for alternative fuels are therefore subject to a degree of jurisdictional overlap in negotiating committees on industrial products, agricultural goods, and trade in environmental goods. Leaving aside the merits of agricultural-based fuels as an alternative to fossil fuels, free trade in these products will ensure that they are produced in the lowest-cost manner.

A successful conclusion to the Doha round could contribute positively to agricultural trade flows if it reduced the legal caps on tariffs (called "bound rates") to their current applied rates, and preferably below. That limits backsliding when and if price trends change. For example, it might be tempting—although wrongheaded—to increase import tariffs to protect farmers in India as prices fall again. Bound limits to tariffs will prevent politicians from increasing import tariffs if they feel it would be expedient. More certain market access would also increase the incentive to invest in agricultural production.

Reform in food aid programs would do much to alleviate the pain to the poorest people from food price increases. The Bush administration, for example, proposed in its 2008 Farm Bill package to increase the proportion of aid that is given in cash rather than U.S.-grown crops, so that more food could be bought in the local developing country market or region. That would save money on shipping costs (inflated because of U.S. requirements that food aid be shipped using U.S. flagged and manned ships) and support local and regional producers. But the bipartisan coalition of farm-state politicians ignored that initiative along with other needed reforms to U.S. farm programs.

There is reason to hope that export restrictions may be eased as food stocks recover and prices come down. Farmers do indeed respond to incentives when they are allowed to do so: rice fields have expanded globally by almost 2.5 billion acres since last year.[8] But if governments prevent the valuable signal given by high prices from getting through to producers, or if they hoard any increases in products from the international market, then prices will not moderate and the food price crisis will continue, with predictable and tragic effects worldwide.

Notes

1. Sallie James, "Food Fight," Cato Institute Free Trade Bulletin no. 31, January 31, 2008.
2. Bureau of Labor Statistics, "Consumer Price Index: September 2008," October 16, 2008, www.bls.gov/cpi.
3. Food and Agriculture Organization of the United Nations, "Food Price Indices: November 2008," www.fao.org/worldfood situation/FoodPricesIndex/en/.
4. For more information about efforts in the Doha round to discipline export restrictions, see www.wto.int/english/tratop_e/ag ric_e/negs_bkgrnd09_taxes_e.htm.
5. International Monetary Fund, Indices of Primary Commodity Prices, 1998–2008, October 8, 2008, www.imf.org/external/np/res/commod/table1a.pdf.
6. International Centre for Trade and Sustainable Development, "Japan, Switzerland Propose Stronger WTO Curbs on Use of Food Export Restrictions," *BRIDGES Weekly Trade New Digest* 12, no. 15, April 30, 2008, http://ictsd/net/i/news /bridgesweekly/11075/.
7. World Trade Organization Committee on Agriculture Special Session, Revised Draft Modalities for Agriculture, July 10, 2008, document number TN/AG/W/4/Rev.3, www.wto.org.
8. "Global Rice Market Seen to Remain Tight in 2009," *International Herald Tribune*, October 20, 2008, www.iht.com/bin/print friendly.php?id=17093549.

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