Food inflation: Treat the causes, not the symptoms

MY Say

BY MAHANI ZAINAL ABIDIN

In January, the UN's Food and Agriculture Organisation (FAO) warned that food prices had hit a record high, moving beyond 2008 levels. The headline "Asia scrambles to contain food inflation" was a top news item in most newspapers in the region.

Here in Malaysia, we hear constant complaints about how much less RM100 buys these days compared with a year ago. In the first three months of this year alone, sugar went up by 27%, vegetables by 16%, eggs, dairy and meat by 10% and fruits by 9%. World corn prices have gained nearly 52%, while soybeans have risen 34% since early 2010 on strong demand for animal feed.

Food affordability is, of course, a major concern for the poor and low-income groups. But the middle-income group is also feeling the effects of spiralling prices. Households earning below RM1,000 spend an average of 33% of their income on food, while those with an income of RM3,000 or less fork out 22%. Food away from home, however, adds another 11% to the expenditure of both groups.

So, how do we handle this vicious spiral of rising food prices? In 2008, spikes in rice prices caused widespread panic. There were riots in the Philippines while Vietnam, a large rice exporter, imposed an export ban to allay fears of insufficient supply in the domestic market.

The effective handling of rising food prices is all the more urgent in view of the number of general elections that will be called in the region, including Malaysia. In 2008, higher prices, especially for petrol, were one of the reasons for public unhappiness and are thought by many to have contributed to the outcome of the 12th general election.

Malaysians have long been familiar with price controls and the immediate reaction would therefore be to call for their continuation. In fact, the government is expected to continue to subsidise basic food items. At the same time, there are more calls for the introduction of a minimum wage policy and increases in wages in general.

There are, of course, counter arguments that complicate the formulation of policy responses. Price controls and subsidies distort the markets and lead to inefficient allocation of resources. Quite often, food importers and middlemen benefit more than the producers. Subsidies are also a fiscal burden and wage increases contribute to cost-push inflation.

If we are to deal with the problem of rising food prices realistically, it is important to understand the nature and causes of the increases. When one talks of inflation, the solution that most often comes to mind is raising interest rates. But if food inflation is not driven by high demand, interest rate hikes will, at best, be ineffective and, at worst, further reduce public welfare by pushing up costs and lowering household incomes further.

Rising food prices are a global phenomenon and not limited to Malaysia. The government has tried to explain to the public that its options are limited because many food products are internationally traded. Many, however, seem unconvinced and hold the view that it is the government's responsibility to ensure food price stability no matter what the cause or cost.

Four factors are driving food prices higher. First, food commodities are experiencing structurally higher demand due to the rising world population, growing affluence and alternative uses. Food prices will rise if world food production does not keep pace with growing demand, especially from large countries like China, India and Brazil.

In recent times, the food-for-fuel phenomenon has also contributed markedly to prices. For example, the price of sugar and corn (maize) has risen steadily mainly as a result of their conversion to ethanol for biofuel.

Second, adverse weather conditions have seriously disrupted food supply. Floods in India, for example, severely curbed onion production and prices have shot up by 18% this year in Peninsular Malaysia and a whopping 59% and 122% in Sabah and Sarawak respectively. Similarly, domestic production of coconut, ladies' fingers, long beans, French beans and tomatoes has been affected.

The third factor is the value of the US dollar. Many internationally traded food commodities, such as wheat, corn and rice, are denominated in this currency and the dollar's weakening means that commodity prices have to rise to retain their original value. The US Federal Reserve is said to be exporting inflation through its loose interest rate and quantitative easing policies.

CONTINUES ON PAGE 68

Liberalisation of import duties will lower food costs

FROM PAGE 64

The fourth factor is speculation. Financial investors have moved into the commodity markets (including food), resulting in volatile prices. This is clearly seen in the price of rice. It hit a peak of US$962 a tonne in May 2008 but had dropped to US$474 by June 2010. The 50% fall from peak to trough cannot be blamed on falling demand because the consumption of rice has actually increased.

These four factors expose us to two types of food price changes. Structural price increases are unlikely to reverse and likely to be sustained. In contrast, food price rises due either to bad weather or speculation can be steep but they could also drop back to normal levels in a very short time.

Malaysia, like many other countries, faces a mammoth task of responding to this global phenomenon. With food imports amounting to RM42 billion in 2010, the government has to ensure that the people's welfare is taken care of, that the strategies to mitigate price increases do not interfere with the workings of the market and that its measures are affordable.

So, how do we achieve all of this?

Where weather-related and cyclical price shocks are concerned, we should let things take their course and wait for production to return to normal levels again, provided the production cycle is short. It is also important to keep the public informed so that the situation can be monitored closely.

We should think about subsidies carefully because of their distortive effects and because they are not a prudent measure. Not only will the poor and low-income groups become dependent on subsidies but importers and distributors will also profit from them. Some subsidies are necessary to cushion the effects of high food prices but they will only be effective and beneficial if they can be targeted at the right groups and the free-ride problem is eliminated.

The response to structural price trends requires careful planning, effective implementation and transformation. This means countries would want food security as a key agenda, where there are ways to ensure sufficient supply and affordable pricing. We have to be serious about food production, either domestically or overseas.

There should be attractive incentives for investment and innovation in food production and the management of the supply chain. It is difficult for any country to be fully self-sufficient in food, so it should work out a scheme, regionally or internationally, to develop a secure food supply chain. Besides looking at increasing food production, stockpiles are also an effective measure. Perhaps we should consider this scheme for key food items in view of the sharp variation in global prices.

Since we import a lot of our food, import tariffs on these items should be eliminated. Liberalisation of import duties will lower food costs and encourage our food industries to be more competitive. In fact, we should go further by revamping our food import system, which includes import licences, transport and distribution.

For the long term, the issue of affordability is very much linked to wage levels. The New Economic Model has set high income as one of its three goals. Indeed, Malaysia has to earnestly look into how to increase wages and consequently purchasing power if it is to effectively cope with food inflation. At the same time, it has to allow domestic food producers and farmers to sell their produce at high prices. E

Datuk Mahani Zainal Abidin is the chief executive of the Institute of Strategic and International Studies (ISIS), Malaysia