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Food Price Volatility

Commodity prices have exhibited increased volatility in recent years. The rapid rise in food and energy prices during 2007 dealt a serious blow to growth and macroeconomic stability in many economies. Poverty incidence increased sharply. The global financial crisis led to a significant correction, but recently commodity prices have started to rebound. Further increases remain a key risk for the sustainability of the global recovery. What are the factors contributing to this volatility and how should policies respond? The October issue of the IMF's World Economic Outlook (WEO) publication provides some answers (available at: http://www.imf.org/external/pubs/ft/weo/2009/02/index.htm).

Although still lower than oil, the volatility of prices for most major crops, including rice, reached record or multidecade highs during 2005-2008. As evidenced during 2007, the macroeconomic effects of surging food and fuel prices volatility can be broad and far-reaching, particularly when increases persist for longer periods. The direct effects are felt through the balance of payments of importers and exporters, (headline) inflation, and poverty levels (food accounts for a large share of consumption expenditure in low-income countries, particularly for the urban poor). Growth is affected as input costs increase. Volatility can also complicate policymaking, including through the effects on government budgets and monetary policy. It also distorts the planning decisions of food producers, processors, and consumers, not in the least because commodities' supply responds slowly to changing economic conditions.

Food prices will always be subject to short-term variability because factors such as weather and crop pests affect harvests. Beyond crop diversification, there is little that policies can do to mitigate these effects.

Research suggests a range of factors that may influence longer-term food price volatility. Macroeconomic factors such as the level and volatility of U.S. inflation, U.S. real interest rates, and the U.S. dollar exchange rate are potential influences as most commodities are priced in U.S. dollars. Indeed, the recognition that U.S. developments play a large role in commodity price setting has contributed to discussions to replace the U.S. dollar as the principle international unit of account. Commodities are often regarded as stores of wealth, and the incentive to hold them—as financial assets or inventory—increases with inflation and lower inventory financing costs (interest rates) and is affected by global investor risk aversion and uncertainty. The exchange rate can affect prices through a number of channels, including international purchasing power and the effect on margins for producers with non-U.S.-dollar costs.

Changes in global economic activity too affect commodity demand, and demand volatility is likely to spill over to food price volatility. Crude oil price volatility may play a role, because of the impact on input costs and, more recently, the demand for food crops as biofuels. Futures market activity, such as changes in open interest and trading volumes may also affect variability, particularly if new market participants follow price momentum strategies and amplify price movements. This has led to calls to reform the regulation of commodities futures markets to curb (leveraged) speculation. In addition, some studies have argued that changing weather patters (El Nino) can have a significant influence on commodity prices.

These factors contributed to the recent quick rebound in commodity prices, despite generally high inventories. The buoyant recovery in emerging Asia, the onset of recovery in other emerging and developing economies more generally, and the improvement in global financial conditions, all played an important role. The possibility of rallying commodity prices remains one of the downside risks to the global recovery.

However, all the factors above are outside the control of policymakers in individual countries. So what can countries do? International experience suggests that policies should aim to reduce the impact on the socially most vulnerable. This is best achieved by allowing domestic food (and fuel) prices to adjust freely to international market prices and to develop a well-targeted social safety net that can protect the most vulnerable households in the face of rising prices through direct income support.

In contrast, despite sounding appealing, other policies that are often advocated are inefficient, unfair, and unsustainable. For example, reducing VAT or excise taxes to offset commodity price increases is inefficient and badly targeted. Selective reductions in these taxes will distort consumer choices among goods and result in overconsumption of the tax-preferred good. Reductions in excise taxes on fossil fuels is of particular concern where these taxes address negative externalities, such as greenhouse gas emissions. In VAT systems, differential rates are difficult to administer and enforce. The price and revenue implications are also difficult to quantify when intermediate inputs are subject to VAT. Apart from these efficiency reasons, equity considerations also argue strongly against tax reductions because higher-income households would receive a disproportionate share of the benefit from a tax rate reduction, particularly on fuel.

Likewise, universal price subsidies suffer from the same policy flaws as tax rate reductions. They distort price signals, resulting in over-consumption. The benefits accrue primarily to higher income households. Finally, they can be costly and unsustainable, especially if, for example, a domestic price is frozen at an absolute level, and the world price increases.

During the increase in commodity prices in 2007, the Philippines followed the above-mentioned best policy response. Consistent with its inflation-targeting mandate, the BSP did not tighten monetary conditions as higher food and fuel prices did not unsettle inflation expectations. The real exchange rate depreciated to accommodate the shock to import prices. The government also withstood calls to suspend the VAT or repeal the oil-deregulation law.

Instead, it has rolled out a cost-effective conditional cash-transfer scheme. As a result, the Philippines is well positioned to deal with another surge in commodity prices where it to occur. What remains outstanding is to reform the National Food Authority to limit its role to ensuring food security and using the fiscal savings for well-targeted pro-poor programs and spending on irrigation, fertilizer, and drying and storage facilities to improve food supply instead.

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