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Subir Gokarn: Food fright

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That rising food prices are a global phenomenon is well-known. Perhaps not as salient are the differences in the intensity of food inflation across the world. Focusing on Asia, while all countries have seen significant surges in the prices of all major food items, the variation in the rate of price increases is quite striking. Apart from agricultural policy and food security in the region, this has implications for the immediate macroeconomic scenario.

Taking a quick look at the numbers, Vietnam is by far the most adversely affected, with consumer prices of food rising by year-on-year rates of over 20 per cent every month this year. April saw a high of 34 per cent. China and Indonesia have also had persistent double-digit increases in food prices. Last week, the April numbers for China's Consumer Price Index came in at 8.5 per cent, significantly increasing the prospects of a strong monetary response and the consequent deceleration in growth. Food prices in Hong Kong are closely linked to those in China, as a result of which prices in Hong Kong also rose by double-digit rates between January and March. Indonesia also experienced increases in food prices between 11 and 16 per cent during the first four months of the year.

By contrast, the other ASEAN economies saw relatively moderate increases. The Philippines and Thailand saw 12 per cent and 10 per cent rates, respectively in April, but were in single digits before that. Malaysia was the least affected, with the food inflation rate at a shade below 5 per cent over the course of this year. Singapore, also totally dependent on imports, saw its prices rise by between 6 and 8 per cent during January-March. The Indian numbers, although measured by the Wholesale Price Index rather than by the Consumer Price Index as for the other countries, also saw inflation rates between 4 and 6 per cent during January-March, although the April number went up significantly to over 8 per cent.

Of the most affluent economies in the region, only Taiwan appears to be experiencing serious problems, with food inflation rates at close to 10 per cent per year. Japan barely seems to have a problem, with prices rising at less than 2 per cent, while Korean prices have been rising at between 2 and 3 per cent. In short, while food prices may be a global problem, at least in Asia, they are clearly a greater problem for some than for others.

However, for food and some other critical commodities, the price index numbers are rarely an accurate reflection of what is actually going on. Virtually all countries in the region, not to mention several outside it, have elaborate control mechanisms covering production and distribution of food, which, among other things, tend to suppress the reporting of inflationary tendencies that consumers actually have to deal with. In many countries, therefore, the reality may be starkly different than the headline numbers might suggest.

Of immediate relevance to the macroeconomic policy debate, though, is the fact that subsidies are an important component in the management of the food economy in most countries. Given this, one would expect to see an inverse correlation between the reported rate of inflation and the maintenance of fiscal discipline, as subsidy bills expand to offset the true increase in prices.

The second macroeconomic implication of persistent food inflation in the region is that it restricts the room that central banks have to manoeuvre. Under more normal circumstances, one would have expected them to start easing up on liquidity and interest rates to allow domestic demand to offset the slowdown in exports to the US. Even while the US Federal Reserve has cut rates so sharply, not only are these countries not in a position to follow suit, many may soon be actually going the other way. China and India have both recently raised their cash reserve ratios.

Third, the pattern of differential inflation rates reflects the suppression of arbitrage opportunities by means of various export restrictions. Any government facing the threat of food shortages will inevitably clamp down on exports from the country. This means that countries that are large producers of some commodities will see domestic prices of these moderate, while countries dependent on imports will face significant price pressure. In countries that both export and import, there will be a change in relative domestic prices.

In India, for example, prices of edible oil, for which imports are significant, are likely to face pressure because exporting countries will tend to impose restrictions. Ironically, neither the large foreign exchange reserves that virtually all these countries have nor the appreciation that most regional currencies have experienced over the past year and a half are of much use here. You can't import your way out of food inflation if nobody is willing to export to you.

Does all of this add up to a doomsday scenario, with the threat having shifted from a US slowdown to food inflation? Not really. The most important safety valve as far as food supply is concerned is the short production cycle. The prevailing price levels for critical commodities should see a significant acreage response in the coming months as countries begin their cultivation cycles. If harvests across countries are reasonably good, there should be an easing of price pressure across the region and, consequently, globally as well.

If, however, the quality of the harvest varies across countries, so will the ability to keep food prices under check. Under these circumstances, the persistence of export restrictions in newly surplus countries, which may arise because governments are wary of a repetition, will obviously hurt countries whose harvests are indifferent and stocks are inadequate to make up the shortfall.

The characteristics of this situation do support a case for collective solutions. Of course, as we saw in the aftermath of the crisis of 1997, Asian economies are suspicious of the ability of multilateral mechanisms to help individual countries come out of a crisis. They now prefer to rely on their own resources reflected in the huge build-up of foreign exchange reserves across the region. As was said above, it is ironic that these reserves cannot be of much help in a widespread food shortage situation. Given the criticality of food, however, a shifting of the balance between individual and collective solutions may provide better protection against a recurrence.

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