



## **The Pathfinder Economic Alert**

### **Impending Food Crisis and Enhancing Food Security: What is to be done?**

#### **i) Introduction:**

The recent floods affecting several districts of Sri Lanka and other weather related events in several parts of the world have brought to the fore a number of public policy issues. Major challenges are looming up on the horizon, both within Sri Lanka and globally. A holistic package of reforms would be needed to address both the short-term food crisis and increasing concerns related to longer-term food security. The upward pressures on food prices are also being amplified by rising oil prices which impact on the former through a number of channels.

The immediate priority for the country is short-term crisis management. In the longer-term, structural changes are required for preventive action that enhances food security for all the people of Sri Lanka.

#### **ii) Short-term challenges:**

In the short-term, policy-makers are faced with the challenge of responding to the combined effects of the internal disruption caused to food production by the floods and the concurrent spikes in international food and fuel prices.

##### **a) Internal disruption:**

Food production has been severely affected by floods in several districts in the Eastern, North Central, North Western, Central and Sabaragamuwa Provinces. Initial estimates indicated that up to 30 percent of the country's total Maha Crop has been destroyed. The ensuing Yala Crop can also be adversely impacted by the non-availability of seed paddy among affected farmers. Many varieties of vegetables have also been destroyed by the floods resulting in soaring prices. However, recovery in this sector can be quicker as these tend to be short-term seasonal crops.

The immediate impact of the supply disruption has been a sharp rise in food prices. The poor spend a higher proportion of their incomes on food items. As a result, increases in the prices of food items affect them disproportionately with highly unfavourable distributional effects. A carefully targeted relief programme would need to attach priority to providing immediate assistance to the most vulnerable, particularly the poor as well as

infants and pregnant and lactating mothers. It would also need to address the needs of those who have lost their homes and livelihoods during the floods.

However, in formulating relief programmes the government needs to ensure that it does not undermine the trajectory of fiscal consolidation set out in the Budget Speech (previous Economic Alerts have spelt out the highly adverse consequences of the budget deficit continuing to be the major source of instability in the system.)

**b) International food crisis:**

The FAO has warned that the world could be on the verge of another global food crisis. The FAO's Food Price Index recorded its highest ever levels in the successive months of December 2010 and January 2011. The current situation is somewhat different from the food crisis in 2007/08 in that the highest sustained price increases have, so far, been in sugar and oil seeds rather than cereals. Global, cereal stocks were 525 mn tones at end-2010, as opposed to 428 mn in 2007/08 (22.7% higher). However, recent weather events are likely to reduce grain production significantly next year. In addition, stocks are already being drawn down. Grains account for 46 percent of the global calorie intake. Hence rising cereal prices not only increase hunger and malnutrition but can also generate social unrest and political instability as happened in some countries in 2007/08. High food prices are alleged to be one of the factors that have triggered the current upheaval in Egypt.

Global grain production has experienced a series of setbacks. The drought in Russia (the world's second largest exporter) and its subsequent export restrictions have been followed by lower than expected harvests in the US, Europe, Australia and Argentina. Production in key rice exporting countries, such as Pakistan, Thailand and Vietnam has also been affected by adverse weather (heavy rains and floods.)

The impact of the weather (La Nina) induced shocks to global food supplies have been amplified by a concurrent increase in the price of crude oil which had increased from USD 70 to USD 90 per barrel. The Egyptian crisis has driven the oil price up to USD 100. In addition to its impact on transport costs, higher oil prices also exert upward pressure on the cost of key hydro-carbon based agricultural inputs, such as fertilizer, insecticides and pesticides. OPEC has, so far, taken the view that there is sufficient oil in the market. Price pressures can be eased if OPEC decides to increase production.

**iii) Impact on Sri Lanka's Macroeconomic fundamentals:**

The combined impact of the loss of crops in some of the most productive regions in the country and the sharp rise in international food and fuel prices will pose formidable macroeconomic challenges for Sri Lanka in the period ahead.

Food price inflation has already begun to increase. Price pressures are likely to be sustained at least until the Yala crop comes on stream. Release of supplies from the paddy buffer stock will have a mitigating impact. However, the disruption to supplies from the floods is likely to more than offset this. High international food prices mean that it will not be possible to reduce food price inflation through increased imports. As food items have a heavy weight in the cost of living index, overall inflation will also increase.

Inflation caused by cost increases stemming from supply disruption would not in themselves affect underlying inflationary pressures (core inflation) in the economy. There would be no need for restrictive demand management measures that would stifle growth. However, if the increases in food prices lead to salary and wage increases and/or if fiscal policy is loosened to meet urgent relief requirements and other political priorities, the cost-push inflation caused by the disruption to domestic food supplies and high international food prices would be supplemented by price pressures generated by an increase in aggregate demand (demand-pull inflation). To avoid this, the response to the effects of the flood would need to contain wages and have a largely neutral impact on the budget. This means that any additional budgetary expenditure designed to provide relief would need to be financed, as much as possible, out of incremental revenue measures and/or cuts in planned expenditure. The authorities would need to pay heed to HE the President's recognition in his Independence Day message that unpopular measures may need to be taken to secure the longer-term future of the people.

Rising inflation stemming from increased aggregate demand will also exert upward pressure on interest rates. If real interest rates turn negative, savings would be disincentivised and it will become more difficult to mobilize the incremental investment required to meet the Government's growth targets.

The exchange rate can also come under pressure, if Sri Lanka's inflation rate rises more than that of its major competitors and trading partners. A further erosion of competitiveness would adversely affect an export performance that is already disappointing.

The disruption to domestic food production caused by the floods will also have a negative impact on the balance of payments. Though Sri Lanka has become 95% self-sufficient in paddy production and possesses a buffer stock, rice imports are likely to increase this year, at a time of high international prices. With the international prices of wheat and sugar also being high, the food import bill will be higher in 2011, thereby having a negative impact on the trade and current accounts of the balance of payments. At the same, the oil import bill is also likely to rise as will the cost of importing fertilizer and other hydro carbon-based agricultural inputs, not least because of the uncertainty in the Middle east and North Africa.

However, the negative impact of the twin problems of higher international food and oil prices on the overall balance of payments is likely to be mitigated by buoyant tea and rubber prices, as well as a continuing increase in remittances. It is difficult, at this point, to prognosticate how things will pan out in terms of the country's external account. However, one may conclude that the risks have increased and the

authorities need to exercise vigilance and be prepared to use all the instruments available to them, including the exchange rate, to maintain macroeconomic stability.

In responding to the crisis, the authorities need to take full cognisance of the fact that Sri Lanka is now a lower middle-income country and no longer qualifies for the same amount of concessional aid as in the past. The country is already more exposed to international capital markets through significantly higher levels of commercial borrowing. If these markets lose confidence in Sri Lanka's ability to pursue sound macroeconomic policies, a very painful financial crisis would be inevitable. A taste of what can happen was experienced in the last quarter of 2008 when a little under USD 500 mn flowed out of the country and the Central Bank was compelled to spend USD 1.2 bn to defend the Rupee.

iv) **Long –term Structural Challenges:**

a) **Domestic:**

While the current spike in prices is due to the internal disruption of production following the floods and high international prices, food prices in Sri Lanka are also adversely affected by low productivity in the agricultural sector. As mentioned in a previous Economic Alert, productivity is particularly low in the paddy sector, which is characterized by fragmented holdings. Considerable resources have been ploughed into irrigation schemes, the fertilizer subsidy, the guaranteed price scheme and extension services. However, the returns have been disappointing. Structural challenges persist regarding land use patterns and land titling. A lack of investment also continues to result in unacceptably high post-harvest losses. The longer-term food security of the country would benefit greatly from a comprehensive plan to improve the productivity of the agricultural sector.

b) **Global :**

There are also a number of structural issues that need to be addressed to strengthen food security at the global level. The FAO estimates that agricultural production would have to increase by 70 per cent, with a 100 per cent increase in developing countries, by 2050 to provide an adequate supply of food for everyone. The demand for food will be boosted not only by a rising population but also by a sharp increase in demand for meat and dairy products, as incomes rise rapidly in the emerging countries, particularly China and India (4 kg of grain is required to produce 1 kg of meat). In a recent newspaper article, Dr Nimal Sanderatne has pointed out that per capita consumption of meat, in China, increased from 20 kg in 1998 to 50 kg in 2009.

The Director-General of the FAO has emphasised that the necessary increase in global food production to meet the rising demand requires significantly higher levels of investment in agriculture. He has called for: an increase in domestic and foreign private investment from \$140 bn per year to \$200 bn; a rise in budgetary expenditure on agriculture in low-income food-deficit countries from

5 to 10 per cent; and an increase in the share of agriculture in foreign aid from 5 to 19 per cent (its level in 1980).

A more recent phenomenon that has affected global food prices is the increase in speculation in commodities following the liberalization of agricultural future markets. As the profitability of other forms of investment has been affected by the global financial and economic crisis, hedging instruments have been converted into speculative financial products. There is a strong case for increasing transparency and strengthening regulation to address speculation in commodity markets, particularly food items.

**V) Conclusion:**

Policy-makers face a challenging agenda, both in Sri Lanka and internationally, to address short-term issues related to soaring food prices. Equally, there are difficult structural issues that also need to be addressed at both the national and international levels to enhance food security. A meaningful long-term strategy to increase food security must also encompass national and international adaptation and mitigation measures to combat climate change. In addition, food production and incomes of farmers in developing countries would be given a significant boost by eliminating the wasteful agricultural support provided by developed countries. These amounts to USD 365 bn per year.

This is the Fifth in the series of Economic Alerts issued by the Pathfinder Foundation. Readers' comments via email to [pm@pathfinderfoundation.org](mailto:pm@pathfinderfoundation.org) are welcome.