Managing food and fuel price inflation needs fiscal space

Concerns with high and volatile prices of food and fuel remain at the centre of the policy agenda. Volatility of commodity prices continues to be influenced by fundamentals of demand and supply, but is exacerbated by the financialization of commodity markets. High global liquidity has played an important role in supporting the persistently high prices of oil and globally traded food commodities. The challenge was highlighted by the head of Food and Agriculture Organization of the United Nations (FAO), Mr. Jose Graziano da Silva, during the opening of the Ministerial Meeting on International Food Prices in October 2013: “International prices have declined but they are still above their historical levels. And prices are expected to remain volatile over the next years.”

Asia-Pacific countries are well aware of this fact. The region was severely affected by food and fuel price hikes during 2007-2008 and 2010-2011, slowing the progress in poverty reduction. ESCAP estimates show that, based on $1.25 a day per capita poverty line, additional 19.4 million people in the ESCAP region remained in poverty due to increased food and fuel prices in 2010.1 Out of these, high prices prevented 15.6 million people to get out of poverty and pushed other 3.7 million below the poverty line. Thanks to the economic dynamism of the region, the actual number of poor decreased by 24.5 million people between 2009 and 2010; but had staple food prices not increased above domestic rates of inflation the number of poor would have decreased by 43.8 million people.

Although food and fuel prices have declined since mid-2011 in tandem with slowing economic growth, the current price levels of food and oil remain close to their peaks in mid-2008 and early-2011 (figure 1). Furthermore, in many countries of the region, movements in consumer price inflation track movements in global food and fuel prices and considerable volatility still remains in these markets due to geo-political factors and recurrent crop failures in major supplier countries.

Monetary policy is not the right tool

Many countries in the region tightened monetary policy through raising policy interest rates during 2010-2011 to contain inflationary pressures. For example, India raised its policy rates 12 times in that period, from 4.8 per cent in February 2010 to 8.5 per cent in October 2011. While tightened monetary policy by raising the policy rate may reduce the overall inflation rate by curbing expenditure on certain products and hence inducing declines in their prices, the food and oil prices themselves may not fall or stabilize as they are usually determined by the prices of these commodities in the global markets and by domestic structural factors such as low agricultural productivity and gaps in transportation, logistic, and regulations that affect the transmission from international prices to domestic prices. In such circumstances, attempt to curb overall inflation by tightening monetary policy in response to higher food and oil prices doubly disadvantages the poor. First, they still have to spend more on food or cut down their food intakes as food prices remain high despite tightened monetary policy. Second, they are likely to lose jobs due to weaker economic activities due to tightened monetary policy.

Consider, for example, the case of fuel inflation in India. Imported energy accounts for around 30 per cent of total energy use in the country, so domestic fuel prices typically track the global prices. Figure 2 (panel A) shows that India’s fuel inflation jumped during 2010-2011 despite a series of policy interest rate hikes.2 Tighter monetary policy appeared less effective in tackling imported inflation. Fuel inflation moderated in 2012 in tandem with global prices. The case of food inflation in Armenia offers the similar picture. At least half of domestic consumption of major food items such as cereals and meat needs to be imported so imported inflation is sizeable. The panel B of figure 2 shows that Armenia’s food prices rose sharply in 2010 despite tightening monetary policy. The overall inflation was also rising, as food products accounted for half of the overall consumer price index. Food inflation moderated in 2011, tracking global food prices, while policy rate remained at a higher level.


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1 Economic and Social Survey of Asia and the Pacific 2011: Sustaining Dynamism and Inclusive Development: Connectivity in the Region and Productive Capacity in Least Developed Countries.

2 The overall inflation came down during this period largely because food inflation softened. In India, domestic production of most key food items largely matches its demand so domestic food prices depend primarily on weather conditions and policy changes. This explains moderating food prices in India during 2010-2011 amid rising international food prices.
In some countries, price increases have moderated as demand-side pressures declined. But for countries with relatively high inflation, rising prices are often due to increased demand or expansionary policies but to supply shocks, such as upward adjustment of administered prices or removal of subsidies. In these countries, the use of monetary policy alone as the main tool to combat inflation may not be appropriate. Moreover, international commodity prices remain volatile and sharp price movements can reduce aggregate demand through negative terms-of-trade shocks on income in net commodity importing countries. Tightening of monetary policy excessively under such circumstances could further weaken effective demand and hence negatively affect growth.  

The use of policy rate may not be the right instrument for monetary tightening even in the case of second round effects. Policy rate is a blunt tool and cannot discriminate among various sectors. For example, higher policy rates can provide some insulation from imported inflation by causing appreciation of exchange rates which, however, adversely affects exports. Furthermore, higher interest rates may attract short-term capital which is volatile and can increase financial sector fragility. Therefore, when the use of monetary tightening becomes essential to curb second round effects of higher food and oil prices, the authorities should use other instruments such as reserve requirements, quantitative restrictions on credit to particular sectors and moral suasion.

**Policy-mix and variety of instruments needed**

To manage food and fuel price inflation, authorities need mix of policies and instruments to address short-term and long-term issues. For a long-term solution to the problem, authorities need policies, including public investment, to encourage investment in agriculture and alternative sources of energy, such as wind and solar power. In the short-term, a variety of measures can be taken as seen from the experience of the Asia-Pacific countries. They include reduced taxes on imports of food commodities, bilateral arrangements to import food, administrative control of food prices, food subsidies to consumers, and social safety net programmes, including cash transfers, feeding programmes, food for works, programmes and strengthening of existing public distribution systems.

**Fiscal space is vital**

These long and short-term measures require fiscal space. Unfortunately, in many Asia Pacific countries, despite rapid growth during the past decades, the tax-GDP ratios remain quite low because of weak personal income and property tax as well as inefficient tax system and administration. In developing Asia, the average total tax-GDP ratio (for the period 1990-2008) was only 0.19 while it was 0.22 in the Latin America and Caribbean region. Countries in the Asia Pacific region are facing many development challenges, including inflationary pressures due to supply bottlenecks and high imported food and fuel prices. They cannot address these when their fiscal space is narrow.

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4 Table 3, MPDD Working Paper (WP/12/01)