

## CONCEPT NOTE

### FAO Initiative on Soaring Food Prices (ISFP)

#### Rationale for ISFP

Many factors have contributed to soaring food prices. The FAO Food Price Index averaged 23 percent higher in 2007 compared with 2006, as international commodity prices (in US dollar terms) increased sharply throughout the past year. Income and population growth in China, India and other large developing economies are contributing factors on the demand side, particularly as income growth tends to shift dietary patterns, as well as demand for cereal feedstock for biofuels and possible impact of markets that use financial instruments linked to the functioning of agricultural commodity markets.<sup>1</sup> On the supply side, there have been short-term supply shocks due to adverse weather conditions; higher oil prices have raised prices for agricultural inputs such as fuel and fertilizer; and low prices during the early years of this decade reduced production incentives. Macroeconomic factors that affect supply and demand, such as a weak US dollar, have also played a role.

The *countries* that are most likely to be adversely affected by the higher food prices are Low Income Food Deficit Countries (LIFDCs) where the exchange rate has remained relatively steady or depreciated against the US dollar. LIFDCs are particularly vulnerable in that these countries tend to be net staple food importers (and net importers of petroleum products), thus recent price increases on world food markets may have increased overall vulnerability.<sup>2</sup> The *people* most likely to be negatively affected by the higher food prices on international markets are net food buyers, among the most vulnerable are urban dwellers and small scale farmers who are net food buyers, especially when international price movements are transmitted to domestic markets. Transmission will be strongest in urban areas where infrastructure provides strong links with world markets or in areas where markets are well integrated.

#### Conceptual framework for ISFP

Tailoring FAO policy assistance to the current food price crisis over the short-term will need to remain focused on the specific situation in individual countries and to the needs of different stakeholders. Countries and policies are very diverse, thus implementing one type of response option may not be effective, especially when it comes to short-term interventions. In the longer term, the best responses to the current crisis are investments in agricultural research, infrastructure (roads, irrigation, telecommunications) and human capital, as well as development of markets (e.g. in risk management) and institutions. These interventions will increase supply, help to lower food prices, and thus reduce food insecurity among vulnerable net food buyers.

Recommended options for action fall within two broad categories corresponding to FAO's twin-track approach: policies and programmes to increase the supply of food in domestic markets through higher productivity and production but also larger food imports. Production oriented measures should promote the supply response of farmers (especially smallholders) to higher prices within a short period of time. If this happens at a large scale, it will alleviate some of the pressure on prices especially in rural areas and more distant markets. The "second track" consists of policies and programmes to protect the most vulnerable groups in the society from drastic reductions in food intake as a result of reduced purchasing power following higher food prices. The Reduction in purchasing power is particularly damaging to the very poor who spend a large part of their income on food.

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<sup>1</sup> Although it is difficult to quantitatively attribute changes in commodity prices to different factors, there is some evidence that biofuels demand has been an important driver of the recent surge in prices. The IMF calculated that about half of the increase in US corn production in 2007 will feed incremental biofuels production; Oil World has made a similar calculation for vegetable oils production. To the extent that biofuels demand is being driven by OECD policies, it may be possible to reduce the risks to food security by changing those policies.

<sup>2</sup> In countries where the currency is tied to the euro, rising international prices in US dollar terms will be transmitted to a much smaller extent (or not at all) because the appreciation of the domestic currency against the dollar can offset most or all of the rise in dollar denominated commodity prices.

While FAO will concentrate on the first track through policy assistance and support to programme formulation and implementation considering a menu of options that can lead to increased supply of food, FAO will work together with Governments, WFP and others in the conceptualization of programmes aimed at increasing access to food and reducing vulnerability in the short term.

### **Operational framework for ISFP**

The FAO intended to play a catalytic role and assisting Governments to deal with this new food market situation. The first element of **FAO's immediate action plan** is to launch missions to several countries to consult with governments, review country-specific contexts, approach donor community and discuss possible policy measures, response options and operational considerations. The immediate action plan will consider several seasonal patterns, including the counter-cycle, as well as planting calendars for rest of 2008 and 2009

Quick-wins should be explored wherever they exist and its nature could vary from country to country. **Several 'quick-win' responses could be operationalized in the immediate term in support to the most vulnerable small farmers, given the FAO experience with voucher programmes.** A limited number of voucher programmes for seeds and fertilizer could be launched after completing rapid feasibility assessments in a number of countries that have requested assistance.

An approach would be to support access to production inputs for small farmers, especially those who are net food buyers, and who, for reasons of market failure or poverty, use inputs such as seed and fertilizer in suboptimal amounts. Input subsidies or vouchers will distort production decisions when markets are functioning, but they can increase economic efficiency and reduce vulnerability when markets are imperfect, with the provision that the support is not so large that fertilizer use is increased beyond the point where it is socially profitable.

Given the widespread nature of market imperfections in developing countries, carefully designed programmes to increase access to fertilizer and/or seed that help small farmers in a sustainable manner will improve productivity in the longer term, especially if they catalyze larger scale interventions and policy measures by national governments. In addition to the potential for increasing productivity, such interventions, if effectively targeted, can also improve the welfare of the poor.

As a practical matter, the focus of implementation would need to be on small farmers, some of whom are net food buyers but some of whom are net sellers. However, targeting of small farmers will not always be easy due to community resistance and elite capture. Proper design of such programmes will increase response time. Furthermore, it should be recognized that input support for small farmers is unlikely to have an impact on market prices in a world that is becoming increasingly integrated, except perhaps in some small localized markets that are relatively isolated from world price movements (areas that were probably not affected by rising world prices in the first place).<sup>3</sup>

If it is decided to provide support by using vouchers to improve access to inputs, it will be critical to make sure that the inputs are available in sufficient quantities, or else vouchers will simply create inflation in local input prices. Consultation with the private sector in the design and implementation of any initiative, both for short-term effectiveness and medium-term prospects, is essential. The private sector offers the best opportunity in terms of being able to scale up successful approaches quickly. Finally, it should be realized that fertilizer support may not have a lasting effect (or even a short-term effect) if it is not accompanied by long-term investments to improve structural constraints, such as lack of roads and markets, lack of water control and lack of market oriented risk management instruments. Consequently, ISFP should be integrated into the National Program of Food Security or similar national policies aimed at a longer term perspective

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<sup>3</sup> The main effect on market prices will come from changes in world macroeconomic forces (e.g. economic growth in the USA) and supply response in large agricultural producers such as the USA, EU, Brazil, China and India.