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Stabilising cereal prices?

Adapting the response to the market

Franck Galtier

Should cereal prices be stabilised? With the Sahel food crisis of 2005, followed by soaring prices on international markets in 2008 and 2010, this is an increasingly pressing issue in national, regional and international policy debates, which address it in a uniform manner. However, the question calls for different analyses and responses depending on whether it concerns domestic markets in developing countries that are subject to food insecurity, domestic markets in developed countries, or international markets.

The Sahel food crisis of 2005 sent shock waves throughout the world. Soaring prices on international markets in 2008 and 2010 and the food insecurity and political instability they generated in developing countries are beginning to break the taboo that has weighed for the last 20 years on state intervention to stabilise cereal prices. However, debates are sometimes confused, and can be clarified by making a distinction between the stabilisation of cereal prices on domestic markets in developing countries, on domestic markets in developed countries, and on international markets.

In developing countries, intervention is necessary

Cereal price instability poses some serious problems for developing countries, where there is considerable risk of food insecurity. It affects consumers, who spend a large proportion of their income on cereals, causing undernutrition and malnutrition. This may lead to political instability, such as the urban riots in some 40 developing countries sparked by the price hikes of 2008. Price instability also affects farmers, who suffer from price drops. It discourages investment, which impedes agricultural modernisation and therefore economic development (Timmer, 2009). Yet, from the English corn laws to Asia's green revolutions in rice, successful experiences of modernising cereal production have almost always gone hand in hand with producer price stabilisation policies (price floor).

To solve the problems created by cereal price instability, some suggest providing aid to vulnerable households (safety nets, food aid). The effectiveness of these instruments is nevertheless limited by the cost and the

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Creating an international fund to finance cereal price stabilisation policies in the most fragile developing countries.

imprecision of targeting. When the number of households requiring aid is high, it may be more effective to stabilise prices (Newbery, 1989). By reducing the frequency and magnitude of price hikes, action on prices would bring down the number of households vulnerable to food insecurity and thereby increase the effectiveness of safety nets. Moreover, in countries that have not yet achieved their green revolution, it is also necessary to protect farmers from price drops. Stabilising cereal prices within developing countries is therefore a necessity.

There are two major obstacles to the implementation of such policies. First, many developing countries lack the means to finance these policies. Certain exceptions include countries with mineral resources, such as Zambia, which financed maize price stabilisation with revenue from copper. Second, the State may give in to pressure from the streets or lobbies and take untimely measures, which disrupt markets: fearing State intervention that could lead to price drops, private operators refrain from storing or importing, which may increase price instability.

These two obstacles could be removed by creating an international fund to finance cereal price stabilisation policies in developing countries. This fund would be reserved for the most fragile countries and would finance only credible stabilisation projects. State intervention would be launched according to simple rules known to all to ensure that it is predictable and that private storage is not discouraged. For example, the State would only intervene if the price left a predetermined band.

In developed countries, a risk of drift

In developed countries, a public price stabilisation mechanism runs the risk of being turned into a price support mechanism.

The renewed debate on cereal price stabilisation in developing countries has led some experts and lobbies to advocate a return to price stabilisation in developed countries. This is especially true in the European Union, with the preparation of the post-2013 CAP.

A different approach is nevertheless required for these countries. Unlike developing countries, cereals account for a very small proportion of household expenditure; rising cereal prices will not result in food security problems or urban riots. There are consequences for farmers and agricultural investment, but to a lesser extent. Indeed, developed countries have achieved the structural transformation of their economy: productivity gains in agriculture have had knock-on effects in other economic sectors, especially through increasing income and demand, and through lower input costs (Timmer, 2009). In addition, unlike their counterparts in developing countries, farmers in developed countries can protect themselves from the risk of price drops by using futures markets. Since the decoupling of CAP aid in 2003, European cereal farmers are increasingly using this type of tool. By combining a put option and a call option, they can even benefit at almost no cost from a floor price, as long as they accept a ceiling price.

Moreover, in developed countries, a public price stabilisation mechanism runs the risk of being turned into a price support mechanism. The organisation of cereal farmers into powerful lobbies, added to the low impact of high prices on consumers, may lead policy-makers to overvalue floor prices. This would lead to inefficiency on three levels: economic inefficiency, as the surpluses generated would be sold on international markets with the help of costly subsidies, generating unfair competition for developing countries; social inefficiency, as aid based on price support would be of greater benefit to large-scale farmers; and environmental inefficiency, as subsidised prices would provide incentives to increase production, regardless of the damage caused to the environment.

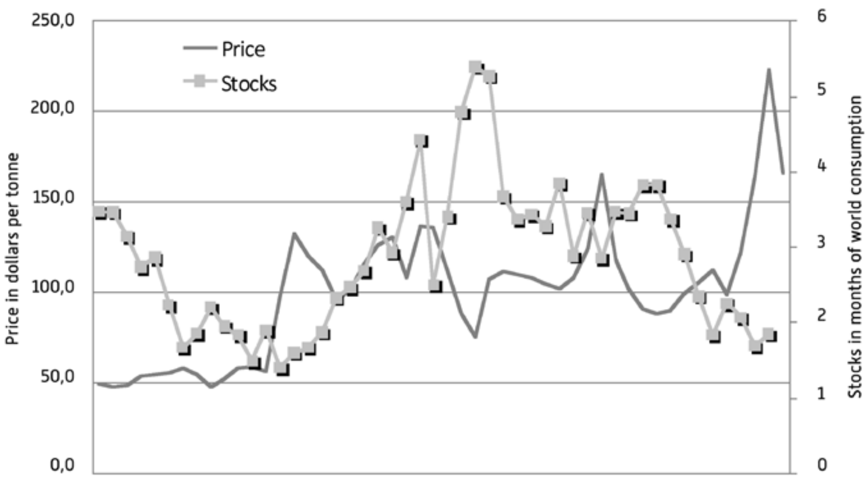
The expected benefits of grain price stabilisation are therefore relatively low for developed countries. Given the costs and the risk of drift associated with these policies, it is almost certainly better to avoid them.

On international markets, intervention is desirable and feasible

There is little doubt that relatively stable international prices are desirable. The main argument (already evoked by Keynes in

1942) is that faced with instable international prices, countries are encouraged to disconnect themselves from the international market. The 2008 crisis was a striking example of this: faced with soaring prices, many countries restricted their grain exports, while others implemented self-sufficiency strategies. These policies further increase international price instability: in 2008, export restriction measures considerably amplified international rice price hikes, thereby penalising importing countries (Headey, 2011). Self-sufficiency policies mean international markets become narrower and therefore more volatile. More broadly speaking, countries disconnecting themselves from the international market harm resource allocation: cereals are no longer produced where production costs are lowest, which increases the cost of food.

International maize prices increase only when stocks are low (1960-2008)



Sources: IMF for prices, and USDA for stocks.

At the international level, attacking the causes of hikes and increasing the level of global grain stocks.

Some experts suggest tightening World Trade Organization (WTO) rules in order to prevent countries from disconnecting themselves from the international market, especially by limiting the right of countries to restrict their exports. This approach seems somewhat unrealistic, as many countries are opposed to such a revision of WTO rules. Even if such rules were adopted, it is unlikely that they would be respected. If rice prices soar on international markets, governments of rice exporting countries would choose to violate WTO rules rather than compromise food security in their country.

Intervention to stabilise prices on international markets therefore seems more desirable than ever to restore countries' faith in the international market. However, such intervention is considered unfeasible by most experts because of the failure of international commodity agreements (coffee, cacao, natural rubber, tin, etc.) that were abandoned in the 1980s (OECD, 2011). However, if these agreements failed, it is above all because their main objective was to support prices rather than to stabilise them, which led to excessive stocks (cacao) or to tension between exporting and importing countries (coffee). The failure of international agreements does not therefore prove that it is impossible to stabilise international prices around their long-term trend.

Moreover, establishing public stocks managed at the international level is not the only type of action that can be undertaken to reduce international price instability. More modest and realistic action can be taken to reduce the frequency and magnitude of price hikes: action attacking the causes of hikes, such as the increase in demand for maize from the biofuels industry or excessive speculation on futures markets; and action aimed at increasing the level of global grain stocks.

Increasing global stocks implies public action as, for staple food products such as cereals, private storage is not enough to build up sufficient reserves. However, it is in each individual country's interest to let other countries bear the burden of storage. Only an international agreement sharing the burden of cereal storage will therefore make it possible to increase the level of global stocks and to guarantee that they will not fall below the minimum level required to avoid price surges.

Modernising agriculture and improving food security

Cereal price stabilisation seems necessary in developing countries, but uncalled for or even risky in developed countries. Where should the boundary be placed between these two groups of countries? Where should emerging countries be positioned? Two criteria can be used to assess the relevance of a stabilisation policy for a given country. The first concerns the share of cereals in household expenditure. If this is high, there is a food security issue; policies aimed at keeping prices below a ceiling are justified. The second criterion concerns the characteristics of farms. If their productivity is low, it is necessary to stimulate investment by keeping prices above a predetermined floor. In countries where traditional and modern agriculture coexist, it is preferable to develop targeted aid.

Cereal price stabilisation policies must be understood from a dynamic perspective.

Cereal price stabilisation policies must be understood from a dynamic perspective. Indeed, they are aimed at enabling structural change: the modernisation of cereal production, which will result in a long-term reduction in prices and will have knock-on effects for the rest of the economy. This implies that the range of intervention prices must follow the long-term price trend, and that the mechanism must be phased out as the desired structural change takes place.

Finally, it seems that national or regional stabilisation policies are not enough to manage instability when it is imported from international markets: some countries are unable to protect themselves from it; and the policies implemented by other countries may increase international price instability. Action at the international level is therefore needed to reduce this instability. Such action is feasible as long as its objective remains modest. The level of commitment from the international community nevertheless remains well short of what is needed, as shown by the recent plan of action resulting from the meeting of G20 agriculture ministers on 22 and 23 June 2011 in Paris. ■

A few words about…

Franck GALTIER
An economist at CIRAD in the MOISA joint research unit (http://umr-moisa.cirad.fr/), Franck Galtier works on the relationship between the organisation and performance of agricultural and food markets. In particular, he has studied coffee, cacao and cereal markets at the international level, in Central America and Africa.
franck.galtier@cirad.fr

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Galtier, 2011 (a). *Managing food price instability in developing countries: a critical analysis of strategies and instruments*. Forthcoming, Editions de l'AFD.

Galtier, 2011 (b). What can the international community do to help developing countries manage food price instability? http://agents.cirad.fr/pjjimg/franck.galtier@cirad.fr/What_can_the_international_community_do_to_help_developing_countries_manage_food_price_instability.pdf

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42, rue Scheffer
75116 Paris . FRANCE
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