Soaring Food Prices Crisis – High Prices and Incentives
A Note Prepared by ES Department (01 July 2008)

High food prices present an opportunity to the agricultural sector to re-establish itself as an engine of growth in many developing countries. A sustainable productivity-led response depends on a favourable and stable incentives environment in which higher commodity prices are transmitted to the farm level and producers have access to affordable inputs.

Incentives that high prices currently provide to developing country producers are not necessarily adequate to increase productivity and production through sustainable intensification. These incentives are actually distorted for two reasons:

First, output prices often do not reach local producers. Recent analyses of price trends show that government policies aimed at limiting the negative impact of price increases on consumers have interfered with the necessary price transmission to producers, particularly for internationally tradable crops that are also locally-produced. Internal market deficiencies also contribute to the poor transmission of prices at the farm-gate (poor transportation and market infrastructure, input/output monopolies).

Second, input costs are increasing as well. The price of fertilizer has increased rapidly since 2006 exceeding the price increases of agricultural commodities. Bringing the cost of fertilizer to affordable levels for smallholders is constrained by an imbalance in global fertilizer markets, characterized by strong global demand that stretches current production capacity to its technical limits. Current estimates project this situation to persist for two to three years when new urea, potash and phosphate plants are expected to come on line, thereby increasing global capacity. Increasing farmer incomes and reducing the real cost of food to consumers through sustained agricultural productivity growth will also be challenged by the rising trend in oil prices with concomitant increases in fuel costs and fertilizer prices.

Changes in output and input prices for selected products and inputs

	Meat	Dairy	Cereals	Oils	Sugar		**Food price index**[1]
(Jan-Apr)	%	%	%	%	%		**%**
2008-07	9	49	80	94	23		**52**
2007-06	5	35	32	29	-39		**12**

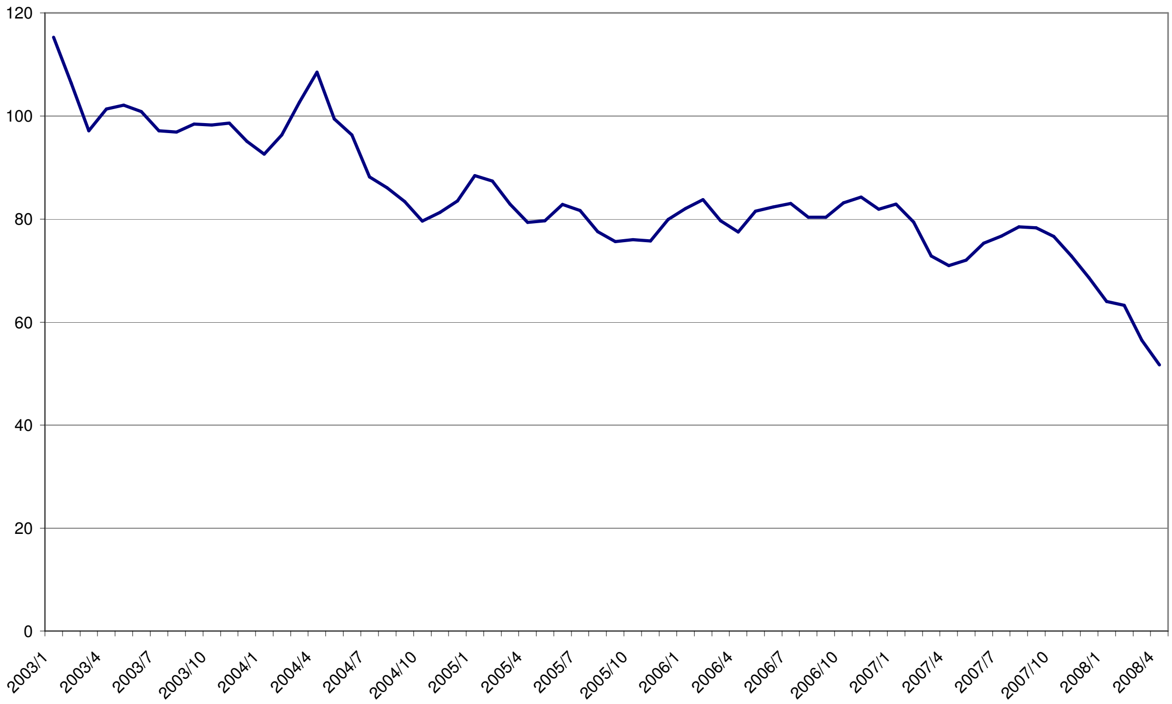
	Ammonia	Urea	CAN	NPK	DAP	IRAC Crude Oil[2]	**Input price index**
(Jan-Apr)	%	%	%	%	%	%	**%**
2008-07	82	31	85	213	163	70	**99**
2007-06	4	29	15	41	33	-3	**19**

[1] Food price index: butter, cocoa, beans, corn, cottonseed oil, hogs, lard, steers, sugar and wheat. Input price index: Ammonia, Urea, CAN, NPK, DAP and IRAC Crude Oil
[2] Imported Refiner Acquisition Cost (IRAC) of Crude Oil in USA.
Sources: For food items: FAO-EST for meat, dairy, cereals, oils and sugar composites, and FAO-EST and Commodity Research Bureau for the food price composite index. For input items: FAO-AGP, Yara and Energy Information Administration.

Beyond the potential for production increases in major producing and exporting countries, the larger challenge posed by the recent increases in agricultural commodity and food prices concerns the capability of smallholders (representing one half of the world's hungry) to increase productivity.

Simply expanding production into new land will not suffice in the face of increasing population trends, changing consumer preferences, expanding demand for bio fuels and the changing climate. In order to match the global demand for affordably-priced food by 2050, annual food production must increase more than 1% annually, while an estimated 80% of the increase will have to come from growth in yields. It is also noted that only productivity-led increases in food and agricultural production will increase not only farme incomes, but will also stimulate backward and forward linkages in the rural economy, and will lead to a reduction in poverty.

Output to Input Price Ratio – Food vs. Inputs (base year: 2003)



Note: Output and input price indices are un-weighted geometric means of the relative nominal prices of the individual commodity prices. The relative price of each commodity is the nominal price over the base period price.
Sources: For food items: FAO-EST and Commodity Research Bureau. For input items: FAO-AGP, Yara and Energy Information Administration.

In addition to assuring a favourable and stable incentive environment, agricultural growth based on a productivity-enhancing smallholder-inclusive strategy, requires significant and systematic efforts to address the diverse structural constraints affecting smallholders' capabilities. As long as the majority of small farmers do not possess sufficient productive assets, lack of access to key farm inputs or live in remote areas with poor access to markets and dysfunctional rural institutions, it will prove very difficult for higher commodity prices to stimulate productivity growth and subsequently contribute to higher farm incomes and lower consumer prices.

Importantly, productivity enhancing measures need to be complemented by a complete set of services and infrastructure to enable smallholders to respond to the consequences of any (not simply the current) price trends, face associated challenges, and eventually boost agricultural development.