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Soaring Food Prices: A Threat or Opportunity in Asia?

Ganesh Thapa¹
Raghav Gaiha²
Katsushi S. Imai^{3*}
Varsha S. Kulkarni⁴

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¹ IFAD, Rome

² University of Delhi & Harvard Centre
for Population and Development
Studies

³ University of Manchester

⁴ University of Delhi

* Corresponding author
Katsushi.Imai@manchester.ac.uk

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Abstract

Rising food prices played an important role in the acceleration of inflation across Asia and the Pacific region during 2007 and the early months of 2008. Not only is food price inflation the most regressive of all taxes, it also leads to lower growth and accentuation of income inequality. Although the index of domestic food prices in Asia has exhibited an upward trend, it is not as pronounced as that of the global index. Yet the looming food crisis has the potential of slowing down the momentum of growth and poverty reduction in this region in the short and medium run. The surge in prices of foodgrains cannot be satisfactorily explained in terms of the fundamentals of supply and demand alone. Analysis suggests that a large part of the surge is attributable to speculation. Further, many countries resorted to protective measures without realising that such measures would force more drastic adjustments and higher prices in global markets. While global foodgrain supply shrank through export restrictions and prices rose faster, food importers escalated demand by bidding aggressively for larger imports to dampen domestic inflation. A vicious circle of spiralling food prices was thus sustained by policies designed to protect domestic consumers, but likely to deepen the food crisis. Even if this bout of food price inflation persists for some time, it would be pessimistic to conclude that the *threat* to the poor and vulnerable sections is inevitable. Much will depend on what the government and development agencies do – especially to strengthen support to smallholders. Given market imperfections, it is imperative that the benefits of more remunerative producer prices accrue in equal measure to smallholders. Expansion of marketable surplus may thus dampen foodgrain price inflation, as well as help to reduce rural poverty.

Keywords: Foodgrains, Prices, Poverty, Speculation, Smallholders, Marketable surplus

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Ganesh Thapa is Regional Economist, IFAD.

Raghav Gaiha is Professor of Public Policy, Faculty of Management Studies, University of Delhi & Harvard Centre for Population and Development Studies.

Katsushi S. Imai (corresponding author) is Assistant Professor of Economics, School of Social Sciences, University of Manchester.

Varsha S. Kulkarni is Visiting Scholar, Faculty of Management Studies, University of Delhi.

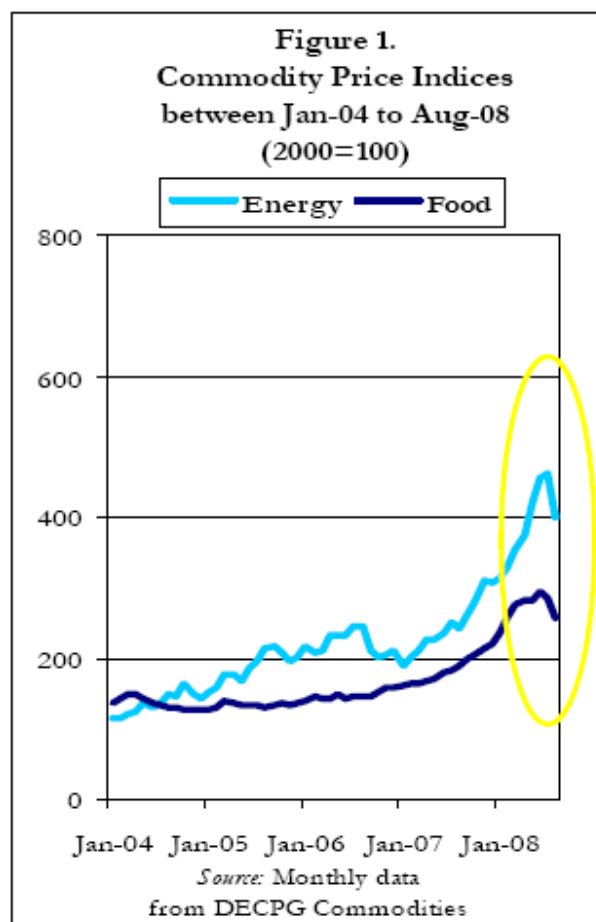
Introduction

A recent World Bank (2008 a) report begins with a dire warning:

The moderation in global prices is scant consolation to the millions who are still facing high domestic prices and have cut back on eating nutritious food and on investing in their child's schooling. While high food prices have pushed more people into poverty, the most serious long-term impacts may come from their effects on those already poor. The razor thin margins between daily earnings and spending has led to households eating less, switching to cheaper coarse cereals and reducing non-food spending, such as on schooling. These sacrifices can lead to irreparable damage to the health and skill levels of millions of poor people worldwide. This is not only a crisis now, but a time bomb for the future, representing lost human and economic potential for poor people (p.1).

Even if there are elements of exaggeration and pessimism in this view, there is much merit in it, as discussed below.

Figure1 illustrates the slight deceleration in global food and energy prices in the last three to four months.



Source: World Bank (2008a)

India has, for example, has recorded a slight deceleration in food prices in recent weeks but prices continue to soar. A recent press release by the Office of the Economic Advisor, Ministry of Commerce and Industry, Government of India, reported that the annual rate of inflation, calculated on a point-to-point basis from the Wholesale Price Index (WPI) (all commodities), stood at 11.07 percent for the week ended 11/10/2008 (over 13/10/2007) as compared to 11.44 percent for the previous week. In striking contrast, the annual inflation stood at 3.07 percent as on 13/10/2007 (i.e. a year ago).

The annual rate of inflation for 'primary articles' stood at 11.53 percent for the week ended 11/10/2008, as compared to 12.68 percent in the previous week. By contrast, it was barely 4.58 percent as on 13/10/2007. The annual rate of inflation for 'food articles' – a sub-group – was 8.74 percent for the week ended 11/10/2008, as compared to 9.69 percent in the previous week. The corresponding inflation rate a year ago, however, was a mere 2.48 percent (as on 13/10/2007).

In the global market, while the food price surge has moderated, the price of crude has plummeted in the last three months, from a peak of \$147.27 a barrel to \$65 a barrel amidst growing fears of a looming recession. As the financial meltdown engulfs emerging and developing economies and wreaks havoc, three questions arise:

- What will happen to oil consumption in USA and China?
- How will producers respond to lower prices?
- Will production cuts by OPEC stop the slide in crude oil prices?

Even if clear-cut answers are ruled out, some conjectures are helpful – especially because high oil prices are so closely intertwined with the surge in commodity prices during early 2008. Besides, whether high food prices will persist in the near future – three to five years – rests crucially on crude oil prices.

Evidence is accumulating on declining demand for oil in developed countries. As a result of the drying up of credit, demand has slowed down in most developed economies (e.g., USA, Japan, France) that account for 60 percent of global demand. Over the past decade, Chinese oil demand surged by 85 percent. Over the last year, China accounted for a third of the extra global demand for oil. However, as exports markets shrink, economic activities – especially manufacturing – have started to decline. But it is risky to extrapolate that the demand for oil will continue to decline. Global oil supplies are also experiencing constraints. These include harder access to resources, political volatility or violence in oil-producing countries, and steadily rising costs of exploration and refining. So as oil prices fall and demand slows, a new concern is whether oil producers will reduce their investment. Finally, it is not self-evident that production cuts by OPEC – that contributes 40 percent of world oil exports– will halt the slide. The cut of 1.5 million barrels a day announced by OPEC on 24 October 2008, failed to stop the slide, as the price dropped again, ending the week near \$60 a barrel. If the sluggish demand for oil persists longer, the prospects for OPEC maintaining its oil revenues seem bleak (Mouawad, 2008).

For our analysis, therefore, softening of commodity prices – especially food – is far from certain. If, in the longer term, oil prices rise above \$100 a barrel – as predicted by many analysts – the historic highs in food prices persisting for three to five years cannot be ruled out.

Soaring food prices

Rising food prices have played an important role in the acceleration of inflation across Asia and the Pacific region during 2007, and especially during the early months of 2008. Not only is food price inflation the most regressive of all taxes, it also leads to lower growth and accentuation of income inequality.

Global cereal prices spiked in early 2008. Rice prices rose steadily until late 2007, with a marked acceleration in the fourth quarter of 2007 and the first quarter of 2008. Wheat prices also surged, but not as much as rice prices. As rice is the basic staple of over two billion Asians, and wheat of an additional billion, their transmission to domestic prices could cause the reversal of policy reforms, social unrest and deepening of poverty. A related issue is the sharp geographical divide in the production and consumption of wheat and rice in Asia – north and west for wheat, and south and east for rice. While wheat production is global, rice is overwhelmingly (over 90 percent) produced and consumed in monsoon Asia. As a consequence, rice exports are confined to a few countries, and the global market is 'thin'. This underlies the greater volatility of rice prices to trade restrictions and changes in supply.

Although the index of domestic food prices in Asia has exhibited an upward trend, it is not as pronounced as that of the global index.¹ Briefly, the reasons are:

- (i) low share of cereal imports in total consumption in countries with large agricultural sectors;
- (ii) low share of rice and wheat in consumer price indices (ranging between 20 and 25 percent);
- (iii) relatively low appreciation of Asian currencies against the dollar, softening the impact of rising (dollar-denominated) global wheat and rice prices; and
- (iv) food subsidies.

Yet the looming food crisis has the potential of slowing down the momentum of growth and poverty reduction in this region in the short and medium run (six months to three years) (ADB, 2008 a, b, c).

In a clear and comprehensive exposition, Timmer (ADB, 2008c) focuses on the dynamics of oil and food prices. He delineates *layers* of cumulative causation of food price inflation. These comprise:

- Rising living standards in the PRC, India and other emerging economies, leading to improved diets – especially greater consumption of vegetable oils and livestock products (and the feedstuff required).
- Rapid deterioration of the dollar, driving up the commodity prices quoted in dollars, and greater attractiveness of commodities as hedging options.
- Mandates for corn-based ethanol in the US (and biodiesel fuels from vegetable oils in Europe).

¹ The average increases in price indices hide changes in individual commodity prices. FAO (2008a) reports that there were large increases in the consumer price of rice in Bangladesh (38 percent), India (18 percent) and the Philippines (about 30 percent) during October 2007-March 2008. These are large increases for poor people, who depend on a single staple food for the bulk of their calorie intake, and typically spend 20-30 percent of their income on this commodity alone.

- Massive influx of capital into commodity markets in search of speculative gains.
- Underlying all these demand drivers is the high price of oil.

Although these factors have been operating for several years, the last two have appeared more recently, with the potential for changing the price dynamics in rapid and unexpected ways (Trostle, 2008; Imai et al., 2008 a; Naylor and Falcon, 2008).

Some of the commodities (e.g. wheat, maize and soya beans) are 'multi-end-use' commodities. Which particular use is driving market prices thus depends on the supply and demand structure of all alternative commodities, macroeconomic conditions and trade policies in importing and exporting countries. Multiple-end-uses lead to 'parameter instability' in the relationship between supply, demand and price. To illustrate, in one month demand for maize/corn to make ethanol may drive up the prices of corn, soya beans and palm oil, while in the next their prices may be delinked and driven more by their own supply and demand. In fact, much depends on substitution possibilities in both production and consumption of these commodities (ADB, 2008 c, Gaiha and Kulkarni, 2008).²

Policy response

In response to spiralling prices, many countries resorted to protective measures without realising that such measures would force more drastic adjustments and higher prices in global markets. Food-exporting countries eliminated export subsidies on foodgrains (China eliminated rebates on value-added taxes on foodgrain exports), imposed export taxes (Russia and Kazakhstan raised export taxes on wheat) and quantitative export restrictions (Vietnam restricted rice exports), and banned exports (India banned non-Basmati rice and wheat exports, Indonesia banned rice exports). Food-importing countries, on the other hand, inflated imports in response to tightening supply: tariff reductions in India (wheat flour), Indonesia (soya beans and wheat), Thailand (pork) and EU (grains); and subsidized distribution of food imports (Venezuela). Therefore, while global foodgrain supply shrank through export restrictions and prices rose faster, food importers escalated demand by bidding aggressively for larger imports to dampen domestic inflation. A vicious circle of spiralling food prices was thus sustained by policies designed to protect domestic consumers but likely to deepen the food crisis (Trostle, 2008; Timmer, 2008; Imai et al., 2008 b).

Impact on poverty and malnutrition

Although there are alarming estimates of the likely impact of food price inflation on poverty – a World Bank estimate of the increase in the number of poor globally, for example, ranges from 75 million to 105 million (World Bank, 2008b) – more plausible and insightful estimates are reported in a recent study by

² ADB (2008a) is emphatic that, since the surge in food prices is largely homegrown and due to excess aggregate demand and inflationary expectations, a tight monetary policy would be effective. It is demonstrated that loose monetary policies pursued throughout Asia (including India and China) were the main culprits in fuelling unsustainable growth of aggregate demand. That this policy prescription follows from standard macro-economic theory is not in dispute or controversial. As argued elsewhere (Gaiha and Kulkarni, 2008), what is indeed controversial is the econometric analysis performed and the conclusions drawn from it.

the Asian Development Bank (ADB, 2008a), taking supply responses to higher food prices into account. An important finding obtained from simulations for China and Indonesia is that the negative effects of food price inflation (e.g. higher incidence of poverty and increase in income inequality) are dampened by the positive supply response in rural areas. The comparison is interesting, as China is a net food exporter while Indonesia is a net food importer. China gains from rising global food prices. Specifically, the largest gains accrue to households dependent on agriculture. Not only does the head-count index of poverty decline, but also the Gini index of income inequality, more than compensating for the unfavourable effects in urban areas. The results for Indonesia, however, differ. Although higher global food prices result in higher consumer prices, appreciation of exchange rate and a loss of competitiveness of Indonesian exports, and a lowering of real GDP, the food crops sub-sector expands. Not surprisingly, therefore, the overall headcount of poverty rises, but slightly.

Additional simulations focus on the impact of a 10 per cent increase in the price of a staple food in a small sample of countries (FAO, 2008a). Households are classified across different characteristics (net market position, income quintile, sources of income). The main findings are:

- (i) urban consumers lose in Bangladesh, Pakistan and Vietnam;
- (ii) in both rural and urban areas, the poorest quintiles are the worst affected;
- (iii) even in some countries where rural households gain on average, such as Vietnam and Pakistan, the poorest of the poor suffer a welfare loss;
- (iv) disaggregating quintiles of households by landownership, the poor landless are likely to be worse-off. In Bangladesh, for example, the welfare loss for the landless is as high as 3.5 percent in the bottom quintile; in Vietnam, the average loss of the landless is 1.8 percent, as against 2.7 percent of the bottom 40 percent.

Classifying households into agricultural 'specialisers' – households that derived more than 75 percent of their income from farming – an interesting finding is that their welfare improves. In Bangladesh, for example, the average welfare of agricultural specialisers – comprising 10 per cent of the rural sample – increases by 1.7 percent (1.3 percent in the bottom quintile, 1.8 in the top). In Vietnam too, the richer agricultural specialisers gain around 2.2-2.3 percent.³ Finally, welfare effects vary between male- and female-headed households. Specifically, in most urban, rural and national samples, female-headed households record greater proportional losses (or smaller proportional gains) than male-headed households. A key explanation is that female-headed households fail to benefit from agricultural income-generating activities, due to their limited access to land, credit and markets (e.g. Bangladesh, Vietnam and Pakistan).

Estimates of malnutrition also paint a grim picture. Globally, there has been marginal progress in reducing the share of underweight children (from 20 percent in 1992 to 17 percent in 2007). FAO's estimate of malnourished in 2007 is 923 million people, up from 848 million in 2004. The World Bank (2008a) projection is that the number of malnourished will go up to 967 million by the end of 2008 (or an additional 44 million people), mainly due to higher food prices. Higher levels of malnutrition will impair growth prospects and productivity in developing countries. The median losses arising from iron deficiency alone are 0.6 percent of GDP in these countries.

³ A negative correlation between rice prices and nutritional status was observed in Bangladesh and Indonesia (Torlesse et al., 2003; Block et al., 2004).

How long is this surge in food prices likely to last? A recent report, *OECD-FAO Agricultural Outlook 2008-2017*, released on 29 May 2008, argues persuasively that high food and fuel prices are likely to persist during the next decade. In a broad-brush treatment of supply and demand factors, it elaborates that, despite record wheat and coarse grain crops in 2007-08 and a sustained moderate rise in production thereafter, grain markets are expected to remain tight up to 2017.⁴ Rising per capita incomes, dietary changes with significantly higher shares of meat and dairy products, and developing food markets have resulted in global demand outpacing domestic production capacity. Besides, growth in grain-based ethanol industries in the US and Europe, as well as feed requirements from thriving livestock industries in developing countries, are likely to exacerbate the imbalance (Gaiha and Thapa, 2008).

Even if this bout of food price inflation persists for five to 10 years, if not longer, it would be pessimistic to conclude that the *threat* to the poor and vulnerable sections is inevitable. Much, of course, will depend on what the government and development agencies do. The panic reaction, and the slew of price and quantity restrictions imposed (e.g. price subsidies or controls, quantitative restrictions on exports and banning of futures markets), are unlikely to work even as short-term palliatives.⁵ Other measures, including subsidised food sales or food distribution to targeted groups in distress, may give partial relief in the short term, but would do little to mitigate food insecurity in the longer term.

Roles of international agencies, donors and national governments

The first important observation is that, while the food system is global, the principal actors are national governments and not international agencies. The latter could play an effective supportive role, but fundamental improvements require sound national policies (Naylor and Falcon, 2008). The second observation is that a distinction must be drawn between long-term or medium-term and short-term policy responses to mitigate the food crisis.

Let us first delineate the supportive role of international agencies and/or groups of countries.

- Although the mechanisms between speculative activities and food prices are far from fully understood, there is a near consensus that supply-demand fundamentals cannot entirely explain the drastic rise in food prices. Rising expectations, speculation and hoarding have contributed to it.⁶ Von Braun and Torero (2008) propose a new global institutional arrangement to suppress

⁴ Projections by OECD-FAO and IFPRI rely crucially on assumptions about the price of crude oil. If oil markets remain tight and the price bounces back with aggregate demand picking up, the persistence of high food prices cannot be ruled out. If the recession is kept at bay through concerted global/regional efforts, there may well be a sharp rebound in oil prices and consequently in food prices (Mouawad, 2008).

⁵ A recent survey (FAO, 2008a) reports that half of the 77 countries surveyed reduced grain import taxes; about 55 percent of the countries used price controls or consumer subsidies; one quarter of the governments used export restrictions and about the same proportion took measures to increase supply by drawing down foodgrain stocks. The policy responses also vary by region. The governments sampled in both East Asia and South Asia, for example, intervened in all four areas, while those in Sub-Saharan Africa showed the least activity.

⁶ Von Braun and Torero (2008) report that the share of non-commercial traders in the total positions (commercial plus non-commercial) in maize, wheat, soya beans, and rice, based on weekly data on futures markets compiled by US Commodity Futures Trading Commission (CFTC), has risen sharply in the last six months, implying the

speculation and panicky government responses (e.g. export restrictions). The key elements of this proposal are: (i) a minimum physical grain reserve for humanitarian assistance; and (ii) a 'virtual' reserve and intervention mechanism to calm markets under speculative activities, backed up by a fund. While questions remain about the financing, storage and monitoring of this proposal, it may help build trust in global markets and institutions, and discourage 'precautionary' and/ or speculative hoarding.⁷

- WTO (World Trade Organisation) rules need to be reviewed. Export restrictions have been given much less attention in the WTO than import barriers. The current situation, however, calls for a more careful scrutiny of export barriers. Arguably, many countries resort to panic buying or hoarding (e.g. the Philippines) on the presumption that exporting countries are not reliable suppliers. Thus, legal restraints on the use of export barriers may spur the reduction of import tariffs and thus lead to longer-term welfare gains (FAO, 2008 a, b and c).
- Subsidies to and tariff protection of biofuel production need re-examination in light of their effects on food security. China, for example, has already restricted the use of grains for ethanol production (FAO, 2008 a, b).⁸
- In the longer term, as a large majority of poor people in developing Asia are concentrated in rural areas and depend on agriculture, higher agricultural growth is imperative for food security, by expanding supply, reducing prices and raising the incomes of smallholders. But yields of food crops in most of Asia are low in comparison with other major producing countries (ADB, 2008 a, b and c; World Bank, 2008a; Imai et al., 2008c). The reasons lie in (i) poor crop management; (ii) use of cheaper seeds; (iii) lack of rural infrastructure and post-harvest technologies; (iv) limited research, the gap between available research and application, and inadequate funding for research and development (ADB, 2008 a, b and c). Besides, this major concern is reinforced by decreasing soil quality and diminishing water tables. In fact, some recent evidence in Imai et al. (2008c) points to a weakening of supply elasticities of foodgrains in a sample of Asian countries during 2000-2005.⁹
- A related issue is that the magnitude of price incentives is lower than implied by the rise in global prices. The transmission of global (real) prices is partial in many developing countries. Specifically, less than half of the most recent global price increases of rice were transmitted to domestic economies, with the exception of Thailand and Vietnam. The average pass-through of dollar prices was considerably lower than 50 percent in China, India and Bangladesh, as against more than 50 percent in Thailand and Vietnam. The reasons lie in policies of rice procurement, public distribution and subsidies, and trade restrictions (ADB, 2008c; Imai et al., 2008b).¹⁰

possibility of a price bubble over and above the fundamentals. For a validation of hoarding spurred by rising foodgrain prices, see Imai et al., 2008d.

⁷ Timmer in ADB (2008c) remains sceptical. He is emphatic that domestic policies will trump international cooperation whenever politicians see a short-run advantage in closing borders or subsidising trade. For a more optimistic view resting on multilateralism, see, Zoellick's (2008).

⁸ This is not to overlook the trade-distorting subsidies in USA and European Union, currently running at \$260 billion per year (Zoellick, 2008).

⁹ As noted in ADB (2008a), setting of appropriate tariff policy will induce more efficient use of water and power for more sustainable resource use. This, however, has to happen in tandem with appropriate agricultural research. For example, given the concern for climate change and water stress, recent research is focusing on making rice more resistant to heat and water stress.

¹⁰ Imai et al., (2008b) use an error correction model to analyse the transmission of global (nominal) prices to domestic prices in India and China for cereals and other food items. The transmission is larger in China than in India.

- Support must be extended, to enable smallholders to expand their production and marketed supply.¹¹ The main areas of support include promoting agricultural research focused on their needs, as many of them farm in agro-ecologically fragile regions; enhancing access to agricultural services, including extension and financial services; securing their access to natural resources, such as land and water; and diversification of their sources of income, including payments for environmental services.¹² There is also a case for strengthening their livelihoods in conditions of greater climatic uncertainty and their awareness of benefiting from new approaches to managing weather and other risks, including new forms of insurance (FAO, 2008a; Gaiha and Imai, 2009).
- Of considerable significance in this context are the results of a recent study by Shilpi and Umali-Deininger (2007), based on a detailed survey of market access in Tamil Nadu – an Indian state. Their analysis shows that (i) an improvement in market facilities implied by a higher value of the market access index is associated with an increase in the farmer's propensity to sell; and (ii) the impact of the market access index also depends on the wealth of a farmer, as reflected in a negative coefficient of the interaction of these variables. So, although wealthy farmers are able to take greater advantage of cheaper modes of transportation to reduce waiting time, this advantage reduces with higher land-owned groups. Simulations with a 20 percent improvement in market facilities show that additional investments in market facilities are pro-poor, as sales of the poorer farmers increase proportionately more than sales of wealthy farmers.
- The response of the international community to the mounting crisis has been fragmented, patchy and diffident.¹³ The USA, for example, has committed about \$2 billion for food aid, through the PL 480 programme, which is the highest commitment by any country. However, barely 40 percent of this amount is spent on food, while the rest goes on transportation and administration, in conformity with Congressional mandates (US-produced commodities as aid must be shipped to their destinations on US-flagged vessels). As energy costs soar, the transportation costs will also soar, reducing the food content of aid. Ironically, US food aid is reduced when costs are high and food is desperately needed by the poor (Naylor and Falcon, 2008). Canada and the European Union have followed a more cost-effective strategy of food aid in the form of cash to relief agencies in needy countries. Food is procured regionally by these agencies, thus reducing transportation costs and boosting local agricultural markets. A proposal to endorse this strategy was resisted by the US Congress, and a bill was proposed to study this idea over a period of four years, at a cost of \$60 million (Naylor and Falcon, 2008). Food aid is in any case a palliative (or, as Naylor and Falcon (2008) put it, a mere band-aid and not a cure). Whether this and other similar commitments will be honoured in the continuing financial turmoil is debatable.¹⁴

¹¹ A review of the Indian evidence confirms that smallholders respond as strongly as others to higher farm-gate prices (Imai et al., 2008c).

¹² Adoption of improved cultivation practices, balanced and timely application of fertiliser and other inputs, and improving farmers' access to modern technology may help close the gap between potential and actual yields in Eastern India (ADB, 2008a).

¹³ While donors bring ideas, energy and resources, they also overwhelm national governments and ownership. In 2006, there were more than 70,000 aid transactions, with an average project size of only \$1.7 million. Last year, the average developing country hosted 260 donor visits. Vietnam had 752 (Zoellick, 2008).

¹⁴ In a pessimistic but not unlikely scenario, Oxfam (2008) highlights some emerging concerns. 'As economies shrink and countries tighten their belts, migrants and refugees could be pushed back to untenable situations. Social tensions could increase, leading nervous governments to clamp down on dissent and impose tough public security policies, curbing civil liberties. Already fragile states could be further weakened by the crisis and slide back into instability and violence. Worse could follow if rich countries decide to use the crisis as an excuse to cut aid and trade. During the 1972-73 recession, global aid spending fell by 15% to just \$US28.8 billion. In 1990-93, donors slashed their spending by 25% over five

- Social safety nets in the short term may help not only in alleviating economic distress, but also in conferring broader social and political benefits. Social protection measures (e.g. targeted food distribution, integrated child development schemes, rural public works) help households maintain access to food, energy and essential services. The adverse effects of economic shocks on health and education are also mitigated. More importantly, when social protection schemes are viewed as fair and compensatory, social stability is enhanced and violent protests are avoided.

Conclusion

In conclusion, while the prospects of maintaining the momentum of growth, poverty reduction and a sustained reduction in hunger in Asia are daunting, what governments and international agencies and other donors do could make a difference. That the current financial turmoil has weakened both developed and emerging economies is not in dispute. What is worrying is that if the financial turmoil changes the policy dialogue and agenda in multilateral and other development agencies, and in national governments in this region, and the focus shifts away from agriculture, the consequences in terms of abject poverty, malnutrition and loss of schooling may be tragic.

years to \$US46billion, and aid did not return to 1992 levels until 2003. Humanitarian aid – what we spend to help people hit by natural disasters and conflict – also fell sharply and over a similar time as a direct result of the 1990-93 recession (only the years of the Rwanda and Kosovo conflicts bucked that trend). In terms of trade, for instance, countries reacted to the 1929 Wall Street crash and global depression by erecting tariff barriers and world trade fell by two-thirds. A replay of that in 2009 would be a disaster for poor exporting countries. Reduced aid and trade could mean that the people in the poorest countries pay the highest price for the profligacy of the credit bubble in North America and Europe’.

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The University of Manchester
**Brooks World
Poverty Institute**

MANCHESTER
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Executive Director
Professor Tony Addison

Research Director
Professor Michael Woolcock

Associate Director
Professor David Hulme

Contact:

Brooks World Poverty Institute
The University of Manchester
Humanities Bridgeford Street Building
Oxford Road
Manchester
M13 9PL
United Kingdom

Email: bwpi@manchester.ac.uk

www.manchester.ac.uk/bwpi

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