On markets and prices

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Bangladesh has been experiencing spiralling and unprecedented food prices for quite some time now. This has led to much speculation as to the cause of this food price inflation and ways to control it. This short note is written on the premise that an understanding of the market mechanism is essential for taking appropriate measures to control food prices. Otherwise, ad-hoc interventions can actually make the situation worse.

First, let's reflect on the reasons for the galloping increase in prices. The food prices have been rising in all countries of South Asia in the current decade. So the Bangladesh case is consistent with the pattern in other countries of the region. For Bangladesh, however, the trend has been made worse in 2007 by output losses associated with the two floods and the devastating cyclone Sidr. The latter, in particular, destroyed much of the aman crop.

So, the increase in price is primarily because of shortage in supply, due to both a cutback in domestic production and inability to import sufficient quantities of food grains in anticipation of the shortfall in domestic production. The food prices have been rising in most countries of the region, at a much faster rate than the general inflation rate measured by the CPI (Consumer Price Index). Thus, demand pressure due to faster economic growth since the '90s cannot account for the galloping food prices.

This rise in price has obviously caused immense suffering to low and middle income groups. In rural areas, the problem is compounded by the fact that the demand for agricultural labour has decreased, so agricultural wage rates are much lower. The loss of the winter crop or aman has coincided with the traditional lean season, explaining the sharp reduction in the demand for agricultural labour. This is compounded by the fact that farmers are reducing the acreage for different crops for the next season, being unable to meet the costs of production due to a fall in farm incomes. The agricultural labourers are, therefore, one of the most vulnerable groups in the present crisis, facing both reduced incomes and rising food prices. This hardship is reflected in the fact that migration to cities in search of food and jobs is increasing.

The steady increase in food prices in South Asia and other developing areas, throughout the '90s and in the current decade, can be attributed to structural adjustment policies, i.e. a series of measures which have affected farm profitability, such as withdrawal of subsidies on inputs, increase in oil prices affecting irrigation and transport costs, and cut-backs in other areas of state intervention, notably extension advice and supply of seeds. This has meant less domestic production in most countries, and reduced availability of food from exporting countries due to reduced surpluses. Consumers, on the other hand, have suffered due to the fact that pro-market policies have meant that the public food distribution system has been dismantled in most countries. Food, therefore, has to be acquired through the market and at market prices.

As a long-term policy, therefore, one needs to re-think this entire strategy of food production and distribution, which cannot be left to the vagaries of the market. Agriculture needs to be subsidised to ensure farm profitability, and a public food distribution system has to be put back in place to protect the interests of low income consumers, i.e. a system of rationing for particular groups at controlled prices.

In the short term, however, the suffering of the people has to be reduced through a two-pronged attack. Thus, the government has to ensure that there is sufficient income in the hands of the rural poor. The best way to achieve this is through public works programs, i.e. building and maintenance of rural roads, culverts, bridges, schools, etc. Thus, programs like VGF targeted at destitute women cannot alone address the problem in this crisis situation.

At the same time, the government should stop threatening the livelihoods of the poor. Most of the poor in rural and urban areas are not part of what is known as the formal economy. They earn their living through petty trade and small-scale production, as vendors, hawkers and owners of small businesses and manufacturing and repair units. These are usually located in make-shift premises, e.g. roadsides, as these people cannot afford to rent, or do not own, more permanent structures.

Attacking these very small businesses for the sake of ensuring discipline or compliance with the law leaves the poor in a precarious situation. It also fails to recognise the importance of the "informal" economy, which caters to the need of poorer consumers and also serves as a major retail outlet for small producers and small farmers. This part of the economy is already outside the system of government incentives and benefits, while traders and producers face various forms of discrimination. Threatening their existence even further is extremely damaging for the economy and for those who earn their livelihoods in this sector.

The next important strategy of the government is to keep prices stable, or help to bring them down. It is understood that interventions in the market are called for. However, one needs to distinguish between positive and negative intervention. Open market sales are, for example, positive interventions, helping to bring down prices, provided there are sufficient stocks in the hands of the government. If the government imports food grains directly or through a specialised agency such as the TCB, this is again a positive intervention, since it may help break importers' cartels which can drive prices up by restricting imports. Another way of making such cartels or syndicates less effective would be to issue licenses to smaller importers of food grains or essential commodities such as cooking oil or milk powder.

Newspaper reports however show that the government has been engaging in negative interventions, despite the advice of economists to the contrary. These are often based on wrong perceptions about how a market system works, and should be avoided at all costs. Monitoring and policing of prices is clearly a negative intervention, creating panic amongst traders.

The same goes for the action against hoarders. It is true that some speculative hoarding is common in the market, driving prices up further, but hoarding is rarely the root cause of increase in prices. The main cause is shortage. It should also be understood that wholesalers often maintain stocks, which helps to ensure a constant supply to the market. This should not be considered as hoarding. It is misguided to take actions or measures based on such wrong perceptions.

The fact that such negative interventions are damaging is obvious from newspaper reports. A recent report tells us that rice was being sent to Dhaka in a panic move by wholesalers, fearing raids by law enforcing agencies or the joint forces. This is bound to create shortages in rural areas in the near future, and will hurt poorer rural consumers. In any case, the market has a tendency to serve those who can pay higher prices, mostly in urban areas. The effort should be to counteract this, and not make things worse.

The general perception of consumers (interviewed on television) is also that prices are being kept artificially high through manipulation by traders, because they see enough goods in stores, and no shortages. However, the current stock does not tell us about the future shortage, and traders are in a much better position to know this and will, thus, raise prices accordingly. These are, therefore, normal market signals, which should be taken into account in determining overall food availability and import requirements.

The other complaint which has been commonly expressed is against middlemen, the "farias" and "beparis." The fact that it is simply a prejudice has been realised by the BDR, entrusted with the job of bringing down prices, soon enough. They have come up with statements to the effect that these categories of middlemen are poor people and not that powerful. It is true that the market structure in many developing countries is such that there are many stages from the farm to the final consumer. Farmers, therefore, often do not get a "fair" price, the profits being shared by traders at different stages.

On the other hand, these traders serve an important purpose. Without them it would not be possible for farmers or other producers and importers to directly market their products. Alternative supply chains can be designed, with a greater stake for producers and farmers, but this cannot be done in an ad-hoc manner. Simply harassing "farias" and "beparis" will disrupt the supply chain and lead to shortages in the market. It should also be recognised that the market is much more integrated these days, with the revolution in communications brought about by mobile phones.

The market mechanism is, thus, complex, and policies should be rational, understanding fully this market mechanism. Economic policies cannot be based on common perceptions.

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