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THE FUTURE ROLE OF MARKETS, PRICES AND POLICY IN THE WORLD FOOD ECONOMY

by

A.F. McCALLA*

1 Introduction

It is an honor and a challenge to be invited by your Association to address the broad, complex and challenging topic assigned me. I want to share with you today some thoughts that are emerging from my experience at the World Bank, which are clearly different than those I used to have in the cloistered environment of a University.

Compared to 1986, -- just 10 years ago, and at the time of the beginning of the 8th Round (Uruguay Round) of GATT negotiations,-- the nature, magnitude and persuasiveness of governments intervention in agriculture, both nationally and internationally is vastly changed. As I shall argue, the degree of liberalization has been substantial but still in many countries agriculture remains the most distorted sector of all. We have come some distance but there remains a long way to go.

There is now an international agreement under the World Trade Organization (WTO) that for the first time in fifty years brings agricultural trade under the rules of GATT/WTO. While the degree of liberalization under the new rules may be far less than was hoped for, nevertheless we are moving in the right direction and are scheduled for further negotiations starting in 1999.

Most of the changes in national policies are increasing the importance of markets and market generated prices, both nationally and internationally, in terms of resource allocation and the distribution of income. Concomitantly, the role of government is changing and in many cases is diminished. True, nowhere has government withdrawn completely from involvement in the food and agriculture sector. Not even in New Zealand, often touted as a liberalized agriculture, is the government completely removed, as statutory Marketing Boards continue (Jacobsen, Scobie and Duncan). Nevertheless, significant changes are occurring which could fundamentally alter the nature of domestic policy choice in an open economy setting. More relevant for us as professional agricultural economists, it will force us to change the nature of our analysis and the focus of our empirical work.

It is this set of issues I wish to address today. I want to do so because all too often we observe day-to-day and year-to-year changes and fail to see the cumulative impact of changes over the longer term. Specifically, I want to do three things. <u>First,</u> give you a global perspective on the nature of the changes that are happening. <u>Second,</u> discuss the impact of these changes on the nature of the policy options open to governments and <u>third</u>, discuss how these changes should change the way we do policy analysis.

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2 The Changing Landscape of Food and Agricultural Policy

2.1 International Changes

The Uruguay Round agreement in agriculture has been rightly criticized for its modest progress in reducing trade distortions in agriculture. But in my view, the far more significant outcome was to bring agriculture under the rules of the WTO. Limits on domestic support and export subsidies, and tariffication means that in the future, governments are constrained from increasing protection and are committed to move towards sustained liberalization. The next challenge will be the 1999-2000 special consultation on agriculture to see whether, having broken through the rules barrier, countries will begin to break down the protectionist barriers that still abound.

The single most important part of the agreement is tariffication, because it forces domestic prices to be indexed in some sense to world prices. Also because tariffication enhances transparency because it makes protection explicit in a single indicator and easy to understand. This changes the nature of the national policy debate profoundly. Specific sectors asking for protection have to defend their case against other sectors. We have focused too much on the obscene levels of tariffs set in some countries (as did my Canadian countrymen on dairy) and failed to recognize that, with tariffs, the price transmission elasticity is no longer zero. How successful 1999 will turn out will likely be influenced by the situation in world markets. Continued high prices (erroneously attributed to GATT) should embolden exporters to further dismantle intervention but of course will frighten importers. Low prices would have the opposite effect. Increased price instability will worry both.

2.2 Latin America

Compared to 10 years ago many changes have occurred in many Latin American countries. Following the lead of Chile, Mexico, Brazil, Colombia, Peru, Argentina, El Salvador, Uruguay and even Bolivia have fundamentally altered their policy regimes. General liberalization, more open borders, flexible exchange rates and some attempts to control inflation through monetary and fiscal restraints have caught agriculture up in the process. General liberalization has significantly reduced the implicit taxes on agriculture of overvalued exchange rates and industrial protection while more open borders have exposed the sector to international competition. In Mexico, CONASUPO is almost gone, the Ejido system is changed and internal prices more reflect international prices. Colombia and Peru are embarked on major liberalization. The formation of MERCOSUR has caused changes in policies in Brazil, Argentina, Uruguay and Paraguay. While there are continuing pressures to backslide, nevertheless the outcome is a more market oriented agriculture, with a less pervasive role of government and prices more reflective of international markets

2.3 Asia

While less liberalization has occurred in Asia, there are beginning signs. Indonesia has liberalized much of agriculture. BULOG is no longer all pervasive though it is still involved in rice and imports of soybeans, sugar and wheat. The Philippines and Thailand are making some efforts to review traditional policy frameworks. India has embarked on a significant program of general economic reform which is opening and liberalizing the economy. They seem poised to take on the agricultural sector, which arguably is one of the more protected in the world. China has sustained internal reforms over the decade and now seems more comfortable with a more open international role. Taiwan, Korea and Japan remain staunch protectionists, although the Uruguay Agreement made some chinks in their armor.

2.4 Eastern Europe and the Former Soviet Union

This region has seen phenomenal changes in the last decade - politically, economically and socially. Agriculture has not been immune to these changes though the progress varies greatly by country. In many countries fiscal realities have greatly reduced subsidies and moved prices toward border parity. One problem is that this is occurring more rapidly for product prices than for input prices. Some countries such as the Baltics (especially Latvia), The Czech Republic, Hungary and Poland have moved significantly to privatize and increase the rule of the market. However, many of these countries yearn for EU accession and seem more eager to adopt interventionist EU policies than more market oriented approaches. Russia has now a very open foreign trade regime in agriculture with relatively low tariffs and practically no quantitative restrictions. It will be a long time before these countries are fully integrated in to world markets. Nevertheless compared to pre 1989, it is a very different and generally more open landscape .

2.5 The Middle East and North Africa

On the surface there is less change in this region. However, despite their best efforts to expand agricultural production, they continue to grow more dependent on international markets. There also are growing aspirations to expand specialty agricultural exports. Policy reform is less obvious, except possibly in Egypt, but some rumblings for reconsidering agricultural policy are clearly there, driven perhaps more by acute water constraints than by an inherent commitment to a liberalized agriculture.

2.6 Sub-Saharan Africa

As usual it is impossible to generalize about 50 plus very heterogeneous entities. It would be hard to argue that there is anything like the regional momentum for change that can be identified in Latin America. Africa remains the region where agriculture is the dominant industry and the region where its performance has been the weakest. My sense is that there is a growing recognition that pervasive government intervention and central planning has not worked. But breaking out of that mold has been difficult. The region also has more than its share of political instability, civil unrest and anarchy.

Nevertheless, what signs there are, are positive. Significant liberalization of parastatal marketing regimes has occurred in parts of West Africa, helped by the devaluation of the CFA franc. Progress in policy reform is well advanced in countries like Uganda and Malawi, where freeing the agriculture sector to respond to market signals is a high priority.

2.7 OECD Countries

I will say little here as you know as well as I do what has been happening. Australia and particularly New Zealand have significantly liberalized policy. The EU, with MacSharry reform, has basically decoupled support entitlements from production decisions and the Freedom to Farm Act in the United States has for the next seven years decoupled more completely U.S. support payments from production decisions. Current high prices have ended export subsidy payments but they could return. However, they would be under WTO discipline. Overall the developed countries are intervening less and border barriers though still high in some cases are beginning to weaken. Certainly the rhetoric for further reform is stronger in both Europe and North America. I do not believe there will be retrogression and prospects for further liberalization are real.

3 The Changing Nature of Policy Choice

The summary of the just completed selective whirlwind tour of world agriculture must be that the landscape, both nationally and internationally, has changed and has the potential to change even more (Valdés and McCalla). Several long standing characteristics of agriculture policy seem to be eroding. First, the generalization has been that rich countries subsidize farmers and tax consumers indirectly (through the price system) or directly (through the tax system) is being adjusted by shifting to direct payments and generally lowering the level of support. By not using the price system, rich countries have less need to manage the border and engage in world market distorting export subsidies. Second, the parallel adage that developing and centrally planned countries tax farmers and subsidize urban consumers is also changing. The incidence of indirect taxation, written about so forcefully by Schiff and Valdés through overvalued exchange rates and industrial protection, is lessening in many countries and extensive consumer subsidization via forced requisition, consumer subsidies and administered prices has fallen prey to economic liberalization and fiscal reality. In both cases market prices, with an international reference, are playing increasing roles in influencing farmer decisions.

Third, the implicit or explicit paradigm of food self-sufficiency, so pervasive in the developing world, is weakening. Such policies are down but not yet out. Food self-sufficiency models brought with them other non-liberal dimensions. Countries acted as if they were isolated from the world, choosing domestic policies for domestic reasons and then managing to border instruments to prevent world developments from upsetting their domestic goals. Further, there was a conventional wisdom that governments, often through parastatals, were more equitable in managing marketing, processing and distribution than were private firms. This approach fostered monopolistic inefficiency and endless opportunities for rent seeking. Finally, self-sufficiency policies lead to resource use inefficiency and lower farmer incomes.

In all countries, as soon as one moves from inward looking, isolationist and protectionist policies towards a more open market driven model, the conceptual framework for policy choice must also change. The old model of setting domestic price and income goals and managing supply and/or the border to accomplish them must be turned on it head so that now domestic policy options are conditioned by WTO rules and world market developments. It is like switching from a system of fixed exchange rates to flexible exchange rates.

This change in paradigm also has implications for world market price stability. The prevailing model allowed countries to dump their domestic instability onto world markets and to prevent, through quantitative restrictions, the import of instability (MCCALLA and JOSLING). This destabilized international markets by making excess supply and demand function very unrealistic. Now to the extent that domestic producers and consumers are exposed to international price fluctuations, world market price must be more stable as more and more economic actors are adjusting to price changes.

But say my friends in liberalizing economies, our domestic price instability has increased, so how can you argue international markets should be more stable? The anomaly is that both could be true. Many governments so managed the domestic agriculture sector through, among other things, administered (therefore stable), guaranteed or fixed (but distorted) price regimes such that domestic prices changed infrequently. The introduction of market forces, with accompanying price variability, means domestic farmers and consumers have to adjust constantly to changing prices where as before they reacted to administered prices. (This very fact of adjustment is what will lead to increased overall stability in international markets.)

Therefore, the traditional elements of what was called agricultural policy surely must change. A schemic policy pyramid helps me make my point (see Figure 1). In many developing countries, agriculture policy, as operated by the Ministry of Agriculture was focused mainly on production and sometimes on marketing - inputs, research and extension and marketing. Policy with respect to prices, trade and food distribution were made elsewhere. Concerns with rural development and natural resource management were also made elsewhere. The consequences was that policies were fragmented, interventionist and inward-looking. They involved public enterprises, parastatals, subsidies, taxes, rule setting, and state management.

Under a new more liberal regime surely this model must change. To the extent that agricultural liberalization is part of a broader liberalization policy, the number of variables that influence food and agricultural decisions increases - interest rates (no more subsidized credit), exchange rates, taxation and fiscal policy, trade policy and international market prices. In fact, it might be argued that successful reforms in agriculture are always part of broader, economy-wide reforms which include trade liberalization, deregulation and privatization. Thus, the environment for decision making at the farm and market level becomes much more fluid and complex. It will put a higher premium on access to information and the capacity to adjust products and inputs. At the country level the decision options, in an open economy are both constrained and simplified. For example, countries wishing to pursue domestic price stabilization policies are severely constrained under WTO rules.

In such a setting, one could contemplate a radically different policy scenario. Figure 2 represents a schematic for conceptualizing how a country could think about its food and agriculture strategy at the national level. All elements should be included - commercial demand, needs for food safety nets and nutrition intervention, domestic production, imports supply potential and international markets as an export opportunity. I submit that few countries and fewer agricultural economists start their approach to policy by thinking in terms of a broad economy-wide food and agricultural strategy.

A second step in re-thinking the policy scenario would be to begin with a clean slate and ask what are the appropriate roles for government rather than the traditional way of starting with the current policy set and tinkering with a bewildering array of often conflicting instruments, that represent a historical accumulation of past policies from different eras. If we begin from the assumption that the goal of Food and Agricultural Policy should be "<u>To provide access to a stable, affordable and nutritional food supply for all citizens</u>", the next step would be to conceptualize the strategy as outlined in Figure 2. The third step would be to identify the areas where government intervention is appropriate. I propose that the following list is a good beginning .

	<u>Role</u>	**<u>Possible Focus / Instruments</u>**
1.	Providing public goods	infrastructure, some research and development, information, education, health
2.	Provide the framework for managing common property/multiple use resources	regulation, taxes and subsidies, public sector ownership
3.	Managing externalities	rules, regulations, enforcement, incentives
4.	Rural safety net	non-farm employment, food stamps, health, training
5.	Adjustment assistance	technical assistance, time-bound subsidies,

		temporary protection
6.	Rules of the game	legal framework, regulatory framework, market monitoring, anti-monopoly, information

Starting from these precepts, one could then ask what are the appropriate instruments given our overall objectives. My proposition is that under this framework, few of the widely used interventions in agriculture would survive. I know it is unrealistic to think that vested agricultural, marketing and consumer interests will willingly give their long-standing access to the public purse for a simplified, open economy, market oriented approach. But as a minimum, we should at least ask whether any future proposed policy changes would be on the new policy agenda. This could help to begin to weed out grossly interventionist policies and move us toward a more market oriented policy.

4 Implications for Policy Analysis

First, our conceptual framework must be broadened to address the food, agriculture and rural sector as a whole entity. Agricultural policy is not just about production, and food policy is not just about public food distribution. This new conceptual framework must be developed in a market oriented, open economy setting. This requires us to be cognizant of linkages between the food and agricultural sector and the rest of the economy and international markets.

The implications of this for our professional capacities are substantial. Underpinning our analysis must be a fundamental understanding of open-economy macroeconomics. In a liberalized economy, macro prices -- interest rates, exchange rates and the inflation rates-- will likely have more to do with success in the sector than will specific interventions. We need to understand the linkages. An open economy approach requires us to explore comparative advantage in the context of international variables -- capital flows, exchange rates and world prices -- and to evaluate our economic activities against alternative sources of supply and export opportunities. Two years experience in the Bank convinces me that traditional agricultural economists, with their strong micro focus and who understand the sector, are left out of the policy dialogue because they are functionally illiterate in macro and international economics. Thus in interaction with our macro and trade brethren we cannot talk their language or understand their concerns. Many years ago, a professor of mine recommended that I should study the "economics of agriculture", not "agricultural economics". He was making precisely this point. It is the difference between studying agriculture as a part of the broader economy and looking at the sector as a water tight compartment.

The implications for the kind of policy analysis we do is also significant. Much agricultural policy analysis is commodity specific and involves comparing the current or proposed intervention to a perfect market. Linkages to input markets or related commodity markets are infrequent and linkages to the rest of the economy are almost non-existent. We are very partial equilibrium in our approach and rush to build sophisticated empirical models before we have properly defined the problem.

What we need to do is take a more general equilibrium conceptual approach. This is not a call for jumping on the Computable General Equilibrium (CGE) model bandwagon. These models often treat markets outside of agriculture with such naiveté as to make their results questionable. It is however a call for us to think in general equilibrium terms as we develop our analysis in a much broader framework which recognizes macroeconomic, intersectoral and international linkages.

Concepts from resource and welfare economics dealing with externalities, common property resources and time will require greater application as we move towards a role for government

which focuses on public goods and providing an enabling policy and institutional environment rather than on intervention, price fixing and border restrictions.
Within that framework, it is our role as analysts to do our work within a realistic and comprehensive framework which reflects the potential realities of the future we are attempting to analyze. It is our job to provide policy makers with an analysis of the consequences of alternative policy choices. If the evolution of the food and agriculture policy environment continues to move in the direction I have suggested, i.e. towards a more liberal, open economy market driven model, then our analysis must be able to capture conceptually and empirically that potential reality. If our results are to have credibility and influence in the policy process we must be able to demonstrate the resource allocation and income distribution consequences of possible future directions.

Agriculture, particularly in developed countries, has been subject to multiple and deep intervention for more than 50 years. Distortions create opportunities for rent seeking and bureaucratic power. Many in the sector have a vested interest in continuing business as usual. Our job is to demonstrate the consequences of these multiple interventions and to explore the benefits and costs of a different system. It is no longer going to be enough to look at a specific policy dealing with a specific commodity.

I recently participated in another debate over the value of the Canadian Wheat Board. One study purported to show that wheat farmers benefited from single desk selling (the capacity to price discriminate). The other argued, quite ad hocly, that the distortions caused by the Wheat Board cost prairie farmers a lot. They used different analytical frameworks, different data sets and addressed non-comparable questions. Thus both could have been right or more probably, both could have been wrong. Neither was addressing the appropriate question - what are the costs and benefits to Canadian grain farmers of a highly intervened sector. Because the Canadian Wheat Board is but one among many interventions which include the regulation of transportation, control of varieties to be grown, constraints on competition in marketing and handling grain, stringent border controls, various subsidies and taxes, and so on.

In the absence of good economic analysis, changes will occur because of political power struggles without the benefit of analysis of potential consequences. If, as this analysis suggests, many economies are moving more and more towards a policy framework based on rules, rather than on discretion, then surely we must be ready to provide analysis of a truly liberalized food and agriculture sector. For if we cannot, the world just may pass us by.

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