SM/08/182
Correction 1

June 27, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Food and Fuel Prices—Recent Developments, Macroeconomic Impact, and Policy Responses**

The attached corrections to SM/08/182 (6/19/08) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 21, para. 27, line 14: "Ghana" removed

Page 21, text figure: "Ghana" removed
source line added to read "Source: 2006 World Development Indicators, World Bank"

Questions may be referred to Mr. Helbling, RES (ext. 36051), Ms. Alonso-Gamo, PDR (ext. 38375), and Mr. Gillingham, FAD (ext. 36359).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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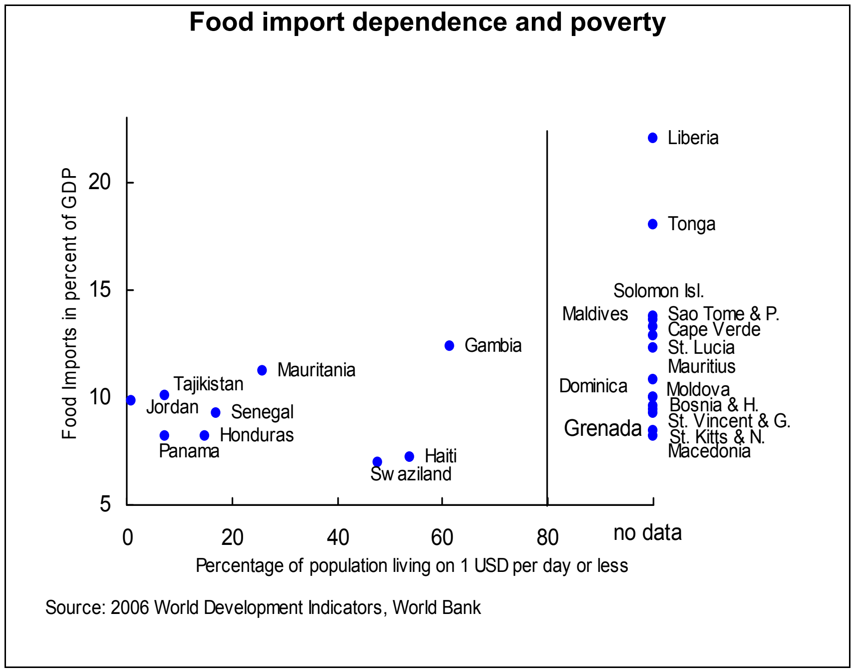
Department Heads

26. **Within countries, the urban poor are the most affected by high food and fuel prices, as the rural poor are more likely to be at least partially self-sufficient in food supplies.** Low-income households are least able to protect their income from inflation, but domestic distributional issues are important in analyzing the most vulnerable groups, not only to higher inflation, but equally as important, to changes in relative prices. The urban poor, together with food-deficit farmers, are the worst affected by food price inflation, because they rely on food purchases for their food supply. Although better protected, even food-surplus farmers may not benefit from the food price surge, as the pass-through of higher input costs (fuel, fertilizer, and transportation) is often faster than that of world market prices for food. Finally, the share of undernourished could rise rapidly above the current 40 percent of total population in developing countries.

27. **High import dependence combined with a high incidence of poverty makes countries more vulnerable to rising food prices.** Low quality data, especially for the most affected poor small countries, make an assessment of the poverty impact difficult. From current estimates, it appears that the Gambia, Swaziland, Mauritania, ~~Ghana,~~ and Haiti are among the countries with most severe poverty impact of food import price increases.



IV. Countries' Policy Responses

28. **The countries most vulnerable to the higher international food and fuel prices typically face a menu of options that is constrained by their limited access to foreign financing, low reserve cushions, or high external or public debt burdens.** External financing that could help the private or public sectors cushion their adjustment may be limited. And central bank credibility can be lower in some of these countries, necessitating extra caution in monetary policy. Therefore, to the extent donors are not providing more aid to alleviate balance of payments pressures, these countries will have little choice but to gear their macroeconomic policies to facilitating the economy's rapid adjustment to the terms of trade shock, through a combination of price adjustment—involving real depreciation and pass-through of world market prices—and fiscal adjustment to offset the higher fiscal costs.

A. The Nature and Cost of Fiscal Responses to Higher Food and Fuel Prices

29. **Increasing world prices for fuel and food products present a difficult policy challenge for governments**. Passing these price increases on to consumers results in a decrease in real incomes for households, especially poor households. On the other hand, passing through the higher prices encourages producers to increase supply and consumers to decrease demand, thus either reducing the adverse impact on the current account balance of net importing countries or increasing the gains to net exporting countries. Without the increases in supply and reductions in demand engendered by full pass-through of world prices, the upward pressure on world prices will be exacerbated. Moreover, less than full pass-through results in fiscal costs that require offsetting measures or additional donor support and can potentially reverse key fiscal and structural reforms. The policy challenge is largest for countries that must rely on imports for food and fuel.

30. **The policy challenge is to ensure that economic efficiency and stability are maintained while at the same time protecting vulnerable population groups.** The best option in the longer term is to develop a well-targeted social safety net that can protect vulnerable households in the face of rising prices. However, the design and implementation of such a program is itself a challenge, and countries have had to resort to less direct policy measures to mitigate the adverse effects of recent price increases.

Changes in Fuel Taxes and Subsidies

31. **This sub-section focuses on tax rate reductions and subsidy increases implemented in response to recent price increases in petroleum products.** The analysis is complicated, however, by the fact that countries use a variety of methods to set fuel prices. It is straightforward to measure changes in taxes and subsidies in countries where petroleum product markets are liberalized or in which prices are set according to rigorously applied formula. In many countries, however, prices are controlled, or price formulas, even though they exist, are ignored. This makes it difficult to sort out the level of price distortion, tax preferences, and subsidies.

32. **Pricing regimes largely explain the degree to which world prices are passed through to local markets.** Liberalized and automatic fuel pricing mechanisms are associated with the highest level of retail fuel prices and price pass-through. In 2007, average retail fuel prices in countries with liberalized and automatic pricing mechanisms were about 25 percent higher than in countries that adjusted prices on an ad hoc basis. In addition, these countries had an average pass-through of international prices between 2003 and the end of 2007 of 121 percent, as compared with 75 percent for countries with ad hoc pricing mechanisms.[11]
Oil importers are more likely to have liberalized pricing regimes than oil exporters, which

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[11] See T. Baig, et al., "Domestic Petroleum Product Prices and Subsidies: Recent Developments and Reform Strategies," IMF Working Paper 07/71 for a detailed discussion of methodology and results.