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THE CHALLENGES OF HIGH FOOD AND FUEL PRICES

Paper for the Commonwealth Secretariat*

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London SW1Y 5HX

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THE CHALLENGES OF HIGH FOOD AND FUEL PRICES

Poverty Reduction and Economic Management (PREM) Network

THE WORLD BANK



THE CHALLENGES OF HIGH FOOD AND FUEL PRICES¹

¹ This paper is a product of the Poverty Reduction and Economic Management (PREM) Network of the World Bank. It relies extensively on inputs from other networks and regional units of the World Bank (see references).

1. Introduction

Twenty-five of the Commonwealth of Nations member states have populations below 1.5 million people, the threshold usually adopted to define small states; and six are fragile states, defined by the World Bank as states with weak institutions and policies (see Appendix).^{2 3}

The economy of these states, especially the smaller ones, is intricately associated with the expansion of world trade in goods, services and factors of production. They benefit from imports and exports, from open migration policies, and sometimes from outsourcing some government functions to regional organizations. But they suffer disproportionately when the expansion of world trade is at risk and when uncertainty is high.

It is therefore timely to examine how small and fragile states are being affected by current events in international markets: with prices of food, oil and other commodities rising steeply first and falling rapidly lately, with inflation expectations increasing worldwide, and financial risks rising exponentially.

The increase in the price of oil and food carry major adverse poverty and macroeconomic implications especially for fragile and small states and for low income households in all developing countries. In terms of their impact on income distribution, inflation, and poverty food prices are of greater and more immediate concern than high fuel prices. However, the impact of the oil price increase on economic growth is likely to be negative and the challenge of crafting appropriate policy responses to the food crisis is made much harder in a context of rising oil prices and ensuing fiscal and balance of payments pressures.

The feasibility of programs to ameliorate the impact of such adverse change of the terms of trade depends on the magnitude and duration of the shock, on government's capacity to finance the cost of buffer programs designed to smooth the effects of the price shock, and – in many cases -- on the availability of aid. For several small and fragile states the estimated size of the adverse terms of trade shock is high and their capacity to adapt to the new adverse terms of trade is limited. In fact, the small size of their domestic markets does not facilitate the reallocation of resources away from energy-intensive goods and services and into other activities in the short- and medium-term; and low *debt headroom* is an obstacle to maneuver on the macroeconomic front.⁴

This paper describes what has happened to fuel and oil prices over the past two years and links these developments to the macro-economic international context. It goes on to describe the consequences of the oil and food price increase for developing countries and especially for

Questions/comments should be directed to C. Braga (cbraga@worldbank.org) and E. Favaro (efavaro@worldbank.org).

² The Commonwealth of Nations is an association of fifty-three sovereign states of Africa, the Americas, Asia, Europe and the Pacific.

³ Fragile states are defined at the World Bank as countries with a Country Policy and Institutions Assessment (CPIA) below 3.2 (in a scale of 1 to 6).

⁴ The *debt headroom* is the maximum increase in debt that a country can withstand before reaching the indicative Low Income Country (LIC) Debt Sustainability framework (DSF) threshold for countries considered to display “weak” policy frameworks.

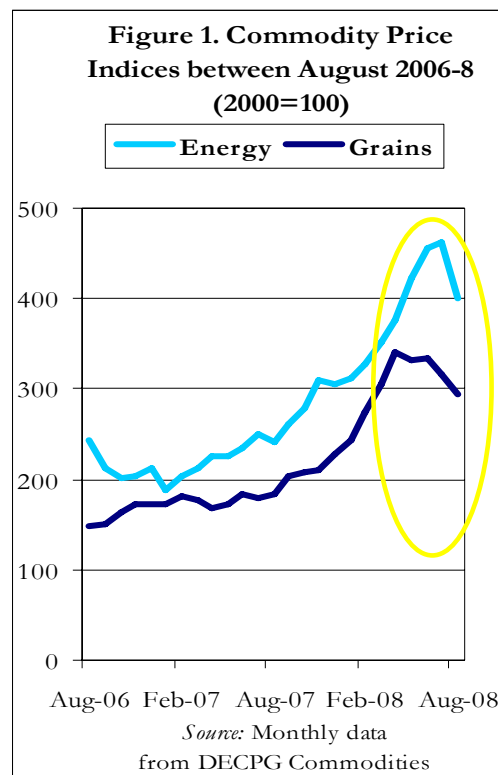
fragile and small states in the Commonwealth. The paper also discusses policy instruments that may contribute to ameliorate the impact of the changes. Finally, it describes how the World Bank can support countries' efforts in addressing these price shocks.

2. Food and Oil Prices in 2007-2008

The price of food and oil increased steadily since 2004 and the rate of increase accelerated in 2007-2008.

Grain prices more than doubled between January 2006 and June 2008, with over 60 percent of the rise occurring since January 2008 (Figure 1); and while they fell in July-September 2008, they are likely to remain above 2004 levels over the medium-term even though a positive supply response is likely to contribute to moderate the path of future food prices.

The rapid growth of the world economy in recent years strained capacity of oil markets, resulting in an unprecedented price rise. Since 2001, the price of oil rose from \$20 per barrel to about \$148 in July 2008, but declined by about 34 percent since then. The run-up in oil prices was driven initially by a demand-driven tightening of market balances, but more recently has been further fueled by a combination of supply concerns and macroeconomic factors. Market tightness is expected to persist because of a sluggish supply response. Projections indicate that although demand pressures will ease as global GDP growth slows, oil prices will drop only modestly over the next two years. Oil prices are also likely to remain volatile, due to a combination of low stocks, limited spare capacity, supply disruptions, and uncertainty over exploiting new reserves and the development of non-oil sources.



Underlying factors contributing to rising food grain prices include high energy and fertilizer prices; the continuing depreciation of the US dollar; sharply increased use of both cereals and vegetable oils in bio-fuel production; and declining global stocks of food grains due to changes to buffer stock policies in the US and the European Union.⁵ Back-to-back droughts in Australia and growing global demand for grains (excluding the growth in demand associated with bio-fuel production) have been modest contributors and on their own would not have led to large price increases.⁶

⁵ Among these, a key factor was the large increase in bio-fuels production in the US and EU in response to policies that subsidized production of bio-fuels, restricted their imports, and mandated their use.

⁶ Global grain demand (excluding bio-fuels) increased by 1.3% per year between 2000 and 2007 and in East Asia (including China) increased by only 0.3% annually during this period. The switch from basic staples as incomes have risen and the greater efficiency of livestock feeding has contributed to this slow growth in demand. Droughts in Australia have reduced exports by around 10 million tons of grains in 2006 and 2007, equivalent to about 4% of global grain exports. For more details see World Bank (2008a).

Underlying factors contributing to the rising price of oil have been a steady increase in world demand and sluggish changes in global supply. The prolonged and rapid expansion of China, India and other developing economies has exerted upward pressure on world demand for energy. This pressure has not been met by an equally rapid expansion of supply and output. Factors explaining the sluggish supply response are: the depletion of existing oil fields, regulatory constraints to open new fields in some regions, and low investment in expanding capacity in oil exporting countries.⁷

But the steep increase in oil food and other commodity prices in the first half of 2008 and the equally sharp fall during the past three months are indicative of the sensitivity of prices of goods with inelastic supply to factors such as expectations of inflation and market uncertainty. It also illustrates how expectations, financial liquidity and interest rates may have a large impact in the formation of prices, even though their influence is likely to be more relevant in the short- than in the medium-term.

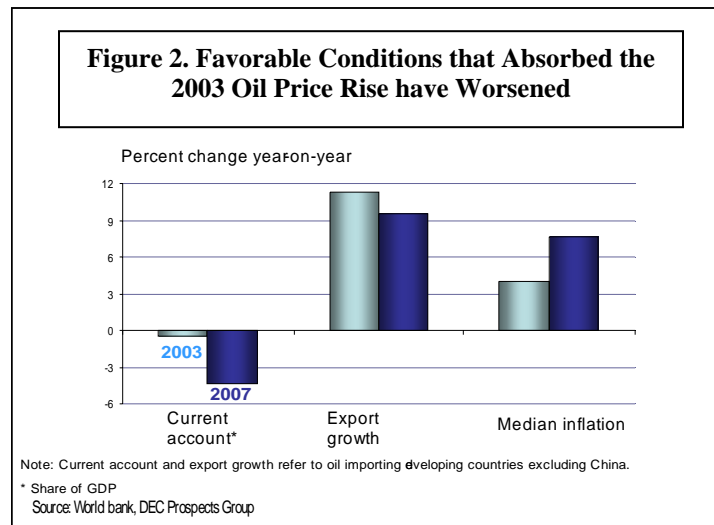
It is premature to quantify the part of the price increase explained by fundamentals (supply and demand) and the part explained by macroeconomic factors. However, the distinction between the two types of causal factors is important from a policy perspective: a change in prices caused by macroeconomic forces such as inflationary expectations, interest rates, etc. is likely to have transitory effects; a change in prices caused by changes in fundamentals is likely to have permanent effects. If the shock is transitory there is a clear case to use fiscal resources to ameliorate the cost of the adjustment; however, if the price increase is permanent the cost of an expenditure smoothing transfer program may be significant and not sustainable over the long-run.

3. Consequences of the Price Increase on Oil and Food Importers

The impact of the price increase on aggregate spending depends on the response of consumers and firms faced with higher prices, on total income, and the capacity to borrow from the rest of the world. The longer the time horizon the more likely is that consumers will substitute away expensive items in the consumer basket for cheaper goods and services and that firms will develop new production methods that save energy costs by using different technologies and by discontinuing production of energy-intensive products. In general, the opportunities to substitute away from oil-intensive sectors will be narrower the smaller the size of the economy and the shorter the time horizon consumers and firms have to adapt to the price changes.

Developing countries are facing the recent surges in food and oil prices in an increasingly fragile macroeconomic context, especially in the poorest countries. Many of the economic buffers that allowed countries to weather the 2003 and 2005 oil price shocks and the initial increase in food prices in 2007 have been depleted. The current account positions of most oil importing developing countries have deteriorated, inflation and interest rates are on the rise – pushed by rising food and oil prices – and both GDP and export growth are slowing (Figure 2). As a result, developing countries – especially those with limited access to financial markets – will be less able to absorb recent price hikes without substantial and painful reductions in consumption, investment and non-oil import spending.

⁷ See, for example, Hamilton (2008).



Terms of Trade Impact. Figure 3 presents an estimate of the impact of the oil and food price increase on the external position of several Commonwealth of Nations member states.⁸ The upper chart portrays the cost of the terms of trade shock (as a percentage of the GDP) for countries with low fiscal capacity following the Country Policy and Institutions Assessment (CPIA) index estimated by the World Bank.⁹ The middle and lower charts portray the cost for countries with moderate and high fiscal capacity to absorb the terms of trade shock. The estimates are upper bounds to the true cost of the price change in that they are calculated maintaining constant the spending shares of food, oil and imports and exports of these items in the GDP. Despite this limitation the estimate provides a useful benchmark to identify countries severely affected by the terms of trade shock and the magnitude of the potential loss.¹⁰

The median of the terms of trade loss as a percentage of the GDP for net importers of oil members of the Commonwealth of Nations is -7.1 percent. This measure is indicative of the magnitude of the required adjustment and the pressure towards depreciation of the real exchange rate these countries are experiencing.

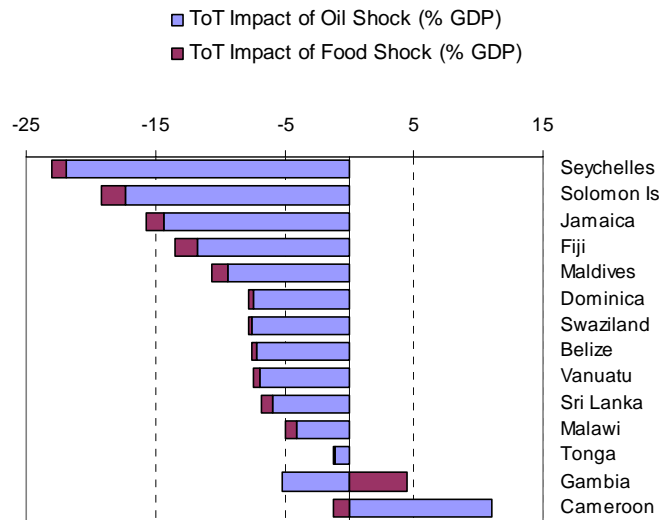
⁸ Food refers to rice, wheat, maize, sorghum, soybeans, groundnuts, and edible oils.

⁹ The CPIA ranks countries on 16 criteria but only two criteria are used here – those related to fiscal policy and debt policy. The ratings are based on the quantitative levels of the fiscal balance and the level of debt, and on the quality of fiscal and debt management institutions. The ratings reflect the situation as of early- to mid-2007, the period before the shocks intensified, and in that sense should be interpreted as proxies for the initial capacity to absorb shocks.

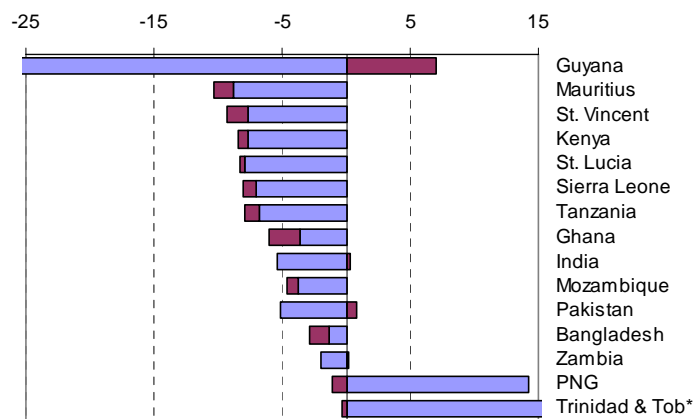
¹⁰ The estimate based on price changes between January 2007 and August 2008 was prepared by the Development Prospects Group (DECPG) of the World Bank. The estimate of the *debt headroom* was prepared by Poverty Reduction and Economic Management of the World Bank.

Figure 3. ToT Shocks and Fiscal Capacity to Absorb Shock

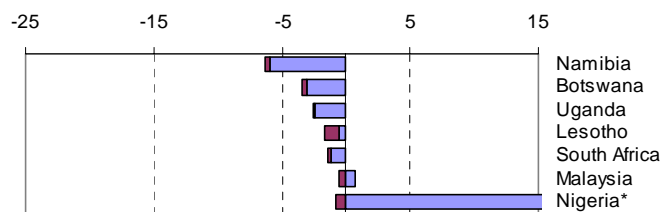
A. Countries with **Low Fiscal Capacity** to absorb ToT shocks



B. Countries with **Moderate Fiscal Capacity** to absorb ToT shocks



C. Countries with **High Fiscal Capacity** to absorb ToT shocks

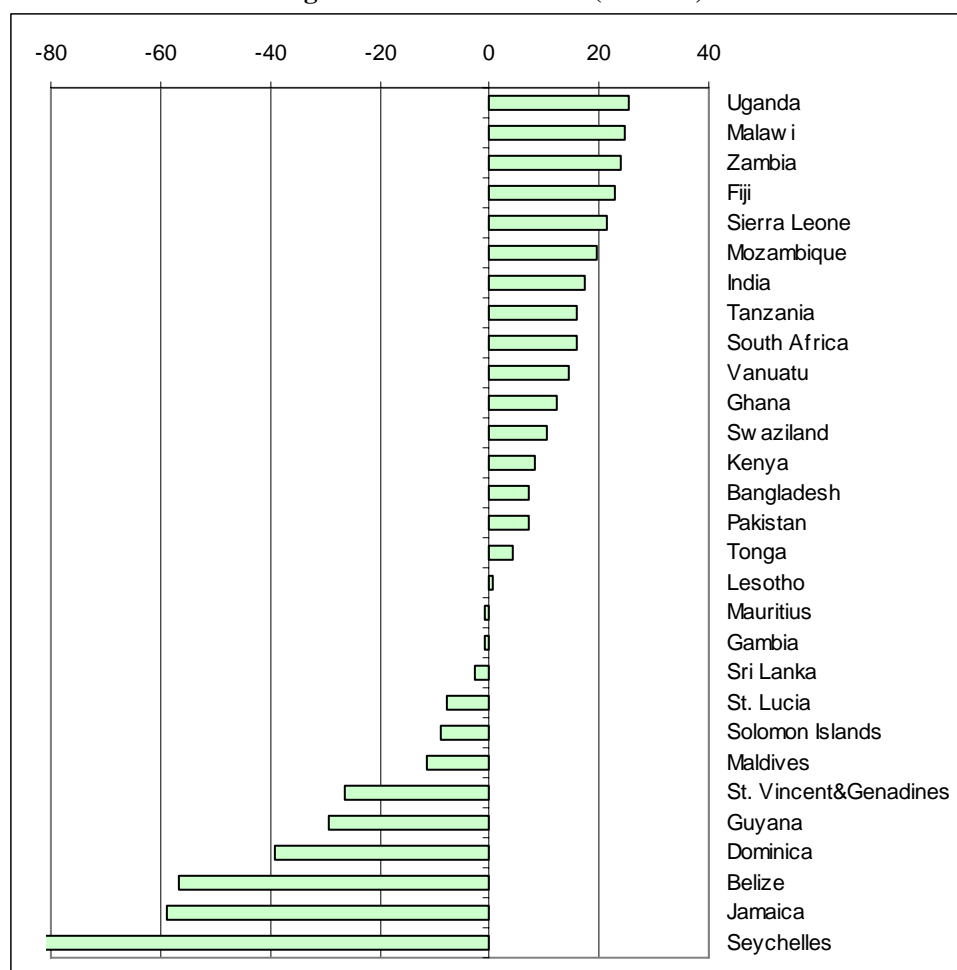


Source: World Bank Development Prospects Group (DECPG)

Notes: Food refers to rice, wheat, maize, sorghum, soybeans, groundnuts, and edible oils.

*For these countries the oil shock has a beneficial impact of greater than 15 percent of GDP.

Figure 4. Debt Headroom (% GDP)



Source: World Bank GDF data, DECPG estimates, and staff calculations.

The Fiscal Deficit and Debt.¹¹ In the medium-term there are four ways to create fiscal space to help finance the costs of the terms of trade shock: (i) improving efficiency in government spending and reallocating expenditures; (ii) raising more revenue; (iii) increasing borrowing; and (iv) aid. However, in the short-term, aid and debt are likely to be the most feasible options.

Figure 4 presents the debt headroom for several members of the Commonwealth of Nations. Negative entries indicate that these countries have virtually exhausted their room to increase borrowing. It is worth noting that several of the countries (at the top of the graph) that show positive headroom have recently received debt relief; in these cases, the measured debt headroom may not properly reflect the capacity of these countries to contract further debt especially on non-concessional terms. All of these countries may require some augmentation in official assistance to deal with the costs of the food and oil price shocks.¹²

¹¹ For further details see World Bank (2008b).

¹² An indicative debt burden threshold of 30 percent of debt-to-GDP was used to determine the degree of headroom, in line with the measure stipulated by the LIC DSF for countries displaying “weak” macroeconomic, fiscal, and debt policy frameworks, as assessed by the World Bank CPIA score.

Income distribution and poverty.¹³ Rising food and energy prices are leading to a substantial redistribution of incomes from consumers to producers and are having significant negative impacts on many individual households, economies, and on global stability. Ivanic and Martin (2008) show that the effects of rising commodity prices on poverty differ considerably between countries and commodities, but that poverty increases are considerably more frequent and larger than poverty reductions. The authors' estimates of the global poverty impact of higher international prices of seven key staples during 2005-07 depends to an extent on assumptions of the extent global prices are passed through to domestic consumers. A pass-through rate of 0.66, for example, translates into a 4.5 percentage point increase in the \$1/day poverty headcount ratio, or an additional 105 million people in poverty in low income countries. This is consistent with other analysis which suggests that higher food prices are likely to have contributed to a 4 percent point increase in the proportion of urban households below the poverty line in developing countries (Dessus et al., 2008) and about 3-5 percent increase in Sub Saharan Africa (Wodon et al., 2008). While overall the number of poor and the depth of poverty have risen due to rising prices, there are countries where these adverse impacts have been muted. For instance a large share of non-tradable staple food items in the Ugandan diet has meant that households have been partially shielded from more expensive maize.

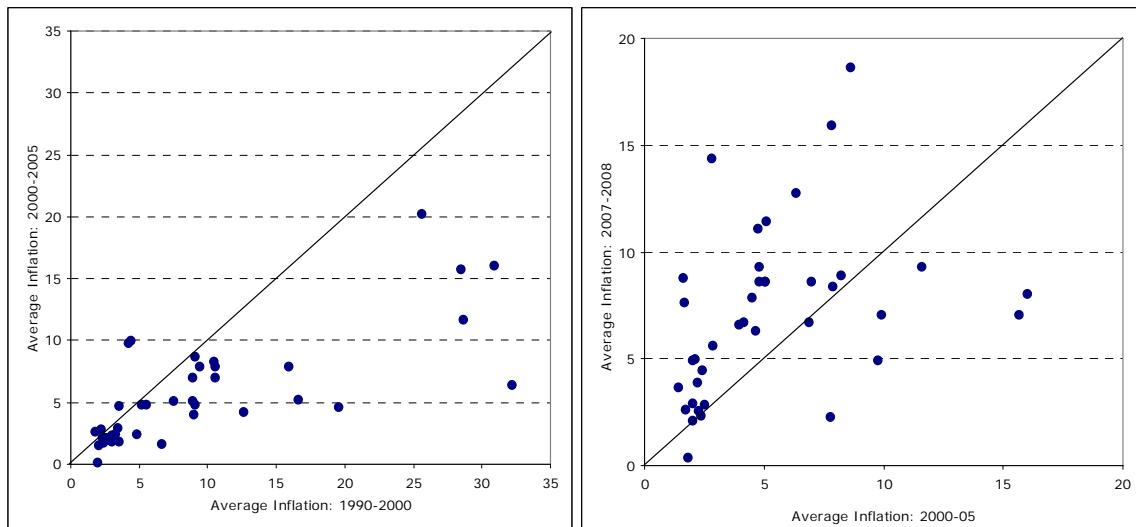
The increase in the number of poor due to the food crisis does not capture the detrimental impact on households who are already poor. Dessus et al. (2008) show that 88 percent of the increase in the depth of poverty in urban areas globally due to the increase in food prices is from poor households becoming poorer and only 12 percent from households falling into poverty. Hence policy responses ought to focus less on identifying the 'new poor' and more on scaling up anti-poverty interventions for the existing poor.

The direct poverty impact of rising oil prices is generally less, since a smaller share of household consumption goes to fuel and energy related products than to food products. However, the impact of oil prices on real wages is likely to be significant as higher energy costs put downward pressure on real wages.

Inflation. Driven by higher global food prices, inflation has been on the rise across developing countries and in Commonwealth member countries (see Figure 5). Median inflation in Commonwealth countries rose from 6.0 in January 2007 to over 9 percent by May 2008. The roots of current inflationary pressures run fairly deep and, barring a world recession, are likely to persist for some years even if commodity prices retreat, as expected, from recent highs. In particular, the risk of second-round effects of higher commodity prices onto wages and price setting more generally is considerable.

¹³ These issues are discussed in further detail in World Bank (2008c).

Figure 5. Commonwealth Countries are Facing a Resurgence of Inflation



Source: Based on IFS data.

Several Commonwealth countries were successful at bringing down inflation in the early 2000s (see first panel of Figure 5 where most countries lie below the 45 degree line). However, these gains in moderating inflation have been threatened in the past two years by the sharp increase in commodity prices and accommodating macro policies (see second panel of Figure 5 where most countries are above the 45 degree line).

Growth. High uncertainty and volatility in financial and commodity markets are likely to feed the ongoing global growth slowdown.¹⁴ In the international trade arena, this uncertainty has been compounded by the difficulties of the Doha Round of multilateral trade negotiations and the trade tensions brought about by the global rise in food prices and the use of export restrictions. The global slowdown will reduce demand for goods and services produced by small states and put pressure on the real exchange rates of these countries to depreciate.¹⁵ Moreover, governments' responses to the price shocks often divert fiscal resources away from growth-enhancing and poverty-reducing investments. This, in turn, may further dim these countries' prospects for sustainable, broad-based growth.

4. Policy Instruments to Ameliorate the Impact of the Price Hike

Oil and food importers face a set of difficult policy challenges: dealing with the redistributive effects of the commodity price shocks, controlling inflation, financing the shock and sustaining

¹⁴ There is a large body of research supporting the existence of a negative correlation between energy prices and measures of the GDP and employment. See, for example, Hamilton (2003).

¹⁵ This note focuses on the impact of price shocks on oil and food - importing developing countries; however, for commodity exporters, and particularly for oil-rich countries, these developments may present an opportunity to convert the "resource curse" into a boom for growth and poverty alleviation. In order to translate this opportunity into reality, however, three main issues need careful attention: the management of the exchange rate consequences of spending out of oil income (the so-called "Dutch Disease" effects), the issue of volatility (oil price volatility, for instance, needs to be managed so that it does not translate into volatile government expenditure patterns) and the pursuit of good governance.

economic growth. Remedies to face these challenges depend on a host of initial conditions: the pre-existent tax and subsidy policy, the availability of fiscal space, the capacity to borrow, and the structure of the economy.

In June 2008, the IMF conducted a survey of 147 countries on the fiscal costs of policy measures undertaken by their governments to deal with the higher fuel and food prices.¹⁶ The most recent update of this survey highlights that in addressing high food prices, tax reduction measures have been more prominent: 57 percent of the countries have reduced food taxes and 18 percent have increased subsidies. In addressing high fuel prices only 27 percent have reduced taxes, while 22 percent of the countries have employed fuel subsidies. Over one-quarter of the countries surveyed spent more on targeted transfer programs in 2008. The total fiscal cost of the measures introduced has been substantial in several countries—over 1 percent of GDP for most of the countries shown in Figure 6, and close and above to 2 points of GDP for half of the countries.

It must be noted that the costs reported in the Fund's survey are actual costs and may underestimate the needs in the countries most severely impacted by higher food and fuel prices, which tend to be poorer on average and where food expenditures are a larger share of GDP. Thus several countries that may just lack the fiscal room to respond, report low or no incremental fiscal costs associated with higher food and fuel prices. On the other hand, oil or gas exporters such as Venezuela, Ecuador, and Turkmenistan are not under equally serious fiscal pressure even though they face high fiscal costs due to their policy responses, which involve untargeted universal subsidies.

Several of the Commonwealth member countries are heavily dependent on ODA flows (see Table 1).¹⁷ While ODA flows in the recent past are an important indicator of the availability of assistance, a focus on current and planned aid is also informative. Looking specifically at programmable aid¹⁸—disbursements available for budget support and projects—reveals that for these highly-vulnerable countries, the planned increase in flows for 2008 (as reported by the OECD in May 2008)¹⁹ will not be sufficient to offset the costs of the combined oil and food shocks (see Figures 3 and 7).²⁰

¹⁶ The survey was updated in September 2008 and it now encompasses information on 161 countries.

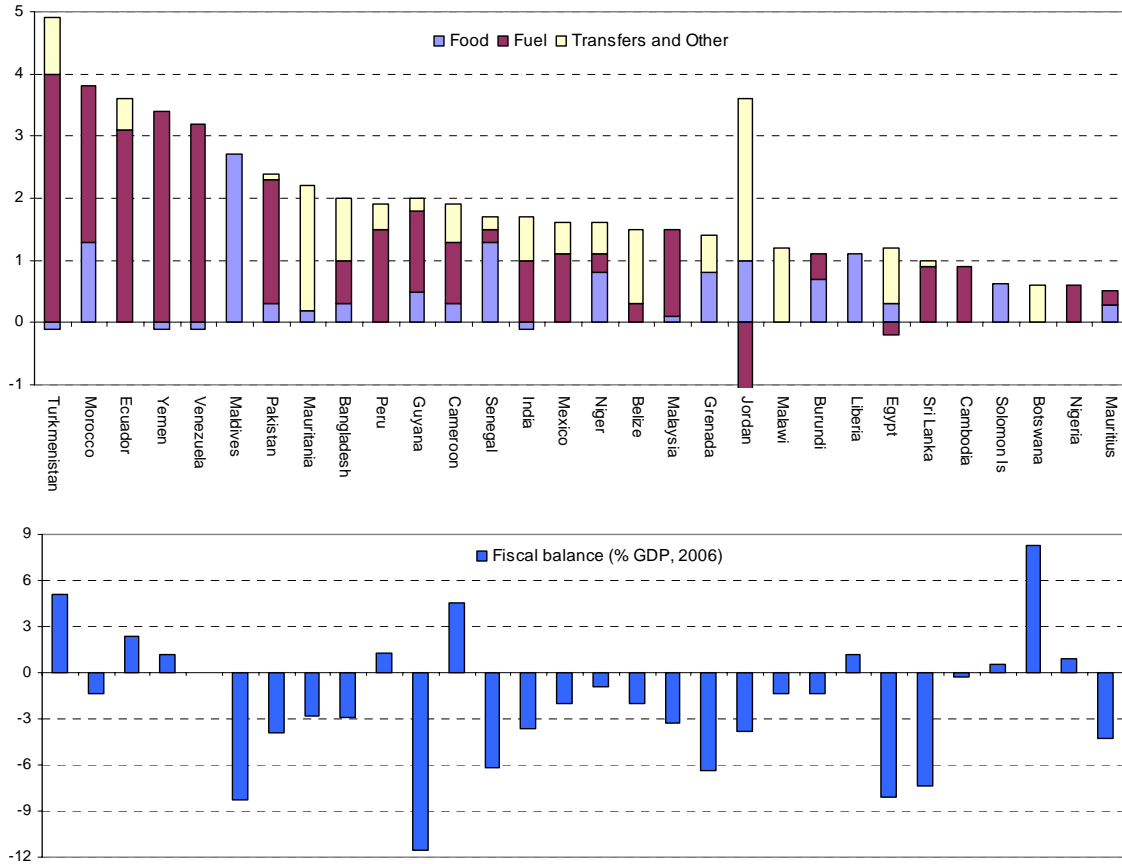
¹⁷ Net official development assistance (ODA) consists of disbursements of loans made on concessional terms (net of repayments of principal) and grants by official agencies of the members of the Development Assistance Committee (DAC), by multilateral institutions, and by non-DAC countries to promote economic development and welfare in countries and territories in the DAC list of ODA recipients. It includes loans with a grant element of at least 25 percent (calculated at a rate of discount of 10 percent).

¹⁸ Programmable aid is defined through exclusion: by subtracting from total ODA aid that is unpredictable by nature (e.g., humanitarian aid, debt forgiveness and reorganization), entails no cross-border flows (e.g., development research in donor country), does not form part of co-operation agreements between governments (e.g., food aid) or is not country programmable by the donor (e.g., core funding to NGOs).

¹⁹ Data on programmable aid is based on OECD surveys regarding planned allocations, as data on actual disbursements is released with a two-year lag. Surveys cover all OECD DAC countries and multilateral agencies, and assume constant flows for USA and Japan, which do not provide this data.

²⁰ OECD (2008) provides estimates for 2008 flows, and planned disbursements for 2008, adjusted for inflation and relative to 2008 GDP.

**Figure 6. Reported Increase in Fiscal Costs since 2006
(Percent of GDP)**



Source: IMF World Economic Outlook database, April 2008 and World Bank staff estimates.

Note: For Jordan, the overall fiscal cost of the policy response was equivalent to 1.3 percent of GDP since 2006. This reflects reduction in fuel subsidies (of 2.4 percent of GDP) that were accompanied by an increase in social transfers (of 2.6 percent of GDP) and an increase in food subsidies combined with food tax rate reductions (a fiscal cost of 1 percent of GDP).

Table 1. Aid Flows as Proportion of GNI

	2003	2004	2005	2006
Antigua	0.7	0.2	0.9	0.4
Bangladesh	2.5	2.4	2.1	1.9
Belize	1.3	0.8	1.2	0.7
Botswana	0.4	0.5	0.5	0.6
Cameroon	6.8	5.0	2.6	9.5
Dominica	4.6	11.5	7.6	6.5
Fiji	2.2	2.4	2.2	1.8
Ghana	12.7	15.8	10.7	9.3
Gambia	18.0	14.5	13.8	16.1
Guyana	12.5	19.8	17.5	20.0
India	0.2	0.1	0.2	0.2
Jamaica	0.1	1.0	0.4	0.4
Kenya	3.5	4.1	4.1	4.1
St. Lucia	2.2	-3.0	1.3	2.1
Sri Lanka	3.6	2.5	4.9	2.9
Lesotho	6.2	5.9	4.0	3.8
Maldives	3.1	3.8	10.6	4.4
Mozambique	23.2	23.0	20.9	26.2
Mauritius	-0.3	0.5	0.5	0.3
Malawi	21.5	19.4	20.5	21.4
Malaysia	0.1	0.3	0.0	0.2
Namibia	3.1	3.0	1.9	2.2
Nigeria	0.5	0.7	6.5	8.4
Pakistan	1.2	1.4	1.5	1.7
Papua New Guinea	7.0	7.5	5.8	5.6
Solomon Islands ²¹	26.6	45.5	66.4	60.5
Sierra Leone	31.5	34.0	29.2	26.3
Swaziland	1.8	0.9	1.8	1.2
Seychelles	1.4	1.6	2.2	1.9
Tonga	16.4	10.1	14.5	9.0
Trinidad and Tobago	0.0	0.0	0.0	0.1
Tanzania	16.8	15.7	10.6	12.9
Uganda	15.9	17.8	13.8	16.8
St. Vincent & Genadines	1.6	2.7	1.1	1.0
Vanuatu	12.3	12.1	11.5	12.4
South Africa	0.4	0.3	0.3	0.3
Zambia	13.9	21.9	13.9	14.4

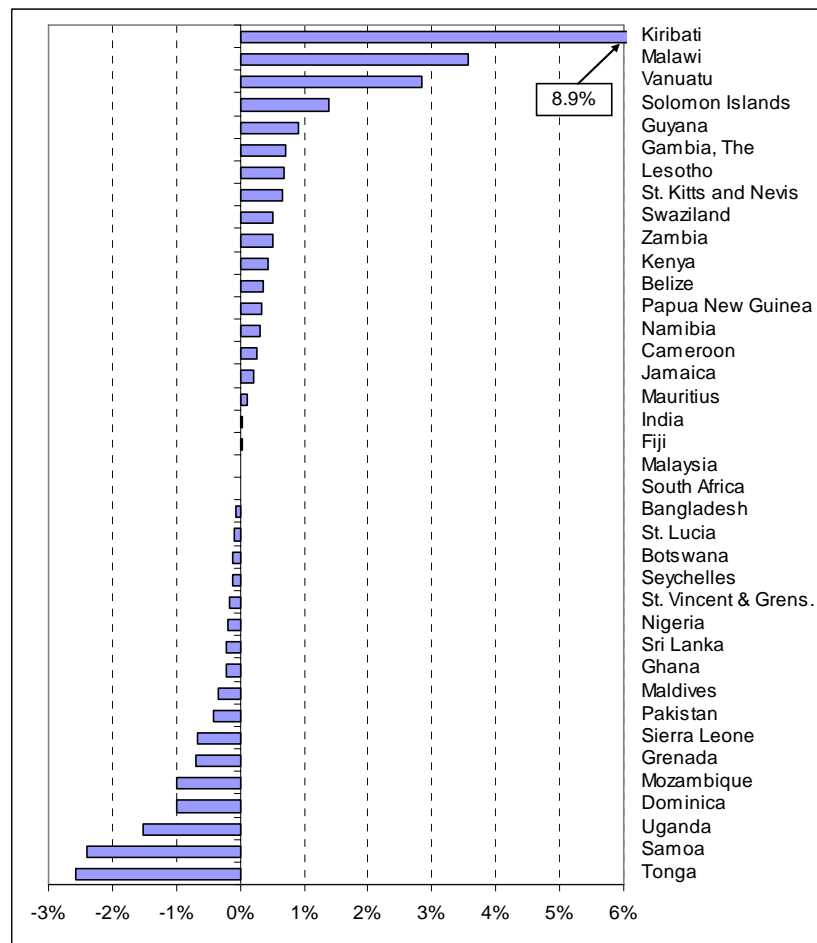
Source: Global Development Finance

Note: Aid or Official Development Assistance consists of net disbursements of loans made on concessional terms and grants by official agencies of the members of the Development Assistance Committee (DAC), by multilateral institutions, and by non-DAC countries to promote economic development.

²¹ The ratio of aid flows to GNI for the Solomon Islands is biased upward by the cost of maintaining an international security and administrative force in the country -- the Regional Assistance Mission to Solomon Islands (RAMSI).

While Figure 7 is based on a preliminary estimate, the fact that it is based on surveys of donor intentions as late as mid-2008 is certainly indicative of the fact that in terms of programmable aid, the response of the donors to countries' additional needs from the price shocks needs close monitoring.

Figure 7. Planned Changes in Programmable Aid (2007-2008 in %GDP)



Source: OECD and World Bank DECPG estimates, and staff calculations.

5. The World Bank and Countries' Efforts to Mitigate the Impact of the Crises

Given its role as a development institution and its mandate to reduce poverty, the Bank is working— in collaboration with the Fund and other stakeholders- to help mitigate adverse distributive impacts of high food and fuel prices and to bring development country experience and perspective to address social and structural sources of vulnerability.

The World Bank will continue to support the responses to the food and fuel crisis through a multi-pillar approach that combines policy advice, expedited financial support,

development of new products and research.²² A key element of this response is the Global Food Crisis Response Program (GFRP) – a rapid financing umbrella facility that is providing technical advice and access up to \$1.2 billion of financial support to countries affected by the food crisis and that includes explicit support for social protection responses. As of September 25, the value of total approved projects and those in the pipeline for approval under this facility amounts to \$851 million.²³ In addition, under the GFRP umbrella, the Bank is putting in place a Vulnerability Financing Mechanism comprising two parallel multi-donor trust funds aimed at mobilizing donor resources and helping developing countries manage the immediate consequences of rising food and energy prices, with a special focus on supporting social protection interventions.

- The Food Price Crisis Response window can be used to support any of the components of the GFRP including support for safety nets and support for improving access for small farms to seeds and fertilizers, under the same eligibility criteria as the umbrella operation. This multi-donor trust fund will also facilitate policy and operational coordination among development partners and help ensure that support to countries is both comprehensive and country specific.
- The Energy Price Crisis Response window will work in parallel with the social protection window of the FPCR and help finance measures that increase the income of the poor in the face of energy shocks, or reduce their energy expenditures without resorting to inefficient or universal subsidies. These include, *inter alia*, targeted cash transfers, workfare programs, targeted public passenger transport vouchers, targeted measures that reduce expenditures by poor households, and technical advice to set up the delivery mechanisms.

In parallel to the GFRP program, the Bank will also increase its financial support to agriculture, nutrition and social protection through its regular IDA/IBRD channels, and provide enhanced support for the energy sector in partnership with other bilateral and multilateral donors via the Energy Projects Initiative.

However, even a large expansion of the Bank’s support would represent only a fraction of the implied financing needs. Thus, while IDA’s successful replenishment provides a good starting point, mobilization of further aid would ensure that low-income countries most adversely affected by terms-of-trade shocks do not have to divert resources needed for making progress towards the Millennium Development Goals. Middle-income countries in turn can draw on an array of new and more flexible IBRD financial instruments offered on more attractive terms, as well as sizeable room for expanded lending given IBRD’s favorable capital position at the current time. In both low and middle income countries, the Bank could play a catalytic role in mobilizing infrastructure finance, which may become more difficult to obtain should global financial turmoil persist.

²² See World Bank (2008a).

²³ In addition to the GFRP, the World Bank has also approved additional lending outside fast-track procedures, bringing its overall response to the food crisis to \$1.3 billion.

The Bank is also contributing to the countries' adjustment efforts by providing advice on removing constraints on economic growth.²⁴ Going forward, on the analytical side it is critical for the World Bank, in collaboration with the IMF and others, to continuously examine the potential risks to these economies using a set of macro vulnerability indicators (both backward and forward looking) with a view to assess the appropriateness of their macroeconomic policies to counter such risks. Stronger analytical work would also provide a better grounding for development policy lending. Public Expenditure reviews could look into the creation of fiscal space for strengthening or developing social protection programs that are now being considered by governments. Another area to target would be a better understanding of the fiscal and quasi-fiscal impact of energy subsidies.

During the 2007 Bank-Fund annual meetings President Zoellick identified fragile and conflict-affected countries as one of the six priority themes for Bank work. Following the announcement the Bank created a working group to lay out the agenda for the theme. Several Bank lending processes and Analytical and Advisory Services are being adapted to improve the quality of Bank assistance to these countries. A similar process of learning and adaptation happened in the late 1990s following the Commonwealth-World Bank task force on small states. Both fragile states and small states have special needs and require products and processes adapted to their characteristics. The challenge of the current oil and food price hike is one more reminder of how pressing these needs are for the livelihood of their citizens.

6. Concluding Remarks

The complexity of coping with the twin price shocks is being compounded by unfolding developments in the global economy. The recurrent nature of the price shocks has complicated the management of inflation expectations, and there are risks of second-round effects. Until recently, there have been also demand pressures stemming from the large capital inflows into developing markets. With inflation on the rise and slower growth in high-income countries, monetary policy developments must be closely watched—for their spillover effects for developing countries.

Spillover effects from weaknesses in global financial markets constitute another very important potential source of fiscal vulnerability. As financial weaknesses originating from the developed world continue to unfold, key issues going forward are how significant will be the spillover effects to the rest of the world, and which countries are likely to be most affected. Stock markets in several developing countries have already been impacted by financial events in developed countries. Authorities will need to keep a close watch on their financial systems, make contingency plans, and maintain a readiness to swiftly tackle any stress that may be spilling over their borders.

²⁴ In the case of food-exporting countries some have adopted export taxes, quotas, or outright bans. The temptation to control food prices by reducing exports is strong, but such measures reduce production incentives and can have a number of unintended economic and social consequences. See Chauffour (2008).

Countries with high current account deficits, rising or high inflation, and those with extensive fuel/food subsidies could be particularly vulnerable to a sharp slowdown -- especially if accompanied by a significant tightening of financial conditions. The strong growth that many developing countries had experienced in recent years is weakening, which could expose or exacerbate macroeconomic imbalances that may have been built-up. Industrial production has already slowed sharply in several developing countries. Policymakers need to focus their attention on the most vulnerable groups and prepare internal vulnerability assessments, including threats to the progress on the Millennium Development Goals (MDGs).

Finally, there is a danger that scarce fiscal resources may be diverted away from growth-enhancing expenditures. The need to finance adjustment to the price shocks in the short-term, may lead to a diversion of spending away not only from priority development programs in health and education, but also from much needed public infrastructure investment or operations and maintenance expenditures. While these expenditures may be relatively "easier" to hold back they could adversely impact growth in the next 5–10 years. That is why the focus should be on gaining resources, for example, through improving the efficiency and targeting of subsidies, supported by higher aid inflows to the most vulnerable countries.

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Appendix. Commonwealth Members: Small States and Fragile States

	Small States	Fragile States
Antigua and Barbuda	X	
Australia		
Bahamas, The	X	
Bangladesh		
Barbados	X	
Belize	X	
Botswana	a	
Brunei Darussalam	X	
Cameroon		
Canada		
Cyprus	X	
Dominica	X	
Fiji	X	
Gambia, The	a	X
Ghana		
Grenada	X	
Guyana	X	
India		
Jamaica		
Kenya		
Kiribati	X	X
Lesotho	a	
Malawi		
Malaysia		
Maldives	X	
Malta	X	
Mauritius	X	
Mozambique		
Namibia	a	
Nauru		
New Zealand		
Nigeria		
Pakistan		
Papua New Guinea		X
St. Kitts and Nevis	X	
St. Lucia	X	
St. Vincent and the Grenadines	X	
Samoa	X	
Seychelles	X	
Sierra Leone		X
Singapore		
Solomon Islands	X	X
South Africa		
Sri Lanka		
Swaziland	X	
Tanzania		
Tonga	X	
Trinidad and Tobago	X	
Tuvalu	X	
Uganda		
United Kingdom		
Vanuatu	X	X
Zambia		

Source: World Bank and Commonwealth Secretariat

Note: (a) Botswana, The Gambia, Lesotho and Namibia have populations above the 1.5 million threshold; even so, they have similar problems to the countries characterized as small states in the table.