EXECUTIVE SUMMARY

Retail prices of staple foods in South Africa have increased rapidly in the past few months, to the extent that they may have adversely affected the state's ability to reach its inflation targets. These increases have caused concerns for the plight of the rural and urban poor in the country, for sound macroeconomic management, and for those concerned with the possibility of market manipulation and even corruption in the price setting process.

In this regard, the purpose of this report was to explain the price setting process for food products at different levels of the supply chain, from the farm gate to the retailer, and to attempt to explain the most important influences. Given the urgency of the project, it was not possible to provide a formal 'proof' of competing hypotheses about the nature of the price mechanisms in the food chain. Instead, a descriptive analysis is provided of the most important events of the past months in order to arrive at a clearer understanding of the forces driving food price increased. This explanation is provided against the background of the most important features of the agricultural and food sector and of the policy decisions that have guided this process.

Commercial and small-scale farmers in South Africa receive less support from the state than their counterparts in every industrial country in the world with the exception of New Zealand. This is the consequence of a process of deregulation that started two decades ago, and became faster, broader and deeper after 1994. The result, in efficiency terms, has been encouraging. Output from commercial agriculture has continued to grow; export growth has exploded, especially in the horticultural sector; farmers have increased productivity; and the sector has become more sustainable in environmental terms.

In equity terms, however, the record is less positive. The policy changes that drove the process of deregulation and liberalisation have created 'winners' and 'losers' among commercial farmers, who had no safety net to protect them from a rapidly changing environment. Historically disadvantaged commercial, emerging and small farmers have also yet to benefit from their involvement in the sector. The state has not succeeded in providing access to resources (land, water, technology, credit) or to input and produce markets for these participants on a meaningful scale.

Within this environment, described in Chapter 1, market forces of supply and demand determine the prices that farmers receive for their produce, and that processors, distributors and traders pay for those products. In Chapter 2 we explain that when a product is exported, the seller (a farmer, a marketer, etc.) receives the price, net of the costs of getting the physical product to the foreign country, that the foreign buyer is prepared to pay. The seller is paid in the currency of the buyer, and hence gains from the depreciation in the value of the South African Rand. When a product is sold in the domestic market, however, the level of the price depends on whether that product can be imported or not.

Generally, when food products, such as most fresh vegetables, are highly perishable, they are not traded internationally on a big scale. Hence, vegetable prices in South Africa are determined by supply and demand conditions in this country. However, in the case of a product such as maize, millers who are the biggest buyer of the maize crop, have the option of importing maize rather than buying local maize. In a deregulated market, they will always buy from domestic and foreign sources for a wide range of reasons. However, the source of the bulk of their purchases will depend mostly on price. When they import the product, the exchange rate has an inordinately important influence on the actual price they pay.

A depreciation in the value of the South African rand will make it more expensive to import products such as maize, wheat and oilseeds, hence providing some protection to South African farmers, and an incentive to produce more in the longer term. Yet if South African, or Southern African producers are unable to supply the full needs of the processors, or if processors are uncertain about South African supplies, they will again look to foreign sources. South African suppliers, on the other hand, will look to the export market in the event that domestic processors are unwilling to pay them the prevailing market price. In this manner, the market sets a 'natural' floor and ceiling price, i.e. a price band, within which such products trade. The mechanism by which these prices are set is the Agricultural Markets Division of SAFEX.

There are two conditions that affect this price band in the case of South African maize. First, the world price of white maize is largely determined by conditions in the South African market, as Southern Africa is the largest point of production and consumption for white maize in the world. For technical reasons that are explained in the report, an increase in the South African price reinforces the world price that is transmitted back into the South African price when the exchange rate weakens. This aspect requires urgent attention, as is pointed out by participants in the market.

Second, the resulting price is not transmitted automatically into the retail price of the product. The historical evidence is that when farm gate prices increase, retail prices increase almost immediately. When farm gate prices decrease, however, retail prices often continue to increase, at least in nominal if not in real terms, and seldom decrease along with farm gate prices. The reason probably lies in the lack of competitiveness in the supply chain beyond the farm gate.

We come to the conclusion, at the end of Chapter 2, that **the recent increase in the farm gate price of basic food commodities has come about as a result of a unique combination of five factors**. These are (a) an increasing world price for these commodities, (b) a lack of competition in the supply chain beyond the farm gate, especially at the retail level, (c) a fast and severe depreciation in the value of the currency, (d) a shortage of maize in the SADC region, and (e) a climate of uncertainty, created specifically by the unfortunate circumstances surrounding the land reform programme and the elections in Zimbabwe, and more generally by the instability in parts of Central and Southern Africa.

Chapter 3 addresses the question of remedial action in broad terms: what can or should be done about food price inflation in South Africa? First, the actual measurement of the CPI is investigated. The main conclusion here is that the authorities have put considerable effort into ensuring that the measurement of food inflation is conducted according to international best practices, yet given the South African realities. While suggestions are made for further improving this measure, there is no evidence that the Food CPI in South Africa systematically over- or understates the actual rate of food price inflation.

The first part of Chapter 4 then addresses the South African, the Southern African and the developing country experience with food subsidies. The lessons from the research on the policy options open to decision makers in the face of increased food prices that has been reviewed here can be summarised as follows:

- There is some justification for targeted food subsidy programmes, and the evidence is that they can succeed in addressing the needs of the poorest. However, these programmes are expensive, and the poor generally get less than half of the benefit, the rest being capture by wealthier people. In addition, food subsidy programmes were introduced in many developing countries in an attempt to compensate for policy deficiencies in other areas of the economy.

- The experience in Southern Africa shows that the market can generate unexpected solutions and successes that make the market work more efficiently. However, the market does not always respond spontaneously, and concerted effort is required by the private sector and by the public sector to lower transactions costs, promote regional trade, and provide market information systems. Further, the private sector's response to liberalization is sensitive to a broader range of government actions than commonly understood.

- The evidence generally is that the 'losers' from deregulation and liberalisation are mainly low-income earners in urban and semi-urban areas, smallholder farmers in remote areas and unskilled farm workers. Policies should be put in place to address production constraints, barriers to market access and non-economic barriers to broad-based economic growth.

In the review a wide range of subsidy instruments commonly used for the explicit purpose of controlling the prices that poor people pay for specific food items, and often to control the rate of inflation of food prices, were identified. Yet there are three important aspects of the context within which these subsidies were implemented:

- There was a strong belief during the 1970s that staple food prices were increasing, and would continue to increase. Measures to protect the poor from the impact of these price increases were, therefore, justified on political and humanitarian grounds. Later, an economic argument was added, namely that subsidies targeted at the poorest would be beneficial for growth. However, commodity prices generally, and the prices of staple foods in particular have declined in real terms over the ensuing decades. The recent transmission of higher food prices into the South African market is a special case.

- There was consensus among analysts and policy makers that the most effective way to increase food production in developing countries was to provide farmers with incentives through higher prices, and with improved technology to lower production costs, and hence to increase their profit margins. However, while such policies would benefit farmers, the landless rural poor and the urban poor would face higher food prices. Interventions in the market to protect these groups were, therefore, justified. Later experience has, however, shown that these groups are only penalised to the extent that higher farm gate prices are transmitted into higher consumer prices.

- The 1970s were characterized by a global fixed exchange rate regime. Higher world prices for staple foods were translated directly into high domestic prices in developing countries that did not have farm price support programmes such as those followed by the industrialised countries.

The analysis in Chapter 2 shows, however, that the South African circumstances differ from this context. **First,** the evidence is that the world price of maize and many other basic commodities has increased in the past few months, and is expected to continue increasing. The analysis has also shown that in a liberalized market, these higher international prices are transferred into the domestic market almost immediately. Thus, there may be some justification for intervention by the authorities. **Second,** however, the lack of competition further down the supply chain has had a bigger effect on the prices that poor people pay for their basic needs than has the supply of farm commodities. **Third,** we live in a world characterised by market-determined exchange rates, and the exchange rate has had a bigger and more immediate impact on the South African domestic price of maize than has the world price.

It is these differences that form the background to the specific recommendations made in the second part of Chapter 4.

Efficient markets: SAFEX

Under 'normal' circumstances, the combination of increasing world food prices, a poor domestic crop and a collapse in the exchange rate is a rarity. In the case of white maize specifically, however, there is a connection between these factors, specifically because Southern Africa is the only region in the world where large quantities of superior quality (white) maize is grown for human consumption[1]. In an efficiently functioning market, the rapid increase in the South African price for maize would result in one of two market reactions, given that the South African price influences the world price of white maize. **First,** imports of high quality white maize should increase. As this is not available elsewhere, imports of lower quality white maize should increase. However, this is not possible at present, for technical reasons. **Second,** in the longer term, i.e. if the shortage of white maize in Southern Africa persists, the increased domestic price, transmitted to the rest of the world, should encourage producers in other parts of the world to grow white maize specifically for the South African market. Again, this is not possible at present. However, it appears that a market solution to this problem does exist.

Recommendation 1

For this reason, we recommend that the authorities, in collaboration with the Agricultural Markets Division of SAFEX, should investigate the desirability of introducing a maize futures contract that makes provision for "non African Origin". The desirability of restricting this to farmers in the USA, and of allowing lower quality maize should be included as part of this investigation.

Efficient markets: further down the chain

The poor in South Africa have been adversely affected over the past few months by higher retail food prices, and that the trends in these prices are largely divorced from prices at the farm gate, especially in the case of maize and wheat. Intervention by the state in primary agriculture in South Africa during the 1930s was initiated because of the (perceived) lack of bargaining power of farmers. Deregulation was introduced largely because the farmer support system had become too expensive, and because the benefits were skewly distributed. This does not, however, mean that farmers have automatically gained sufficient bargaining power, as has been proven over the past few months. There is, in fact, an argument that the control mechanisms that were put in place in the 1930s initially improved the bargaining power of farmers through the system of co-operatives and marketing boards but later led to increased bargaining power of processors, distributors and traders which was the result of practices such as restrictive licensing.

Recommendation 2

For this reason, we recommend that the relevant authorities initiate full investigations into the degree of competitiveness in the supply chain for the strategically important commodities that constitute the basic food needs of the poor in South Africa, under the auspices of the Competition Act. Such investigations should include an identification of the barriers to access to markets, including inadequate infrastructure, inappropriate pricing strategies for modes of transport, a lack of communications facilities, etc.

[1] White maize is grown in Mexico for the manufacturing of *tortilla*, but this does not change the main argument.

Efficient markets: the farm level

There is little evidence that small farmers have benefited from the new trading environment in agriculture, while there is strong evidence that the efficiency and the fairness of the agricultural sector would be enhanced by a successful land reform and small farmer support programme. As a result, most small farmers in South Africa are still poor, are net food buyers, and are as adversely affected by higher consumer prices for food, as are the landless rural and urban poor.

Recommendation 3

For this reason, we recommend that greater consideration be given to successful land reform and farmer support programmes that result in the creation of successful livelihoods for the millions of current (and potential) farmers from disadvantaged communities who deserve these opportunities. While the plight of the rural poor in South Africa is better now than a decade ago, the agricultural sector has not been allowed to play the important role that it should in the fight against rural poverty. Government needs to reverse the decay in agricultural infrastructure, and refocus efforts in support of poor and disadvantaged farmers.

Alleviating the plight of the poor

It is clear that poor people living in the rural, the urban and the peri-urban areas of South Africa have been most affected by the increase in the farm gate prices of staple foods. Our analysis shows that the consumer prices of these products will not decline in nominal terms in the short to medium term despite the strengthening of the rand in recent months. Hence, there is an argument for measures to alleviate the plight of the poor.

While we understand the need for remedial action, however, it is clear that South Africa already has mechanisms in place to combat poverty. These include the Public Works Programme, the Primary School Nutrition Programme, and the proposed Comprehensive System of Social Security. Further, experience has shown that specific food subsidies have unintended consequences and, like all subsidy programmes, are difficult to terminate once initiated.

Recommendation 4

For this reason, we recommend that the Government take an in-principle decision not to meet short-term emergencies such as the current rise in consumer prices for basic foods with short-term reactions. The solution rather lies in sound risk management strategies, and properly implemented poverty alleviation policies.

Calculating the CPI

The analysis has shown that considerable effort has been expended in ensuring that the calculation of the CPIF accords with recognised international practices. However, it is clear that the current practice could lead to a misrepresentation of the actual rate of food inflation. It is not clear whether the current practice over- or understates the real rate of inflation in the prices of food products.

Recommendation 5
For this reason, we recommend that StatsSA should give serious consideration to finding a more satisfactory definition of rural areas; that provision should be made for the inclusion in the CPI calculations for the sale of food products through informal sector outlets in urban and rural areas; and that consideration should be given to including the price trends for food consumption away from the home.