POLICY BRIEF NO. 2

RICE PRICE POLICY OPTIONS IN THE SHORT TERM

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AUGUST 1999

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Beginning in the second half of 1997, the Indonesian rice economy entered a period of crisis due to unfavorable weather patterns, financial market disruptions, and political uncertainty. In early 1999, however, a process of smooth transition began, and the rice economy is now well on its way to a renewed period of stability. The world price of rice in real domestic currency equivalent terms has been stable for nearly a year at the same level that prevailed in 1996 (before the crisis). World prices for rice have fallen, but depreciation of the exchange rate has provided protection to farmers and fully offset the fall in the world rice price. Although domestic rice prices are still substantially above import parity prices, they are on a steady transition toward realignment with trend world prices – the situation that prevailed throughout most of the 1980s and 1990s. Because the transition to renewed stability is well under way, only one important change needs to be made in rice price policy at the present time.

The Level of Domestic Prices and the Tariff

Throughout the period of crisis, real domestic rice prices never fell below the levels that prevailed in the earlier part of the decade (see Figure 1). For a full year (August 1998 to July 1999), domestic rice prices were nearly 60% above the average price in 1996. After reaching a peak in the second half of 1998, real rice prices have steadily declined toward import parity levels. Farmers still benefit, however, because domestic rice prices are about 40% higher than comparable world rice prices. This continued gap is due to a specific tariff of Rp430/kg and the uncertainty that continues to surround the exchange rate, which imposes risk on traders and provides a degree of natural protection to farmers.

If the desired policy target is to achieve rough equality between domestic prices and trend world prices, some consideration might be given to lowering the specific tariff. There is no convincing rationale for raising the tariff, since domestic prices are still considerably above world prices. Although world prices for rice are currently depressed and below their long-term trend, the depreciation of the rupiah has compensated farmers for this decline. Figure 1 shows that real (inflation-adjusted) import parity prices (at the wholesale level) have been stable for nearly a year at approximately Rp1700-1800/kg, the level that prevailed in 1996 (before the crisis). Therefore, the argument for raising the tariff to protect farmers from temporarily low world rice prices is not convincing. The optimal choice at this point is to leave the specific tariff on rice at its current level. The tariff should be reduced later as world prices recover and rise toward a trend level.

The Level of the Floor Price

One important dimension of the Indonesian rice economy – the level of the floor price – has not returned to equilibrium. Figure 2 shows emphatically how the long-run stability of the floor price in real terms was severely disrupted by price policy decisions taken in 1997 and 1998. During the 1980s, the floor price averaged Rp850/kg (in real July 2000 rupiah), with little variation around this level. In the first half of the 1990s, this level ratcheted up 10 percent to Rp935/kg, again with little variation around that level. (Nominal increases in the floor price were intended to offset inflation, thus keeping floor prices constant in real terms.) But a series of policy decisions to enact very large floor price hikes – which raised the nominal floor price from Rp525/kg in 1997 to Rp1400/kg in 1999 – increased the real floor price by 55 percent to unprecedented levels (comparing the average in 1999-2000 with the average from 1990-1996). One rationale for these policy decisions was to adjust the domestic rice economy to an anticipated higher structure of import parity prices brought about by the depreciation of the rupiah to levels well in excess of Rp10,000/US$. Subsequent events have shown, however, that the equilibrium level of the rupiah/dollar exchange rate is probably between Rp7000/US$ and Rp8500/US$.

Because the cumulative effect of the floor price adjustments in 1997-1998 proved to be a large overcorrection, there is no rationale for increasing the floor price again. At the same time, the nominal level of the floor price has never been lowered in Indonesian history, and now is politically not the time to start. As with the tariff, therefore, the best path is to preserve the status quo – except for a return to a uniform policy price throughout Indonesia (replacing the three-tiered structure introduced in December 1998).

Adjustments in the Floor Price Mechanism

The mechanism for implementation of the floor price has changed because of two important factors. First, the level of the floor price is substantially above previous historical levels, as shown in Figure 2 and noted earlier. Second, Bulog no longer has the ability to tap an unlimited line of credit at favorable interest rates to defend the floor price. Both of these changes appear to be irreversible. It will be politically difficult to lower the floor price, and the Ministry of Finance (and the IMF) are unwilling to provide Bulog with the credit guarantees that banks require before they are willing to lend substantial amounts to Bulog. In addition to being irreversible, both of these changes make it extremely difficult for Bulog to defend the announced high floor price. The government's credibility has suffered as a result.

A good solution to this dilemma is to move from a floor price (*harga dasar*) to a procurement price (*harga beli*). Under a well-functioning floor price system, the government (Bulog) stands ready to buy as much of the crop as is necessary to keep the general level of prevailing market prices at or above the floor price. Because weather and growing conditions are highly variable, it is not easy to predict when a bumper harvest will occur. Defense of the floor price thus requires that Bulog be ready to buy as much of the crop as is necessary, which in turn requires easy access on short notice to very large lines of credit. As noted above, Bulog no longer has easy access to unlimited lines of credit, and this situation is unlikely to change.

Under a procurement price system, however, the government instead agrees to buy a certain amount of the crop (preferably during the peak of the harvest in the main surplus areas) at a procurement price that is previously set and announced by the government. The quantity to be procured is determined by the budget allocated for such purposes. Once this budget is used up, government purchases will stop, and there is no guarantee that market prices will stay above the level of the procurement price. A procurement price system thus allows the government to provide some support to farmers, without guaranteeing that prices will stay above the announced procurement price at all times or in all locations.

The systemic change from floor price to procurement price is already underway in actual practice. In light of its budget constraint, Bulog can procure only limited quantities of rice and these constrained purchases cannot guarantee defense of a high floor price. Hence, no major policy initiatives are necessary to complete the transition. As the transition is taking place, a useful intermediate step would be to have cooperatives (including, but not limited to, KUDs) continue to procure rice at a price equal to the current "floor price" – now announced as a "procurement price" – in support of farmer income. At the same time, Bulog has operational needs for rice stocks to support disbursements under the OPK program and its (recently much reduced) distributions to civil servants and the military. If Bulog is having difficulties (either physical or financial) in procuring enough rice for these purposes from cooperatives, it should be allowed (at the discretion of the Kabulog) to procure domestic rice at a price different (either higher or lower) from the government-mandated procurement price. Such flexibility would be consistent with Bulog's planned transition to become a more commercially oriented organization.

This change from a floor price system to a procurement price system would have several advantages. It would continue assistance to rice farmers, permit Bulog to procure enough rice to meet its distribution needs, facilitate transparent accountability within Bulog, limit government budgetary outlay, and ensure that announced government policy could be implemented effectively.

Figure 1. Real Rice Prices, Jan. 1996 - July 2000 (all prices adjusted to wholesale level in Jakarta)

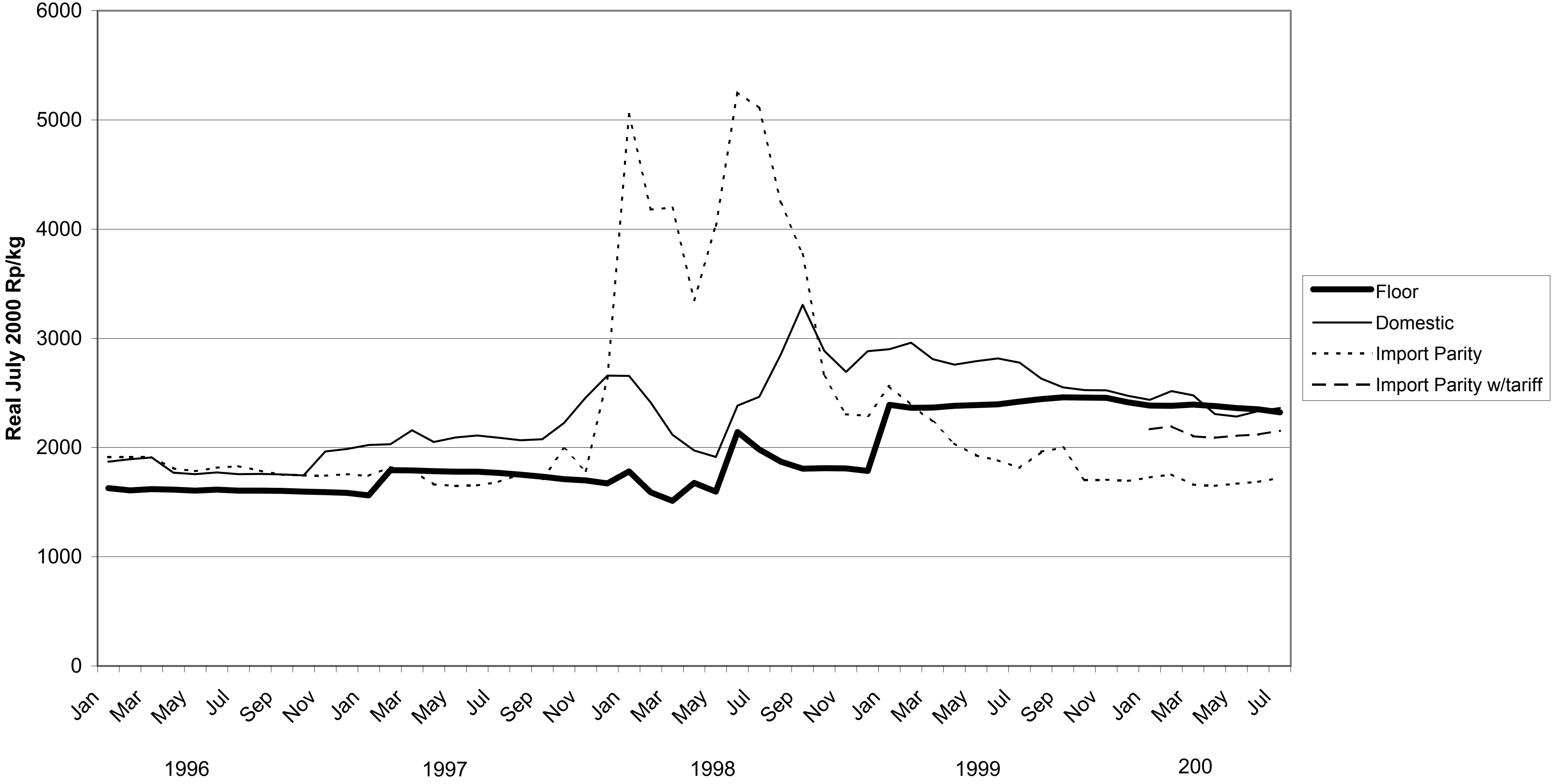

Figure 2. Real (Inflation-Adjusted) Floor Price (GKG Terms), 1973 - 2000