POLICY BRIEF NO. 5

RICE POLICY IN TRANSITION : FROM STATE CONTROL TO MARKET ORIENTATION

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Rice Policy in Transition:

From State Control to Market Orientation

In early September, 2000, Indonesia's rice economy is caught mid-way in a transition from being a sector heavily regulated by a centralized Ministry of Agriculture and stabilized by a well-financed food logistics agency (Bulog) to being a market-oriented sector which depends on farmer and consumer decision making to allocate resources efficiently. The large gap between domestic and world prices that emerged during the financial crisis in 1997 is narrowing, but Indonesia's rice prices remain substantially above world prices--in contrast to the long-run parity seen from the mid-1970s to the mid-1990s.

The key question at this juncture is how to complete the transition to a market-oriented rice economy while recognizing the constraints on policy initiatives that face the new government. This memo identifies those constraints and assesses the costs of maintaining the status quo for rice policy versus pushing forward with the market orientation of the rice economy. The most difficult issue is what to do about the floor price. The current level of Rp 1,400 per kg for mill dry gabah (GKG) is sharply out of line with both domestic and world market prices.

It is worth reviewing briefly how rice prices were stabilized and maintained on the long-run trend in world market prices before the financial crisis and why the policies that achieved that desirable outcome are no longer appropriate. The details of this story are contained in the first three reports of the BAPPENAS/USAID/DAI Food Policy Team (August, 1999—see the reports attached to this memo). Bulog defended a floor price and a ceiling price through a combination of the following policy instruments:

-- monopoly control over international trade in rice,

--access to an unlimited line of credit (at heavily subsidized interest rates in the early years; at commercial rates with a Bank Indonesia guarantee in the later years),

--procurement of as much rice as necessary to lift the price in rural markets to the policy-determined floor price, and

--extensive logistical facilities, including a nation-wide complex of warehouses, which permitted seasonal storage of substantial quantities of rice (including the one million tons for the "iron stock" that was considered essential for Indonesia's food security). These rice stocks, accumulated through domestic procurement in defense of the floor price and, when these supplies were inadequate, through imports, were then used to defend a ceiling price in urban markets. In the early years, the ceiling price was explicit and announced publicly; in the later years, it was informal, providing local Dolog officials more flexibility in maintaining stability of rice prices.

There is no question this was a heavily interventionist approach to formation of rice prices in Indonesia. Still, few observers doubted the need for such intervention in the late 1960s and through the period of instability in the world rice market in the 1970s. An econometric assessment of the 25-year period from 1970 to 1995 concluded that Bulog's stabilization efforts paid very high dividends in fostering faster economic growth during Repelita I and II, apart from the additional benefits provided by enhanced political stability. But even this assessment concluded that benefits were diminishing as rice became a much smaller proportion of the value added in the economy and as a share of consumers' budgets. By the mid-1990s there was clearly a need to design a much more market-oriented price policy (see Timmer, "Does Bulog Stabilize Rice Prices? Should It Try?" *Bulletin of Indonesian Economic Studies*, August 1996).

This need for reform of rice policy was driven by two forces. First, the price stabilization program was very expensive in budgetary terms, because heavy subsidies had to be provided to Bulog to maintain large stocks, subsidize exports when surpluses accumulated, and subsidize imports when domestic supplies were short. The increased corruption in the agency in the mid-1990s further called in question the use of public funds to support the price stabilization role. Second, successful stabilization of rice prices enhanced the profitability of growing rice and biased farmer decision making toward its cultivation. This bias was probably desirable as new rice technology and extensive investment in rural infrastructure, especially irrigation, meant farmers had to learn how to manage a new production possibility frontier. But by the 1980s, the bias was causing serious difficulties in diversifying Indonesia's agriculture toward higher- value crop and livestock systems.

A long-run decline in the price of rice in world markets, and significantly greater stability in world prices, have now sharply lowered the opportunity cost of rice to the Indonesian economy (see Dawe, "The Future of the World Rice Market and Policy Options to Counteract Price Instability in Indonesia," DAI Team Report No.

5). To have better income-earning prospects in the future, farmers will need to diversify out of rice growing.

The alternatives to this high-cost and inefficient approach to rice price policy were already under discussion in the mid-1990s (see Timmer, "Building Efficiency in Agricultural Marketing: The Long-run Role of BULOG in the Indonesian Food Economy," *Journal of International Development*, 1996). Although various analysts had differing priorities for reform, the core ideas were similar. Indonesia should rely much more heavily on rice imports for its food security, including taking the lead in forming a free trade zone for rice in East and Southeast Asia (possibly to include Bangladesh and India as well). Substantial investments in rural infrastructure to improve efficiency of rice marketing would be needed so that traders and farmers would buy and store nearly all of the harvest. Continued development of rural capital markets would also be needed to ensure that the financial liquidity traditionally provided by Bulog procurement in defense of the floor price would be available from the formal banking system at reasonable rates to farmers and traders. Greater variability in seasonal prices would be permitted so that these farmers and traders could earn adequate returns on their investments. Such variability would not be a problem for consumers because rice had declined to a small and manageable share of their budget expenditures. In case of large increases in rice prices in world markets (less likely with a large Asian free trade zone) or localized shortages, subsidies to poor consumers could be targeted through special logistical efforts (Bulog had already experimented with such a program during the drought in 1991). Variable tariffs on rice imports were also discussed as a mechanism for stabilizing rice prices in Indonesia without the need for a costly logistical agency.

These discussions about improving the efficiency of the rice economy were put on hold during the financial crisis, although both the IMF and the World Bank pushed for liberalization of rice trade and curtailed Bulog activities as part of their support programs. Indeed, it is these donor efforts that have pushed Indonesia into the transition that is currently underway, and it is clear the donors would prefer to see the process completed as rapidly as possible.

There is substantial merit to the market-oriented rice economy seen at the end of this transition, and it remains a highly desirable goal. But there are also substantial barriers in the way of this outcome, especially in the short run. In particular, the new government is facing the prospect of announcing a new rice price policy by early

October when there is little agreement on how to match the political objectives of supporting farmers using the limited policy instruments available to achieve those objectives. More worrisome, there seems to be little understanding of how the previous rice price policy was designed and implemented, what its true costs were, and what the implications might be for price stabilization if Bulog is converted into a commercially-oriented state enterprise (*Perum*). Thus the current discussions are being conducted in a near vacuum of institutional memory and experience with policy design and implementation. It does not seem that now is a good time for radical policy reform, no matter how desirable such reform might be on the basis of technical analysis designed to improve overall economic welfare.

The most acute problem facing policy makers at the moment is what do about the floor price for rice, currently set at Rp 1,400 per kg in Wilaya I and slightly higher in the other two regions. As Figures 1 and 2 (attached) demonstrate, this level of the floor price is very high in relation to both domestic and world rice prices (Figure 1) and in relation to historical levels of the real floor price itself (Figure 2). A simple analysis of these two figures points to an obvious policy change—the floor price should be lowered significantly, probably to about Rp 1,000 per kg if historical and market relationships are going to be re-established. The average real floor price in the 1980s was only Rp 850 per kg (in current prices). It moved up about 10 percent from 1990 to 1997, to about Rp 935 per kg. A level of Rp 1,000 would be a further step up from these historically high levels.

At this level, even a diminished Bulog would be able to defend the floor price during the main harvest in nearly all surplus areas and still operate within the financial constraints imposed by the Ministry of Finance. These financial constraints limit Bulog's funding to the amounts needed to supply its logistical commitments to the targeted rice distribution program (OPK) and its distribution commitments to the military and Budget Groups. There is currently no financial mechanism for Bulog to procure rice beyond these logistical needs, which specifically do not include a mandate to contain price rises during the pre-harvest period. This task has been turned over to the private sector, which is permitted to import rice with a Rp 430 per kg tariff (approximately a 30 percent tariff in view of current rice prices in world markets and the Rupiah—USD exchange rate).

A formal announcement to lower the nominal level of the floor price will be very painful for the new government, which has pledged to find new ways to support agriculture in general and rice farmers in particular. Are less painful alternatives available? What are the implications of keeping the nominal floor price at Rp 1,400 per kg? Is it possible to keep the floor price but not defend it completely? Or does the government's credibility depend on doing what it says? If so, what would be the costs and consequences of devoting enough resources to defend a floor price as high as Rp 1,400 per kg in the coming harvest?

These are extremely difficult questions. Technical analysis with precise answers is not possible in the current situation. The rice economy has not been in equilibrium for long enough to use long-established supply and demand parameters to evaluate the impact of alternative price scenarios. What follows is impressionistic. Efforts to place magnitudes on costs and benefits are rough, and the results depend as much on historical intuition as on formal quantitative modeling.

The most important conclusion is that any attempt to implement fully a floor price of Rp 1,400 per kg in the coming main harvest (February to May, 2001) is doomed to failure. The price set at Rp 1,400 per kg is simply too high in comparison with the costs of importing rice from Vietnam, Thailand, China, and India. This current level of the floor price, which is intended for rice in rural areas, is actually higher than the wholesale price of rice in Jakarta, which itself is nearly half again as high as the landed cost of imports before the tariff is paid. To be successful, implementation of the floor price of Rp 1,400 per kg would require the entire structure of rice prices to be built on top of the value of the floor price in rural areas. It would thus require a ratcheting up of domestic wholesale prices by perhaps 20 to 30 percent, and this approach is not feasible unless the price of imported rice can be pushed up as well. Given the potential for smuggling in the face of such wide margins, supporting the floor price at Rp 1,400 per kg in Indonesia's rural areas also means supporting the price of rice in markets in exporting countries. That is, Indonesia would be attempting to implement a floor price for all of Asia's rice producers, not just its own farmers. A similar effort occurred in 1985 during the bumper harvest that year, and thousands of tons of foreign rice flowed into Indonesia illegally, attracted by Bulog's efforts to support the domestic floor price.

The dilemma is clear. It is not politically feasible to lower the floor price, but it is not economically feasible to implement it either. Although all historical and technical analysis shows the current floor price is significantly too high, some compromise path is needed. This path should allow the government to get credit for implementing the floor price to some extent and not get too much blame whenever local prices drop below the floor. In some sense, the goal is to "muddle through" during the coming year, while being sure that the transition to a market-oriented rice economy is not set back.

Even this approach will be difficult and may depend on additional financing for Bulog procurement than is presently being planned. The danger, however, to expanding Bulog's potential procurement is that its warehouses already have more rice than is needed for its logistical operations. Even worse, much of the rice is of very low quality, and recipients are already voicing complaints. To force Bulog to procure an additional 1-2 million metric tons of rice, only to have it deteriorate in its warehouses, will be at least as scandalous as a failure to enforce the floor price in the first place.

A memo prepared by the DAI team in late August 2000 (see Report No. 12 in the set of attachments) addresses this dilemma directly. It recommends that the formal floor price be switched to a procurement price. Procurement could be at the announced floor price if necessary and could be limited to sales by (public and private) cooperatives. But the government would need to publicly announce that Bulog's requirements for additional rice supplies are limited by the quantities required for OPK and other rice distributions and that rice procurement would be limited to these quantities. Additional supplies available in local markets would need to be bought by private traders (or retained in on-farm storage by producers). The KUPEDES program would need to be sure that farmers and traders knew of the availability of credit for such activities and that procedures for obtaining it were quick and efficient. The public announcement is crucial because farmers and traders need to be able to form accurate expectations about how much rice Bulog will procure and how much rice will be available for private storage.

Equally crucial will be the determination of the government to push forward on the transition of the rice economy to its market-oriented future. If the government uses the coming year to plan carefully and fully brief the legislature, most of the policy reforms should be ready to implement by September, 2001, in time to announce the policy to farmers before the rains start for the following main season crop. In the meantime, maintaining the floor price at Rp 1,400 per kg, but converting it to a procurement price limited to Bulog's purchases for logistical needs, is probably the best the government can do in the next month. With sufficient flexibility on the part of the Ministry of Finance, BRI, Bulog, and the Ministry of Agriculture, such an approach may be good enough.

In summary, the following decisions and actions need to be taken by the executive and legislative branches of government to carry out the strategy suggested in this memo:

I. By early October 2000

1. Convert the floor price system to a procurement price system and announce a procurement price of Rp 1,400 per kg throughout Indonesia. The procurement quantity will be set by Bulog's need for rice to distribute to the OPK program and to Budget Groups still receiving Bulog rice.
2. Announce special efforts by BRI and other commercial banks to encourage expansion of rural credit at market rates of interest, especially for crop storage activities.
3. Announce the planning for a new program of rural infrastructure investments to promote the construction of drying floors and village-based storage facilities in rice-growing areas.
4. Maintain the specific tariff on imported rice at Rp 430 per kg.

II. By early October 2001

1. Determine the political feasibility of reducing the procurement price and lowering the procurement quantity in line with reductions in the OPK program. A separate evaluation of the costs and benefits of extending the OPK program should be conducted.
2. Evaluate the effectiveness of rural lending by commercial banks and alleviate bottlenecks to expanded rural lending.
3. Implement the investment program in rural infrastructure for rice drying and storage facilities in rice-growing villages
4. Adjust the specific tariff on rice imports so that Indonesia's wholesale rice prices approach a level approximately 10 percent above the anticipated trend in comparable world prices when delivered to domestic markets.
5. Analyze the continuing need for policy instruments able to stabilize domestic rice prices in the case of substantial fluctuations in the exchange rate or in world rice prices.