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Running on Empty: South Asia's Food and Fuel Crisis

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The rapid rise in global food and energy prices has created political and economic stress all over South Asia with serious strategic implications for India, Pakistan, and the region at large. The energy crisis is the most immediate. With oil hovering around $120 a barrel, developing nations with high energy demands like India and Pakistan are particularly vulnerable. The food crisis, on the other hand, is more systemic. While rising energy costs have exacerbated inflation and commodity prices, the shortage of food in India and Pakistan reflects a more endemic need to deal with a lagging agricultural sector.

Import-dependent energy markets: India and Pakistan have different and diverse energy mixes. More than 60 percent of India's energy needs are satisfied by coal, 90 percent of which is domestically produced. Pakistan derives more than 50 percent of its energy from natural gas, almost all of which is domestically produced.

In both countries, oil remains a secondary source, but one that is vitally important for transportation and the modern parts of the economy. What makes these countries vulnerable to high energy prices is the steady increase in their energy consumption and their high import dependence. According to the U.S. Energy Information Agency, India was the sixth-largest global oil consumer in 2006. Its domestic crude oil production is about 900,000 barrels per day, while its consumption is more than 2,700,000 barrels. In essence, India imports approximately 67 percent of its oil from the rest of the world, two-thirds of which comes from the Middle East. Pakistan imports 80 percent of its crude oil, mostly from the Persian Gulf.

Balance of payments and budget: Increasing energy prices affect the Indian and Pakistani economies mainly through the balance of payments and the national budget. India spent $61 billion on oil imports in 2006, or 33 percent of its import bill. Even after subtracting the $19 billion it earned from exports of refined petroleum products, oil was its largest import. Since then, international prices have doubled. This will strain India's balance of payments, although India's high reserves-currently more than $300 billion-will protect it from an immediate crisis.

For Pakistan, oil represented 28 percent of its imports in 2006-2007, and the value of oil imports is likely to increase by at least 50 percent in 2007-2008. Pakistan's trade balance is more unfavorable than India's, and its reserves are much lower, barely $11 billion. So the impact on Pakistan's reserve position will be more severe, unless Pakistan receives financial assistance. Pakistan has applied for a $500 million loan from the World Bank to help stabilize its economy and is also reported to have asked Saudi Arabia to defer payments on its recent oil bills. The real danger is that Pakistan will have to resort to short-term debt. In the past, such borrowing during hard times has led to a disastrous balance-of-payments crunch.

Rising oil prices also feed both countries' budget deficits. The oil sector in both countries is dominated by the public sector, and consumer prices of sensitive energy products are subsidized. State-owned oil companies get caught in the middle, and growing deficits could accelerate inflation.

Consumer prices, the "third rail": Politically, the most painful effect of rising oil prices has been on the price of basic fuels. In the mid-1990s, India started a four-year process of decontrolling the prices of politically sensitive commodities, such as kerosene and diesel. Expensive crude oil forced the government to continue subsidizing these goods. In June 2008, with few alternatives left and to prevent a financial meltdown of the state-

owned companies, the federal government raised the price of petrol, diesel, and kerosene. Individual state governments like West Bengal, Bihar, and Tamil Nadu are attempting to offset the recent price increase by reducing taxes on these products, but their efforts will not be entirely successful. With taxes on petrol averaging around 50 percent and diesel around 30 percent, tax cuts of a few percentage points will barely put a dent in oil prices.

Pakistan has also carried out price hikes similar to India's. Natural gas prices in Pakistan, which rose by 46 percent between May 2007 and May 2008, rose by another 30 percent in the first half of July, while petrol and diesel prices went up by 20 percent in the same time frame. The problem has been compounded by Pakistan's inability to increase its electricity-generating capacity in the past decade, making power cuts a fact of life around the country.

In both countries, the price hikes have contributed to a spike in inflation. India's wholesale prices in mid-June were about 11 percent higher than last year, while Pakistan's inflation rate hit 20 percent year on year in May. Stock markets in Mumbai and Karachi have suffered dramatic losses across the board.

The outlook-more energy, more expensive: India's economic growth is expected to remain robust over the next decade, even though it may dip slightly to approximately 7 percent in the coming year. As a result, its energy demand will continue to grow relentlessly. Estimates range from 3.6 percent to 4.3 percent per year, depending in part on GDP growth rates. India's dependence on imported oil, coal, and gas are also expected to increase, with imported oil likely to rise from 70 percent to 90 percent of the total energy demand over the next two decades. Given that international energy prices fluctuate, it is plausible that oil prices may eventually fall from today's level, but one thing is clear-India will continue to struggle between the twin perils of a yawning budget deficit and rising prices for politically sensitive goods.

Pakistan's domestic price structure situation is less severe, but it faces the same need to expand its energy supply and has a more problematic current account deficit. This will inevitably translate into new requests for financial assistance from its international allies.

The food crisis: The rising cost of fuel affects the cost of fertilizer and electricity and consequently shows up in the price of basic food, such as grains and wheat. Increases in food prices also reflect systemic problems in the agricultural sector. In both India and Pakistan, agricultural reform has sorely lagged behind improvements in other sectors of the economy. Notoriously water short, Pakistan has substantial potential for hydroelectric power and irrigation, but inter-provincial disputes have prevented its exploitation. Outdated farming methods, inefficient price distortions, and problems with water availability and use have all contributed to a declining agricultural sector with a growth rate far lower than the rest of the economy.

The Green Revolution of the 1960s made India largely self-sufficient in terms of food production. But agricultural growth has hit a plateau at a mere average of 2 percent per year since 2000, well below the strong growth in the rest of the Indian economy. Lack of investment in new agricultural technology and irrigation projects has held down growth, and today, a meager 40 percent of India's farmland is irrigated. Additionally, price distortions and inadequate storage and transport provisions, especially for perishable products, are often cited as reasons for lagging agricultural performance.

Food prices in India are approximately 14 percent higher than a year ago, a sharp increase in food inflation compared to the 4 percent inflation rate in December 2007. These price increases are felt heavily in the low-income sectors of India where households spend anywhere from one-third to half of their income on food. In comparison, in the United States only 6 percent of the household budget goes to food.

Pakistan has been hit even harder by food inflation than India. Between the mid-1970s and the current decade, Pakistan tripled its wheat production and successfully shifted from being an importer to a net wheat exporter. But the recent surge in food prices has forced Pakistan back into the import column with purchases of about $800 million worth of wheat in 2008. Pakistan's spending on food imports has grown by 25 percent in the past year. Furthermore, between May 2007 and May 2008, consumer prices rose at an annual rate of about 20 percent, with food prices rising approximately 28 percent.

Although this year's monsoon came early to the major grain-producing areas in India and Pakistan, the monsoon season has been hugely disappointing overall. Recent data show that as of late July, rainfall has been 33 percent below normal. If the monsoon season ends badly, it will ensure that food prices remain high until the end of the fiscal year. If we see an improvement in the rainy season resulting in good crops, increased government procurement of rice and wheat will swell government stocks and ease upward pressure on food prices. However, even in the best-case scenario, beyond the present year, both countries face increasing demand. This makes overall strengthening of the agricultural sector an essential part of the solution.

Ban on exports: India and Pakistan have responded to the food crisis by banning certain food exports in the last few months. India, the world's second-largest exporter of rice, embargoed rice exports to keep inflation under control, whereas Pakistan banned wheat exports in order to mitigate domestic food inflation and alleviate wheat flour shortages.

Political fallout: In India, national elections must take place no later than May 2009, and several state elections are due before then. Inflation in food and fuel prices is being felt all over the country, its impact magnified by nationwide trucking strikes. In early July, more than 4 million Indian truckers took their vehicles off the roads. The steady decline in the national vote share of the two major parties over the past two decades taken together with these developments suggests that we could see some unexpected results at the polls.

In Pakistan, economic discontent was a factor in the decisive rejection of President Pervez Musharraf's party in the February 2008 elections. Continued dissatisfaction with the economy is already adding to the unpopularity and fragility of the newly elected government. With the government distracted by political infighting and mitigating terrorism in the northwest, Karachi has been beset by transport strikes. Although Prime Minister Yousaf Raza Gilani has cut food and fuel subsidies in response to a slowing economy and market pressures, subsidies still account for more than a third of the government's deficit.

Elsewhere in the region: All the countries of the region have been hit by higher food and fuel prices. Bangladesh has seen its rice imports swell by 300 percent in the last year, as a result of the damage caused by Cyclone Sidr. As the cost of rice steadily rises, Bangladeshi consumers are increasingly under pressure to meet their consumption needs. These concerns have been mounting as Bangladesh comes closer to its expected election time at the end of 2008. India has made an exception to its export ban on rice for Bangladesh but still faces the prospects of a neighbor with a humanitarian crisis on its hands.

Virtually all of Nepal's imports come in through India, including energy. When the state-owned Indian Oil Corporation (IOC), which supplies all of Nepal's oil, cut supplies to its neighbor by almost half in response to unpaid debts, the Nepalese government raised domestic fuel prices by almost 25 percent. Massive strikes ensued around the country, shutting down the capital Kathmandu and shaking up the new Maoist government. A strike by the country's oil dealers has only been postponed through the efforts of the Nepali business group, the Federation of Nepalese Chambers of Commerce and Industry (FNCCI).

Afghanistan has been particularly hard hit by the wheat export ban in Pakistan, a major wheat supplier. Prices of bread and flour doubled within two weeks of the ban. Thousands of bags of wheat are smuggled daily out of Pakistan and into Afghanistan by corrupt officials and smugglers. Some Western officials have been cited as saying that the food crisis poses more risk to President Hamid Karzai than the insurgency.

Managing the storm: During the energy crisis of the 1970s, energy prices, in real terms, were slightly below present rates. At that time, the international community mobilized major resources for the "most seriously affected" developing countries. The oil-producing countries financed much of this effort. Today, however, many of the oil-producing countries are cash short as food and fuel prices are rising together, and there has been no special mobilization effort. Although international financial support can avert an immediate disaster-as with the 1970s experience-this will most likely leave serious debt that could take years to work through.

Inevitably, there has been much finger-pointing in an attempt to pin the blame for rising food costs on a single factor-pressure from the developed world to grow crops for biofuels in place of food, food export bans, and even increased food consumption in the developing world. In today's integrated global economy, with both developed and developing countries becoming increasingly dependent on trade, disruptions in food supply and consumer

prices have global causes and far-reaching repercussions. Inevitably, however, it is the poorer nations of the world that are more vulnerable to the international dislocations involved. Within South Asia, India is in the best position to weather the economic storm, though its economic growth could suffer slightly in the next fiscal year. But there, as in the rest of the region, the United States needs to be prepared for short-term financing needs and for an increase in political volatility.

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