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Complex factors drive food price increases

OAK BROOK, IL July 23, 2008: Understanding the complex and multiple factors influencing food prices today is important as future policy options are debated, according to a new study released today by Farm Foundation.

“Today’s food price levels are the result of complex interactions among multiple factors. However, one simple fact stands out: economic growth and rising human aspirations are putting greater pressure on the global resource base,” says Farm Foundation President Neilson Conklin. “The difficult challenge for public and private leaders is to identify policy choices that help the world deal with the very real problems created by today’s rising food prices without jeopardizing aspirations for the future.”

Written by Purdue University economists Wallace Tyner, Christopher Hurt and Philip Abbott, the study, *What’s Driving Food Prices?*, identifies three broad sets of forces driving food price increases: global changes in production and consumption of key commodities, the depreciation of the U.S. dollar, and growth in the production of biofuels.

“We made no attempt to calculate what percentage of price changes are attributable to the many disparate causes and, in fact, think it is impossible to do so,” says Tyner, the lead author of the report. “But examining the interplay of the forces driving food prices gives a clearer picture of what has been happening.” Tyner is an energy and policy economist, most recently specializing in biofuels policies. Hurt works in analysis of commodity markets and Abbott in international trade and macro factors.

The authors reviewed current reports and studies, considering the findings of that literature as they did their own analysis of the situation. Here are some key findings.

- Rapid economic growth in developing countries has led to growing food demand and dietary transition from cereals toward more animal protein. As a result, global consumption of agricultural commodities has been growing rapidly. This demand growth has been broad-based. While many studies focus attention on China and India, neither country is a major trader of most agricultural commodities. However, China’s rapidly growing oil imports have had an indirect effect on food prices by impacting world prices for crude oil.
- Demand for agricultural commodities has increased, while growth in agricultural productivity has slowed. Over the past four to eight years, depending on the commodity, this combination has resulted in a change from a surplus to a shortage era, setting the stage for commodity price increases. When weather and crop disease problems occurred in 2006 and 2007, stocks of many agricultural commodities were already low, exacerbating the impact on prices. Policy actions by some countries to isolate their domestic markets through export restraints made the situation even worse, particularly for rice. Increased investment in agricultural research is important, but not a short-term solution.
- The effects of supply and demand on commodity prices are clear. Less clear are the effects of changes in the structure of commodity markets, particularly speculative activity. There is no

doubt that the amount of hedge fund and other new monies in the commodity markets has mushroomed. Price volatility has increased, partly due to increased trading volumes. Based on existing research, it is impossible to say if price levels have been influenced by speculative activities.

- Most commodities, including crude oil and grains, are priced in U.S. dollars, but are purchased in the local currency. When the dollar falls, as it has over the past six years, there is a link with rising commodity prices. The link between the U.S. dollar exchange rate and commodity prices is strong and more important than many other studies imply. The decline of the dollar is linked not only to higher demand for U.S. agricultural commodity exports, but also to higher oil prices.
- Some studies conclude that oil prices and rising production and transportation costs have helped drive current commodity price increases. But many of these impacts occur with a significant lag. Higher crude oil prices have pushed up the cost of producing agricultural commodities through increases in the price of inputs, such as fertilizer and diesel, but the long-term impact of these increases has yet to be felt.
- Crude oil's strongest and most direct impact on food prices has been through its effect on the demand for biofuels. In the United States and the European Union, public policies, such as subsidies and mandates, lead to the development of the biofuels industry and its growing demand for corn and vegetable oils. In the last four years, most of the growing global demand for corn has come from its increased use for ethanol production. Ethanol blender credits, tariffs and the Renewable Fuel Standard are factors causing increased corn prices, but quantitatively, most of that price increase is driven by high oil prices.
- Agricultural commodity price increases have a much greater impact on low-income consumers, especially in developing countries, because food is a larger fraction of total expenditures and commodities are a larger share of their food consumption. One side of higher commodity prices that has gotten little attention is the potential for farmers in developing countries to increase production and productivity. Higher prices could induce these farmers to purchase and use such inputs as improved seeds and fertilizer, leading to substantial increases in productivity and economic gains. For this to happen, governments would have to permit higher prices to be transmitted to farmers.

“We commissioned this report to provide a comprehensive, objective assessment of the forces driving food prices,” Conklin said. “It is the intent of Farm Foundation that the information will help all stakeholders meet the challenge to address one of the most critical public policy issues facing the world today.”

Farm Foundation works as a catalyst for sound public policy by providing objective information to foster deeper understanding of the complex issues before the food system today. Farm Foundation has a 75-year history of objectivity. It does not lobby or advocate.

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Webinar offered: On Wednesday, July 30, Farm Foundation will host a free webinar on the report, *What's Driving Food Prices?* The webinar begins at 1 p.m. EDT. To register for this event visit the Farm Foundation Web site, www.farmfoundation.org.