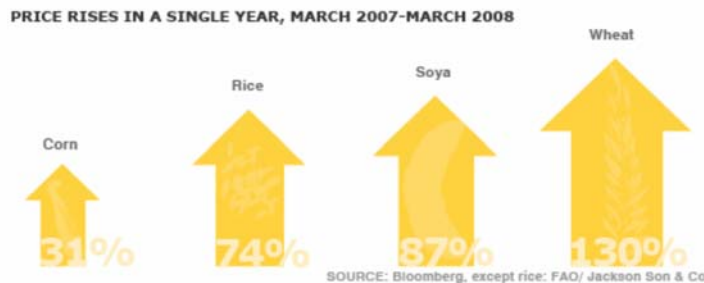


*“Round up the usual suspects” - Captain Louis Renault, Casablanca 1942*



Although it would have been hard to believe a couple of years ago, food inflation has now replaced global warming as the dinner-party subject for the “concerned” classes. As the diagram (from the BBC) above shows, at least some of that concern is justified. There have been street protests and riots in a number of developing countries (with some deaths in Haiti) against food price increases and the media - as the recent cover of Time magazine shows - has been quick to name biofuels as the root cause of this misery.



The reality, as always, is more complicated and, after an office discussion around the coffee machine, we came up with our top ten explanations for this recent burst in food prices. Before we start, however, we should point out that higher food prices are not bad for everyone. The winners are those working in rural areas; the losers are the urban poor. And the real losers are the city dwellers in the world’s poorest countries. In Nigeria, for example, food accounts for a third of total consumer spending. In China the figure is 25%. In the UK it is around 7% and in the USA it is around 5% - enough to moan about but not enough to cause a riot.

At **number 10** in our count-down we have **“High freight rates”**: they have quadrupled over the last two years and significantly increase the cost of getting food to the market. Of course, you have to ask yourself why they have doubled and the answer is because of a surge of demand for iron ore and coal in India and China and that will feature again later in our list. However, you have to start somewhere and as you will see as we move up the list, it is very unclear who is driving whom.

At **number 9** we have put a **“Growing world population”**. It is a popular theme with the press, but not a convincing one. After all, the world population was growing just as fast in the 80’s and 90’s – periods of low agricultural prices and mountainous surpluses, especially under the EU’s Common Agricultural Policy. To blame food inflation on population growth is a hark back to the late 19<sup>th</sup> century when Malthus predicted that agricultural production could never keep pace with population and that we would all starve. He forgot about improvements in technology and in crop yields. Those who blame population growth now are doing the same thing.

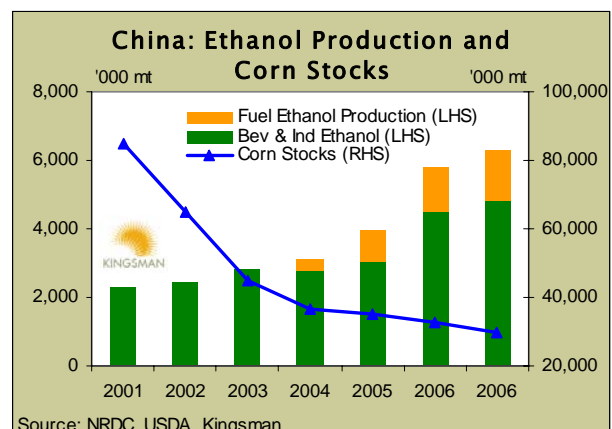
So let’s move on to **“Speculation”** which enters the charts at **number 8**. Index funds now own around 20 mln mt of sugar and it is obvious that by keeping this off the market they force prices higher. But wait a minute: they don’t keep that sugar off the market, they “borrow it” and then return it at every expiry when they roll forward their positions. Index funds inflate forward values and send strong

signals to farmers to step up production but then they abandon that extra production once it becomes spot. Looked at from that angle, Index Funds are a bearish influence on food prices.

At **number 7** we have put **“A lack of investment due to years of low prices”**. That may deserve to be higher up as a driver. It’s certainly a significant factor in non-agricultural commodities where it can take up to 20 years to get approval for a new copper mine or aluminium smelter, but agricultural products have a shorter lead time. That is, unless they are constrained by government intervention in the form of set aside land or production quotas. The collapse of the Soviet Union which led to a large disinvestment in agricultural production in the 1990s also didn’t help.

That leads us to **number 6, “Politics”**. There the list is long and sad. Export bans artificially depress domestic prices (sending wrong signals to farmers) while inflating world prices. Domestic price controls and export taxes do the same thing while domestic subsidies (for example on ethanol in the US) can distort the market just as much. And while we are talking of beggar thy neighbour policies, the long history of export subsidies in the USA and Europe have kept world prices low for years, encouraging farmers in poor countries to abandon their fields and head for the city slums. So flashing red on our list under “politics” has to be the winding down of Europe’s CAP: it has to be a major factor in the recent world price increases.

At **number 5** we put **“Biofuels”**. If we had put it any lower we would have been accused of being biased, but with 30 percent of the US corn crop going to ethanol, it’s got to be attracting headlines. Of course on a global basis less than 5% of the world’s grains and less than 8% of the world’s rapeseed, palm and soy oil is used for biodiesel, but it’s still enough to put the industry’s promoters on a back foot. There is no doubt that the sector has been taken by surprise by the rapid increase in food prices over the past year; it is not impossible that some of the mandates now being talked get pushed back into the committee stage.

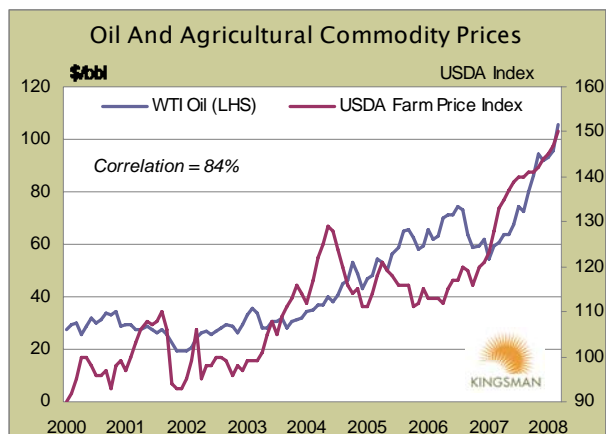


The chart above shows the situation in China where their ethanol programme was launched partly as a way to use up old (deteriorating) stocks of corn. Those stocks are now gone – and the corn ethanol programme is going with them.

At **number 4** we have **“The Weather”** and at **number 3** we have **“The Weaker Dollar”**. Over the last three years we have seen a major drought and frosts in Argentina, drought in Australia, Southern Africa and areas of China and India, heat waves across southern and eastern Europe, serious flooding in the UK and major hurricanes around the globe. Low rainfall and heat stress have also limited crop yields in areas of the US grain belt. All this bad weather (and the increasing evidence of climate change) has had a major impact on production. Meanwhile, the dollar has declined considerably. A significant proportion of recent commodity price rises have merely offset the dollar’s fall. (But a weaker dollar doesn’t explain why US domestic grain prices expressed in dollars are rising so much.)

At **number 2** we have **“Rising World Income”**. In 1980 meat consumption in China was 20kg per capita; in 2007 it was 50kg per capita. In the USA it was 125kg. Just imagine what happens if China ever reaches those levels! It takes eight kilos of wheat to produce a kilo of meat and up to ten times more water. Changing consumption patterns are putting pressure on agricultural prices just as they are putting pressure on energy prices. And that is where things get more complicated.

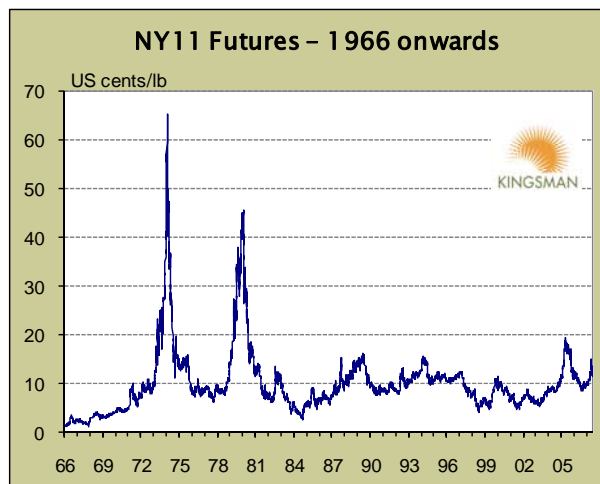
The chart opposite shows how farm prices have moved in line with oil prices over the last eight years. The correlation, at 84%, is significant. Many analysts explain this by arguing that higher oil prices have increased demand for crops used for biofuels, which in turn raises the price for these commodities. That may be partially true, but it doesn't explain the strong relationship that existed between oil and agricultural commodity prices for at least the last thirty years. Oil and energy costs are a significant proportion of a farmer's gross margin. The cost of operating farm machinery, purchasing fertilizer and transporting farm produce all increase with higher energy costs, as do the processing costs of food manufacturers. Commodity prices peaked in line with oil in the early seventies and eighties when there was no biofuels industry to speak of.



As such, we have to put **“Higher Oil Prices”** at **number 1** in our price pop chart. But as we all know, in this modern world, everything is both connected and inter-related. Growth in China is pulling up energy and freight prices which in turn are pushing up agricultural costs (which are themselves pulled up by China's growth) and pulling up demand for biofuels. Which came first, the chicken, the egg or this increasingly messy chicken omelette?

We would like to leave you with two parting thoughts. The first we expressed in an ethanol editorial last summer. The current media “feeding frenzy” surrounding the impact of biofuels on food prices seems strange given the lack of column inches devoted to the impact of farm subsidies on food prices throughout the developed world over the last half century. OECD figures suggest that American consumers paid an extra \$16.2 bln to domestic agricultural producers in 2004 or \$146/household through higher retail prices. This doesn't include what is allocated as direct payments to farmers under the federal budget. Consumers in Europe and Japan pay as much or more than their US counterparts. Why are food prices such an issue now when they weren't then?

The second thought is that there is no such thing as food inflation. Agricultural prices have risen dramatically in the last two years for all the reasons outlined above, but no one is pretending that we are running out of land (even without cutting down rain forests), nor that technological change has come to a sudden end. Government incompetence takes a large part of the blame for poor production in a number of countries and overproduction in others. As the sugar chart shows, prices rise and fall and the spikes leave quite a production hangover. In a few years time it may not be consumers demonstrating on the streets, it might be the farmers.



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