

Why Your Food Dollar Doesn't Stretch As Far: Higher Oil Prices and Surging Global Demand Primary Factors

The recent economic news is grim. Americans are paying more for everything from gasoline to groceries. The most recent CNN poll shows that 74% of Americans believe the nation is in recession.¹ In this climate of economic unease, some have seized upon the fears of millions of Americans and begun to aggressively and, in some cases, dishonestly blame the expansion of the American ethanol industry for higher prices in the grocery aisle.

Cooler, impartial heads have studied the issue and discovered that several factors play a more significant role than ethanol in what Americans pay for groceries.

Energy and the Marketing Bill

It should be no surprise that the marketing bill – the difference between the value of the food produced on the nation's farms and what consumers pay at retail – plays a significant role in determining the price of food. The Federal Reserve Bank of Kansas City recently noted:

"In 1950, marketing costs (the difference between the farm value and consumer spending for food at grocery stores and restaurants) accounted for 59 percent of total retail food costs. Over the past three decades, rising labor and energy costs have boosted that share steadily, from 67 percent in the 1970s to 80 percent today."²

[See the full report here: http://www.kc.frb.org/RegionalAffairs/MainStreet/MSE_0108.pdf]

The Federal Reserve Bank also estimated that "a 10 percent gain in energy prices could contribute 5.2 percent to retail food prices."³ According to the Energy Information Administration, the crude oil price as of March 7 was \$105.12 a barrel, an increase of more than 45 percent from a year ago.⁴ Extrapolated out, the rise in oil prices has contributed more than 20 percent to retail food prices over the past year.

Surging Global Grain Demand

Developing economies around the world are surging, with China and India leading the way. The resulting increase in not only affluence of the population, but the population itself, is putting strains on the world food supply. While energy prices, weather, market speculation, and to a small degree biofuels, have led

¹ "Poll: Three-quarters think U.S. in recession," CNN, March 17, 2008.

² "What's Driving Food Price Inflation," [The Main Street Economist](http://www.kc.frb.org/RegionalAffairs/MainStreet/MSE_0108.pdf). Federal Reserve Bank of Kansas City, March 2008. http://www.kc.frb.org/RegionalAffairs/MainStreet/MSE_0108.pdf

³ See above.

⁴ "This Week in Petroleum," Energy Information Administration, March 12, 2008.

to higher commodity and food prices, perhaps no factor will play a more significant role moving forward than rampant global demand for grain and meat.

In a recent *New York Times* article entitled “A Global Need for Grain That Farms Can’t Fill,” author David Streitfeld stated:

“Many factors are contributing to the rise [of food prices], but the biggest is runaway demand. In recent years, the world’s developing countries have been growing about 7 percent a year, an unusually rapid rate by historical standards.

“The high growth rate means hundreds of millions of people are, for the first time, getting access to the basics of life, including a better diet. That jump in demand is helping to drive up the prices of agricultural commodities.”⁵

[Read the full article here: <http://www.nytimes.com/2008/03/09/business/worldbusiness/09crop.html?ref=us>]

A Weak U.S. Dollar and Wild Speculation

Adding to the perfect storm of surging global food demand, soaring energy prices, and poor growing conditions in some areas is the precipitous devaluation of the U.S. dollar and resulting economic turmoil it creates.

Robert Glavin, of the *Boston Globe*, in his March 9, 2008 article, “Surging costs of groceries hit home,” wrote:

“Darin Newsom, senior analyst at DTN, said the same dynamics pushing oil prices to new highs are at work in agricultural commodities. They start with strong global demand, growing as living standards improve in developing nations such as China and India and food consumption increases.

“The weak US dollar, at or near historic lows against the euro and other currencies, adds more pressure. Oil and other commodities trade in dollars, so when the dollar is worth less, producers demand higher prices to make up for the loss in value. This pressure raises inflation fears, which in turn make commodities attractive to investors, who view them as holding value during inflationary periods. As investors buy, demand grows and commodity prices go even higher.”⁶

[Read the full article here:

http://www.boston.com/business/personalfinance/articles/2008/03/09/surging_costs_of_groceries_hit_home/?p1=Well_MostPop_Emailed7]

The Role of Biofuels

To be clear, biofuels do play a role, albeit a minimal one, in the higher prices of commodities. Demand for corn created by the expansion of the U.S. ethanol industry has helped strengthen the price of corn and in turn eliminated the need for more than \$6 billion in annual farm program payments.⁷

Compared to the factors listed above, however, the role of ethanol and corn prices is small when it comes to determining the price of food consumers pay. According to Informa Economics, a Memphis-based economic consulting firm, the role of corn prices is an insignificant factor in determining consumer food prices:

⁵ “A Global Need for Grain That Farmers Can’t Fill,” Streitfeld, David. *New York Times*, March 9, 2008.

⁶ “Surging costs of groceries hit home,” Glavin, Robert. *Boston Globe*, March 9, 2008.

⁷ Testimony of former USDA Chief Economist Keith Collins, Senate Agriculture and Forestry Committee, January 2007.

“...the statistical evidence does not support a conclusion that the growth in the ethanol industry is driving consumer food prices higher. This is demonstrated by the fact that the R-squared statistic between nearby corn futures prices on the Chicago Board of Trade (CBOT) and the food CPI is only 0.04, which means that only 4% of the change in the food CPI is “explained” by fluctuations in nearby corn futures prices. Even when the corn price is lagged to allow for the effects to work their way through the food supply chain, the statistical results do not improve.”⁸

[Read the entire Informa Economics report here: <http://www.informaecon.com>]

Conclusion:

The factors contributing to rising commodity and food prices are many, and issues surrounding them are complex. To single out any one factor, biofuels in particular, as the sole or the major cause of the recent price gains is empirically irresponsible and intellectually dishonest. Factors ranging from increasing demand to soaring energy prices and labor costs play a far greater role in determining what Americans pay for food than does the use of ethanol to reduce our dependence on imported oil.

⁸ “Analysis of Potential Casuses of Consumer Food Price Inflation,” Informa Economics. December 2007. www.informaecon.com.