



Talking point

Food prices on the rise: weather events exacerbate a tight supply-demand balance

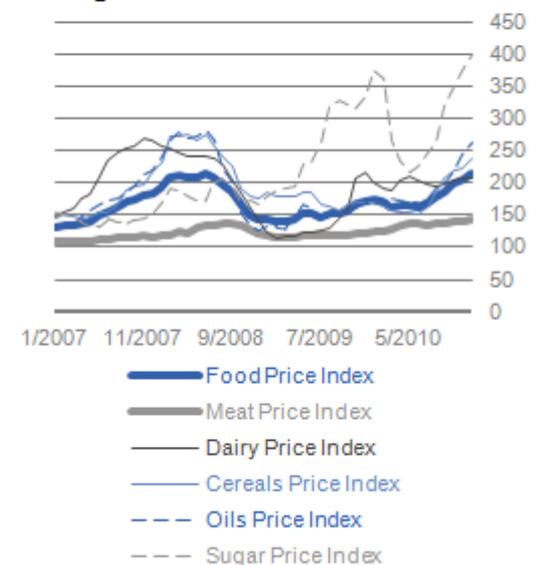
January 12, 2011

Food prices are rising considerably, prompting talks of another impending food crisis. The UN's Food and Agriculture Organisation announced last week that prices for basic commodities hit record highs last month. Global prices increased between June and December 2010 by 57% for grains, by 56% for oils and fats and by 77% for sugar. Prices for wheat, corn, sugar and oil seeds are now above their highs of 2007-2008. As Robert Zoellick (President of the World Bank Group) puts it, "rising prices are re-emerging as a threat to global growth and social stability".

Weather-driven crop failures have been a major driver of recent upswings in food prices. Drought and wildfires in Russia last summer affected wheat supply globally (exacerbated by a ban on exports). Recent record-setting rainfalls in parts of Australia also heavily affected the wheat harvest. Dry weather in South America and the Western US plains may compound the problem. These weather disruptions all appear to be symptoms of the La Nina phenomenon referring to low sea surface temperatures across the equatorial Eastern Pacific Ocean (counterpart of El Nino). There is a vast consensus among climate change experts that extreme weather events are likely to happen with increasing frequency, thus further affecting agricultural (and oil) prices, especially since they occur in the context of a tight supply-demand balance.

Structural limitations remain. Indeed, income and population growth, rising energy prices and subsidised biofuel production boost the consumption of agricultural products. At the same time, productivity and output growth are impaired by water and land constraints, underinvestment in rural infrastructure and agricultural science, as well as farmers' limited access to agricultural inputs. The overall mechanism of price transmission between international and local markets is complex – subject to the level of (managed) trade, exchange rates, transport costs, etc. – and should be further investigated, especially for the most volatile commodities/countries. Given that the current upward movement in prices is mainly due to weather-driven supply-side shocks, it is likely that extreme price levels will recede within a year or so.

Food prices: above 2007-2008 levels in most categories



Sources: DB Research, FAO



Food price volatility is expected to remain high long term, due to temporary supply shortages combined with more structural supply issues (and increasing linkage with oil prices). Agricultural exports tend to be highly concentrated (over two or three countries for major agricultural commodities). This means that a bad crop or a change in regulation in one of these countries can have a strong impact on global prices. As discussed above, price increases are driven by supply-demand factors (population, income, productivity, energy prices, policy responses) but in some instances speculation might have added to the price movement. This will likely attract the attention of regulators who are expected to require more transparency for derivatives to keep serving their initial purpose (cope with price volatility). Agricultural commodities in a low-interest rate environment are increasingly viewed as an attractive asset class which offers hedging opportunities given its low correlation with other financial asset prices.

Food price inflation is a special concern in low-income

countries. High food prices have contributed to sparking social unrest in the past in several countries of Latin America, Asia and Africa. Current riots in Algeria and Tunisia (occurring in a tense economic-political context with high unemployment) were partly triggered by high food prices. Food price inflation is rising sharply in several countries e.g. to 18.3% in India, 15.6% in Indonesia, 11.7% in China (vs overall inflation rates of 9.7%, 7% and 5.1% respectively). It is an obvious concern in countries where the poor spend most of their income on food. Beyond average inflation, some high prices have a higher potential to cause anger when they apply to foods which have a special cultural significance (e.g. tortillas in Mexico, kimchi cabbage in Korea, onions in India). Whether high food prices translate into a food crisis partly depends on how individual countries manage to protect the most vulnerable in the short-term and boost agricultural productivity in the longer term.

Global action from public and private sector called for

Short-sighted responses such as hoarding or export bans (potentially decreasing local farm incomes) could exacerbate a tense situation whereas global action has the potential to limit the impact of price spikes on poor countries' populations and economies, and thus global growth. The G20 has the opportunity to take useful steps – e.g. establish local strategic reserves where required, boost smallholder production, improve access to critical data (such as quantity of grain stocks and weather forecasts), or further develop risk management tools, including market-based products. The private sector also has an obvious role to play, especially in integrating smallholder farmers into global food supply chains.

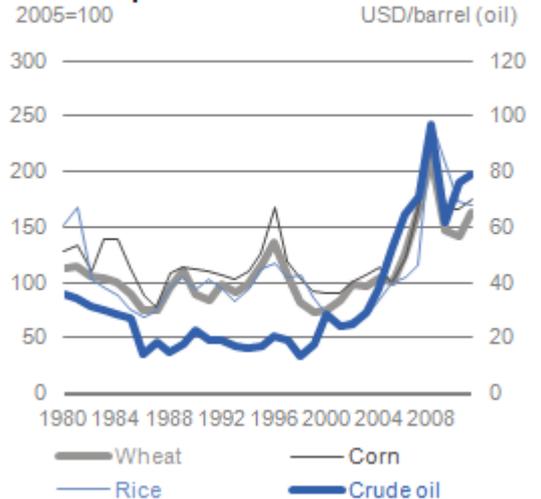
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Sources: DB Research, IMF



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