

# Less bread for your dough

The impact of rising food prices on the global economy



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- ▶ **Grain prices have soared due to a severe US drought**
- ▶ **Ample stocks should prevent prices rising further, providing governments don't panic**
- ▶ **But headline inflation rates are still set to rise, particularly in emerging markets**

The worst US drought in 25 years is gripping two-thirds of the country, sending grain prices soaring. Corn is up 25% since the start of the year, wheat is up 30% and soybeans 42%. As grains also feed cattle and, increasingly, cars, this is leading to a more generalised commodity price shock.

As yet, nothing suggests that prices will continue to spiral upwards. Coming into this year, most grain stocks were reasonably high; these can be run down to help meet demand until new harvests are reaped in unaffected parts of the world. But much depends on government behaviour. With memories of Haiti's 2008 food riots and the Arab Spring (where high food prices played a part) still fresh, panic buying by governments and/or export bans would only exacerbate the problem and may cause social unrest.

Even if prices stabilise at these levels, we are likely to see headline inflation rates rise across the world in the coming months, particularly in the emerging economies where food accounts for a larger proportion of household spending. Latin America is more susceptible than Asia where rice is the more common staple. So far rice prices remain subdued.

With labour markets across the world generally softening in response to the slowdown in global trade, we're unlikely to see workers asking for higher wages to compensate for higher food prices. This will largely allow central banks to ignore any rise in prices as an exogenous cost shock, though it may make them more cautious in aggressively stoking demand.

We conclude that this is another dampener for the global economy at a time when the headwinds are already acute. The squeeze on consumer pockets is unlikely to be compounded by monetary tightening. But should governments panic and begin hoarding, this has the potential to escalate, carrying dangers of social unrest in parts of EM, as we have seen clearly in the past.

# Less bread for your dough

- ▶ Severe droughts in the US are pushing food prices up again
- ▶ Rising headline inflation will put pressure on household budgets
- ▶ Central banks should worry about the impact on growth, not inflation
- ▶ The situation is unlikely to escalate unless governments panic, hoarding grain and limiting trade

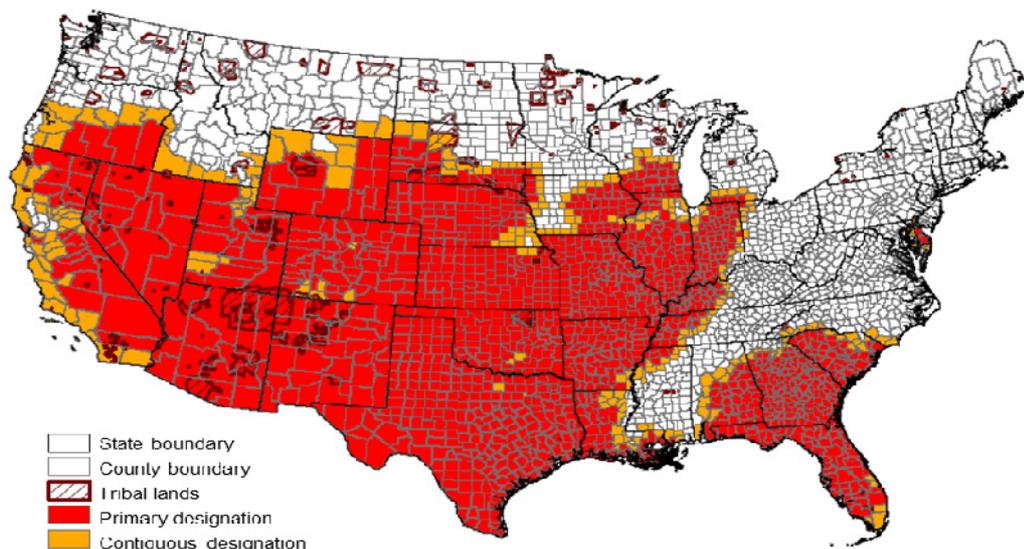
## Here we go again

For the third time in five years, food prices are on the rise. In 2008 the spike was caused by exploding demand in emerging markets. In 2010, droughts in Russia and too much rain in Canada and Pakistan were to blame.

This time the problem is severe drought in the US. Two-thirds of the continent is designated as being in moderate to exceptional drought from California to upstate New York (Chart 1). This has destroyed 45%

of the corn and 35% of the soybean crop – the worst harvest since 1988. In addition, India has seen below-average rainfall and water in reservoirs is reportedly 20% below normal (see [India Monsoon monitor](#), Leif Eskesen, 14 August). To make matters worse, Russia and Ukraine, two other major global commodity exporters, are also having a bad harvest with forecasts for crop production this year down more than 20% on last year.

1. Two-thirds of the US now in a designated 'drought disaster incident' zone



Source: USDA, data as at 3 August 2012

## Chain reaction

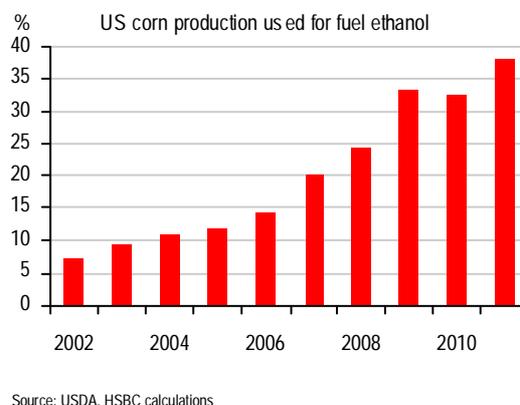
As a result the price of wheat, corn and soyabean has rocketed by 30%, 25% and 42%, respectively (Charts 4-6) since the start of the year.

These cereals are used to feed livestock. The drought has also affected farmland in the US with 55% of pastures designated as being in very poor or poor condition, increasing the need to buy grain to compensate. Upward pressure on meat prices in the coming months looks likely (Chart 7). See also [Global Agriculture: blame it on the US drought](#) (27 July).

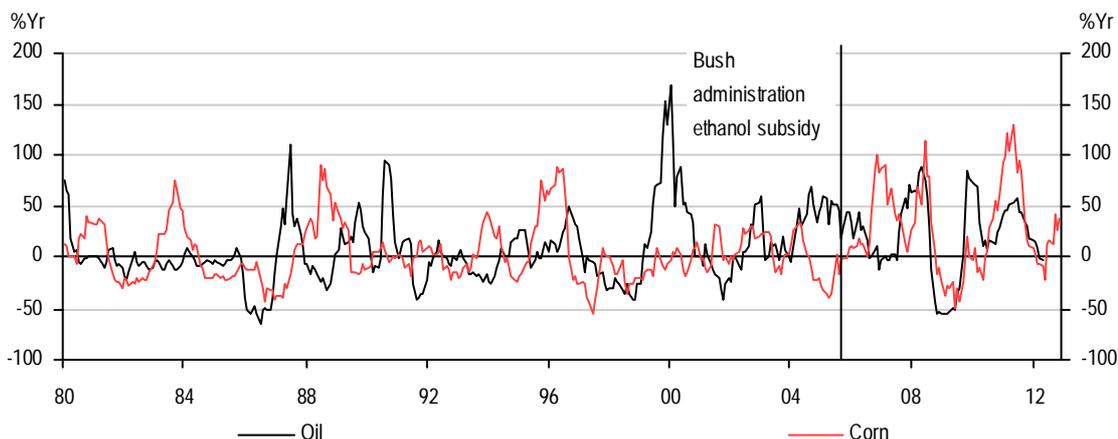
Moreover, corn has increasingly been used to fuel cars, following subsidies instigated by the Bush administration in the US in 2005. As a result an increasingly significant proportion of grain goes to produce fuel ethanol – filling cars rather than tummies (Chart 2). For this reason foodstuffs and energy commodity prices have become considerably more correlated than they have been in the past (Chart 3). Tensions in the Middle East which serve to push up oil prices now quickly filter through to food commodity prices and poor harvests affect energy prices. After dipping to USD90/barrel in June, oil prices are now up almost 30%.

The consolation is that so far this is not feeding into rice prices, another staple for consumers, particularly in Asia. Substitution effects could start to increase the pressure but as Fred Neumann discusses in [Food again](#) (13 August), Thailand, the world's largest exporter of rice is sitting on large inventories which could be released should prices start to jump.

2. Corn now used to feed cars rather than people



3. Since the fuel-ethanol subsidies in the states in 2005, food and oil prices have become considerably more correlated



Source: Thomson Reuters Datastream, Note: assumes corn prices stay at current levels until the end of 2012

## Commodity dominoes

4. Corn prices have reached a new high



Source: Thomson Reuters Datastream

5. Wheat prices are up 30%



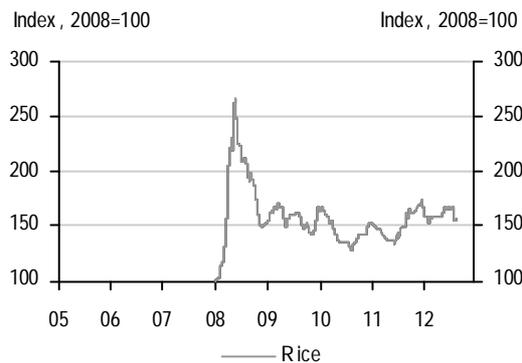
Source: Thomson Reuters Datastream

6. Soy is at a new high



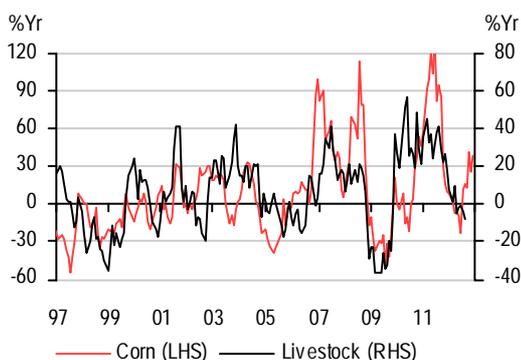
Source: Thomson Reuters Datastream

7. The saving grace is that, so far, rice prices are stable



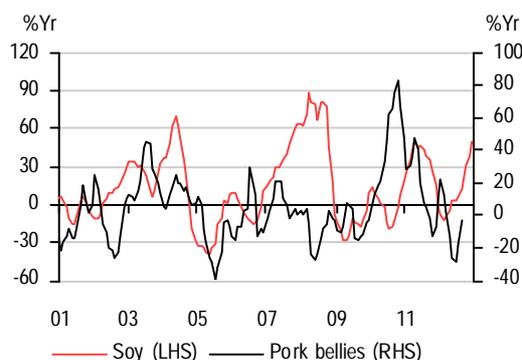
Source: Thomson Reuters Datastream

8. Higher feed prices will push meat prices up



Source: Thomson Reuters Datastream

9. Higher soy (a key feedstock for pigs) could dent the Chinese appetite for pork



Source: Thomson Reuters Datastream

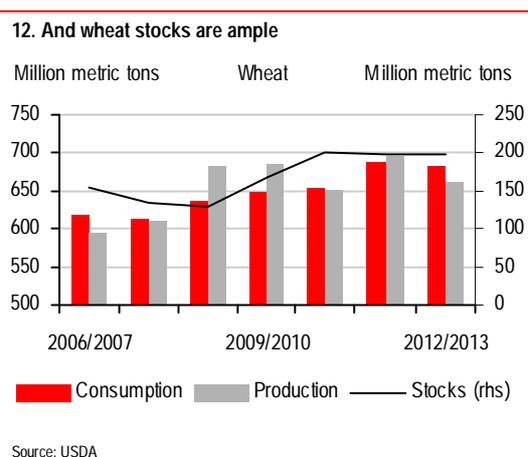
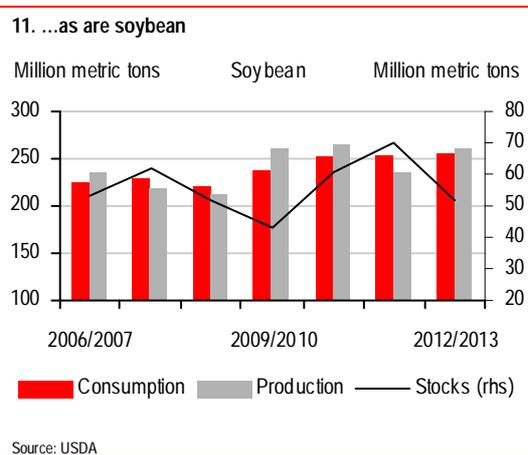
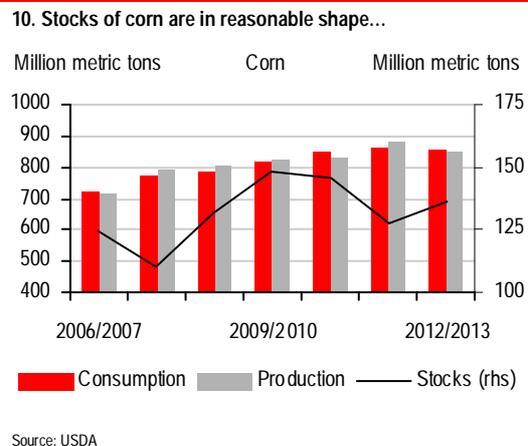
## Stocks in reasonably good shape

Both the previous spikes of 2008 and 2010 proved temporary, but for different reasons. In 2008, the collapse of the global economy, and alongside it demand, helped ease pressures across all commodity prices. Oil prices fell from USD145/barrel to USD35/barrel in the space of seven months.

In 2010, the supply shock happened at a time when stocks were ample. This provided some cushion until other parts of the world were able to respond with additional crop planting. The UN also helped prevent widespread government hoarding, which would only have served to push prices higher.

The stock situation this time is more mixed. For corn, we entered the 2012/2013 year with stock levels lower than those seen in 2010 (Chart 10). Soybean stocks (Chart 11) were around average levels and wheat stocks are at a decent level (Chart 12). This should help prevent prices escalating rapidly from current levels, although much does depend on the government response. Panic buying and hoarding could turn a reasonably sanguine picture into something more severe. The US has already announced a USD170m programme to create a 'meat bank' for 'federal food nutrition assistance'.

The UN has appealed for calm and asked the US to immediately suspend government-mandated US ethanol production. This is a delicate political issue in the run-up to the election and as yet it is unclear whether the request will be complied with. Even if it is, we may merely see the benefits of a reduction in food prices, offset by a jump in oil prices.



## A consumer squeeze

Even if prices don't rise significantly further, the gains seen so far will put pressure on inflation rates and household budgets in the coming months. In the developed world, food makes up a relatively small proportion of the household budget. In addition, although many of these crop prices are at record highs, the percentage change is smaller than that seen in 2008 and 2010 so the impact on headline inflation should be less.

In the emerging world food accounts for a much larger share of household budgets (Table 13). The most vulnerable are the importers (Charts 14-19). For the major producers of grain, governments will collect more tax revenue which can help ease the burden on its home consumers through subsidies. In addition, currencies may well appreciate, reducing other import costs. In Asia the largest importers of corn are Japan, South Korea, Taiwan and Malaysia, while Indonesia is a large importer of wheat. China isn't a key importer of wheat or corn but does take in

a huge volume of soybean (much of which is used to feed pigs).

In Latin America, diets are more heavily skewed towards grain-based foods. But Brazil and Argentina are also major exporters. If price rises seriously dent consumer confidence governments may start to think about limiting exports. Mexico is not in such a fortunate position, being both a larger consumer and importer of grain.

Russia is a large net exporter, but harvests there are also looking subpar. In 2010 Russia was quick to instigate an export ban but given they are about to enter the WTO this may deter them this time. Egypt remains particularly vulnerable to rising food prices, which may further hinder its road to reform and recovery.

Governments in the emerging economies may choose to subsidise prices to keep costs down, in which case the result may be deteriorating government finances rather than inflation.

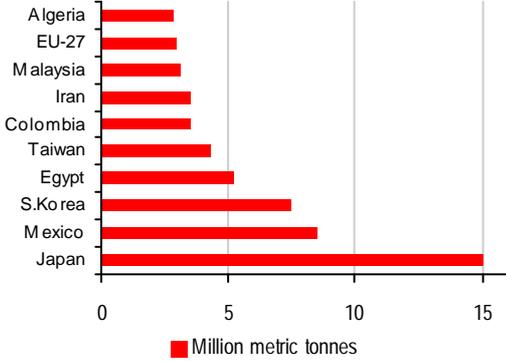
13. Food is a much larger proportion of the CPI basket in the emerging world

	Food (%)	Cereal and bakery products (%)	Rice (%)
<b>Developed</b>			
US	14.3	1.2	n/a
UK	9.8	1.7	0.1
EMU	13.9	2.6	n/a
<b>Asia</b>			
China	30.5	2.8	1.6
Hong Kong	33.7	2.0	0.6
India	24.3	3.8	1.8
Indonesia	19.6	4.7	n/a
Japan	25.3	2.2	0.8
Korea	12.7	2.3	0.6
Pakistan	34.8	8.1	n/a
Philippines	38.9	12.4	8.9
Singapore	22.1	n/a	1.7
Taiwan	26.1	2.0	0.5
Thailand	33.0	2.9	n/a
Vietnam	39.9	n/a	n/a (estimate 20%)
<b>EMEA</b>			
Egypt	39.9	n/a	n/a
Poland	22.0	4.2	n/a
Russia	27.9	1.4	0.2
South Africa	14.3	3.1	n/a
Turkey	26.2	3.2	0.4
<b>Latin America</b>			
Argentina	37.9	8.0	0.3
Brazil	23.3	3.4	0.5
Mexico	30.6	3.0	0.1

Source: National statistics offices

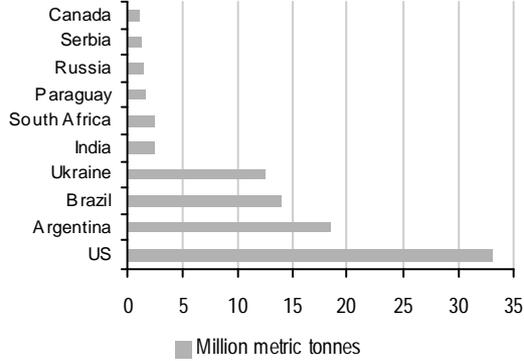
## The winners and losers of rising prices

14. Corn imports



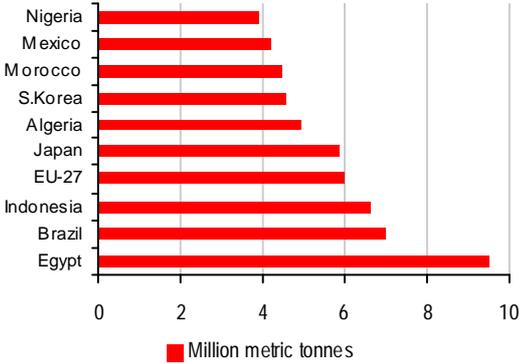
Source: USDA

15. Corn exports



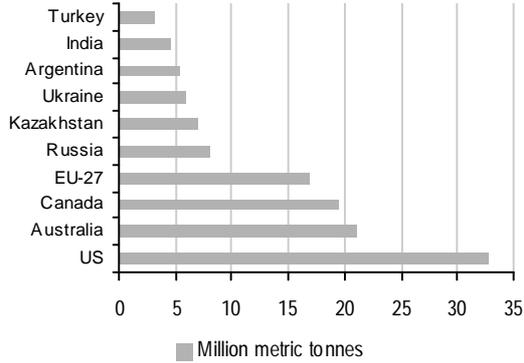
Source: USDA

16. Wheat imports



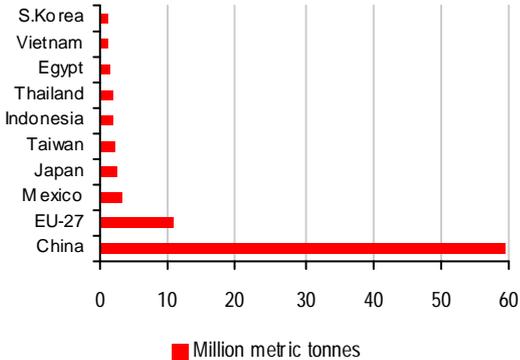
Source: USDA

17. Wheat exports



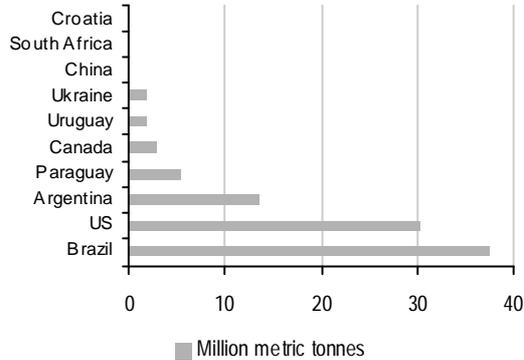
Source: USDA

18. Soybean imports



Source: USDA

19. Soybean exports



Source: USDA

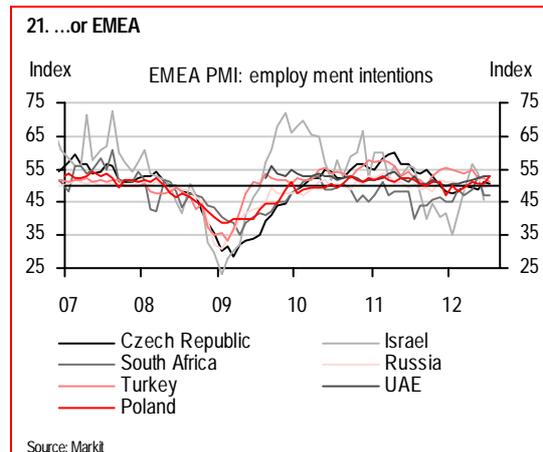
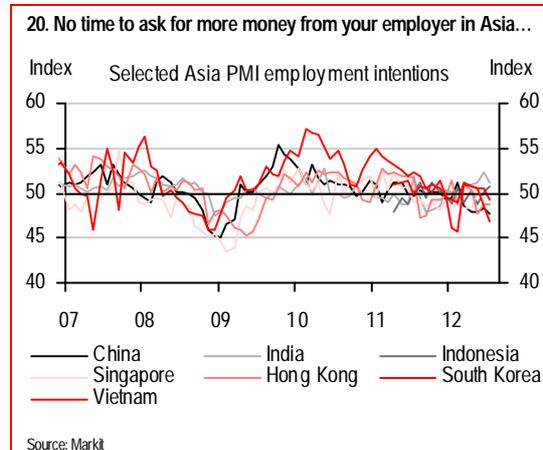
## Policymakers should see this as a problem for growth, not inflation

We may see headline inflation rates pushing up in the coming months on the back of these food price moves, in turn putting pressure on household budgets. The question then is whether workers feel sufficiently confident in their employment to ask their bosses for higher wages to compensate. Tight labour markets would see employers concede and a food price shock could lead to a more generalised inflation problem. Central banks around the world will be taking a close look at the state of the labour market and demand to see whether such ‘second-round effects’ are likely and whether they should lean against such effects and tighten policy.

In the developed world, high unemployment rates have seen all the cost shocks of the last few years absorbed in real wages. As such, rising commodity prices depressed growth and if anything spurred more policy stimulus rather than less.

In the emerging world, growth has also slowed, in part due to domestic tightening and the fall in exports to the struggling West. While unemployment rates across much of the developing world are low, the latest PMI data point to subdued orders and hiring intentions are waning (Charts 20 and 21). As a result, fears of second-round effects may be more limited than in either the 2008 or 2010 episode. As Andre Loes points out in [Food inflation...less than you'd think](#) (26 July) when demand is weak, pass-through to final food prices tends to be lower.

Therefore in this environment, policymakers are less likely to respond with higher interest rates. It may however make them a little more cautious in stoking growth with aggressive easing.



## Conclusion

The latest food shock comes at a bad time for the global economy. With demand faltering across most parts of the world, few consumers will compensate themselves by asking for more pay. Central banks would do well therefore not to fret about inflation but instead to worry about growth. Whether this is merely another hindrance to growth or something more meaningful depends on governments’ behaviour from here. Earlier spikes have become truly problematic when governments have responded with panic buying and export bans. This is something we must watch carefully in the coming weeks.

# Weather on steroids

- ▶ Extreme weather events are becoming increasingly common
- ▶ There is increasing scientific evidence this is related to climate change
- ▶ More disruption is likely but timing and location are uncertain

## Climate change factors impinge on agriculture

In July, global temperatures were the fourth-highest on record. Much higher-than-average monthly temperatures were experienced in most of the US and Canada, where drought has disrupted corn output.

Agricultural productivity is particularly susceptible to climate change factors.

During the growing season, for every 1°C temperature gain above the optimum, yields decline by 10%. In hotter temperatures plants require more water. Since water is not evenly distributed (droughts in some areas, floods in others), agricultural productivity will be disrupted.

In addition, deforestation (for food) and agricultural processes are emissions contributors. We looked at how climate change could disrupt global agriculture in detail in [Agriculture: Double Trouble](#), 12 December 2011. Essentially, countries that are most vulnerable to climate change are also more dependent on agriculture as a contributor to GDP.

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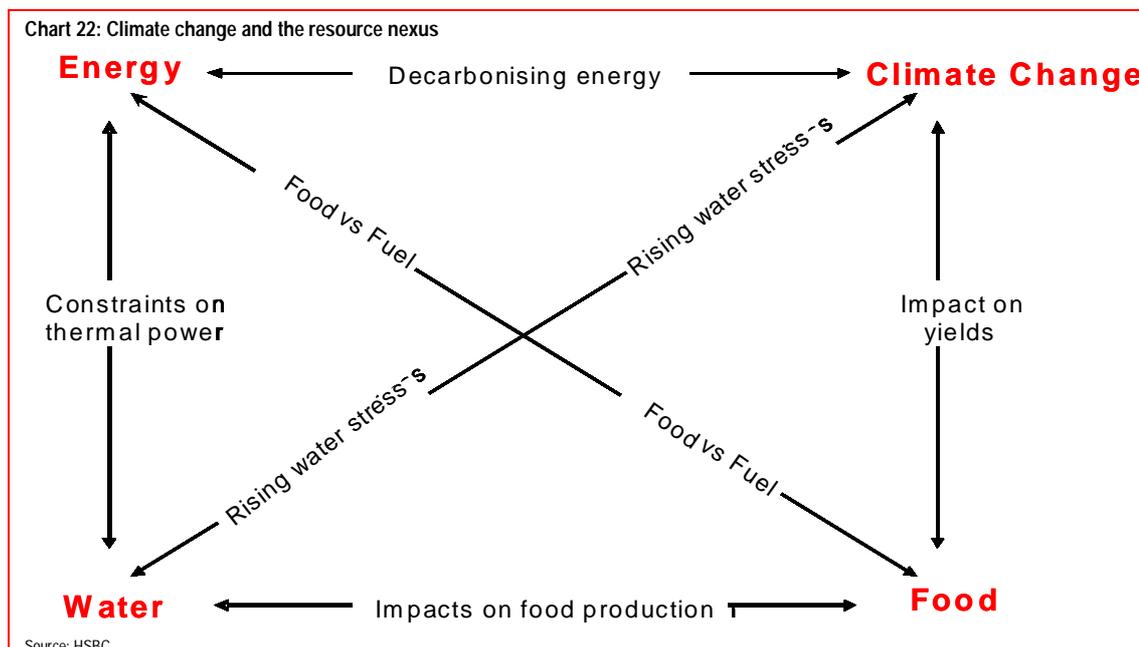
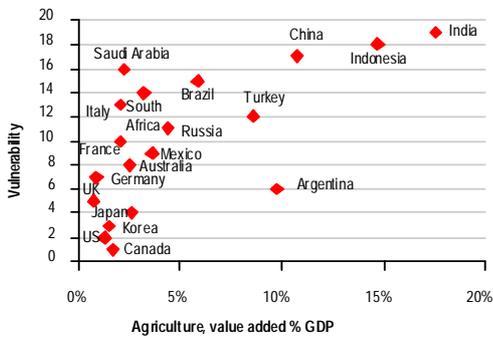
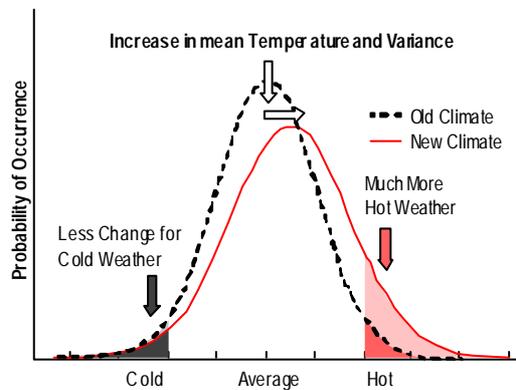


Chart 23: Climate change vulnerability and agriculture (19 = high relative vulnerability, 1 = low relative vulnerability)



Source: HSBC, World Bank (2008)

Chart 24: Shifting the probabilities - increasing mean and extreme



Source: Pew Centre for Climate Change

## Increasing evidence

In the last 12 months more scientific papers have assessed the degree to which individual weather extremes are linked to climate change. In July, the American Meteorological Society published a paper, *Explaining extreme events of 2011 from a climate perspective*.

It included this useful analogy: “Consider a cricketer who starts taking steroids and afterwards hits on average 20% more sixes in a season than before. For any one of the sixes during the years the player was taking steroids, you would not know for sure whether it was caused by steroids or not. But you would be able to make an attribution statement that, all other things being equal, steroid use had increased the probability of that particular occurrence by 20%. Attribution assessment distinguishes the effects of anthropogenic climate change (steroids) from natural variability (player talent)”. (See [Weather on steroids in 2012](#) – 19 July 2012).

These shifting probabilities mean there will likely be more weather disruption.

NASA recently published a paper analysing mean summer temperatures since 1951. Dr James Hansen noted that “this summer people are seeing extreme heat and agricultural impacts. We’re asserting that this is causally connected to global warming”.

## More of the same expected

Going forward, weather extremes are likely to continue. The *Special report on managing the risks of extreme events and disasters to advance climate change adaptation* found that “it is virtually certain that increases in the frequency and magnitude of warm daily temperature extremes and decreases in cold extremes will occur in the 21st century on the global scale” (see [Extreme climate: expect more droughts and floods](#) – 22 November 2011).

## Conclusion

There is mounting evidence of a link between climate change and extreme weather, which is useful for long term investment decision making. Of course there is still no way of predicting where these events will happen and when.

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