Economist.com

Cheap no more Dec 6th 2007 From The Economist print edition

Normally, sky-high food prices reflect scarcity caused by crop failure. Stocks are run down as everyone lives off last year's stores. This year harvests have been poor in some places, notably Australia, where the drought-hit wheat crop failed for the second year running. And world cereals stocks as a proportion of production are the lowest ever recorded. The run-down has been accentuated by the decision of large countries (America and China) to reduce stocks to save money.

Yet what is most remarkable about the present bout of "agflation" is that record prices are being achieved at a time not of scarcity but of abundance. According to the International Grains Council, a trade body based in London, this year's total cereals crop will be 1.66 billion tonnes, the largest on record and 89m tonnes more than last year's harvest, another bumper crop.

That the biggest grain harvest the world has ever seen is not enough to forestall scarcity prices tells you that something fundamental is affecting the world's demand for cereals.

One is increasing wealth in China and India. This is stoking demand for meat in those countries, in turn boosting the demand for cereals to feed to animals. The use of grains for bread, tortillas and chapattis is linked to the growth of the world's population. It has been flat for decades, reflecting the slowing of population growth. But demand for meat is tied to economic growth and global GDP is now in its fifth successive year of expansion at a rate of 4%-plus.

Higher incomes in India and China have made hundreds of millions of people rich enough to afford meat and other foods. In 1985 the average Chinese consumer ate 20kg (44lb) of meat a year; now he eats more than 50kg. China's appetite for meat may be nearing satiation, but other countries are following behind: in developing countries as a whole, consumption of cereals has been flat since 1980, but demand for meat has doubled.

Calorie for calorie, you need more grain if you eat it transformed into meat than if you eat it as bread: it takes three kilograms of cereals to produce a kilo of pork, eight for a kilo of beef. So a shift in diet is multiplied many times over in the grain markets. Since the late 1980s an inexorable annual increase of 1-2% in the demand for feedgrains has ratcheted up the overall demand for cereals and pushed up prices.

Because this change in diet has been slow and incremental, it cannot explain the dramatic price movements of the past year.

The second change can: the rampant demand for ethanol as fuel for American cars. In 2000 around 15m tonnes of America's maize crop was turned into ethanol; this year the quantity is likely to be around 85m tonnes. America is easily the world's largest maize exporter—and it now uses more of its maize crop for ethanol than it sells abroad.

Ethanol is the dominant reason for this year's increase in grain prices. It accounts for the rise in the price of maize because the federal government has in practice waded into the market to mop up about one- third of America's corn harvest. A big expansion of the ethanol programme in 2005 explains why maize prices started rising in the first place.

Ethanol accounts for some of the rise in the prices of other crops and foods too. Partly this is because maize is fed to animals, which are now more expensive to rear. Partly it is because America's farmers, eager to take advantage of the biofuels bonanza, went all out to produce maize this year, planting it on land previously devoted to wheat and soyabeans. This year America's maize harvest will be a jaw- dropping 335m tonnes, beating last year's by more than a quarter. The increase has been achieved partly at the expense of other food crops.

This year the overall decline in stockpiles of all cereals will be about 53m tonnes—a very rough indication of by how much demand is outstripping supply. The increase in the amount of American maize going just to ethanol is about 30m tonnes. In other words, the demands of America's ethanol programme alone account for over half the world's unmet need for cereals. Without that programme, food prices would not be rising anything like as quickly as they have been. According to the World Bank, the grain needed to fill up an SUV would feed a person for a year.

<u>America's ethanol programme is a product of government subsidies. There are more than 200 different kinds, as well as a 54 cents-a-gallon tariff on imported ethanol.</u> That keeps out greener Brazilian ethanol, which is made from sugar rather than maize. Federal subsidies alone cost $7 billion a year (equal to around $1.90 a gallon).

In the 1960s food (including meals out) accounted for one-quarter of the average American's spending; by 2005 the share was less than one-seventh. In other words, were food prices to stay more or less where they are today, it would be a radical departure from a past in which shoppers and farmers got used to a gentle decline in food prices year in, year out. It would put an end to the era of cheap food. And its effects would be felt everywhere, but especially in countries where food matters most: poor ones.

Obviously, farmers benefit—if governments allow them to keep the gains. In America, the world's biggest agricultural exporter, net farm income this year will be $87 billion, 50% more than the average of the past ten years.

Guess who loses. According to the World Bank, 3 billion people live in rural areas in developing countries, of whom 2.5 billion are involved in farming. That 3 billion includes three-quarters of the world's poorest people. So in principle the poor overall should gain from higher farm incomes. In practice many will not. There are large numbers of people who lose more from higher food bills than they gain from higher farm incomes. Exactly how many varies widely from place to place.

In every country, the least well-off consumers are hardest hit when food prices rise. This is true in rich and poor countries alike but the scale in the latter is altogether different. As Gary Becker, a Nobel economics laureate at the University of Chicago, points out, if food prices rise by one-third, they will reduce living standards in rich countries by about 3%, but in very poor ones by over 20%.

Not all consumers in poor countries are equally vulnerable. The food of the poor in the Andes, for example, is potatoes; in Ethiopia, teff: neither is traded much across borders, so producers and consumers are less affected by rising world prices.

As the World Bank's annual World Development Report shows, the number of urban consumers varies from over half the total number of poor in Bolivia, to about a quarter in Zambia and Ethiopia, to less than a tenth in Vietnam and Cambodia.

But overall, enormous numbers of the poor—both urban and landless labourers—are net buyers of food, not net sellers. They have already been hard hit: witness the riots that took place in Mexico over tortilla prices earlier this year. According to IFPRI, the expansion of ethanol and other biofuels could reduce calorie intake by another 4-8% in Africa and 2-5% in Asia by 2020. For some countries, such as Afghanistan and Nigeria, which are only just above subsistence levels, such a fall in living standards could be catastrophic.

In general, it is better to subsidise poor peoples' incomes, rather than food prices: this distorts price signals the least and allows farmers to benefit from higher prices.

There is one last important knock-on effect of agflation. It is likely to help shift the balance of power in the world economy further towards emerging markets. Higher food prices have increased inflation around the world, but by different amounts in different countries. In Europe and America food accounts for only about one-tenth of the consumer-price index, so even though food prices in rich countries are rising by around 5% a year, it has not made a big difference. There have been clucks of concern from the European Central Bank and a consumer boycott of pasta in Italy, but that is about all. In poor countries, in contrast, food accounts for half or more of the consumer-price index (over two- thirds in Bangladesh and Nigeria). Here, higher food prices have had a much bigger impact. Inflation in food prices in emerging markets nearly doubled in the past year, to 11%; meat and egg prices in China have gone up by almost 50% (although that is partly because pork prices have been pushed up by a disease in pigs). This has dragged up headline inflation in emerging markets from around 6% in 2006 to over 8% now. In many countries, inflation is at its highest for a decade.

And all this is going on as the economic balance of power is shifting. Growth in America and Europe is slowing; China and India are going great guns. Financial confidence in the West has been shaken by the subprime-mortgage crisis; capital flows into emerging markets are setting records.

This shift will be tricky to handle. Such transitions always are. The risk is of a bubble in emerging markets. As Simon Johnson, the IMF'S director of research, wryly notes, “every bubble starts with a change in the real economy.” Food markets are an obvious place to start. How emerging countries fare—and how poor consumers cope—depends on their economic policies. The imposition of food-price controls was not exactly a good start.