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Food commodities and policies

Some long-run factors affecting prices

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Factors affecting the outlook for food commodity markets

The evident signs of recession in industrial economy markets means food commodity prices will be affected. Leading trade indicators (e.g. recent falls in the Baltic Dry Index: chart) point to dramatic falls in the short term. But several of the fundamental forces behind the 2007/08 commodity price boom are still in place (macro-economic growth, low inventories). Although prices for fuel and mineral commodities remain near the record levels of the 1970s food price rises have been much more moderate or—as in the case of wheat—have already adjusted to improved supply balances.

Barring an intense global downturn, the extent of falls from recent high levels will be modest. IMF projections are for a fall of 6% in the non-fuel commodity index over the remainder of 2008 and through 2009, slightly larger fall (7%) in the food-commodity component of the index.

1. Securitized market volatility washing out

The same pricing failures (and accommodating monetary policies) that affected the mortgage-securities markets leading to the collapse of financial credit markets, have affected commodities prices, too. But the impacts of the speculation (mostly on US prices) seem unlikely to last beyond the unwinding of current contracts.

Commodity	2006	2007	Sep-07 to Sep-08	Aug-08 to Sep-08
	Price index: 100 = 2005		Change in index	
Wheat	125.8	167.4	-9.5	**-10.3**
Maize	123.6	165.9	46.1	**-0.5**
Rice	105.5	115.5	118.8	**-2**
Barley	122.7	181.3	2.6	**-10.8**
Soybeans	97.5	142.2	26	**-7.1**
Soybean meal	94.3	128.1	26	**-6.3**
Soybean oil	111.2	161.3	22.2	**-10.5**
Palm oil	113.4	195.6	-10.5	**-15.8**
Beef	97.4	99.4	9.4	**-4.5**
Lamb	95.5	100.5	3.9	**-4.2**
Swine Meat	94.4	94.1	12.7	**-15.8**
Poultry	93.7	105.8	8.4	**0**
Fish	124.6	111.9	10	**-6.3**
Shrimp	104.9	116.4	-34.3	**10.9**
Sugar	132.5	101.7	25.2	**0.7**
Bananas	118.4	117.4	21	**0.7**
Oranges	97.9	113.8	-10.6	**-18.4**
Coffee	111.5	129.1	15.7	**-1.4**
Cocoa Beans	103	126.8	37.5	**-4.5**
Tea	111.7	97.9	39.1	**-0.1**

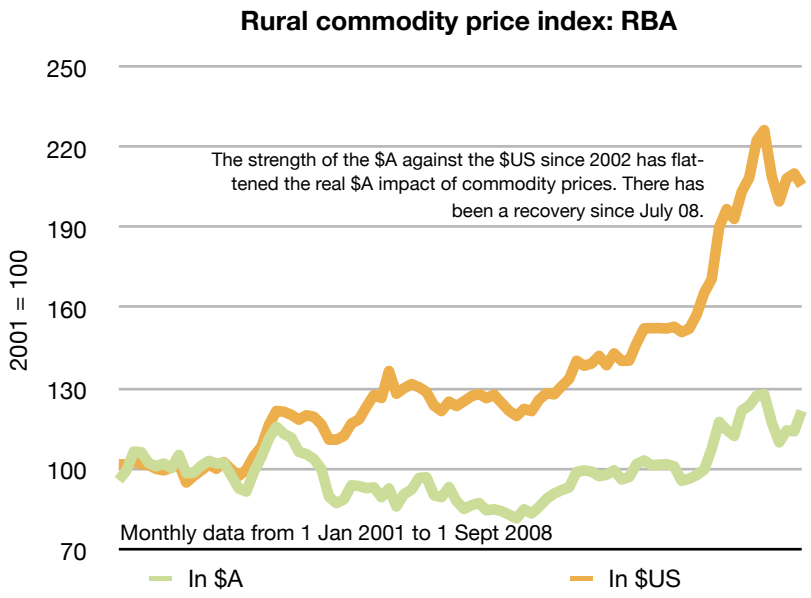
January 2007 saw the creation of several 'Exchange Traded Funds' (ETFs) that repackaged futures contracts in wheat, corn, soy-beans, sugar and coffee as loan instruments that were traded heavily in the 'over the counter' market as speculators wary of credit markets sought real asset backing for investments. Although prices in some of these commodities, such as wheat, had been creeping up since the last global market slump in 2001-02, the price rise accelerated rapidly in 2007. Predictably there has been a sharp fall in the prices of *securitized* commodities e.g. in the IMF indexes for August/September 2008 while most other food commodity markets saw only a modest fall as financial market conditions tightened.

2. Research shows why dollar 'buffer' will continue for Australian producers

The real Australian price of rural commodities has been held lower by the strength of the Australian dollar against the US dollar since 2002. Since the end of the last recession in 2001 the Reserve Bank index of Australian prices has climbed a maximum of 30% (although it has moved over a 50% range in that time) and has fallen back by about 12% since January 2008 (within a range of about 15%).

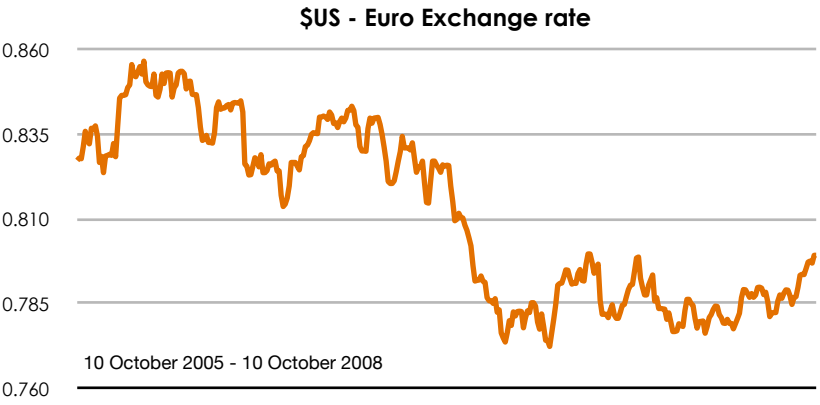
But the recent weakening of the exchange rate suggests that the likely downturn in prices, too, will be moderated in $A terms. We can already see that happening in the upturn in the $A index since June 2008.

On balance, the dollar is likely to remain a stabilizing influence on real producer returns. Despite the weakening of the US dollar against other currencies since early in 2002, the recent 'flight to safety' in $US treasuries (see $/Euro chart below) has seen the value of the dollar rise despite the chaos in US financial markets, especially against the $A (which has also been dumped by Japanese investors).



Even when 'overshooting' is taken into account, however, the outlook for the $A is now weaker than in 2007, offering Australian producers a continuing buffer against more moderate world market prices.

Recent statistical analysis has shown that the exchange value of the $A (and certain other 'commodity currencies') is a very robust predictor of commodities prices over a short period: more robust than commodities futures markets prices[1].



An intuitive explanation for the correlation is that the market is pricing the commodities price outlook into the $A. Since future exchange rates are themselves difficult/impossible to predict, the most valuable result of than analysis may be that it illustrates/ confirms the dampening effect of the $A on the volatility of real producer returns over a short period.

3. Border protection will remain 'sticky'

There is no prospect of a WTO agreement this year and little prospect of an agreement before 2010, given the likely preoccupation of the US administration. The financial markets crisis increases the need for certainty about the direction of protection policies. But there is no apparent danger that governments will respond to the lower growth outlook with preemptive protection.

The policy environment of 're-regulation' will, however, serve the interests of those who argue for greater 'policy space' for developing countries and food importers. Destabilizing 'flex' barriers such as SSM and 'special' products seem likely to become permanent features of WTO agreements on agriculture whenever they are revived and on whatever terms.

There is a small risk of renewed export subsidies from Europe and increased food 'donations' from North America as recession slows domestic demand and lower prices trigger higher support spending. There is also a small risk that net-

1 Chen, Rogoff, and Rossi (2008), "Can Exchange Rates Forecast Commodity Prices?", NBER Working Paper 2008-02.

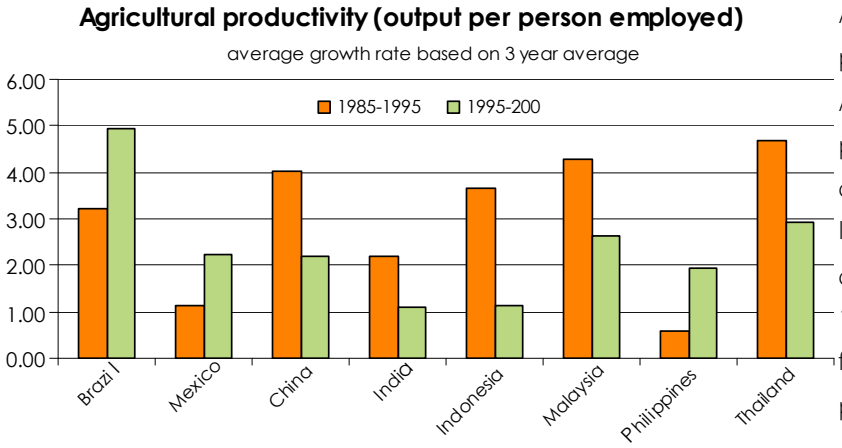
importing developing countries in Asia will increase border protection to support the same prices they were attempting to depress with export restrictions just six months ago.

4. Weaknesses on the supply-side

Much has been made of the secular nature of some demand-side factors—especially demographic changes—responsible for recent price rises, leading the RBA among others to project a permanent terms-of-trade improvement for Australian rural commodity exports. Supply factors identified have been short term (inventories) and stochastic shocks (drought). But there are other, long-term factors also at play on the supply side that will contribute to firmer food commodity prices even as a slide in macro-economic growth weakens demand.

(a) Falling agricultural productivity in emerging economies

Emerging economies, notably in Asia, have neglected agricultural productivity in the past decade. World production of rice and wheat has barely increased in the past 10 years, and agricultural productivity has severely slowed in several key producing countries.



Source: Gad Levanon, Vivian Chen, Janet X. Hao and Utsav Kumar: "The Sources of Global Inflation", The Conference Board, June 2008

According to the Conference Board, labor productivity in agriculture has fallen in Asian economies including China (2 percent per year from 1996-2003, compared to 4 percent from 1989-1996), India (around 1 percent from 1995-2005 compared to almost 2 percent from 1985-1995, and Indonesia (only 1 per cent from 1995-2004 compared to more than 3 percent in 1985-1995).

(2) Re-distribution of China's rural land

China is the world's largest producer and consumer of food and the largest producer of grains. Last year it returned to harvests of more than 500 mt for the first time in a decade. But China has had a difficult time maintaining production levels due in part to the small scale of most production, the fragmentation of farm land, the own-consumption orientation of most producers and the rapidly rising cost of agricultural labour.

The announcement this month that Beijing has decided to give or sell farmers transferrable title to their land is a dramatic step that finally puts an end to the worst aspects of socialized agriculture: the uncertainty of title that made arbitrary resumption by the state possible and rural finance impossible (for lack of mortgage collateral). If the reforms go ahead, we can expect a rapid re-distribution of land use toward the most highly valued uses. But what will that be? On the one hand if it is 'large scale agricultural production' the overall impact on China's food output could only be positive. But it seems even more likely that the redistribution will be toward urban uses: housing and manufacturing.

5. Policy impacts on the demand-side

The impact of policy factors on the demand side of the recent price increases—such as the impact of subsidies for ethanol or biofuels use—has been a matter of controversy. USDA Secretary Schaefer told the FAO Conference on food security in June that bio-fuel demand contributed only 2 - 3% of global food price inflation. This assertion, apparently based on advice from the Council of Economic Advisors, seems to be an error. According to USDA's Chief Economist, the

Department now concedes that rising demand for ethanol and bio-diesel demand contributed more than 10% of the overall increase in prices.

Despite the downturn in the macro-economic outlook for this year and 2009, US legislation still requires oil companies to use about 34 billion liters of ethanol in 2008/9.

6. Fall in BRICs growth will have little impact on the demand-side

Emerging economies are the most likely source of continuing price support for fuel and non-fuel commodities, as they have been for a decade. Uncertainty about future commodity price trends is due principally to uncertainty about the impact of the financial markets crash and the industrialized economy recession on their growth.

It is impossible that BRICS economies will be quarantined from the impacts of the recession. Trade contributes as much as 70% of GDP (China) and exports to the major industrialized markets comprise between one-third (China) and two thirds (Russia) of trade sales. A 'mid-range' projection among Australian analysts (industry and government) is for China's growth rate to fall by as much as one-third in 2009.

'Poles' of the trading system	Current 'poles' of trading system		Potential 'poles' of trading system			
Overall indicators^	European Union*	United States	Brazil	China	India	Russia
Population, millions	459	299	189	1312	1110	142
GDP, billions PPPUS$	12634	13202	1708	10048	4247	1704
Total merchandise exports, billions US$	1456(1)	1037(2)	138(16)	969(3)	121(20)	304(8)
(ranking in world) [% world total]	[16.22]	[8.56]	[1.14]	[8.00]	[1.00]	[2.51]
Total merchandise imports, billions US$	1697(2)	1918(1)	95(19)	791(3)	175(11)	165(12)
(ranking in world) [% world total]	[18.26]	[15.44]	[0.77]	[6.37]	[1.41]	[1.33]
Total services exports, billions US$	539(1)	398(2)	18(19)	91(4)	75(5)	31(13)
(ranking in world) [% world total]	[26.57]	[14.38]	[0.65]	[3.31]	[2.71]	[1.11]
Total services imports, billions US$	453(1)	308(2)	27(16)	100(4)	63(7)	44(9)
(ranking in world) [% world total]	[23.36]	[11.74]	[1.03]	[6.37]	[2.40]	[1.66]
Total trade, billions US$	4145	3660	178	1951	434	544
Total trade/GDP, %	26.4	26.0	**26.4**	**69.0**	**42.2**	**55.8**
Total trade per capita, US$	7444	9714	1235	1207	309	3047
Percentage of merchandise exports shipped to EU and USA - -	23.1	20.7#	**40.6**	**30.6**	**36.2**	**59.0#**

^ Trade data=2006, Trade policies=2007 * EU=EU27, data excludes intra-EU trade #Exports to EU only
Based on Evenett, S.J. "EU Comercial Policy in a Multipolar Trading System", sourced from stat.wto.org

Fortunately, these economies are now much more robust to external economic shocks than they were in the past. Large external surpluses and more than a decade of high macro-economic growth rates (not India) leave them in a much better position to weather the storms than during the 2001-2002 'dot-com' recession. The microeconomic impacts (profits) and macroeconomic impacts (inflation) of a softening of mineral and fuel commodity prices can only be beneficial.

But the BRICS economies account for less than 10% of total world merchandise imports: ⅔ of U.S. imports and barely more than ½ of EU imports. Furthermore, although their import profiles are more commodity intensive, only Russia is a significant importer of food commodities. For good or ill their impact on Australian export food commodity prices is likely to be small.