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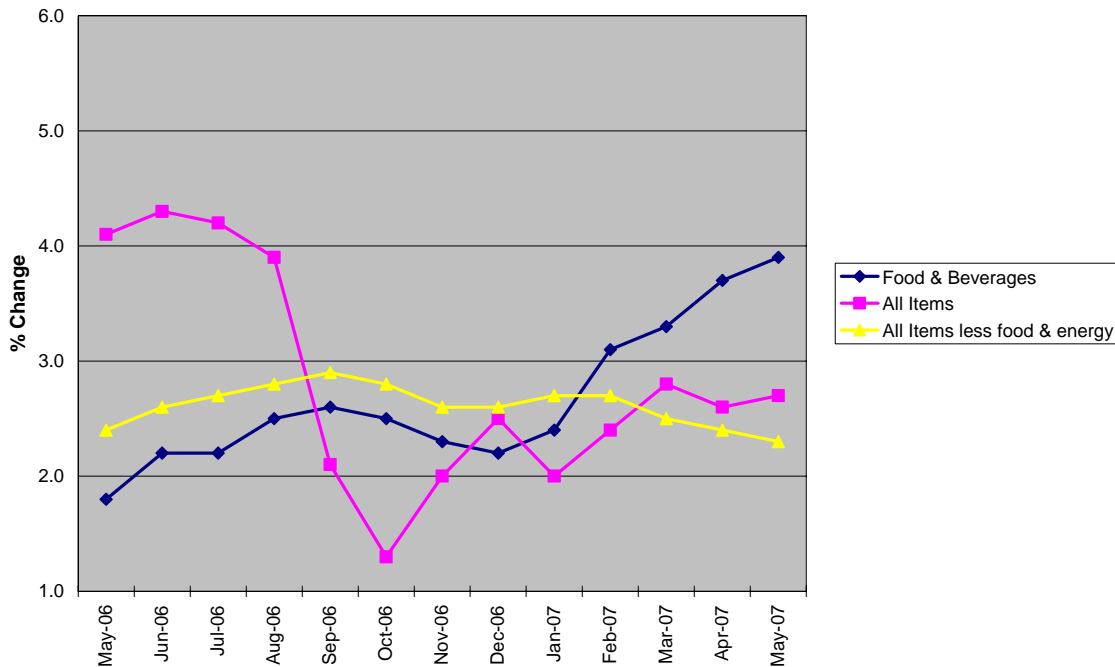
Fuels versus Food: Is it Rhetoric or Reality?

Hardly a day passes without reading an article or hearing a report that higher corn prices, due to the increased fuel demand for ethanol, are causing higher food prices. Yet these articles and reports are generally vague about the specific connection. In fact there is little, if any, evidence that higher corn prices have influenced consumer food prices to date.

Back in November this author published an article looking at the possible impact of ethanol and higher corn prices on food prices. The basis for the article at that time was an economic analysis done in conjunction with the Food and Agriculture Policy Research Institute (FAPRI) that showed little impact from ethanol on food prices in 2006 and 2007 and then a 0.2% rise in the food CPI price index 2008. In 2009, the food CPI would rise 0.5% and then the next three years the food CPI would be 0.7% higher than would otherwise be the case.

It should be emphasized that these numbers are for the food CPI which accounts for just under 14%---slightly less than one-seventh---of the weighting for total CPI. So if the food CPI should increase at a 0.7% rate it would add only 0.1% to the total CPI. This could hardly be characterized as an explosion in inflation. Indeed, food and energy are usually separated from the rest of the economy in reporting what is defined as the “core” rate of inflation. Food and energy are deemed to be volatile and subject to rapid changing supply and demand conditions due to weather (food) and geo-politics (energy) that do not necessarily reflect the underlying “core” inflation rate.

Consumer Price Indices, All Urban Consumers



But so much for theory, economic models and the long-term outlook several years into the future, what has happened in recent months and what is happening today? Have higher corn prices, which began to increase last September, caused a rise in the food CPI? If not, what may be influencing the food CPI, which has experienced a moderate increase in recent months?

The Nitty-Gritty of Corn Price Transfers

Before proceeding further, however, it is important to understand exactly how higher corn prices may affect the food CPI. Some 99% + of the corn raised in this country is field corn that is utilized for feed, export, ethanol and a few consumer related products lumped under the category of industrial. For the current 2006/07 corn crop year the respective numbers are 50%, 19%, 19% and 12%. Even the 12% number overstates the amount utilized in the food sector. As the title indicates some of it goes to industrial products and a small fraction into a new, but rapid growing sector of biodegradable plastics. However, the largest single use in this category is for high fructose corn syrup (HFCS), utilized primarily as a sweetener in the soda industry and in the bakery sector.

Since the bulk of corn consumed by humans (50%) comes via the meat and dairy sector, through animals and birds, how exactly does this work? As the price of corn rises it increases the cost of feeding an animal or bird until it becomes unprofitable. After suffering a loss for a long enough period of time---remember both corn prices and animal prices fluctuate so losses must accumulate for some time to convince the producer this is not just a temporary situation---producers decide to adjust their production downward. Ironically, in the short term this can actually increase the amount of meat being offered to

the consumer as producers liquidate a portion of their herds or flocks, resulting in lower meat prices.

At some point the production of meat, milk, etc., is reduced. The farm price of that commodity---animal, bird or related product---will eventually rise to a higher level that makes production profitable and induces producers to expand production, thereby renewing the cycle.

It should be noted that there is an enormous difference in the lead-lag time associated with the adjustments of the various bird and animal sectors. It is a function of the time it takes for gestation and raising the animals or birds. The adjustment of chickens as broilers or layers for eggs may be a matter of a few months, while the beef sector can take two-to-three years. Hogs lie in between, approximately 12 months.

What the data says about production adjustments and prices

The rate of increase in red meat supplies has indeed been reduced the past couple of quarters, but this is a process that has been going on for over a year, long before corn prices increased last fall. Red meat supplies increased 4.9% over the year earlier period in the first quarter of 2006, but had dropped down to a 3.4% year-over-year rate by the fourth quarter of 2006. This represents a significant increase in production and as a result the average price farmers received for their cattle and hogs declined 2.1% and 5.5%, respectively.

During the first quarter of 2007, approximately four months after corn prices began to increase, red meat production rose at a 2% rate and is forecasted to increase at slightly more than a 1% rate the next couple of quarters. What needs to be noted, with regard to the 2007 red meat supplies, is that there has been no significant increase. In other words, there is little evidence of any ethanol induced liquidation shy of anecdotal reports of cow/calf sales due to drought in the West and Southeast. While feed costs are higher than a year ago, in general, they are not so high as to push feeders into a prolonged negative profit situation up to this point.

The situation with broilers is even more telling. Quarterly production measured on a year-over-year basis slipped from 4.2% the first quarter of 2006 to -1.2% by the fourth quarter. This further dropped to -4.1% the first quarter of 2007. However, this was largely due to a 9% decline in the price producers received in 2006. Prices were high in 2005, encouraging producers to expand production. By the second quarter of 2006 prices had declined over 10%. This did induce losses and producers began to reduce broiler output **but this happened long before corn prices began to increase.**

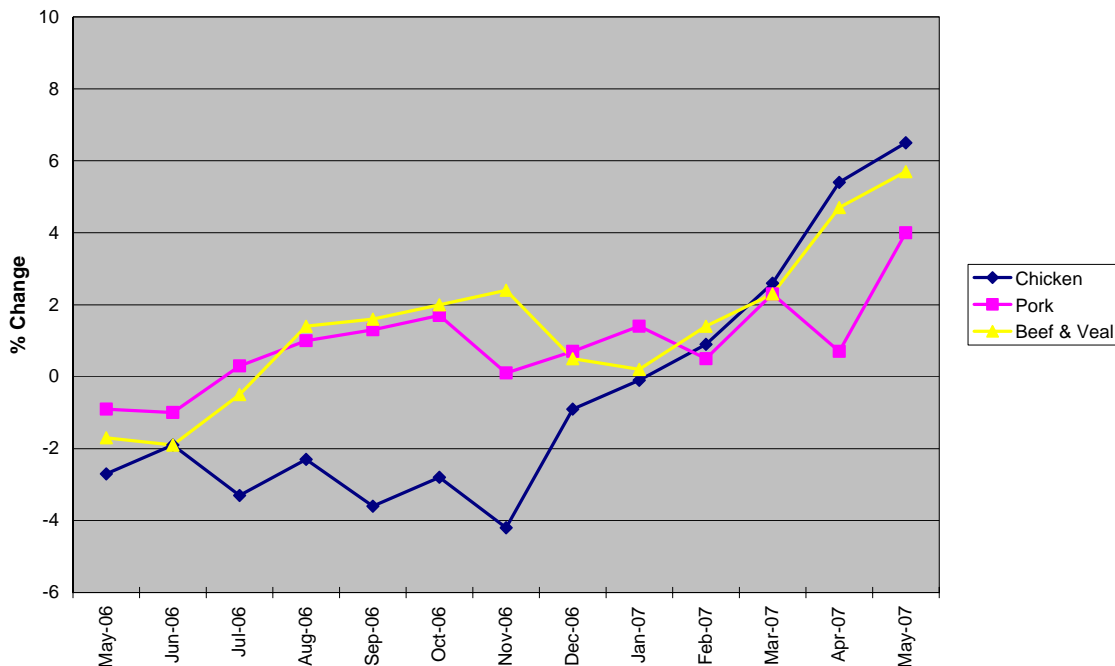
The last example is milk, which experienced a rapid run-up in production in 2005 and early 2006. Consequently, in 2006 milk prices literally “fell out of bed”, declining 15% from a year earlier. Predictably, dairy farmers slowed the rate of increase in milk production and by 2007 milk prices began to rebound. Ironically, this occurred at a time when the world demand for milk protein for a variety of traditional (cheese) and new

products (energy drinks and power bars) was increasing significantly, thereby pushing milk prices to new record high levels. U.S. export of milk byproducts has virtually exploded in recent months. Again, this had absolutely nothing to do with ethanol and corn prices.

Looking at consumer prices

If the higher price of corn is unlikely to be responsible for higher consumer food prices, what is causing them to increase? That can be ascertained to a large degree by looking at the different food price categories measured as a part of the CPI. As a point of reference it should be noted that core inflation in the United States has been running at about 2.5%. As can be seen in the first chart on overall inflation rate (CPI), food and beverages and the core rate, food prices had been running at the core rate through January but began to accelerate in February.

Meat Sector

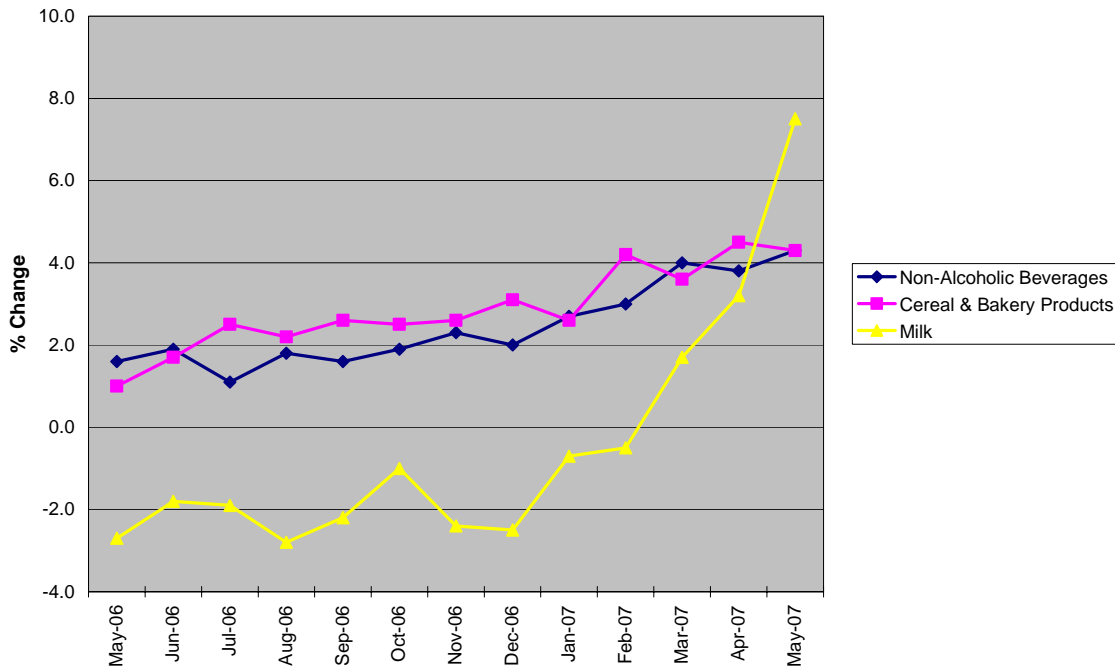


Looking first at the meat sector, the rate of increase had been running at the core rate for most of the past year. However, over the last couple of months the rate of price increase has risen to 4-6% range. This would add some upward bias to the overall food CPI rate although, as previously explained, it has virtually nothing to do with corn prices.

Milk prices were actually declining for the bulk of the past year, but are in a catch-up mode at this point, accelerating the past couple of months. Again, this is due to the underlying supply and demand condition that has little, if anything, to do with corn prices or ethanol.

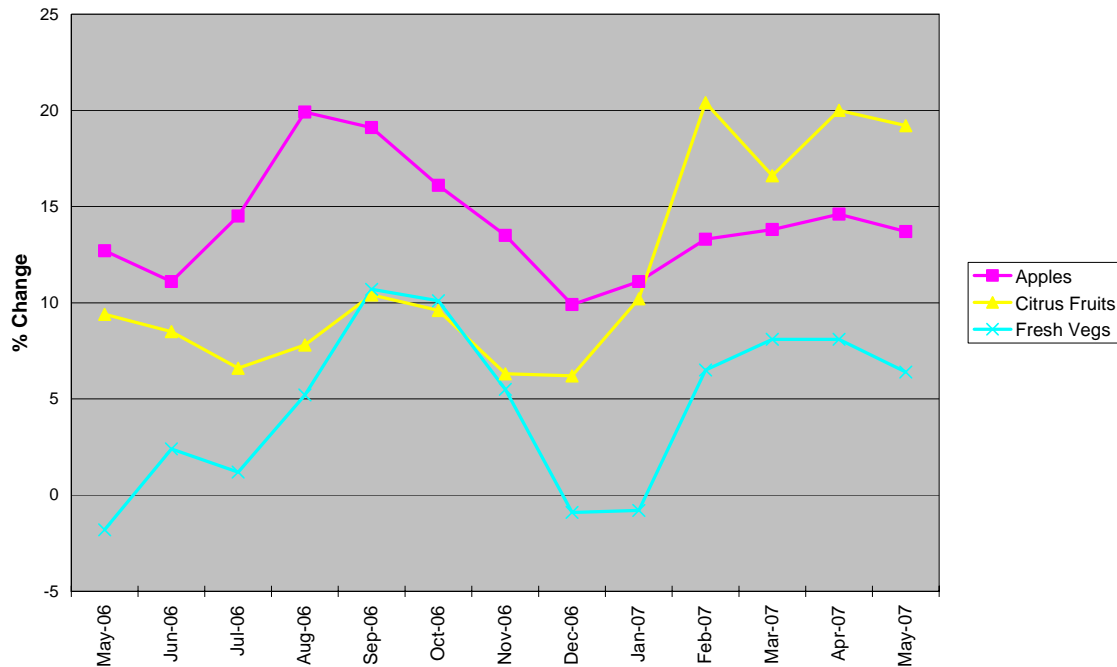
Turning to non-alcoholic beverages and material there is a similar pattern. Through January prices were increasing close to the core rate, but have picked up the past three months. So the logical explanation might be that higher HFCS prices have risen which is subsequently reflected in higher soda prices. This may be a good theory, but then it turns out that soda producers contract for their HFCS supplies once a year, typically at the start of the calendar year. Only about one-half the run up in corn prices occurred before the first of the year so higher corn prices would have had only a moderate impact on increases in this category.

Milk, Non-Alcoholic Beverages, and Cereal & Bakery Products



Cereal and bakery products have also experienced a rate of increase higher than the core inflation rate since January. This is due to higher wheat prices, which reflect an increasingly tight world supply and demand situation for wheat. However, this is wheat

Fruit and Vegetables



and outside of a small amount of HFCS used as a sweetener in bakery products, it has nothing to do with corn and ethanol

Finally we turn to fruits and vegetables where prices are significantly higher during the entire period. Some categories, such as fresh vegetables and citrus fruits, have been influenced by weather events such as the Easter freeze. Other products, such as apples, have been in relatively tight supply for over a year with price increases several times the core rate of inflation. This category is a significant contributor to the higher food CPI.

Summary— If it was not clear before, readers should now understand that the fuel versus food issue is one of rhetoric, not reality. It is unlikely that the production of meat has been affected by higher corn prices to date. In fact, there is little evidence that any food category has been affected by higher corn prices in any significant manner. Certainly it is true that some food product manufactures have claimed higher corn prices are increasing their manufacturing cost, using this as justification for raising their product prices.

A notable example might be a cereal company that makes some variety of corn flakes. The value of corn going into a box of corn flakes was previously estimated to be 2.2 cents. Even if the cost of the corn doubled, it is hard to understand how this relates to an increase of 10 to 20 times that much in the price of a box of cereal. There are other examples, such as a feeder/packer complaining about how the higher price of corn has raised company costs. Yet, just a few days prior, this same company reported record high profits in its' quarterly income statement.

While there is plenty of rhetoric in the media about higher corn prices due to ethanol causing higher consumer food prices, nearly all the evidence points to other factors. The reality is that to date higher corn prices have had very little impact on consumer food prices. At some future date higher corn prices will probably be more of a factor in rising food prices, but even then the increases are likely to be moderate and extended over a period of several years. Finally, any increase in food prices will be more than offset by the diversification of our energy supplies, lower farm program payments and the improved environmental effect of utilizing ethanol. It is a win-win situation for consumers, farmers and taxpayers.

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