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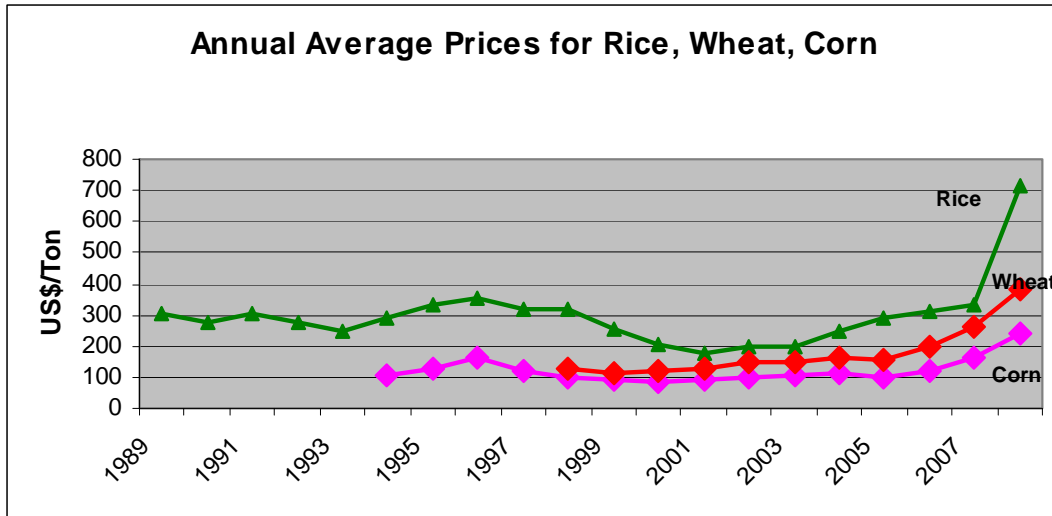
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Summer 2008 News

International Investors Discover Agricultural Commodities as World Food Prices Soar: Implications for U.S. Biofuels Policy by Susan Scurlock Theiler, Director of Business Development, The GIC Group

The year 2008 will be remembered as the year when escalating food and commodity prices made the agriculture sector interesting, at last. The reality of higher food prices crept up gradually on the American public, however, while our attention was on the price of gasoline. Personally, I first noticed it around February when a young family at the checkout line buying milk made a bitter comment about the price. Then, I couldn't find any two-for-one deals on eggs to color at Easter. A loaf of bread was up by \$1.00. One day, I read with surprise that global private equity funds were starting to buy up agricultural land. Then in April, food riots made headlines in the Philippines, Egypt, Haiti, and India. By the time the Cedar River was flooding in Iowa in June, worldwide concern was mounting, and Americans started bargain shopping in earnest. The low U.S. dollar was not buying as much, while pushing our exports out the door.

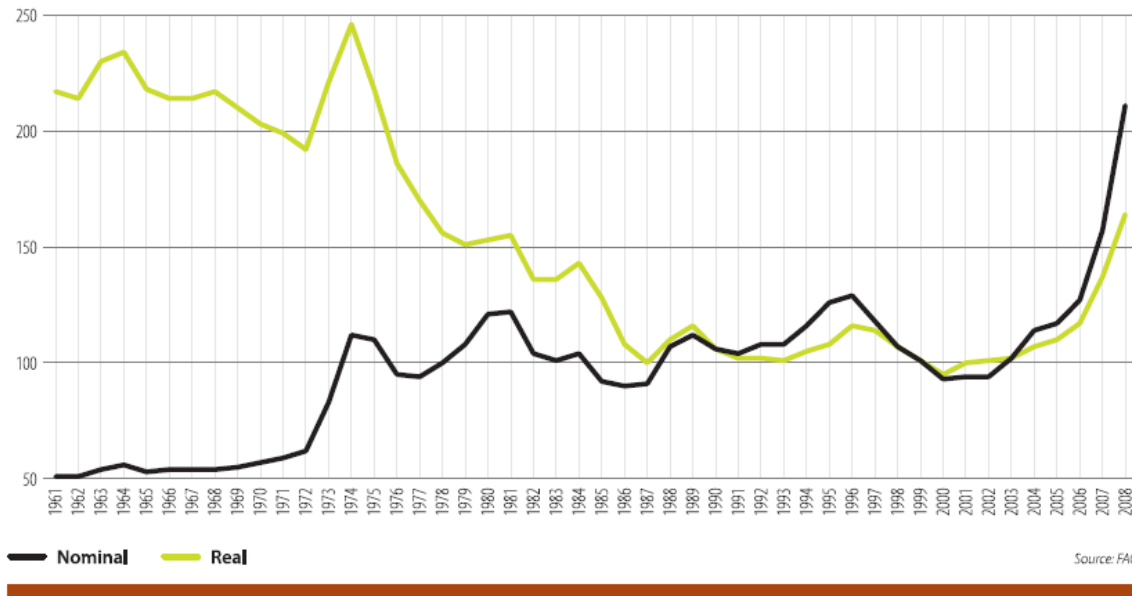
Indeed, food prices worldwide skyrocketed in 2008, and commodities tripled in one year. Prices for rice, wheat, corn, soybeans, and milk reached historical highs. In April, rice hit \$1,000 per ton for the first time in 35 years, and the increase in wheat prices was unprecedented. Food riots broke out in more than 30 countries. The FAO called the United Nations, World Bank and international leaders to a special [Summit](#) in Rome to deal with the crisis. The United States pledged \$200 million in new food and development aid by releasing supplies from the Bill Emerson trust, and [U.S. congressional leaders](#) called for more funding for research to jump-start a new green revolution.



U.S. Food Costs. The chart above shows the peaks hit this year, but notice the long straight lines indicating stagnant change in real terms in the decade after 1996. We've grown up in a world where the price of food has stayed the same and even gone down in real terms for most of our lifetime. The story in agriculture has usually been one of surplus, not scarcity (for those with sufficient incomes). Only during the turbulent early 1970s of the Oil Embargo and the Soviet Grain Embargo have food prices risen so quickly as in 2008.

FAO Index of Food

2000=100



Americans spend on average less than 10 percent of our income on food, and many of U.S. are unaware of the price of a gallon of milk or a dozen eggs. Besides, the cost of the commodities in the United States is only a small share of the final price of grocery products. Labor, advertising,

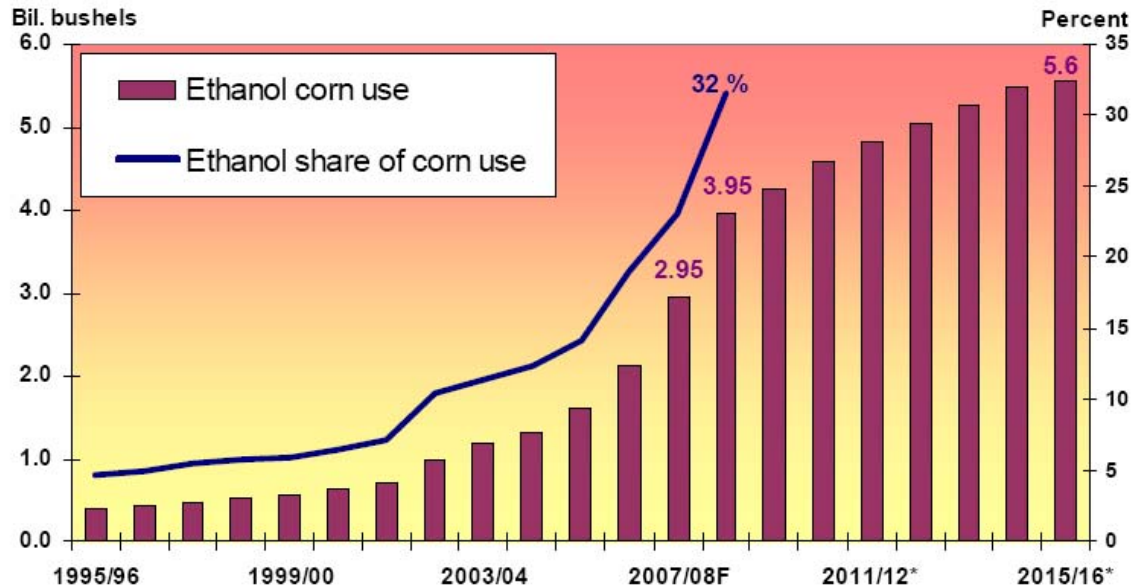
transport, and rents are more important. While some items are priced noticeably higher, overall, the U.S. Department of Agriculture estimates that U.S. food costs are rising at only about 5 percent a year in 2007-2009. U.S. prices for beef and pork have been down or level, as higher slaughter rates in response to high feed prices have caused temporary surpluses. See [U.S.DA Briefing](#).

Ethanol. The food price story has caused a raging controversy among the farm sector and the food industry, particularly with regard to the effect of ethanol policy on commodity prices. Today, about one-third of U.S. corn production is transformed into ethanol. With corn being the foundation of the nation's diet, critics questioned the massive subsidies to the biofuels industry in the 2007 [Energy Bill](#) and the new [Farm Bill](#). Ethanol factories enjoy a \$0.51 cent tax credit (lowered to \$0.45 in the Farm Bill), a protective tariff of \$0.54 on imported ethanol, a mandate of 9 billion gallons growing to 36 billion gallons in 2022 to be used in fuel, and generous grants and loans for startup businesses. The livestock industry and [food processors](#) argue that the increased corn demand for ethanol raises their input costs so dramatically that they are having to shut down. The [corn farmers](#) and ethanol producers point out that higher acreage and yields have increased corn production more than the 3 billion bushels sent to ethanol plants. Corn production in the United States has climbed to record levels, from 10.5 billion to 13.1 billion bushels in 2007/08, offsetting the larger ethanol usage.

[Statements by the U.S. Secretary of Agriculture](#) and findings by the [U.S. Council of Economic Advisors](#) estimate conservatively that only about 3 percent of the rise in food prices is due to increased corn used for ethanol. The [U.S. EPA](#) recently determined that ethanol policies are not creating undue hardship for the livestock industry. A study by the [Farm Foundation](#) also concluded that ethanol, given its contribution to lowering fuel prices, was not overly damaging to other interests. That a maximum had probably been reached for usage of corn as fuel was recognized in the Farm Bill where most of the grants and subsidies for future biofuels production are targeted to the nascent cellulosic ethanol industry that will use non-food inputs such as wood byproducts, corn stover, switchgrass, and even algae.

Lawmakers have decided U.S. cellulosic ethanol should receive millions in grants through the 2007 Energy Bill and the 2008 Farm Bill, as well as through state grants, but their its future will require more scientific breakthroughs to reach profitability. Meanwhile, the ethanol industry has seen its already poor profit margins further attacked by the higher corn input costs.

U.S. Corn used for Ethanol



Source:

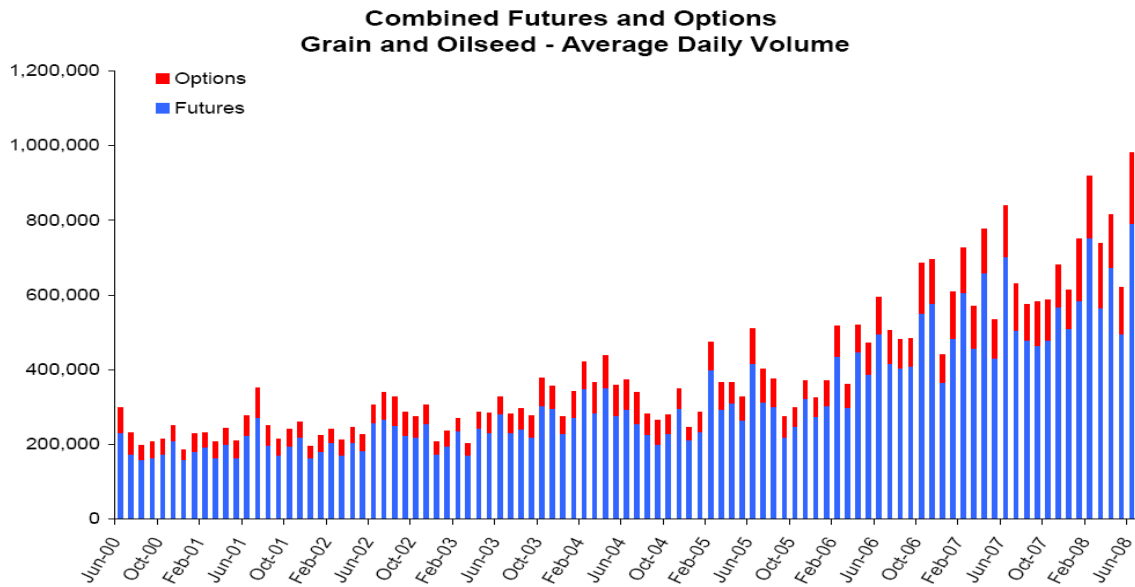
Futures Trading. A lot of blame has been targeted at price speculation in the futures markets. With the flight from real estate and the stock market, investors have poured more money into the commodities market. Over the counter derivative trading has skyrocketed, and institutional investors such as index funds, hedge funds and other non commercial investors have been active. An unusual session was called in April by the Commodities Futures Trading Commission to examine the possible role of new, outside investors in driving up commodity prices. The CFTC is taking a series of measures to prevent investors who have no role in the actual delivery of commodities from dominating trading. See [CFTC Hearings](#).

Congress also took a hard look at CBOT practices this spring. A red flag is up because trades by active derivative traders who utilize options are increasing faster than regulated hedgers who utilize futures. According to the Chicago Board of Trade, in the period January through June, grain and oilseed options increased by 34.3 percent from 2007 to 2008, while futures increased by 19.3 percent. The derivative traders also appear to increase market liquidity and price volatility. The new [Farm Foundation](#) study concluded, however, that futures trading speculation was not seriously detrimental to the price situation. At September hearings at the [House Agriculture Committee](#), the CFTC testified that their research also shows there was no direct evidence of speculators driving up commodity prices and that the prices of commodities and oil were not tracking (not rising and falling in tandem).

What has certainly changed is that the food industry must devote extra resources to risk management. They have recognized that a long position in agricultural commodities would hedge surging prices. Food companies, who used to utilize procurement management, are hiring commodity traders to hedge rising ingredient costs. At their service are investment banks who are putting money in commodities teams that give advice to food and consumer goods companies on how to hedge their risk exposure.

Companies are also taking a more global look at emerging markets where agricultural potential has not been fully tapped and where cash prices are lower. For example, Nestlé is trying to reduce its reliance on global milk markets by investing more heavily in farming co-operatives in

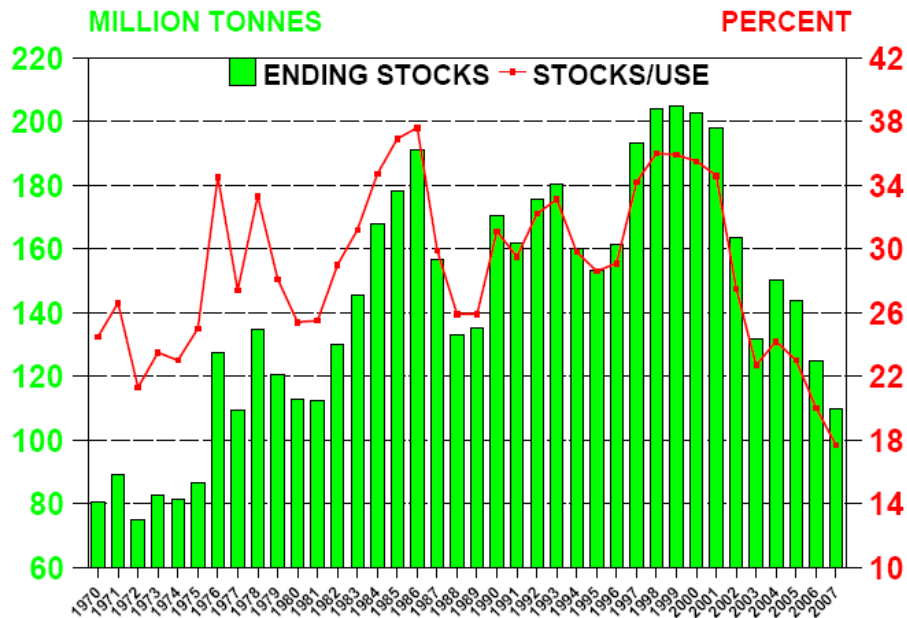
countries such as India and China. Brazil, the Ukraine, and Russia are the new focus of the multinationals.



Source: CBOT

Ending Stocks. It is important to look at the fundamentals behind the commodity price increases. Foremost are ending stocks and stocks to use ratios. Good old-fashioned weather problems, possibly related to global warming, share the blame. Taking wheat, world production has been uneven and problematic resulting from catastrophic droughts for two years in Australia, and poor crops in other major producing countries including Europe, Russia, Canada, and the Ukraine. All the while, consumption has been increasing. Therefore, world wheat stocks to use ratios were the lowest in 60 years at about 18 percent, according to [USDA](#). Ending stocks for wheat were the lowest since 1977, but will improve to 21 percent of use in 2008/09. Corn and soybean stocks are both down in the United States due to consumption and trade increases, despite near record crops.

WORLD ALL WHEAT ENDING STOCKS AND STOCKS-TO-USE RATIO 1970/71 THROUGH 2007/08



2007 WORLD ENDING STOCKS ARE THE LOWEST SINCE 1977 AT 110 MMT (4.04 BILLION BUSHELLS)
WORLD STOCKS TO USE IS THE LOWEST ON RECORD AT 17.7%

Source: Commodity Futures Trading Commission

Embargoes. Perhaps even more problematic for prices has been the reaction of some governments to this supply information. India acted first by ordering an embargo on exporting wheat from their country to secure supplies for their own public. According to [experts](#), that move also impacted world rice markets, as the threat of tight supplies of food sources caused rice prices to shoot up. Other countries had a similar reaction to shortages and rising prices; they also enacted export controls. Argentina, Egypt, Vietnam, Russia and its neighbors, and China followed suit. Their irresponsible policies made the problem even worse as price rises sent a panic through the lower-income populations. In many developing countries, one-third to over half of income is needed for food purchases.

China Factor. The growing population and spending power of China are often cited as the global engine of demand for food products, but China has worked diligently to avoid exactly that situation. They have remained largely outside the world trading system, importing only a minor percentage of food needs. The exception is soybeans, where China is a huge factor in demand. As far as food grains--wheat, rice, and corn, they have increased domestic production and are usually net exporters, and they prefer to hold very large stock levels. India wants to play by similar rules. Their national policy is be self-sufficient and not to import wheat or rice. Rather, they are typically a major rice exporter. Recently, their wheat stocks have been at very low levels. Both China and India embargoed exports of key food crops in 2008.

China: Trade in Major Food Crops (metric tons)

	2003	2004	2005	2006	2007	2008*
CORN						
Imports	120	2,308	3,975	65,216	35,198	100,000
Exports	16,389,452	2,318,161	8,611,815	3,073,999	4,847,753	500,000
RICE						
Imports	258,570	761,710	513,966	719,010	471,541	330,000
Exports	2,610,198	896,017	671,804	1,236,899	1,339,658	1,200,000
WHEAT						
Imports	473,000	7,269,000	3,555,000	625,000	112,000	30,000
Exports	2,785,000	1,223,000	755,000	1,681,000	3,252,000	1,000
SOYBEANS						
Imports	16,930,000	25,800,000	28,320,000	28,730,000	35,400,000	35,500,000
Exports	320,000	390,000	350,000	450,000	350,000	380,000

*Forecast

Source:

U S D A

Farm Income. Times are good in farm country, although high costs for inputs and energy temper the enthusiasm brought by favorable prices. [Net cash income](#) for farmers increased 16 percent in 2008 over 2007 and will rise again in 2009. The value of U.S. crop production (\$188.8 billion) is forecast to exceed the 2007 record by \$38 billion, a 25-percent increase. With favorable prices, the farm sector is cautiously optimistic, but still not without many challenges. The price rises for key inputs – fertilizer and tractor fuel, have been serious cost factors. Another issue is the change in the commodity futures market that have made hedging difficult as so many local grain elevators can not obtain credit to meet margin calls and refuse to accept further long-term risk. Livestock and poultry producers are not sharing in the rise in end-product prices, but are left only with higher costs.

U.S. Dollar and Oil Prices. Remember when U.S.\$1.00 was roughly equal to Euro 1.00 when the Euro debuted in 1999? The value began to decline soon after and has continued to go down until late this summer. Since commodities are priced in U.S. dollars, the weakening of the dollar has made U.S. farm products more attractive on world markets. [U.S. agricultural exports](#) have soared by 39 percent over 2007 to a record \$114 billion in 2008.

In addition, the rising prices of gasoline, oil-based fertilizers, and other related inputs to farm production have been a key factor in food price rises. Transport costs, packaging, and related price increases have prompted manufacturers to raise prices whenever they can without dampening demand.

Conclusions and Prognosis: It is the fundamentals that should solve the problem of price volatility, and investors should be wary of the commodity markets. Commodity prices took a

serious dive after July. Along with crude oil prices, food prices also turned down by about 30 percent. The table below shows corn futures dropping from a record of \$8.00/bU.S. hit in late June, to a low of \$5.00 in August. The drop was only partially explainable by revisions in crop forecasts.

Prices of Corn for December '08 Delivery, U.S. cents/bushel, 2008



Could agriculture return to the most typical surplus position? This year's crops of soybeans and corn in the United States are expected to be strong, but less than the recent records, while stocks are still low. Wheat has improved, with Europe's wheat crop (143.2 MMT) up 20 percent, Russia's (57MMT) is up 15 percent, and Australia (22 MMT) is back with a doubling of output after two drought years. In the coming years, there are several areas of the world where increased efficiencies and investment should lead to higher production. Low cost producers like Russia and Ukraine are coming on strong in the global grain market for wheat (milling and feed wheat), soybeans, barley, rye, and to a lesser extent, corn. Efficient production policies could greatly improve output and yields. In Brazil, more farmland is still available for increased cultivation, and China has potential, should they decide to categorically adopt biotechnology.

The major causes of food price increases were oil and other input costs, the weak U.S. dollar, supply and demand (weather problems cut output, and stocks to use ratios fell to record lows), and government over-reaction in instituting trade embargoes. Add to the mix, the deleterious impact of high tariffs and other trade barriers, declines in research break-throughs, and a dose of demand from ethanol. Experts view that volatility will continue, but that markets will re-regulate themselves, and agricultural production will continue to increase. The global ethanol industry will add output from a cellulosic base.

[GIC Group](http://www.gicgroup.com) is an agribusiness investment advisory and marketing services consulting firm located in Alexandria, Virginia. Contact Susan Theiler at susantheiler@gicgroup.com. To hear comments on food prices by Rick Gilmore, President/CEO of GIC Group, on the Today Show, visit <http://www.msnbc.msn.com/id/21134540/vp/25187131#25187131>.