

## Food inflation rears its head

Global economic update: March 2011

By Kevin Lings and Laura Jones, STANLIB economists

Food prices are rising at an alarming rate, threatening global and local inflation rates

The Food and Agriculture Organization of the United Nations (FAO) recently forecast that food prices will increase dramatically during 2011 because of poor weather conditions in many areas of the world as well as unrest in the Middle East which could affect traffic through the Suez Canal.

### Food prices up 10% in three months

The FAO measures a basket of food prices made up of key commodities such as wheat, milk, oil and sugar. The FAO's monthly Food Price Index averaged 230.7 points in January 2011, up from 223.1 points in December 2010 and 206 points in November 2010. Ten years ago, the index was at 90. In particular, the FAO's Cereals Price Index, which includes the prices of staple foods such as wheat, rice and corn, rose to an average of 244.8 points in January, the highest level since July 2008.

The main causes of the rise in food prices are:

- Increased consumption, especially in developing countries
- The increased production of biofuels which diverting crops away from consumption
- Extreme weather conditions which affect agricultural production.
- The weakening of the US dollar which affects the price of exported produce.

### *Consumption is increasing*

We first flagged the rise in global food prices in August 2010. At that point the increase was attributed to specific events such as extensive fires in Russia which affected their wheat crop, leading to export restrictions and higher global wheat prices. However, recent increases in agricultural prices, including sugar and meat, have started to reflect in various countries' consumer food inflation rates. These include China, India, US, and the euro area, where consumer food inflation is clearly on the rise.

As the developing world grows, its consumption increases. As the standard of living rises, so does the demand for resources. China, with its population of 1.3 billion people, is leading the pack of nations that are moving towards a more Western lifestyle of materialism and heavy resource consumption; India is not far behind with 1.1 billion citizens. A growing middle class in countries like China, India, and oil-rich economies like Saudi Arabia and Russia, is contributing to a surge in demand for commodities.

### *Competing with biofuels*

Another contributing factor is the increased production of biofuels to meet rising energy demands as oil prices increase. The production of bioethanol, for example, requires sugar and starch. Government subsidies have made the bioethanol industry much more profitable, spawning a surge of growth and expansion in the industry. Farmers find it more profitable to grow crops for biofuel, so less land is available for food crops.

### *Extreme weather conditions*

Extreme weather conditions in many parts of the world are aggravating the situation further. For example, relentless flooding in north-east Australia devastated crops. Snow disasters are being experienced in the northern hemisphere, from the US and Europe to China and Mongolia. Britain's winter is the coldest since 1683 and close to being the chilliest in nearly 1 000 years. The cold bites directly into the agricultural sector, as do floods, drought and heat.

### *Dollar pricing*

Another leading factor is the weakening of the US dollar which continues to affect the prices of nearly all agricultural and non-agricultural commodities. The increase in international prices of food commodities, all of which accrued in the second half of 2010, boosted the overall food import bill for 2010.

### *Impact on South Africa*

South Africans cannot expect to escape food inflation, especially if the rand continues to weaken and the oil price continues to increase. Consequently, we now expect SA food inflation to breach 10% year-on-year before year-end. There is even a possibility that prices will rise even higher.

As would be expected, this will have a significant impact on South Africa's overall inflation rate in 2011/2012 (food has a weight of 14.27% in the Consumer Price Index). .

Using some basic assumptions, we can estimate the type of impact that higher food inflation will have on SA's overall inflation rate. If:

- SA's food inflation rises to over 10%/y/y by the end of 2011 and
- the rand weakens to around R7.70/\$ by year-end and
- the oil price hovers around \$100/barrel

then it is extremely likely that SA's inflation rate will breach the 6% level before the end of the year.

The equation is simple - food is a relatively inflexible commodity in terms of demand. People need to eat no matter how bad the economy gets. Therefore, demand can basically be measured by the size of the world population. So, as demand remains steady and supply pressures continue to worsen, food prices will have only one place to go, and that is up.

*Liberty Group is an Authorised Financial Services Provider in terms of the FAIS Act (Licence no. 2409). The information contained in this communication, including attachments, is not to be construed as advice in terms of the Financial Advisory and Intermediary Services Act of 2002 ("FAIS") as the writer is neither an appointed representative of Liberty, nor a licensed financial services provider as contemplated in FAIS. Please consult your financial adviser should you require advice of a financial nature and/or intermediary services.*