

Policy Brief

National Press Club
Washington, DC
November 11, 2008



For much of this year, grocery manufacturers and their allies in Washington blamed corn-based ethanol for a dramatic increase in food prices. But the dramatic drop in corn prices that followed demonstrates how flawed recent “food versus fuel” claims have been. Corn and other agricultural commodity prices have shrunk by more than half since June, yet food prices continue to rise. The implication is clear: U.S. ethanol demand, while growing, plays a marginal role in total consumer food pricing, particularly when compared with the speculative bubble driven earlier this year by investors fleeing equities markets for commodities, as well as rising global demand, fuel prices, weather events and currency trends.

While corn prices have shrunk by half, leading consumer packaged goods companies (CPGs) are still raising prices—and watching their profits grow by 10 percent or more this year. Having complained so loudly in the spring about higher food prices, they are reluctant to see them drop.

The Grocery Manufacturers Association (GMA)—engineer of much of this year’s “food vs. fuel” debate—and its members face a tough choice: admit they were wrong about ethanol being the leading driver of food costs (and keep today’s high prices), or stick to their script (and lower their prices appropriately).

But this is more than a “gotcha” moment for the GMA. By exaggerating both ethanol’s impact on corn prices and corn prices’ impact on consumer food costs, GMA and its allies have distracted policymakers, the media, industry and consumers from the larger trends and challenges we face in feeding the planet and enhancing our energy security. It is essential that interested parties work together to address the flawed assumptions those biased calculations helped promote.

“HASTY JUDGMENTS, DRIVEN BY HIGHLY QUESTIONABLE, AGENDA-DRIVEN CALCULATIONS”

In a March 4, 2008 memoranda outlining its upcoming campaign to “change perceptions about the benefits of bio-fuels,” the GMA made its position on consumer food prices clear: “Food prices are rising twice as fast as inflation... [and] a mandate in the 2007 Energy Bill requiring gasoline refineries to blend 15 billion gallons of corn ethanol in the nation’s gas supply is the primary reason.”

Rising food and fuel prices have led the biofuel industry to take a beating on Capitol Hill the past few weeks. But the pummeling hasn’t been by chance—it’s part of a concerted effort spearheaded by the Grocery Manufacturers Association...

Beating Up on Ethanol,
Roll Call, May 14, 2008

We would again caution, therefore, against hasty judgments driven by highly questionable, agenda-driven calculations...

Letter from Secretaries of Energy and Agriculture to Honorable Jeff Bingaman, Chairman of Senate Committee on Energy and Natural Resources, June 11, 2008

There’s been a big effort by others to blame ethanol for increased feed and food costs and certainly ethanol production has been a small portion of that. But it’s easy to kick around the new kid on the block, and so we attack ethanol...

Remarks of Secretary of Agriculture Ed Schafer, October 27, 2008

The notion that ethanol is the *primary* driver of food prices is an extreme one. While GMA acknowledged “several factors” behind rising consumer food costs, its claim that ethanol is the most influential driver in America’s \$1.3 trillion food economy is impossible to justify.

A U.S. Department of Agriculture study

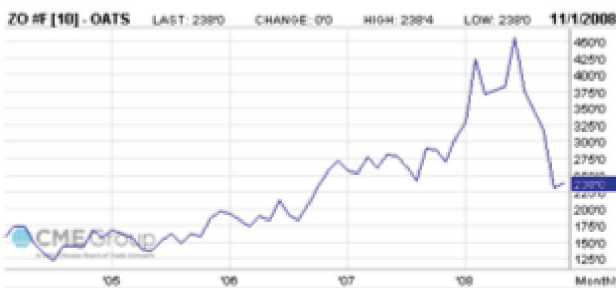
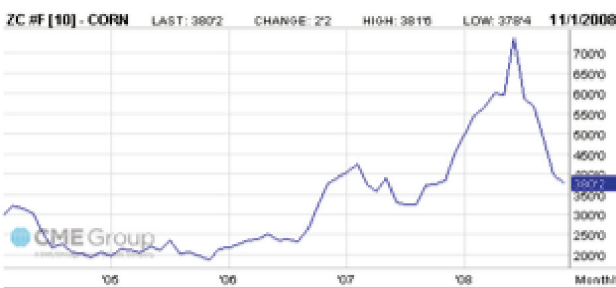
(published near the peak of this year’s commodity price run-up) identified approximately 14 factors (from 1996 to 2008) that are driving food commodity prices. These range from escalating crude oil prices (2002 to 2008), severe weather (2006-7; including droughts in Australia, Europe and Russia, coupled with floods in the U.S.), dollar devaluation (2002 to 2008), and growth in demand caused by increasing population, strong economic growth and rising per capita meat consumption (1996 to 2008).¹ In China, for example, per capita income has tripled since 2000 (from \$1,000/year to \$3,000/year), generating approximately \$3 trillion in additional spending power (2008 vs. 2000), much of which is spent on grains, meats and dairy. As a result of this

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rising demand, China has begun importing U.S. soybeans.

Moreover, these 14 factors generally relate to *commodity* prices, which represent only 20 cents of every dollar spent in the U.S. on food. The remaining 80 cents is driven by labor, packaging, advertising and other costs, which have little to do with corn-based ethanol.

Faced with hearings, intense media interest and substantial lobbying on the GMA’s claims, the Secretaries of Energy and Agriculture wrote Congress in July 2008 to “caution, therefore, against hasty judgments driven by highly questionable, agenda-driven calculations, some of which have been featured prominently in the popular press.”²



1 Global Agricultural Supply and Demand: Factors Contributing to the Recent Increase in Food Commodity Prices, USDA Economic Research Service, May 2008.

2 June 11, 2008 Letter from Secretaries of Energy and Agriculture to Honorable Jeff Bingaman, Chairman of Senate Committee on Energy and Natural Resources.

3 Chicago Mercantile Exchange Group.

RECENT PRICES DISPROVE GMA's "FOOD VS. FUEL" ANALYSIS

In an environment where each of the USDA's 14 factors, combined with a massive increase in speculative investments from hedge funds and others fleeing global equity markets, are producing record commodity prices, it can be difficult to avoid "hasty judgments."

But in the last four months, commodity prices, in general, and corn prices, in particular, have fallen dramatically—*despite the fact that demand for corn for ethanol continues to grow*. Today's prices demonstrate how small ethanol's impact on corn and consumer food prices actually is. They also demonstrate the strong correlation of corn and other agricultural commodity prices with fuel prices. Finally, the rapid flight of speculators out of the corn market from July through August (and subsequent plunge in corn prices) demonstrates the power these speculators have had in 2008.

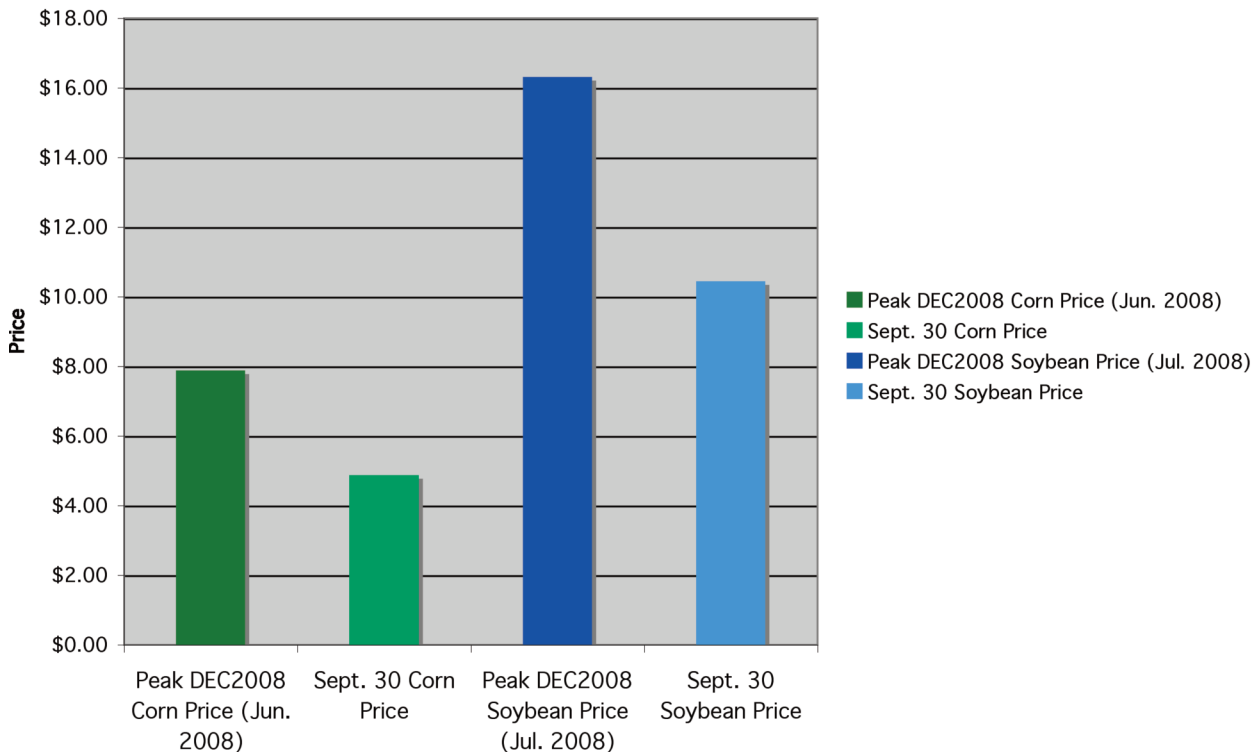
WITH COMMODITIES PRICES DROPPING, GROCERY MANUFACTURERS "SOW PROFIT GROWTH"

The price of corn, soybeans and other farm commodities is down. The price of oil, which affects food prices at each step in the food value chain, is down. Yet food prices have not fallen, and, in some cases, have risen dramatically. Some CPGs have shrunk portion sizes, without lowering prices. The grocery manufacturers that have been complaining so loudly about higher food prices now seem reluctant to see them drop.

As *The Wall Street Journal* noted in an October 17, 2008, article titled "Food Companies Sow Profit Growth":

Grain and soybean prices have fallen by about 50% since their summer highs. But don't expect grocery prices to drop anytime soon. Food companies are typically quick to pass along higher

Peak vs. Sept. 30 Prices for Corn and Soybeans



commodity costs on the way up, slower to reduce prices on the way down. That could bring a continuing run of profits for packaged-food companies even as consumers add higher food prices to the pressures they face from falling housing values and shrinking credit.

By September 30, corn and soybean prices had fallen dramatically, respectively.⁴ Yet, during this same month, grocery store prices increased nearly 8 percent, while an important subset of those prices, cereal and bakery goods, rose 14 percent.⁵

Among recent developments:

- Nestle SA, the world’s largest food company, raised prices 8 percent from January to June 2008. Key commodity prices, like corn and wheat, have since fallen by approximately half, but Nestle has no plans for significant price cuts.⁶
- On November 5, the company reported quarterly profits of 15 percent, based, in part,

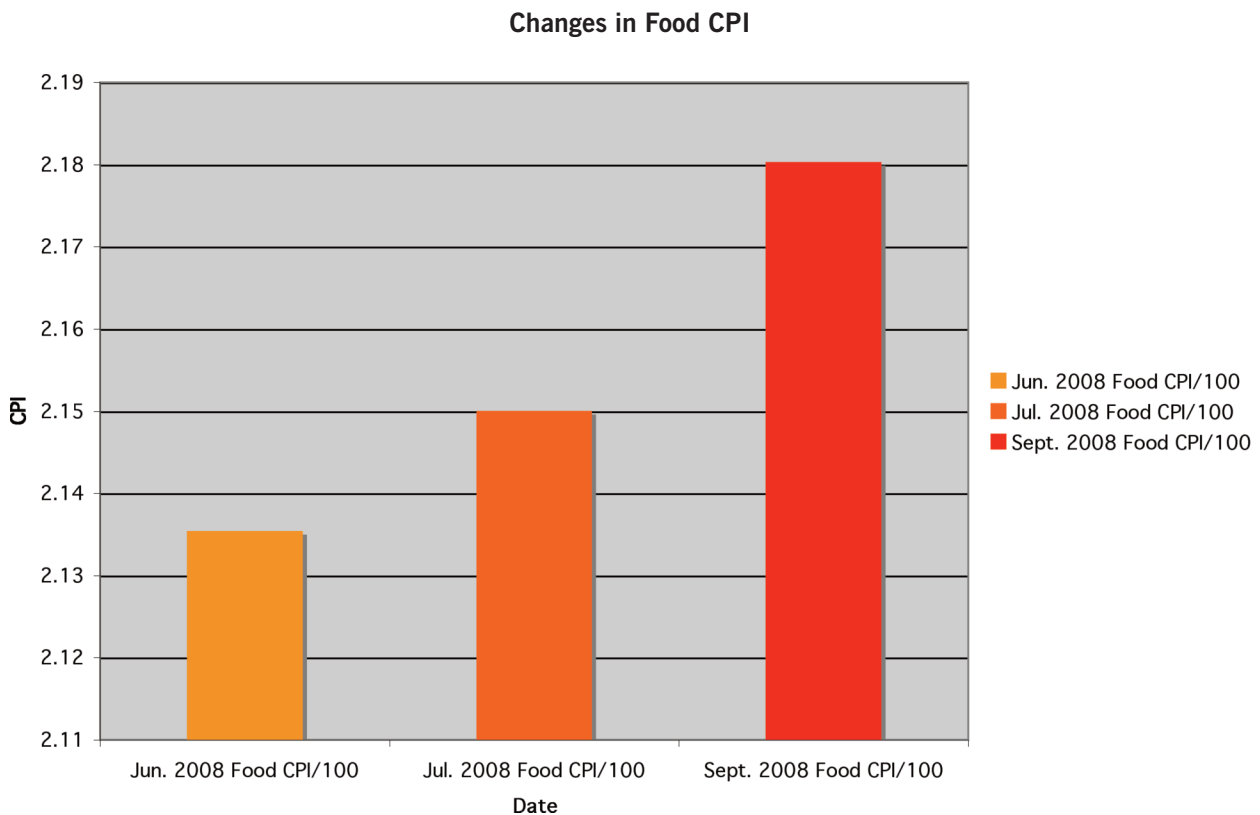
on higher prices. Last June, Sara Lee had projected its commodity and energy costs would increase by \$500 million in their current fiscal year (which began on July 1), but key commodity prices have since fallen by half.

- Dean Foods announced on November 5 that its net earnings for the most recent quarter were more than twice the previous year, due, in part, to lower dairy costs.
- Analysts expect General Mills, Nestle and Kellogg’s profits to rise approximately 10 percent this year.

As Credit Suisse analyst Robert Moskow explained in a report cited by *The Wall Street Journal*, “[consumer packaged goods companies] generally held onto the price increases they had taken while enjoying the benefit of slightly lower input costs.”

GMA FACES TOUGH CHOICE

If ethanol really is the largest factor influencing food prices, the subsequent drop in corn prices is the clearest indicator that today’s packaged foods are overpriced.



4 Chicago Mercantile Exchange Group.

5 Percentage increase over prior year. U.S. Bureau of Labor Statistics.

6 Increases relate to U.S., Canada and Latin America prices. *Food Companies Sow Profit Growth, The Wall Street Journal*, October 17, 2008.

The GMA, engineer of much of this year's "food vs. fuel" debate, faces a tough choice: it can admit it was wrong about how much corn prices drive their costs (and keep today's high prices), or it can continue to argue that corn prices remain the primary driver of food costs (and acknowledge prices must drop).

In its (successful) response to the GMA's RFP for its anti-ethanol campaign, a Washington-based lobbying and PR firm promised to "obliterate whatever intellectual justification might still exist for corn-based ethanol among policy elites."⁷ To accomplish this, the firm pledged to "clearly show the direct and irrefutable link between corn-based ethanol policy and the variety of harms caused by that policy, above all food price inflation."

The problem? Corn prices and food prices are not strongly correlated.⁸ In fact, food prices traditionally correlated more closely with both non-commodity food costs ("marketing bill" expenses, like labor, transportation, advertising and packaging) and oil prices.⁹

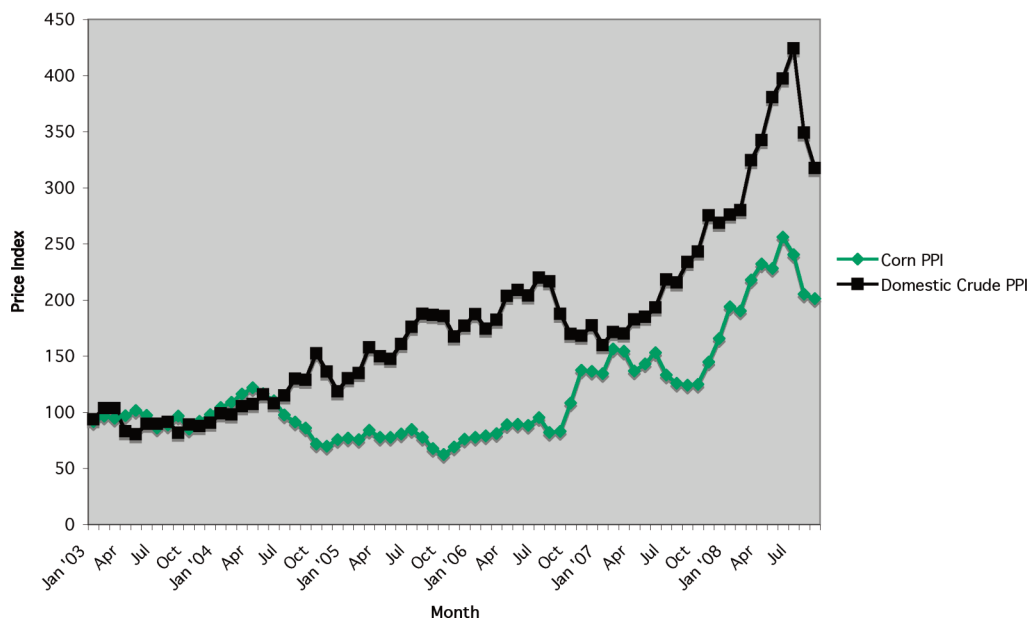
For each retail dollar spent on food, only 20 cents goes toward farm commodities—and corn is a direct input in about 25 percent of those goods.

Therefore, in order to maintain its argument that ethanol is the top driver of food costs, GMA had to exaggerate both ethanol's impact on corn prices and corn prices' impact on consumer food costs. It also had to ignore other inputs, including rising fuel costs and, more recently, speculation by hedge funds and other private investors operating entirely outside the food business.

GMA and its allies exaggerate the impact of ethanol demand on corn prices—and ignore the close correlation between the price of oil and agricultural commodities.

Ethanol will account for approximately one-third of this year's U.S. production, about two-thirds as much as livestock feed. And because one-third of each bushel processed for ethanol returns distiller grains, which can be used as a high-protein livestock feed, ethanol's net impact on feed supply is substantially less than its market share would

Corn and Domestic Crude PPI, Jan. 2003 - Sept. 2008



⁷ *Beating Up on Ethanol*, Roll Call, May 14, 2008.

⁸ *Analysis of Potential Causes of Consumer Food Inflation*, Informa Economics (November 2007). Food CPI correlation of .20. Corn and cattle, pork, chicken and milk price correlation are weak (correlation coefficients of .18, .15, .25 and .27, respectively), even when allowing price lag as costs work through system.

⁹ *Analysis of Potential Causes of Consumer Food Inflation*, Informa Economics (November 2007).

suggest. While ethanol-driven demand for corn is growing, so are U.S. exports, which should account for approximately one-fifth of this year's production.¹⁰

GMA and its allies ignore many of the price inputs identified in recent USDA reports, but the most obvious omission is the impact of rising oil prices on agricultural commodities, in general.

In fact, energy prices have a stronger influence on overall food costs than corn prices do. While each \$1 increase in the cost of a bushel of corn

translates into a .3% increase in consumer food prices, a \$1 increase in a gallon of gas increases consumer food prices by twice that amount (.6%).¹¹

Fuel costs affect nearly every step in the food value chain, from running plows and irrigation equipment; to harvesting and shipping raw commodities; to processing, packaging and distributing the final product. After examining approximately 25 food price studies and conducting their own analysis, a team of economists at Purdue estimated that energy prices accounted for 75 percent of a recent \$4 increase in corn prices (from \$2 to \$6 per bushel).¹² To demonstrate the comparative power of energy costs of commodities costs, another analysis has noted that CPGs pay four times more to ship a box of corn flakes from the manufacturer to your grocery store than they pay for the corn that goes in the box.¹³

GMA and its allies exaggerate the impact of corn prices on total food costs.

Assuming corn costs of \$4 per bushel, the corn in a \$3.50 box of cornflakes costs CPGs about five cents. Corn represents about 20 cents of the cost

of a \$6 beef steak,¹⁴ 14 cents on a one pound broiler chicken, and 22 cents of a 12-pack of soda.¹⁵

These statistics typically invite one of two questions:

1. How can a box of corn flakes cost so much, when the corn in it costs so little?
2. If corn represents such a small portion of cereal and beef costs, how can ethanol be the "primary" source of food cost inflation?

It is essential that interested parties work together to address the flawed assumptions those biased calculations helped promote.

Food costs are divided into two categories. "Farm costs" represent the cost of grains, meat and dairy and other commodities that go into food products. The "marketing bill" covers everything else, from the fuel used to process and ship the food, to the cost of labor, advertising and packaging. Farm costs vary by food group, generally depending upon how much processing, packaging and shipping is required. For example, cookies or frozen foods will have higher marketing costs than raw vegetables or eggs. With key expenditures, like breads and cereals, poultry and beef, farm costs are smaller than the marketing bill (particularly for foods consumed outside the home).¹⁶

Corn, as an ingredient in foods or as a feed for livestock, directly contributes to about 25 percent of the consumer's food basket.¹⁷ Together, corn and other grains, meat, dairy, fruits and vegetables, edible oils and other commodities represent the total "farm cost" of the food consumers buy. These "farm costs" represent less

¹⁰ Based on 2007 data.

¹¹ *The Relative Impact of Corn and Energy Prices in the Grocery Aisle*, John M. Urbanchuk, LECG (June 2007).

¹² *What's Driving Food Prices?*, Farm Foundation Issue Report (July 2008).

¹³ The average food product travels 1,500 miles to get to the store shelf. A semi can haul 4,200 boxes of corn flakes at a time, and with 10 ounces of corn in each box, that represents 46.9 bushels of corn. At a \$6.00 corn price, the corn in all 4,200 boxes has a value of \$281.40. To haul those boxes 1,500 miles, however, would cost \$881.25 with diesel priced at \$4.70 per gallon. That means it takes 21 cents of diesel per box to get it to the store, yet the value of corn in that box is less than 7 cents.

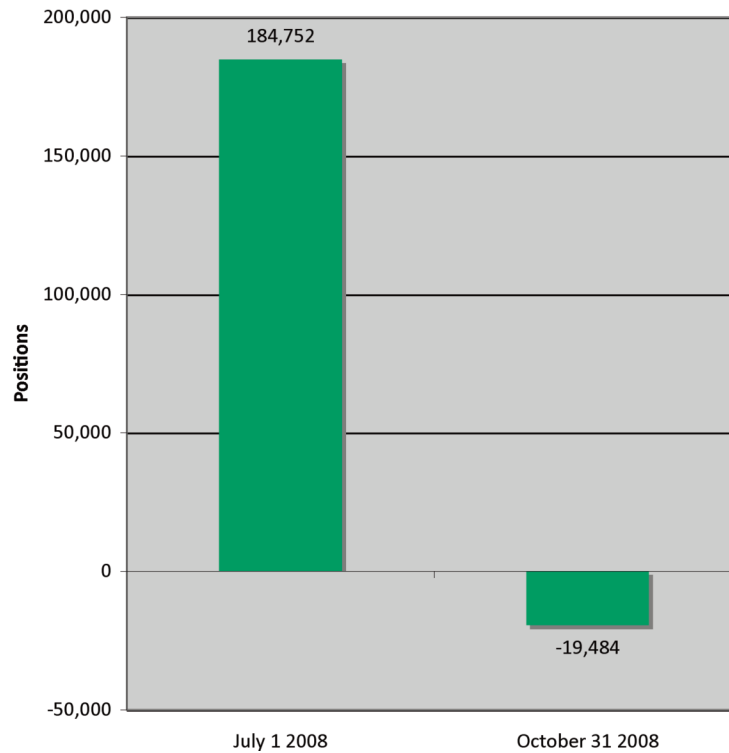
¹⁴ *Food and Feed vs. Fuel: Renewable Fuels Perspective*, John M. Urbanchuk, LECG (July 2008). Estimates vary, depending on price assumptions. See, e.g., *The Effects of Ethanol on Texas Food and Feed*, Agricultural and Food Policy Center, Texas A&M (April 2008) and *What Is Driving Food Price Inflation?*, Federal Reserve Bank of Kansas City (2008).

¹⁵ *The Effects of Ethanol on Texas Food and Feed*, Agricultural and Food Policy Center, Texas A&M (April 2008).

¹⁶ USDA estimates breads and cereal consume about 13 percent of the typical family's at-home food costs, while poultry and beef represent 4 percent and 7 percent of those costs, respectively.

¹⁷ *Food and Feed vs. Fuel: Renewable Fuels Perspective*, John M. Urbanchuk, LECG (July 2008).

Net Long Non-Commercial Positions in Corn



than 20 percent of total food costs. In other words, for each retail dollar spent on food, only 20 cents goes toward farm commodities—and corn is a direct input in about 25 percent of those goods.

GMA and its allies ignore the impact of speculation by investors outside the food business.

At the peak of this year's speculative corn bubble, Advanced Economic Solutions (AES) published a study that found "ethanol is currently the most significant factor driving corn and other agricultural commodities to record levels."¹⁸ AES made no mention of the impact non-commercial investors were having on corn's unprecedented price run-up, despite the fact that total cash inflows into commodity ETFs, which are a strong indicator for non-commercial/speculative investment demand, had surged 25 percent during the first half of 2008. In comparatively "thin" markets like non-commercial commodity investment vehicles, a 25 percent increase's impact can be enormous.

The USDA, on the other hand, acknowledged the growing importance of non-commercial investors in an analysis issued one month later. (Producers of corn that trade in corn futures are "hedgers," subject to different investment rules than outside

investors—non-commercial investors, or speculators—seeking to profit from price moves.) In its July report on factors contributing to food price inflation, it noted that, "[i]n 2006, rapidly rising agricultural commodity prices began to attract hedge, index, and sovereign wealth funds as investors sought to diversify their financial portfolios." While the USDA did not attempt to measure speculators' impact on the recent run-up, it did credit them with dramatically increasing market volatility.

The report also noted that many appeared to be investing without regard to agricultural market fundamentals. This was certainly true. Starting with the commodity markets "double bottom" dip in 2000, hedge funds, pension funds, index funds and other non-commercial investors began investing in commodities. As the USDA noted, this flow of funds from equities and other classes into commodities accelerated in 2006, then again in 2008 (as concerns about global equities spiked). By mid-February, speculators held approximately 480,000 long positions in CBOT corn futures.

In late May, the balance of long to short positions taken by speculators was a net positive of approximately 350,000. In other words, investors

¹⁸ *Rising Commodity Prices and their Impact upon U.S. Food Inflation*, Advanced Economic Solutions (June 2008).

had bought and held open approximately 350,000 more long positions than short positions. By summer, weakening in the credit markets, declining oil prices and strong corn production caused these speculators to flee. On July 1, the balance of long to short positions was a net positive of nearly 185,000 contracts (down nearly 50 percent from late May). By early October, the balance had dropped to a net positive of approximately 135,000 (down approximately 60 percent). And, on October 31, the balance of long to short positions had flipped to a net negative of nearly 20,000 contracts. This swing of 370,000 contracts in just five months coincided with a nearly 50 percent drop in corn prices.

WHY THE GMA'S STRETCH ON ETHANOL MATTERS

By exaggerating both ethanol's impact on corn prices and corn prices' impact on consumer food costs, GMA and its allies have distracted policymakers, the media, industry and consumers from the larger trends and challenges we face in feeding the planet and enhancing our energy security. While the Secretaries of Energy and Agriculture warned in July about "hasty judgments driven by highly questionable, agenda-driven calculations," it is essential that interested parties work together to address the flawed assumptions those biased calculations helped promote.

Critics have gone to great lengths to blame ethanol for a range of economic and social problems that has stretched credibility. For example, critics argue that ethanol has prompted farmers to shift from corn to soybeans, but they ignore the fact that, from 2006 to 2008, approximately 4.6 billion bushels of U.S. soybean demand disappeared when U.S. grocery manufacturers and restaurants (anxious about new Federal trans fat labeling regulations) cut back on hydrogenated oils, which drove soybean's share of the edible oils market dropped approximately 13 percent. Similarly, critics focusing on an increase costs of cereal or chicken should also consider the household savings at the pump, which the U.S. Departments of Agriculture and Energy estimate range from

\$28 to \$49 billion dollars this year. A typical household would pay as much as \$300 more for gas each year, without ethanol.¹⁹ In order to replace 2008 biofuels, the U.S. would have to import another 7.2 billion gallons of gasoline—a five percent increase.²⁰

Identifying Ethanol as the #1 Global Food Cost Driver May Be Good Politics, But It Is Bad Policy

This year, a range of "highly questionable, agenda-driven calculations" flooded the market, laying blame on U.S. corn-based ethanol for disruptions around the world—without fully recognizing the power of speculators to drive prices up, or the close link between food prices and the cost of the energy used to produce that food.

The recent drop in corn prices (along with the price of most other agricultural commodities) demonstrates convincingly that ethanol demand was not the "primary" driver of food prices. But we must do more than simply acknowledge this fact.

The problem with blaming so much of recent food turmoil on a single factor (biofuels), is that we ignore other factors, large and small—including those factors that are easiest to understand and mitigate. Focusing disproportionately on a marginal factor of food costs, like ethanol, could distract policymakers from larger policies and investments that could dramatically improve farm productivity, particularly in developing markets where demand for food is growing most. To produce more food and make the most of renewable energy crops, we should be focusing on infrastructure for storing and transporting crops, better plowing and irrigation methods, better seeds and more agricultural R&D.

We must return our focus to increasing farm productivity. And we must encourage the GMA and its allies to answer a simple question: Were they wrong about ethanol driving costs (in which case, today's high prices might be justifiable), or were they right? If the GMA and its allies choose to stick with their arguments on ethanol, it is time for their prices to come down. Fast.