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Testimony to the Committee on Agriculture, Nutrition & Forestry of the United States Senate

August 18, 2008, Omaha Nebraska

Thank you, Mr. Chairman, for the opportunity to address the committee. Today's hearing to explore the changing economic landscape for agriculture (including the role of renewable fuels) is highly relevant and particularly timely.

My name is Bill Lapp, and I am the principal of Advanced Economic Solutions, LLC, located in Omaha, Nebraska. Advanced Economic Solutions is dedicated to providing high quality economic and commodity analysis for a broad array of food companies. AES provides forecasts and analysis for procurement and risk management decisions, in order to help these companies in their decision-making processes and strategic thinking. With my background in providing commodity analysis and support for risk management decisions for food companies, I would like to bring to you the perspective of restaurants, food manufacturers, and primary input producers.

Spikes in the price of commodities since 1981 have been mostly weather-related; in all cases increases in commodity prices have been short-lived, with limited impacts upon consumer food inflation. For the most part, these increases in commodity prices have been absorbed by food manufacturers to avoid loss of market share. This contrasts with the current

environment of sustained increases in commodity prices. Today, food manufacturers are unable to absorb the sharp and sustained increase in input costs, and as a result, food price inflation has begun to accelerate, and annual rates of food inflation are likely to continue to increase in the coming years.

Food Company Views On Rising Input Costs and Food Inflation

The overwhelming majority of the companies that Advanced Economic Solutions works with indicate that rising input costs, driven by the surge in commodity prices, has created the most challenging environment from a raw material cost perspective that they have faced in more than 20 years. The current environment, with a sharp and sustained increase in prices, has created significant pressure on margins, and compelled the food industry to raise prices to consumers.

In a survey conducted by Advanced Economic Solutions during February 2008, food manufacturers and restaurants were clear in expressing their concerns about the rising input costs in 2008 and beyond:

- More than 90% believe 2007 was the most challenging year they have faced, and more than 90% believe 2008 will be equally or more challenging than 2007
- More than 90% believe the increase in food costs we have seen will be sustained over time
- Around 75% indicate they have begun to reflect higher costs in consumer prices, but more increases are forthcoming in the next year
- Among the causes of the increased food input prices, over 90% indicated ethanol was a primary driver of the rise in food input prices

Food Inflation History and Outlook Going Forward

The Bureau of Labor Statistics data on food prices,¹ the consumer price index (CPI) and producer price index (PPI), confirm the trend of rising food input costs as well as consumer food prices. Historically, the CPI for food increased by an annual average of 2.3% during 1998 and 2006, and food inflation has not been in excess of 6% per year since 1980.

However the impact of higher commodity prices began to translate into higher consumer prices in 2007 – from December 2006 to December 2007, the CPI-Food rose by 4.9%. Further acceleration in food prices has occurred in 2008. The consumer price index (CPI) for food rose at a 7.6% annual rate during the first seven months of 2008. This includes double-digit rates of inflation for staples such as bread, cereal, salad dressing, rice and eggs.

There are two things to note about the rise in food price inflation during the first half of 2008. First is that while consumer prices were increasing rapidly, the producer price index (PPI) for food, reflecting rising input costs, rose at an even greater rate during the first half of 2008 (9.8% annualized). While increases in the CPI-Food and PPI-Food tend to run in close parallel over time, this has not been the case recently – the annual rate of gain in the PPI-Food has been in excess of gains in the CPI-Food for the past 18 months by an average of 2.3%. The data reflect an environment where the US food industry has begun to pass on higher costs, but not to the extent they have been incurring increasing costs. In order to close this gap, one of two things will happen – either consumer food prices will go up, or producer prices will go down. Market fundamentals suggest that it will be the former.

¹ US Department of Labor Bureau of Labor Statistics (www.bls.gov)

The second point is that the increase in consumer food prices during the first half of 2008 has occurred with only modest increases in meat prices. The CPI data indicate June 2008 beef and chicken prices have risen by 3% from a year ago, while consumer pork prices have declined by 1% from a year ago. This is consistent with the American Farm Bureau Federation's Survey of Supermarket Prices,² which indicates the five meat prices they track had risen during April-June 2008 by an average of just 1.7% from a year ago. Due to the biological limitations (i.e. the time it takes for an animal to mature), as well as high levels of fixed costs, livestock producers do not typically respond quickly to changes in feed costs. However in the current economic environment that is characterized by poor or negative margins, producers are expected to reduce their output in response to the high feed costs. USDA's most recent forecast is for total meat and poultry production to decline by 1.2% in 2009, a development that will lead to significantly higher livestock prices in 2009 (according to USDA price forecasts).

Earlier this year, Advanced Economic Solutions completed an analysis of the outlook for food inflation during 2008-12.³ The report concludes that the rise in commodity prices, led by corn, is having a direct impact on consumer food inflation. As a result of the sharp and sustained increase in input costs, Advanced Economic Solutions estimates that food inflation will rise by an average of 9 percent annually between 2008 and 2012, as the rising costs are passed on to consumers.

² www.fb.org

³ "Rising Commodity Prices and their Impact upon US Food Inflation", Advanced Economic Solutions, June 2008

Corn's Relevance to Food Prices

Corn is the largest crop produced in the US, with production more than four times larger than either wheat or soybeans. It is an extremely important part of the American diet, and changes in the price of corn directly impacts the price of other grains and oilseeds, as well as the price of livestock, dairy and eggs.

The price of corn and other commodity prices has risen sharply over the past two years, and is dramatically impacting the costs to produce food, costs that ultimately will be passed on to consumers. While the recent decline in the price of corn and other commodities is a welcome development for end-users, we should not take too much comfort in the current situation.

Note that the recent USDA projection of the 2008 US corn crop (12.2 B bushels) historically is adjusted up or down by an average of 6.6% between the August forecast and the final estimate.

The need for more acreage will be a significant driver of the price of corn and other crops in the coming months (and perhaps years). In 2008, 234.8 million acres were planted to four major crops (corn, wheat, soybeans and cotton), a five million acre increase from a year ago and highest level since prior to the start of the Conservation Reserve program. In order to meet existing (2008/09) demand and the growth in demand to meet the rising ethanol and bio-diesel mandates, US farmers will need to plant 240 million acres in 2009, including an increase in corn acreage from 87.3 million to 93.0 million acres.

We need more acreage to be planted in 2009 and beyond, largely to meet the increased bio-fuel mandates. If additional acres are not “found”, prices are going to have to increase to ration scarce supplies. Further, weather problems in 2009 would lead to a dramatic increase in the price of grains and oilseeds from current levels. This year, early flooding caused corn prices to spike to over \$8 based on the threat of reduced supply. Next year, with increased demand pressure from biofuels, the situation is even more precarious.

Recent studies have discussed how a box of corn flakes is impacted by higher corn prices⁴, but this focuses on a very minor component of corn usage. In 2007/08, USDA estimates that 192 million bushels of corn were used in the production of all cereal – this represents 1.8% of total domestic use of corn and is equal to just 0.1 pounds of corn per person per day. By contrast corn use in the production of livestock, dairy and eggs totaled 6.05 B bushels – representing 58% of total domestic corn used in 2007/08 and equal to 3.1 pounds of corn per person per day. While it may be popular to discuss how little higher corn prices impact a box of corn flakes, the impact of higher corn prices upon livestock, dairy and eggs is 31 times more important to US consumers.

⁴ As an example, see “Corn Prices Near Record High, But What About Food Costs?”, USDA Economic Research Service, February 2008 (www.ers.usda.gov/AmberWaves/February08/Features/CornPrices.htm)

Ethanol and Its Relationship to Corn and Food Prices

The relationship between the growing use of corn to produce ethanol and the impact on corn prices and ultimately food prices has been the subject of several studies, reaching a wide range of conclusions. Because so many views are held, it may be useful to review some of the facts surrounding ethanol, corn and food prices.

1. **FACT:** While there has been discussion of the impact of poor weather in recent years, USDA data indicate otherwise. World wheat and coarse grain yields in 2006/07 were the 3rd highest on record and 4% above the previous 5-year average; world wheat and coarse grain yields in 2007/08 were record high and 5% above the previous 5-year average. *In other words, it is difficult to blame weather for the dramatic rise in prices we have seen in recent years.*
2. **FACT:** World wheat and coarse grain usage is forecast by USDA to increase at an annual rate of 3.3% between 2006/07 and 2008/09, well above the growth rate of 1.2% during the previous 10 years and higher than the average increase in yields per acre of 1.58% over the past 25 years (1982-2007). The growth in world wheat and coarse grain use is dominated by ethanol. During 2006/07 through 2008/09, 46% of the growth in world demand is attributable to increased use of corn to produce ethanol (2.0 B bushels or 50 million tonnes additional demand for ethanol, out of a 110 million tonne increase in total world wheat and coarse grain use). *As the US and world struggles with tight stocks, high feed costs and increased food inflation around*

the world, we should keep in mind that nearly half of the growth in grain use can be attributed to mandated use of corn to produce ethanol.

3. **FACT:** Growing use of grains has led world stocks of wheat and coarse grains, as a percent of usage, to the two lowest levels on record at the end of 2007/08 and 2008/09. This has occurred in spite of record high grain and oilseed prices. *At present and for the foreseeable future, the impact of a decline in yields would be dramatic for grain and oilseed prices, and ultimately for consumer food prices.*
4. **FACT:** More acreage will be needed to meet the growth in demand, particularly the demand mandated via the Renewable Fuel Standard for ethanol and bio-diesel. In the United States, just to meet existing demand plus growth in ethanol, US farmers will need to plant an additional five million acres of major crops (corn, wheat, soybeans and cotton) in 2009. *Grain and oilseed prices are already high, but a shortfall in acreage or yields in 2009 would drive prices dramatically higher.*
5. Livestock margins have been extremely poor due to the rise in feed costs. USDA analysis suggests livestock producers will reduce output by 1.2% in 2009, with prices for livestock expected to increase. *Although there have been limited gains in consumer prices of proteins to date, the reduction in the availability of meat will ultimately be reflected in higher consumer prices for meat at some point in the coming year.*

Thank you, Mr. Chairman, for the opportunity to share my thoughts and analysis to the committee. I would be happy to respond to any questions.