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Global recovery, might – *or might not* – boost commodity prices

By Jon H. Harsch

If you're watching commodity price charts, supply/demand reports and the weather closely – add a few more items to your list. That's according to three Purdue ag economists who've updated the "What's Driving Food Prices?" report they wrote for Farm Foundation last July.

In the update they released Wednesday, Wallace Tyner, Christopher Hurt and Philip Abbott conclude that the dollar exchange rate and crude oil price "are critical to agricultural markets."

Last July, the three economists found that the sharp run-up in food prices was the direct result of three major drivers:

- World agricultural commodity consumption exceeding production growth, leading to very low commodity inventories around the world,
- the decline in value of the U.S. dollar, and,
- the new linkage between energy and agricultural markets due to growth in the production and market penetration of biofuels.

Now, eight months later, the world is totally different – but the drivers are the same. After a rapid move toward tight supplies and prices peaking last July, "Weak world demand and better than expected yields" have averted the predicted shortages and pushed commodity prices lower. Over the same period, the July peaks caused in part because "A weak dollar and strong macro economics drove prices higher," have been replaced because "A stronger dollar and weak world economy are leading prices lower." The economists also conclude from the run-up and subsequent downturn that biofuels provided the third driver in both directions: "Energy and agricultural markets became directly linked….both on the price upside and downside."

Their report charts the direct oil/ag linkage this way:

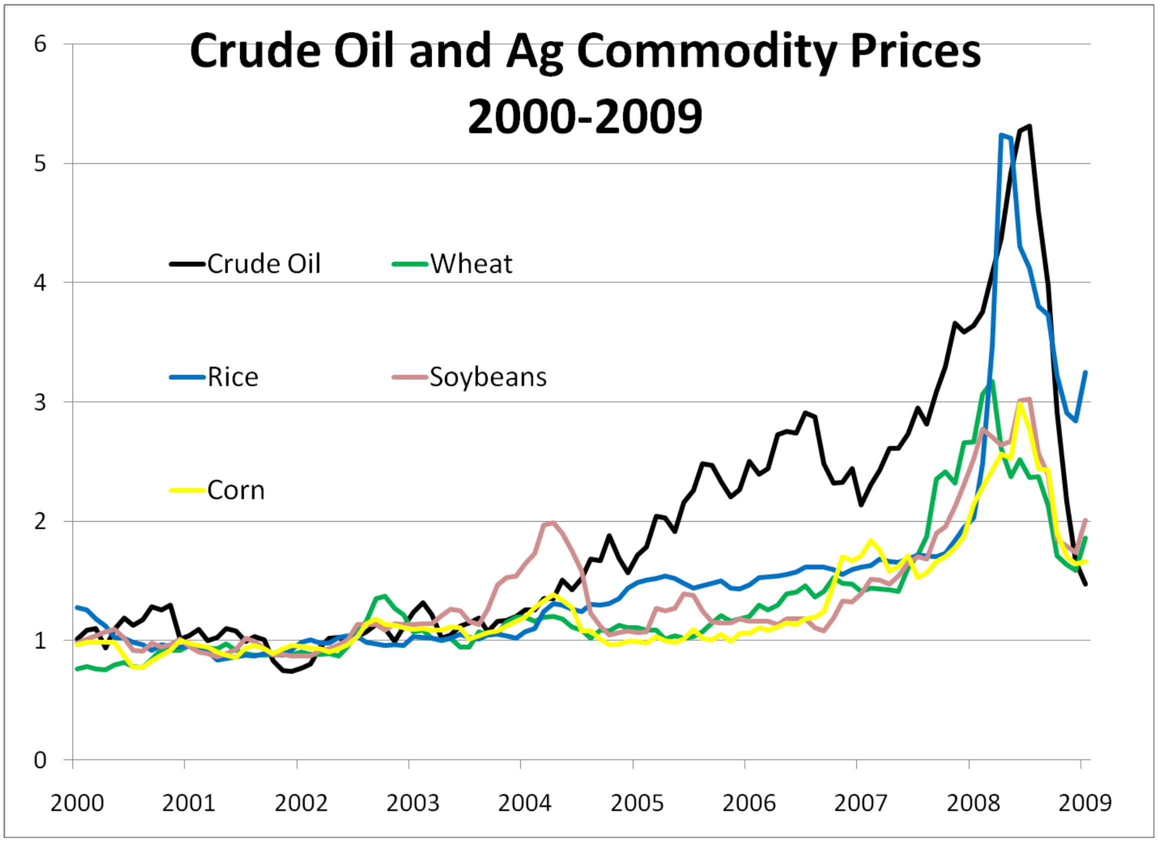

Chart from "What's Driving Food Prices? March 2009 Update" for Farm Foundation

Tyner, Hurt and Abbott explain that "We began this work by asking if there were some major driving force that was behind all the price increases or was it a perfect storm of individual commodity supply and demand circumstances that just happened to come together at the same time? It was a combination of diverse and complex factors involving commodity supply and utilization, U.S. dollar depreciation, and biofuels. Those same factors (global supply and demand, value of the U.S. dollar, and biofuels) also are behind the recent drop in commodity prices."

As for what lies ahead – their answer is lots of questions and more volatility. A further drop in commodity prices is possible because "Grain and oilseed prices have dropped sharply from record-setting peaks, but remain well above long-term norms." The one certainty is that "Future agricultural commodity price changes will depend greatly on exchange rates and crude oil prices, which in turn are linked and depend on macroeconomic performance. These drivers are highly volatile and difficult to predict."

To read a 4-page executive summary of the Farm Foundation update, click here:
http://www.farmfoundation.org/news/articlefiles/1702-Farm%20-%203-10-09%20-%20Food%20Prices%20Update%20-%20Exec%20Summary.pdf

To read the complete 51-page Farm Foundation report update, click here:
http://www.farmfoundation.org/news/articlefiles/1702-Farm%20-%203-10-09%20-%20Food%20Prices%20Update%20-%20Book%20for%20Posting.pdf

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