

Feeding high prices

A number of factors are driving food price inflation



PHOTOS BY GARY BARBER



After the number of hungry little mouths in the Sturgill household doubled, the family assumed their grocery bill would, too. Instead, it nearly tripled. Yes, the family buys more food, but what they've always eaten now costs significantly more.

Back in 2002, when milk was just a dollar a gallon and Bobby and Debbie Sturgill had two children, their grocery bill was around \$300 a month. Today, milk is usually more than \$3 a gallon and, with four children and a new baby, groceries are about \$800 a month.

"Bread, cereal, eggs have all gone up significantly," says Debbie, 33, who maintains the family's budget. "Even apples are getting really expensive."

Living in western Missouri, Debbie first noticed significant increases in almost every aisle of the grocery store about a year ago, which, according to data, is when soaring food prices had the highest gains nationwide in nearly two decades. In 2007, food price inflation rose twice as fast as overall inflation, with prices increasing 4 percent above levels from the year prior. A 2.5 percent increase is the norm most years, according to federal data.

Another sharp gain is expected this year, says Jason Henderson, an economist and the Omaha Branch executive of the

Federal Reserve Bank of Kansas City. He recently researched factors driving food price inflation.

Henderson says more expensive grocery bills and restaurant tabs are the result of several factors, including:

- larger populations and larger incomes: people are eating more meat, which means more grain is needed to raise livestock;
- biofuels: ethanol and other renewable fuels mean fewer crops for food use;
- weather: droughts devastated Australian crops last year as did other conditions in Europe;
- weak dollar: the low value of currency buys less overseas and sends more food overseas;
- high input costs: rising labor and energy expenses affect every aspect of food, from fertilizer to packaging.

"Today's momentum in food prices may be signaling a new era of even higher food prices in the future," Henderson says. "Keeping food prices in check will depend on whether agriculture can increase supplies. With global food demand projected to rise, the agriculture sector will be tested."



THE INCREASING COSTS OF INGREDIENTS—especially cheese, meat and flour—has led to higher prices for customers of Wheat State Pizza, a Kansas-based franchise. Most pizzas are about a dollar more and chicken wings, for example, are 50 cents more. However, the shop in Lawrence, Kan., hasn't seen a slowdown in business, making anywhere from 150 to 400 pizzas a day.

Explaining the hike

Increases in food prices were seen across the board in the food industry, Henderson's research shows.

Some of the largest gains were in meat and dairy:

- Dairy prices rose 7.4 percent in 2007 after declining the year before. Strong export demand for dried milk underpinned overall dairy prices.
- Poultry and pork prices spiked after falling in 2006.
- Beef price increases were the result of robust demand.
- Fish and seafood prices were steady.

Crop-based food products also saw rapid gains:

- Cereal and bakery product prices jumped 4.3 percent, after three years of increases.

- Fat and oil product prices increased almost 3 percent as a result of strong national and international demand.

- Fruit and vegetable price gains eased after rebounding from freeze damage in 2006.

- Processed fruit and vegetable prices have inflated, which is a reflection of higher processing costs.

This year, the highest prices—with upwards of a 5 percent increase—are predicted for cereal and bakery products, and fats and oils. Meat, poultry, fish and dairy products are anticipated to increase less than 3 percent.

Marketing costs are in large part driving food prices. This cost is the difference between what farmers receive and what the consumers spend at the grocery store or restaurant. These costs have risen significantly during the past several decades, biting into a larger share of

the retail food dollar. In 1950, marketing costs made up 59 percent of total retail food costs. Today, these costs make up 80 percent, mostly as a result of rising labor and energy costs.

Labor costs are the most expensive component of processed and prepared foods. These costs have risen as people consume more of these types of food, as well as food eaten away from home. Additionally, food manufacturers and food service firms are increasingly paying employees higher wages, especially as minimum wage increases take effect.

Energy prices also are boosting food prices by raising the costs of processing, manufacturing and transporting products, more so as oil exceeds \$100 per barrel and gasoline rises above \$3 a gallon.

"In the past, food prices have surged during times of high crude oil prices," Henderson says. "Research shows energy prices are quickly passed on to food, with these prices rising half a percent for every 1 percent increase in energy prices. However, the volatility of energy markets makes the impact on food prices uncertain."

Farm commodities have remained stable with the average corn price from 2000 to 2005 equaling the price farmers received in the 1970s. Although their share of retail food prices has diminished, commodities still account for a substantial part of the retail food dollar. This does, however, vary by food type—commodities represent a smaller percentage of retail costs for foods requiring more processing, packaging or advertising. For example, farmers receive 19 cents from every dollar spent on a bag of wheat flour, but just 4 cents from every dollar spent on a box of corn flakes cereal, according to the USDA.

Dining out

Not too long ago, Ryan Murphy noticed the weekly delivery of flour to Wheat State Pizza restaurants was heftier than before. The key ingredient to the trademark crust is still in 50-pound bags—it's the bill that hit Murphy like a ton of bricks.

"It's gone from \$10 a bag to \$30," says Murphy, who is president of the Kansas-based franchise, adding that higher wheat prices

could mean an increase of as much as \$400 a month for flour. The higher costs of other ingredients—specifically meat, cheese and vegetables—and the increased cost of labor also influence the bottom line, he says.

"It's affected our restaurants," Murphy says. "That has to be passed to the customer, and that's the big fear of businesses."

As a result, Wheat State raised the price of pizzas about a dollar, but Murphy isn't worried about losing customers, or worse, closing shops. In addition to the 10 regional restaurants opened since 2004, at least two more eateries will open by the end of the year.

The convenience and ease of dining out has busy families lining up at drive-thru windows and filling restaurant booths, where they are likely to see price increases, too.

"People are eating more processed foods and consuming more food away from home," Henderson says. "Processed foods and restaurant meals have higher marketing costs as do packaged foods, contributing to lower farm costs per retail food dollar."

From the farm

The price of wheat has more than tripled from a year ago, while both corn and soybeans are trading at about double the price from the year prior. On the heels of planting the most acres of corn since World War II, U.S. farmers plan to plant less corn and more soybeans this year, according to a USDA prospective planting report. Ethanol demand had prompted farmers to forgo soybeans for corn in recent years. This shift back to soybeans could push already-high corn prices even higher. More expensive livestock feed and corn-based products mean even higher prices for everything from meat to corn flakes cereal.

"Nobody's seen prices like these, ever," says Royce Schaneman, executive director of the Nebraska Wheat Board. "We've hit historic high prices. ... It won't last."

The Nebraska Wheat Board promotes wheat breeding research and consumer education, among other related efforts, to ensure profitability for producers.

After rising sharply in the 1970s,

commodity prices had been relatively flat, according to Henderson's research. The average prices of corn, wheat, soybeans, pork, beef and milk from 2000 to 2005 have been equal to the average prices during the 1970s. Schaneman says today's soaring prices don't mean that producers are cashing in. Some were able to sell significant amounts of their wheat crops early at high prices, but most sell at harvest time when the supply is abundant and prices are lower.

The cost of production bites into producers' profits, which are typically low for packaged and processed foods because the portion of wheat actually in these items is small. For example, only about 5 to 6 cents from the cost of a loaf of bread goes back to the farmer, Schaneman says. The price of these commodities is small compared to their processing costs, such as transportation.

"The United States is used to a cheap, reliable food supply," Schaneman says. "To have this safe, abundant food supply, we've got to pay for it. And that's what we're doing now."

A new era of high prices?

Coupons and in-store specials add a little relief to the food budget for the seven-member Sturgill family. They try to leave expensive packaged items on the store shelves; Debbie makes baked goods from scratch; the family eats all its leftovers and only dines out on special occasions—even McDonald's or pizza for everyone can cost \$30.

One of Debbie's biggest concerns is not sacrificing the family's nutrition in an effort to lower the grocery bill. So this spring, the Sturgills planted a small vegetable garden to supplement fresh foods bought from the store. Regardless of price, though, Debbie knows there are items they have to purchase, such as milk, eggs and fruit.

"It's extremely challenging," she says. "I think that we have to cut back, but there's not too much we can trim."

There's just not a lot consumers can do in response to high food prices, says Ephraim Leibtag, an economist with the Food Markets Branch of the USDA.

"Food overall is like gas overall," Leibtag says. Consumers notice price hikes, complain, but don't change their behavior much.

While consumers likely won't eat less food, there may be some trade-offs, such as eating fast food rather than at a sit-down restaurant, or substituting a cheaper item for a more expensive one, such as chicken in lieu of beef, at the grocery store. But because all food sectors are more expensive, these trade-offs likely will be limited, Leibtag says.

To compensate, "other things are going to be cut out that aren't necessary," Leibtag says. "And that's a lot harder for lower-income households."

The world's most poor are already in crisis mode. In the past year, food shortages have caused uprisings in Haiti, Pakistan and several countries in Africa.



IN AN EFFORT TO EASE THE FAMILY'S FOOD BUDGET, Debbie Sturgill plants a small garden in the backyard of their Missouri home with the help of her three oldest children, Joshua, Elizabeth and Christine. The seven family members have seen their grocery bill rise significantly in recent years.

For families everywhere, today's higher food costs may be the new norm, Henderson says. High demand for farm commodities could overrun existing production capabilities, which strains food supplies and boosts prices. Additionally, population growth (up nearly 2 billion from a decade ago) and rising incomes are changing food consumption worldwide, in effect boosting the demand, which supports these higher prices.

Meanwhile, nonfood use of crops, such as biofuels, is affecting global crop inventories, which are expected to drop to historic lows this year. Droughts worldwide also are trimming supplies.

Boosting agricultural productivity may be the best option for expanding the global food supply, but environmental concerns, water access, transportation infrastructure, financing and other issues could limit crop potential. These issues may be offset by evolving technol-

ogy, which historically has helped farmers meet rising demand.

"To meet growing demand, agriculture will need to put more acres to the plow," Henderson says. "But, as in the past, stronger agricultural productivity will be needed to keep higher food price inflation at bay."



BY BRYE STEEVES, SENIOR WRITER

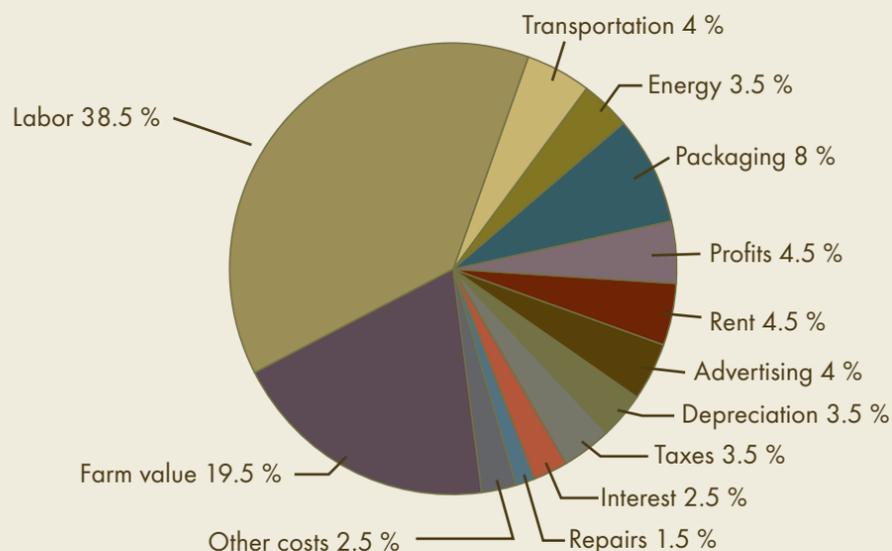
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"WHAT IS DRIVING FOOD PRICE INFLATION?"

By Jason Henderson
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COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Components of retail food costs



Source: USDA