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Washington Is Starving the World's Poor

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Changes in government policy cause changes in asset prices and can often have unintended consequences. A prime example of this is how U.S. ethanol policy, which was intended to reduce our dependence on foreign oil, has instead hijacked the supply curve for food. The unintended consequence of this policy has been to connect rice prices to oil prices, thus starving the poor people of the world.

Until now, food and oil have not substituted for each other. The implementation of a government ethanol policy mandating that one third of the U.S. corn crop be converted into motor fuel dramatically changed the relationship between food and fuel. To understand the unintended consequences of this action, one must first understand the economics of supply and demand.

Supply curves are upward sloping, meaning that as prices increase, quantity supplied increases. In the short term the supply curve for oil is almost vertical because oil has few close substitutes, long lead times and heavy capital expenditures. This means that any short term change in oil demand up or down will produce a large change in price rather than a large change in quantity supplied.

Food, like wheat, corn and rice, has a very different and much flatter supply curve because there are many close substitutes for different foods. Also food's production function, the time required to adjust output, is much shorter, typically one growing season, or at most, 12 to 18 months. In the medium term, these nearly horizontal supply curves mean that any change in food demand up or down will be mostly met with a change in quantity rather than a dramatic change in price.

Ethanol policy mandating that corn and oil become substitutes has forced these two very different supply curves to become one. The much larger global oil market expropriated the supply curve of the U.S. corn market. In short, oil markets now set food prices. This unintended consequence can be seen in global commodity markets.

From early 2007 to the peak in 2008 oil prices climbed from near \$50 a barrel to over \$145/barrel. Global food markets followed, as rice, corn and wheat prices more than kept pace with oil price increases. The recent offshore drilling debate along with expanded oil substitution and conservation has broken the price of oil and food markets in the short term. Recently oil has fallen by 25% and food stuffs by much more.

Correlations are never perfect, but one gets the point. High oil prices helped cause high food prices globally because U.S. ethanol policy forced both markets to act as substitutes sharing the same supply curve.

We should not be starving the poor people of the world by implementing a poor domestic ethanol policy. To solve the problem of high prices at the gas pump and the grocery store we should allow free markets to discover the right mix between offshore drilling, wind power, solar power and bio-fuels. We should never allow the government to tell markets what to do. If government gets out of the way, expect oil and food prices to continue their descent.

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