A Worrisome Rise in Commodity Prices

William R. Cline contends that the Federal Reserve should pay careful attention to the latest worrisome price increases for food, metals, oil, and other commodities.

Edited transcript, recorded March 29, 2011. © Peterson Institute for International Economics.

Steve Weisman: The price of oil and commodities is rising all over the world, casting a shadow on the prospects for economic growth. William Cline, senior fellow at the Peterson Institute for International Economics, has been studying the phenomenon. This is Steve Weisman at the Institute. Thank you, Bill.

William Cline: Thank you.

Steve Weisman: The news suggests that commodity prices are rising across the board -- oil, gold, food. What is the pattern?

William Cline: I think it's a pretty accurate portrayal. If you look at the four major grains -- wheat, rice, corn, and soybeans, and also put in oil, copper, and gold -- from 2005 to middle of 200, with most of the increase occurring late in that period, the index went from 100 to 250. More than almost three times the previous price level.

Then, of course, in the great recession, oil and copper fell back very sharply. In fact, they went below 100. The four grains stayed up relatively high at about 150. And by the end of 2010, the index for these seven raw materials was back up to 230, almost as high as it got in 2008. The evidence is that there has been this pretty generalized rise in prices.

Steve Weisman: But also a lot of volatility.

William Cline: The volatility has been very high. You can find periods when volatility was even higher if you take the price spikes in 1973-74, when we had the U.S. embargo on soybeans exports, you'll recall.

Steve Weisman: And also the oil embargo.

William Cline: Oil embargo, yes.

Steve Weisman: How temporary or permanent are these rises?

William Cline: I'm coming to the initial conclusion that for food stuffs, these rises may be with us longer than we might have thought. If you take a longer perspective, we've had 20 years of cheap food that I think may not be representative of the longer term supply and demand.

If you take the four major grains: the real price of those four major grains deflating, by manufactured unit values, from 1985 to 2005, with an index of 100. By now it's up to 200, OK? But it was also an average of 200 in 1961 through 1980. So we've had sort of this U-shaped period of real prices. Now is this going to persist? There are some real factors going on here.

Steve Weisman: What are some of them?

William Cline: In terms of the temporary things, we've had--hopefully temporary--we've had a run of droughts: Russia, South Africa, Australia for 2006-7. You had shortages that prompted export bans and so forth. But the longer term picture I think is a bit of a concern, because basically the growth rate of grains production globally relative to the growth of demand has slowed down.

In 1960 through 1990, the growth rate of grains was 3 percent a year in terms of output. From 1990 to 2010, that's slowed down globally to 2 percent. Global demand just didn't slow down that much. It was probably growing a little bit more slowly than global output in the first period which is why you started to have that long slide down to the bottom of the U.

And with the rising share of low-income countries in world product and a greater presence on world markets, if anything world demand may be growing a little bit faster than it was before. You've had a slowdown in the yield increases with the winding down of the Green Revolution. In the 1960s and the 70s, yields were rising at almost 3 percent a year. And after 1985, that slowed down to about half of that.

So I think there are some real factors on agriculture that suggest that even though there may be some easing off of agricultural prices, it's, I think, unlikely that we're going to go back to the period of the cheap food that we seemed to enjoy for 20 years or so.

Steve Weisman: An Econ 101 question: when demand rises and prices rise, won't that compel producers to produce?

William Cline: Well, that's right. And that's why, for example the U.S. Department of Agriculture is projecting that if you look out three or four, five years from now that there should be some easing off of these prices. But I think unless we were to have a return to more rapid yield growth--something like we had we had with the Green Revolution--you would, I think, expect the level of the real prices of these grains to be perhaps closer to where it's been in the last three of four years than to where it was in the '90s.

Steve Weisman: Inflation: is this a harbinger that the Central Banks of the world including the Fed should worry about underlying inflation?

William Cline: Of course their policy at present is basically to ignore it, and talk about core inflation. The case for ignoring prices because they're not in the core becomes more tenuous if the trend persists over periods of a decade or so.

So I think that needs to be revisited. I think the U.S. practice on this is somewhat different from the European practice where, I think, there's more attention in the ECB [European Central Banks] to headline inflation. But, in short, I think there probably might be a case for giving more weight to observed commodity prices than we are currently doing in the U.S.

But there's probably still also a case for treating them separately. You see the other thing that has happened is that there's been an erosion in labor's ability to enforce cost of living increases with the de-unionization in this country in particular. Whereas it used to be perhaps the case that if you had a bump up in commodity prices, that could get built into labor demands.

That mechanism doesn't work as strongly anymore. So, the difference between a one-time jump and ongoing inflation, which is the principle concern of the Fed, probably has grown greater.

Steve Weisman: How much do these prices, which consumers experience in the grocery store and at the gas pump, cast doubt about the U.S. recovery?

William Cline: I think that's a good question. I haven't looked so much at the consumer price level. My impression is that by the time you get the wheat packaged into bread and put in the supermarkets, there is a very substantial muffling of the swings in the prices at the level of international trade.

It shows up more at the gas pump because there's a more direct relationship there. But sure, it's not helping in terms of consumers' confidence.

Steve Weisman: It sounds like it's moderately worrisome at this stage.

William Cline: I think it is moderately worrisome, and I think it's interesting to think about what we could do about it. One of the things that apparently has happened is that we've had a sharp decline in the stockpiles of grains. Those were up to 30 percent of annual consumption in the '90s; they're down to more like 20 percent now. So we might think about, should there be a more conscious government policy to build up stockpiles when and if the prices start to ease off.

There's, of course, the whole question of whether we should be subsidizing the use of corn for ethanol. The preliminary numbers I've seen would suggest that it's perhaps not as big an impact on global grains prices as some of the press accounts might suggest. The U.S. is a fraction of global corn. Global corn is a fraction of global grains. So it's perhaps more limited than one might think from the discussions.

But I think, it really behooves us to be thinking what we can be doing on the policy side to get a more sustainable, longer term situation.

Steve Weisman: Bill Cline, thank you very much.

William Cline: Thank you.