

The Fed and the Price of Rice

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Rice prices have ratcheted up during the past three years. In the last year alone, they've more than doubled, sparking urban food riots in several countries. Politicians have been quick to blame speculators and hoarders. Their blame is misplaced.

The most recent rice price spike is partially the result of countries such as India and Egypt imposing restrictions and bans on exports, plus the desire of other governments including the Philippines, the world's largest rice importer, to bulk up their stockpiles. But the blame for the long-term trend of higher prices should be placed upon those who've delivered a weak U.S. dollar.

Not surprisingly, those who reside inside the Beltway, including Donald Kohn, vice chairman of the Federal Reserve, disagree. Mr. Kohn said in a speech in May that "the reduced foreign exchange value of the dollar may have played a role in the rise in the prices of oil and other commodities, but it probably has been a small one."

But determining what's behind the escalation in commodity prices involves a principle to which economists universally pay lip service but in practice often ignore or forget: the distinction between nominal prices and relative (real) prices. Nominal prices of commodities are determined by the value of the currency used to stipulate them, while relative prices of commodities are determined by supply and demand – scarcity, glut and other "real" causative factors.

When the value of the dollar falls, the nominal dollar prices of internationally traded commodities, like gold and rice, must increase because more dollars are required to purchase the same quantity of any commodity. That is why commodity traders know that everything trades off of changes in the value of the greenback. Accordingly, a weak dollar should signal higher commodity prices.

The accompanying chart tells the story. As the value of the dollar declines, the nominal dollar price of gold (our benchmark) increases. This is followed by a parallel change in the nominal dollar price of rice. The monthly price history of gold for the last 60 years is divided into three categories, according to whether the nominal dollar price of gold rose more than 10% in a month, rose less than 10%, or declined.

In the first category (22 months), the gold price rose more than 10% in "month zero" and the price of rice climbed sharply over the ensuing months, with an average cumulative increase of 25% over the next 12-month period. In the second category (278 months), the gold price rose in "month zero" by less than 10% and



the price of rice rose moderately, with an average cumulative increase of about 7% over the next 12 months. In the last category (398 months), the gold price was stable or declined and the price of rice barely moved over the next 12 months.

Other data also suggest that the effect of the gold price on rice prices is roughly proportionate. For example, during the long period of the dollar's strength, from the end of 1979 to the end of 2001, gold suffered a cumulative decline of 40%, while rice experienced a cumulative decline of 52%. During the subsequent six years from the end of 2001 to the end of 2007, the price of gold rose 191% and the price of rice rose 127%.

Officials should stop wringing their hands over sky-high rice prices caused by alleged changes in rice's supply-demand fundamentals, and politicians should refrain from pointing accusative fingers at speculators and hoarders. The rice-price problem is a weak dollar problem. Until the dollar strengthens, the nominal dollar prices of rice and other commodities will remain elevated.

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