



EUROPEAN CENTRAL BANK

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Box 4

EURO AREA FOOD PRICES: RECENT DEVELOPMENTS AND OUTLOOK

The prices of several agricultural commodities, such as cereals and oilseeds, have increased significantly in world markets in the past few months.¹ In part, these price increases reflect temporary factors affecting the global supply of these commodities, such as adverse weather conditions in some major agricultural commodity-exporting countries. Global food prices have also been bolstered by the strong increases in the global demand for foodstuff resulting from the changes in food consumption patterns in many developing economies and from the emergence of new sources of demand for some agricultural commodities, for example for the production of biofuels. As these latter developments are of a structural nature, they are likely to have a more persistent upward impact on global food prices in the future.

The rise in global food prices has already led to notable increases in food prices in the euro area, at both the producer and the consumer level. The producer prices of food products and beverages rose by 7.5% in annual terms in October, compared with a rate of 2.2% on average in 2006. At the consumer level, the annual rate of change in HICP processed food excluding tobacco rose to 4.0% in October, up from 1.6% in 2006 (see Table A). By contrast, unprocessed food prices, which are traditionally more volatile, seem to have been less affected by the recent developments in global food prices so far.

The impact of global food prices on consumer prices in the euro area is also evident from a detailed breakdown of prices by product and category. For example, within the HICP processed food component, the prices of bread and cereals as well as of milk, cheese and eggs rose

1 For more information, see the box entitled "Recent food price developments in world markets and the euro area" in the September 2007 issue of the Monthly Bulletin.

Table A Unprocessed and processed food components of the euro area HICP

(annual percentage changes, unless otherwise indicated)

	HICP Weights (%)									
	2007	2004	2005	2006	2007					
					May	June	July	Aug.	Sep.	Oct.
Food	19.6	2.3	1.6	2.4	2.4	2.4	2.3	2.5	2.7	3.5
Unprocessed food	7.6	0.6	0.8	2.8	3.1	3.0	2.8	2.4	2.1	3.1
Meat	3.8	1.5	1.3	2.4	2.9	2.5	2.1	2.1	2.2	2.7
Fish	1.2	0.8	1.6	3.7	3.0	2.4	2.8	2.4	2.1	2.2
Fruit	1.2	0.7	-0.5	1.0	2.2	5.6	3.3	4.2	4.6	5.1
Vegetables	1.5	-1.7	0.1	4.3	4.0	2.2	3.9	1.8	-0.3	3.3
Processed food excluding tobacco	9.4	1.3	0.5	1.6	1.1	1.3	1.3	1.8	2.6	4.0
Bread and cereals	2.5	2.2	0.8	1.4	2.4	2.4	2.5	2.8	3.8	5.4
Milk, cheese and eggs	2.1	0.8	-0.1	0.6	0.7	1.1	1.3	2.2	3.9	7.6
Oil and fats	0.6	3.9	2.2	9.9	-5.1	-5.4	-5.2	-1.2	0.0	1.2
Sugar, jam, honey, chocolate and confectionery	1.0	1.6	0.0	0.9	1.0	0.9	0.9	0.9	1.1	1.5
Food products not elsewhere classified	0.4	0.5	0.0	0.9	0.5	0.7	0.6	0.6	0.5	0.7
Tobacco	2.5	12.2	7.8	3.9	4.9	4.8	4.3	5.2	5.2	3.1

Sources: Eurostat and ECB calculations

Note: The processed food aggregate also includes mineral waters, soft drinks, fruit and vegetable juices, spirits, wine and beer, which are not reported in this table.

Table B HICP processed food excluding tobacco across euro area countries

(annual percentage changes)

	2004	2005	2006	2007	
				May	Oct.
Belgium	1.6	2.0	1.9	3.2	5.0
Germany	0.3	0.2	1.0	1.6	5.2
Ireland	0.5	0.0	0.2	0.1	3.7
Greece	4.7	3.2	4.7	0.9	3.7
Spain	3.9	2.8	4.4	0.9	6.8
France	1.3	-0.6	0.7	0.1	1.3
Italy	2.2	0.6	1.9	1.8	3.5
Luxembourg	2.0	1.7	1.8	1.8	4.0
The Netherlands	-3.7	-1.8	0.2	0.3	2.8
Austria	2.3	0.8	1.5	2.5	6.5
Portugal	2.4	-0.8	1.7	0.5	3.8
Slovenia	0.8	-1.3	1.4	2.6	11.2
Finland	-4.0	-0.8	0.9	0.5	1.1
Euro area	1.3	0.5	1.6	1.1	4.0

Sources: Eurostat and ECB calculations

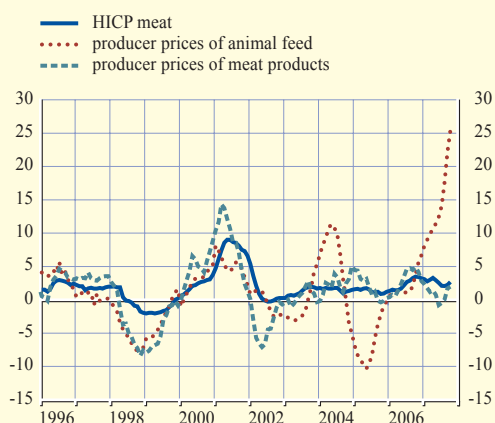
particularly sharply in October (see Table A). These items have a combined weight of around half of the total processed food component excluding tobacco. Anecdotal evidence suggests that the recent price increases in dairy products may also reflect the specificities of the formation of milk prices in some European countries, in addition to the price increases in global markets of animal feed and other input costs.

Although food prices at the producer and the consumer level have risen in all euro area countries in recent months, the extent to which the global food price shock has been transmitted to individual euro area countries has varied significantly. For example, the annual rate of increase of HICP processed food excluding tobacco was slightly above 11% in Slovenia in October, the highest rate within the euro area. In the same month, Belgium, Germany, Spain and Austria also saw sharp annual price increases in this component of between 5% and 7% (see Table B). By contrast, inflation for processed food excluding tobacco in France and Finland was significantly below the euro area average.

A number of factors are behind the diverse food price developments across countries. Retail food markets are traditionally segmented across countries. In this respect, differences in market structures and competitive conditions in the retail and distribution sectors are likely to explain the diverse reaction of retailers' profit margins across countries to a common external shock and therefore account for most of the difference seen in consumer food price inflation across countries. In countries where food price increases have been relatively contained, it appears that, in the context of high competition among retailers, profit margins may have acted as a buffer cushioning the steep increases in global food prices. Moreover, if the underlying economic conditions in a certain country are perceived to be weak, retailers may be reluctant to fully pass on high increases in food prices. Additionally, fixed periods for the negotiation of prices between suppliers and retailers may have also delayed the pass-through in some countries. By contrast, in countries where food price increases have been more considerable, it seems that retailers' profit margins have not acted as a buffer. In some cases, this might be due to the fact that food retailers operate in an environment of compressed margins. Under these conditions, input price shocks tend to be passed on to consumers more quickly. In some other countries, a

Chart A Prices for animal feed and meat in the euro area

(annual percentage changes)



Source: Eurostat.

Chart B Selling price expectations and producer prices of food and beverages

(percentage balance; annual percentage changes)



Sources: European Commission Business and Consumer Surveys and Eurostat.

lack of competition in some food market segments, in a context of robust underlying economic activity, may have also resulted in a quick and, in some cases, stronger pass-through to consumers.

Looking ahead, HICP food price inflation may increase somewhat further in the very near term as the past increases in producer costs are passed through to retail prices. Preliminary November data suggest that this is the case. Barring further shocks in food commodity prices, HICP food price inflation should subsequently fall back towards levels more consistent with its historical average. This outlook is in line with the information from futures contracts in global markets for food-related commodities. The balance of risks is on the upside. Meat prices, which represent around 50% of the unprocessed food component and which have been fairly muted so far, could be affected by the recent strong increases in the producer prices of animal feed (see Chart A). Moreover, the recent upsurge in the selling price expectations of producers of food, beverages and tobacco, as reported by the European Commission's Business Survey, signals further upward pressures on food prices in the near term (see Chart B).

Further ahead, the outlook for both world and domestic food prices remains highly uncertain. Although the supply of agricultural products should eventually respond to the increase in demand, the catch-up period may be more prolonged than currently envisaged. Moreover, food price developments depend on a number of factors which are difficult to predict, including technology advances and possible changes in energy policy. Hence, risks in the medium term also seem to be on the upside.

Against the background of a marked increase in international food commodity prices, it appears useful to review the impact of the EU's common agricultural policy, and to analyse whether further liberalisation and reforms in the EU agricultural markets would benefit European consumers in terms of lower prices (Box 5 provides some background to this discussion).

THE EUROPEAN UNION'S COMMON AGRICULTURAL POLICY AGAINST THE BACKGROUND OF GLOBALLY RISING FOOD PRICES

Global food prices have risen significantly in 2007. This is the result of a number of factors, such as increases in energy and fertiliser prices, adverse weather conditions in some regions, greater demand for biofuel production and a generally strong demand for crops in emerging economies (see Box 4 in this issue of the Monthly Bulletin). The increase in food prices has also raised questions regarding the effects of the EU's common agricultural policy (CAP) on food prices. This box provides some background to these questions.

The CAP of the European Union is anchored in Article 33 of the Treaty establishing the European Community. Its objectives are (i) to increase agricultural productivity, (ii) to ensure a fair standard of living for the agricultural community, (iii) to stabilise markets, (iv) to assure the availability of supplies and (v) to ensure that supplies reach consumers at "reasonable prices". The CAP also contains policies and measures to improve rural development and the environment. In 1980 the CAP accounted for 69% of the total EU budget, with the share declining to 50% in 2003 and 43% today. It is expected to account for 36% of the budget by 2013.

Originally, the CAP supported EU farmers' incomes through import levies, export subsidies and guaranteed prices for products that would otherwise have remained at the much lower world market price level. By the 1980s, these measures had led to high budgetary costs and an oversupply of agricultural products. Against this background, the EU introduced various measures to limit expenditure and production, such as introducing milk quotas in 1984, imposing planting restrictions on vineyards, establishing ceilings on national aid for various products and introducing a programme for setting aside agricultural land (see below).

In 2003 the CAP was reformed extensively in order to meet the requirements of international trade liberalisation agreements (such as the Doha trade round), to alleviate EU budgetary pressures and to make EU farming both more environmentally friendly and more competitive. The reform lowered guaranteed prices substantially and introduced a "single farm payment" to replace many of the previous payments that were tied to production and direct payments to farmers. Most CAP expenditure is now accounted for by aid to farmers that is not coupled to production.

As well as setting import taxes and import quotas, the CAP imposes two important types of direct supply constraint: production quota regimes and "set-aside" obligations. Production quotas are imposed on certain products (in particular, milk and sugar) and result in penalties such as milk super-levies in cases of overshooting. Farmers are also obliged to "set aside" (i.e. leave uncultivated) a specific proportion of agricultural land. The rate of obligatory setting-aside can vary between harvest years.¹ The obligation to set land aside is expected to be abolished in the near future, and the European Commission is also in favour of gradually phasing out milk quotas so as to reduce market distortions on the supply side of the CAP².

1 In July 2007 the European Commission decided to set the obligatory set-aside rate for sowings in autumn 2007 and spring 2008 at 0%, in response to the increasingly tight situation in the cereals market.

2 For more details, see "Preparing for the 'Health Check' of the CAP reform", Communication from the Commission to the Council and the European Parliament, Brussels, November 2007.

Given the substantial reduction of guaranteed prices as a result of the 2003 reform³ and the increase in prices on world markets⁴, the instrument of export subsidies has hardly been used.

The 2003 reform succeeded in diminishing distortionary effects on the agricultural markets by, for example, reducing the market intervention price for a number of agricultural products (such as butter, skimmed milk powder and rice). The decoupling⁵ of farm payments under the reformed CAP has reduced the instruments that affect supply. However, despite the 2003 reform, CAP policies still entail distortionary effects and divergence between the EU prices and the international prices of a number of agricultural products (such as milk, beef and sugar). The impact of higher food prices is regressive, given that poorer households spend a higher fraction of their income on food. Certain subsidies are still linked to production or land area, and thus often benefit larger farms.⁶ The Commission has acknowledged this distortion and recently proposed an increase in the decoupling rate, as well as payment cuts for larger farms. In general, an excessive use of the CAP may trap resources in a low-productivity sector, thereby hampering the EU economy's capacity to adjust. A more market-led allocation of resources in the agricultural markets should, in principle, be beneficial for the most efficient, innovative and productive farmers, thus guaranteeing an efficient allocation of resources.

Against the background of a marked increase in international food prices, further liberalisation and reforms in the EU agricultural markets are particularly important. Reforms would help to enhance market efficiency and benefit European consumers in the form of lower prices. In order to allow consumers to profit from lower farm-gate prices, adequate competition in the downstream sectors (food processing, retail trade and catering) and compliance with Single Market provisions are necessary. The successful conclusion of the Doha round of world trade negotiations should also help to improve the functioning of global trade in general, and of agricultural markets in Europe and worldwide in particular.

3 Before the 2003 reform, guaranteed prices were intervention prices that guided the market prices. After the reform, the guaranteed prices became "safety-net" prices like those in the US Farm Bill.

4 See the box entitled "Recent food price developments in world markets and the euro area" in the September 2007 issue of the Monthly Bulletin.

5 The rate of decoupling is the percentage of EU agricultural aid that is given to farmers without any link to actual agricultural production or land use.

6 OECD, "Economic Survey of the European Union", Paris, 2007.

3.2 INDUSTRIAL PRODUCER PRICES

Following a period of gradual decline since mid-2006, the annual rate of change in overall industrial producer prices (excluding construction) has rebounded strongly over the last two months, driven by the recent increases in oil and food prices. It recorded a 3.3% increase in October, from 2.7% in September and 1.8% in August (see Chart 39). As in the previous month, this development was largely due to a sharp rise in energy producer prices, reflecting a very strong increase on a month-on-month basis and, to a lesser extent, a base effect. Excluding energy and construction, annual producer price inflation remained unchanged in October at an elevated level (3.1%). However, this masks counteracting developments among its components. As in the previous month, short-term dynamics in the producer prices of both intermediate and capital goods remained moderate, reflecting to some extent favourable effects from the appreciation of the euro. By contrast, the annual rate of change in the producer prices of overall consumer goods continued