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Monitoring Price Developments

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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE AND THE COMMITTEE OF THE REGIONS**

FOOD PRICES IN EUROPE

Including a roadmap to improve the functioning of the food supply chain

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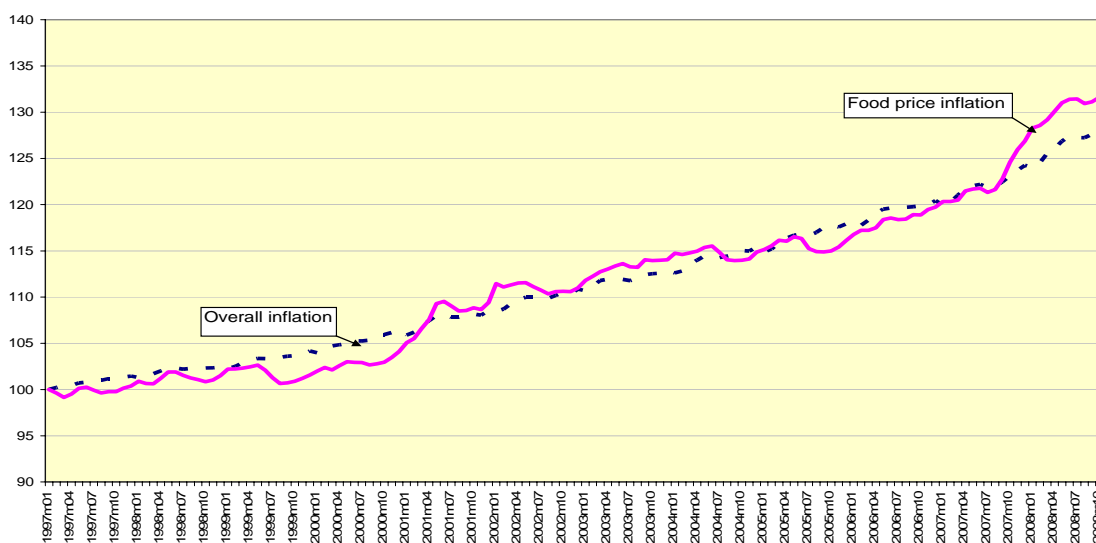
Monitoring Price Developments

1. INTRODUCTION

After more than thirty years of decline in real terms, the prices of many agricultural commodities started to increase steadily in 2006 and during the first semester of 2007 before exhibiting a sudden and very sharp rise during the summer 2007 at both EU and world level. Prices increased dramatically in the second half of 2007 and reached exceptional levels in the first months of 2008. In Europe, prices for wheat, barley and maize increased by 120%, 103% and 75% respectively between July 2006 and March 2008 when they peaked. Likewise, the prices of dairy products showed very significant rises ranging from 57% for butter to 75% for skimmed milk powder between July 2006 and autumn 2007.

The commodity price surge generated a rapid increase in food price and headline inflation, although to a much lower extent owing to the low and declining share of agricultural raw materials in the value of food products at consumer level. The increase in food prices seems to have reached its highest in July 2008 when it stood at 8.3%.

Graph 1 Overall and food price inflation in the EU (Jan 1997=100)



Source: Eurostat.

In its Communication "Tackling the challenge of rising food prices – Directions for EU action" of 20 May 2008, the European Commission set out potential policy responses to mitigate the effects of rising global food prices. The document, which was discussed at the European Council on 19-20 June, analyses structural and cyclical factors and proposed a three-pronged policy response, including short-term measures in the context of the Health Check of the Common Agricultural Policy and in the monitoring of the retail sector; initiatives to enhance agricultural supply and ensure food security including the promotion of sustainable future generations of biofuels; and initiatives to contribute to the global effort to tackle the effects of price rises on poor populations.

Since last spring, agricultural prices have trended downwards: butter and skimmed milk powder prices dropped by around 30% and 40% respectively from their peak and wheat prices fell by about 40% from March to October this year following the strong production response. Likewise, food prices showed their first monthly decrease in August 2008 (-0.6%). The price decline recently gained pace in the wake of the increased nervousness and uncertainty about the economic outlook and the general turbulence in the global financial system.

The main objective of this document is to provide a broad overview of the latest developments as regards the price situation on EU and world agricultural commodity markets and for food products at consumer level in the EU as mentioned in the abovementioned Commission Communication. It will also provide the main features of the medium-term perspectives for the prices of the key agricultural products as well as their impact on food price developments for the EU.

2. DEVELOPMENTS IN THE MARKET PRICES OF AGRICULTURAL PRODUCTS

The surge in commodity prices mainly resulted from a combination of steadily increasing demand and lagging supply or production shortfall, exacerbated by short-term economic and policy factors¹. Whereas these factors are either structural or of short-term nature², it is important to note that their contribution and combination vary between sectors. For example, high food grain (wheat and rice) prices are for the large part attributable to supply-side factors which tended to trigger greater price responses. By contrast, maize and soybean markets have been mainly driven by a strong growth in global demand both for meat consumption (through feed use) and for industrial (bio-fuel) use, with significant, though more modest, price increases³.

Although the structural factors like the growth in global food demand and the long-term decline in productivity growth can be expected to help maintaining prices at sustained levels over the medium-term, commodity prices have sharply declined over the most recent months owing to a series of factors⁴. Some of the short-term drivers which amplified the increase in agricultural prices in the second half of last year have started to vanish (e.g. more favourable climatic conditions). The policy environment has been adapted in order to stimulate supply adjustment (e.g. suspension of mandatory set-aside of land and a 2% increase in milk quota in 2008 in the EU). The production response has

¹ European Commission, *Issues paper on high food prices*, 2008, Staff working paper.

² Structural factors include the gradual rise in global food demand, the emergence of new market outlets (biofuel – mainly in the US), a slow down in world food crop grain yield and an overall incapacity of major exporting countries to keep pace with demand growth, and the characteristics of world agricultural markets which are thin and often show a slow adjustment capacity owing to the seasonality of production. These structural factors have set conditions for tighter markets and firmer price levels which were amplified by short-term factors such as adverse climatic conditions, the low level in many world commodity stocks, the rise in energy prices, the growth in activity of investment funds and trade restricting behaviour of many major exporting countries.

³ European Commission, *High prices on agricultural commodity markets: situation and prospects - A review of causes of high prices and outlook for world agricultural markets*, 2008, Staff working paper.

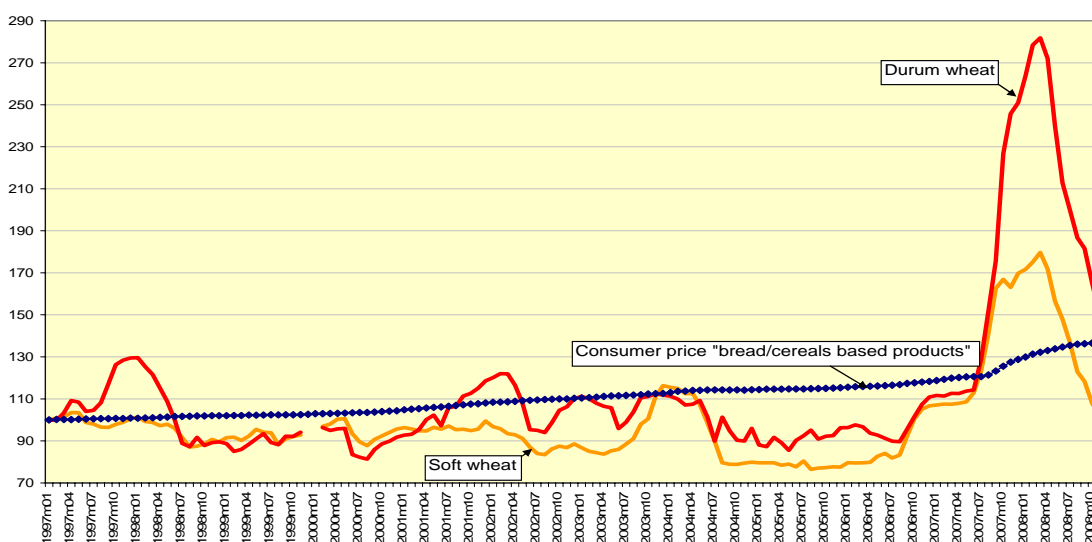
⁴ European Commission, *October update on recent developments on EU agricultural commodity and food prices*, October 2008, Staff working paper.

been very strong in many countries with additional production factors mobilised to benefit from higher producer prices. The prices of many agricultural commodities have now come back to levels similar at or even below those before the price spikes as the fall in prices accelerated in the most recent weeks with renewed volatility due to rising concerns for the economic environment and the global financial upheavals.

2.1. Cereal sector

World production had stayed below world consumption in the wheat sector during the last 6 years. This development was not due to unforeseen changes in demand, which had continued increasing at a rather constant pace but rather to the significant production shortfall in major suppliers (with for example Australia facing 3 severe droughts in the last 6 years and poor harvests in the EU). As a result, world stock declined significantly during the same period. In 2008, world wheat production is projected to reach a record 683 mio t, up 73 mio t or 12% against 2007. Wheat production is forecast to have risen in most major producing countries, most notably in the EU, Russia and Ukraine. Despite higher projected global wheat consumption, world ending stocks should rise by 30 mio t to 150 mio t.

Graph 2 Cereals/bread: EU agricultural market and consumer price developments (Jan 1997=100)



Source: DG AGRI, Eurostat.

In the EU, total wheat production would reach an all-time high at 147 mio t (+22% versus 2007) thanks to higher area (+7%) and yields (+14%). These 27 mio t of additional wheat production would be partially absorbed by the rise in domestic feed use and export. It would also enable to replenish EU wheat stocks which would increase by more than 8 mio t to stand at 25 mio t (i.e. a stock-to-use ratio of 20%). Similar developments are projected for the barley and rye markets which are both forecast to exhibit sustained growth in production and stock levels at world and EU level (supply would rise by approximately 13% and 18% respectively).

Although the ending stock level in the five major grain exporters (Argentina, Australia, Canada, EU and US) –generally considered to be one of the main drivers behind world price levels- would continue to remain at relatively low levels, these market developments have progressively led to a gradual decline in wheat prices on EU and

world markets. At the end of October 2008, wheat prices fell in the EU to 146 EUR/t (Delivered Rouen) and in the US to 149 EUR/t (SRW US FOB, Gulf). The fall in wheat prices accelerated in the most recent weeks with renewed volatility due to rising concerns for the economic environment and the global financial upheavals.

Within the EU, wheat prices could fall even further towards support price levels on account of abundant harvests and higher transport and marketing costs, most notably in Hungary or in land-locked regions of Slovakia, Poland, Bulgaria and Romania. In that respect, it cannot be excluded that some grain may be offered into intervention during the 2008/09 marketing year.

World maize markets have been driven since 2003 by the increased use of maize for ethanol in the US and increasing maize imports in developing countries, mainly China and Mexico. The subsequent price increase led to a strong supply response in the US, China, Brazil and Argentina, but could not prevent a rapid decline in stocks. In 2008 world maize production is projected to decline slightly to 773 mio t (-2% or down 14 mio t against the bumper 2007 harvest) owing mainly to the fall in US maize production by around 20 mio t. This would generate a drop in world maize stock at a 5-year low of 111 mio t (down 17 mio t from last year) as total maize consumption would continue to grow steadily to reach a record 790 mio t (driven by ethanol use in the US). In the EU, higher area and yield are projected to boost maize production by 25% at more than 60 mio t. Like wheat and other cereals, maize prices have considerably fallen over the last four months to stand at around 128 EUR/t (Delivered Bayonne) and in the US to 141 EUR/t (US Fob Gulf) at the end of October 2008.

World rice production and consumption increased at a similar, slow pace of around 1% per annum during the 1995-07 period with no major market shocks (except from the poor harvests in India in 2002 and China in 2003). In spite of a sustained population and economic growth in the main consuming countries, per capita consumption has been affected by changing dietary patterns (e.g. China, Thailand). Total rice stocks have remained stable at relatively low levels over the last 4 years. Therefore it seems that the recent price hike may have more to do with the overall commodity price boom and policy decisions (including export restrictions) that accentuated price variability in a very thin market (only 7% of rice is traded) than with changes in market fundamentals.

After reaching a peak at 1057\$/t in May 2008 (from 327 \$/t in July 2007), the price for rice (Thailand 100%, B) started to decline gradually as the global perception about market perspectives, and most notably the availability of exportable supply, changed. Prospects for larger export supply, the continued fall in oil prices and the first estimates of a production recovery in 2008 at world level combined to consolidate the drop in rice prices. This fall in prices accelerated over the most recent weeks when the abovementioned prices dropped to 550 \$/t at the end of October.

2.2. Oilseed market

The recent developments in the oilseed complex have been supported by the strong demand coming from both feed use of oilseeds and oilseed meal in China (linked to increased meat consumption), and increased use for vegetable oils and palm oil, initially for human consumption but recently and increasingly for biodiesel production.

Production and consumption of soybeans (the dominant crop in the complex) grew at very strong pace of about 5.0% per annum during the period 1995-2007. Whereas demand from EU and Japan somewhat stabilised, the rapid increase in Chinese imports

was met by increased exports from US, but especially from Brazil and Argentina. The growing use of vegetable oil for EU biodiesel production has turned the EU into a net importer of rapeseed and sunflower oil, and an increasing importer of palm oil.

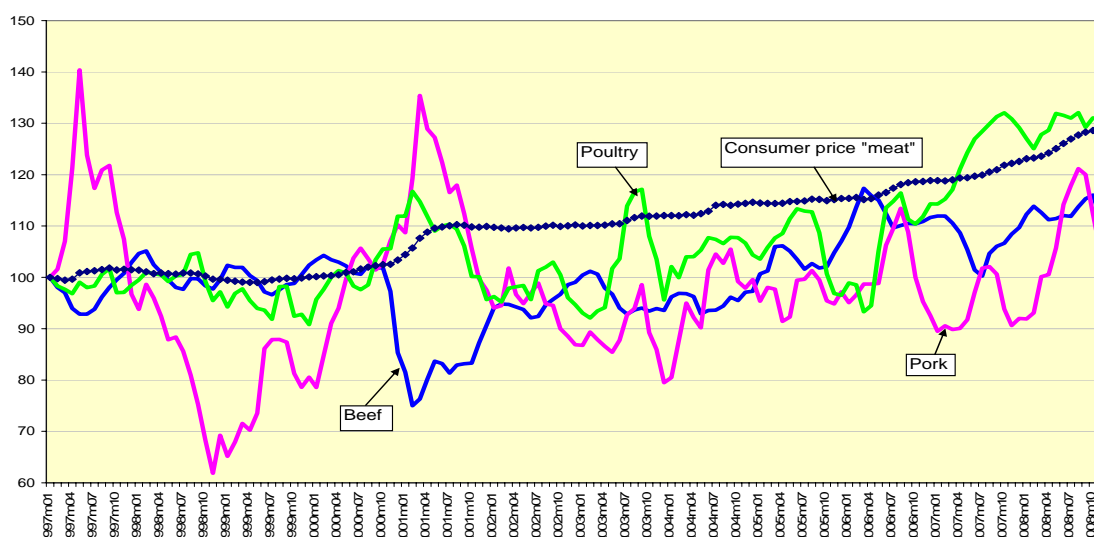
After the decline observed in 2007, world oilseed production is estimated to resume growing by 7% (or up 27 mio t) driven by increased soybean production (and to a lesser extent sunflower seed and rape seed). Large supply conditions combined with moderate prospects for demand have led to a general decline in the price of the oilseed complex. Oilseed prices have already started to fall from the peak reached at the beginning of the summer, from 634 \$/t to 330 \$/t for soybean (US, Fob) at the end of October, with similar trends observed for rapeseed and sunflower seed. The prices of oilseed meal and vegetable oil have also shown price drops in the range of 35 to 55% over the same period.

2.3. Meat sector

In the last decade, meat markets have experienced a generalised and continuous expansion of world consumption in all meat categories, driven by world population growth and increasing per capita income in developing countries, particularly in China. World meat production was able to smoothly adapt to the increase in demand. Whereas a significant share of the rise in meat consumption was met by the growth in domestic production (e.g. China, India, Russia), the swift emergence of some key exporting countries (most notably Brazil in the beef and poultry sectors) has helped to prevent major price pressures.

In contrast to the grain and the dairy markets, the world meat markets exhibited moderate price movements in 2007. However, higher feed costs driven by stronger cereal and oilseed prices, and relatively low meat prices put meat producer margins under severe strains. The slow adjustment of meat production and the production constraints for some types of livestock (e.g. pork cycle) have prevented a rapid and full transmission of higher feed costs to meat producer prices. In line with its short production cycle and supported by growing consumer demand, the poultry sector has been the first meat sector to show significant price increases.

Graph 3 Meat: EU agricultural market and consumer price developments (Jan 1997=100)



Source: DG AGRI, Eurostat.

Between July 2006 and October 2008, meat prices in the EU rose by 6% in the beef sector, 3% in the pork sector and 14% in the poultry sector. Similar developments took place on world meat markets. Over the next few months, meat prices in the EU are projected to reflect the recent developments in feed prices and lower domestic production and stock levels. The projected increase in EU poultry and beef production in 2008 driven by a rise in domestic demand in the poultry sector and improved profitability prospects, and the increase in milk quotas in the beef sector would be more than compensated by the significant production decline in the pork sector (owing to the drop in the sector profitability prevailing since the summer 2007) and in the sheep sector (as a result of climatic and sanitary difficulties in 2007).

2.4. Dairy sector

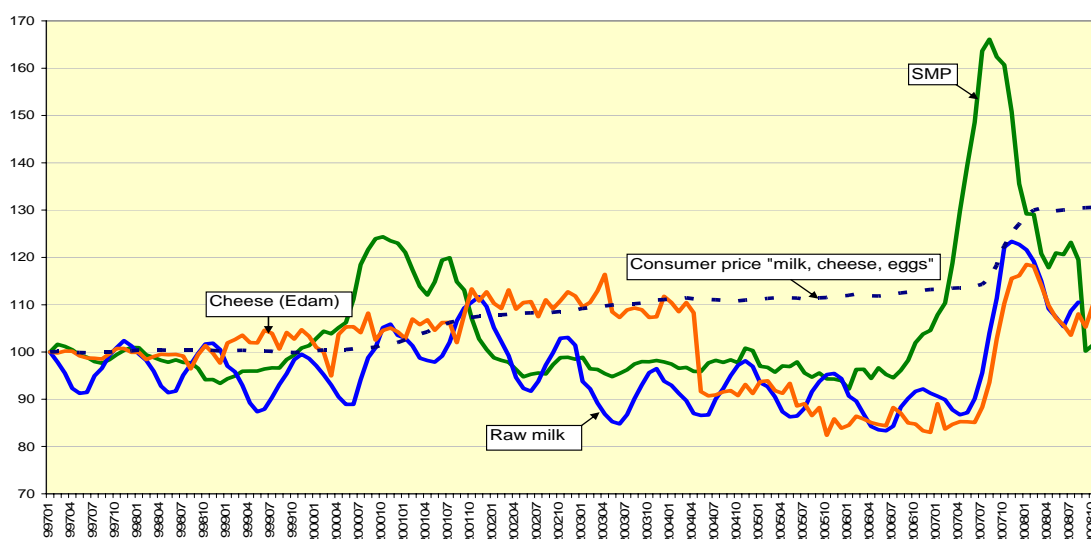
The world dairy markets have been mainly influenced in most recent years by the steady growth in global demand, largely in developing countries, driven by growing population, urbanisation and economic growth, and the more limited supply development in the major dairy exporting countries (linked to production constraints and/or policy environment). The stocks of most dairy products fell in 2007 to low levels owing to the significant production shortfalls observed in many major producing and exporting countries (e.g. Australia, EU), which combined with rising production costs (in particular for feed and energy costs) and restrictive export policies in some countries triggered a dramatic rise in the prices of most dairy products in a rather thin world market (less than 10% of dairy products are traded).

Whereas the dairy sector was the first to face a significant increase in prices, it was the first among the agricultural sector where prices started to ease in the wake of a significant supply response. In the EU and especially in the US (less constrained because of the absence of quotas), the strong production recovery stimulated by higher prices (and the 2% increase in milk quotas implemented from April 2008 in the EU) led domestic prices to return to more normal levels by historical standards. In Australia and New Zealand, production is expected to recover strongly from the impact of the drought which affected milk supply last year.

In the EU, total milk delivered to dairies is projected to increase by 0.8% in 2008 (compared to +0.2% in 2007) driven by a strong first quarter expansion in response to the high EU milk producer prices that -following two years of decline- exhibited a strong increase in the second half of 2007 to stand 34% above the price level of 2006. Since December 2007, they have displayed a declining pattern, falling by around 15% from their peak.

After three years of dynamic expansion, the increase in EU production of cheese and fresh dairy products lost some momentum in 2007 as the exceptionally high prices of butter and skimmed milk powder channelled increasing amounts of milk into their production. A firm domestic demand combined with lower prices for bulk dairy commodities is projected to generate an increase in the production of cheese, fresh dairy products and casein (at the expense of butter and skimmed milk powder which are forecast to stagnate and/or fall slightly). The outlook for milk powders remains highly dependant on the supply situation in the competing exporting countries: EU whole milk powder is projected to grow significantly in 2008 driven by export possibilities particularly during the first semester, while SMP output is forecast to decline slightly as exports are hindered by cheaper US supply.

Graph 4 Dairy: EU agricultural market and consumer price developments (Jan 1997=100)



Source: DG AGRI, Eurostat.

EU and world commodity prices have been continuously declining since their peak in the second half of 2007. The start of the production season in Oceania and the gloomier economic environment is expected to add further downward pressure on bulk commodity prices. The decline in butter, skimmed and whole milk powder prices has gained further momentum since August 2008 falling below their pre-peak level. Milk powder prices dropped by 23% in Oceania and 15% in the EU between August and October 2008 (i.e. by around -40% against October 2007 in the EU). Butter prices declined by around 18% in Oceania and 8% in the EU over the same period (i.e. by some 30% since October 2007 in the EU). As a consequence the EU and Oceania prices are steadily approaching the effective EU intervention buying-in price. On the other hand, EU cheese prices have so far exhibited a lower rate of decline, remaining slightly above the pre-peak period in the EU. However, they are expected to follow the price fall of bulk dairy commodities in the wake of the economic slowdown.

3. DEVELOPMENTS IN THE CONSUMER PRICES OF FOOD PRODUCTS

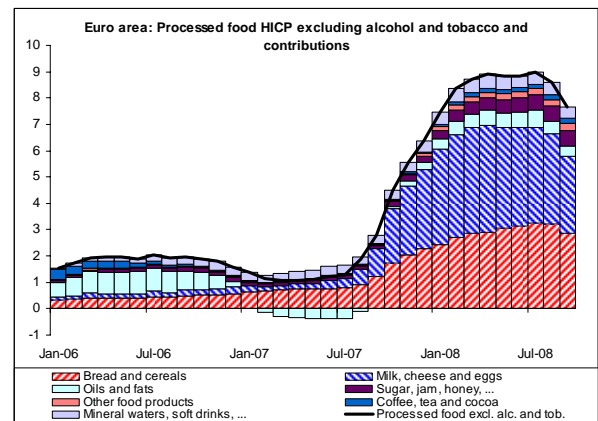
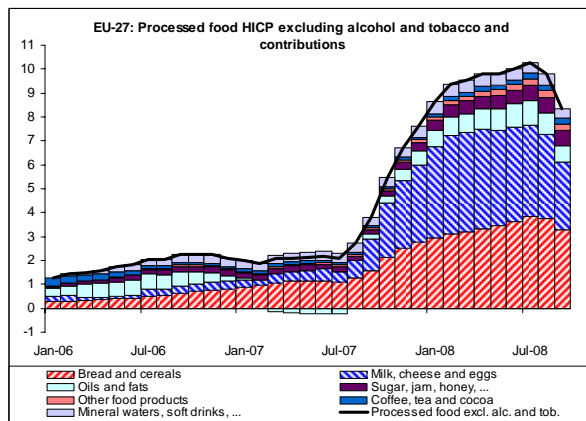
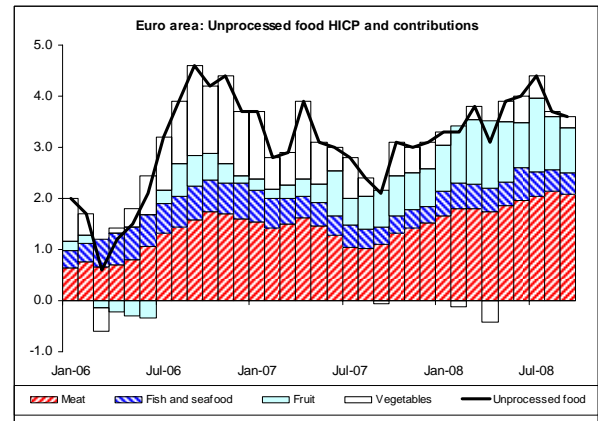
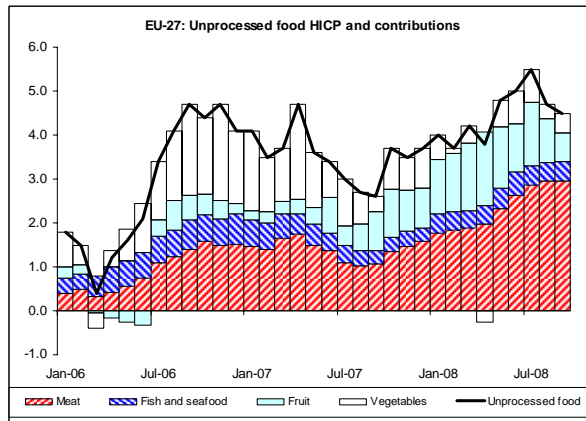
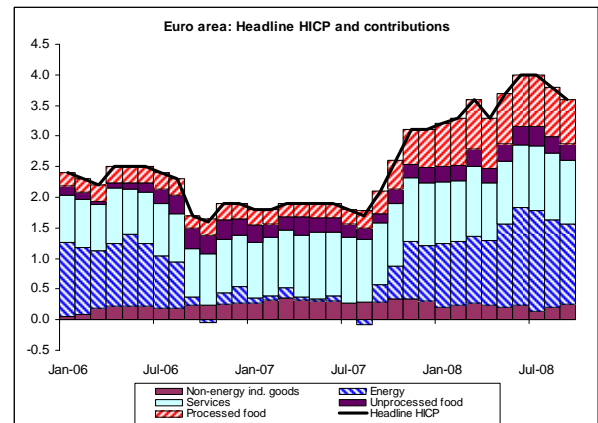
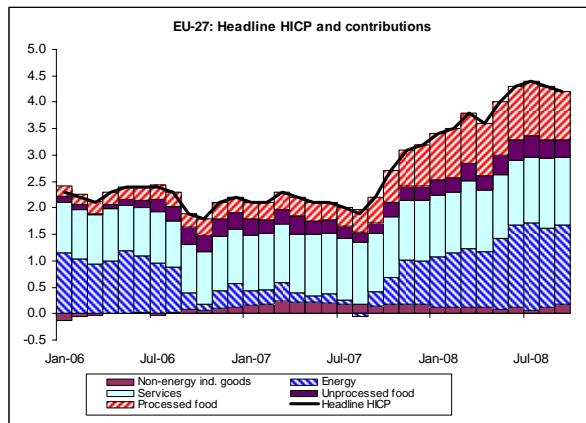
3.1. Developments in consumer food price inflation at the EU and euro area level

Together with oil price increases, increases in international agricultural commodity prices have had a major impact on inflation in the EU over the past year. From the beginning of the shock in August 2007 until July 2008 inflation in the EU rose from 1.9 to 4.4 percent before falling to 4.2 percent in August and September. In the euro area, inflation increased from 1.7 to 4.0 percent over this period, subsequently falling to 3.6 percent in September (the Flash estimate for October foresees a further decline to 3.2 percent). Food price inflation currently accounts for around 1.3 pp. of inflation in the EU and 1.0 pp. in the euro area. The other major contributors are energy inflation, contributing about 1.5 pp. in the EU and 1.3 pp. in the euro area, and services inflation, contributing 1.3 pp. and 1.1 pp. in the EU and euro area, respectively.

The increased importance of the food category to inflation in the EU can largely be attributed to price developments in the *processed food* category. Between July 2007 and July 2008 inflation in processed food (excluding alcohol and tobacco) accelerated from 1.3 to 9.0 percent in the euro area, subsequently falling to 7.7 percent in September, and from 2.1 to 10.3 percent in the EU, subsequently falling to 8.4 percent in September.

Recent inflation developments in processed food have largely been driven by price increases for two sub-categories: 'Bread and cereals' and 'Milk, cheese and eggs'. Inflation in '*Bread and cereals*' reached 12.3 percent in the EU and 10.2 percent in the euro area in July 2008, up from 3.5 percent and 2.5 percent in July 2007, respectively. Since then, rates declined somewhat to 10.5 and 9.0 percent, in September, respectively. Similarly, inflation in '*Milk, cheese and eggs*' recorded rates of 10.2 percent and 10.4 percent in the EU and euro area, respectively (down more than 4.0 pp. in both regions since the peaks achieved in April). Just over a year ago, inflation in this category was around 2.8 and 2.2 percent in the two areas. The impact of high rates of inflation in these categories has been compounded by their relatively high weights. These developments reflect the pass-through to the HICP of strong growth in international agricultural commodity prices for cereals and dairy products over the past year. While inflation in '*Oils and fats*' has also increased substantially, its relatively lower weight means it has not, individually, had a major impact on food price inflation.

Inflation in *unprocessed food* also rose substantially from the last quarter of 2007 on. From 2.1 percent in September 2007 unprocessed food inflation rose to 4.4 percent in July 2008 in the euro area. In the EU the rate increased from 2.6 percent to 5.5 percent over the same period. Since then, however, rates have fallen somewhat in both regions to 4.5 percent in the EU and 3.6 percent in the euro area. While developments in this category are volatile and strongly affected by the seasonality of some of its components e.g. 'Fruit' and 'Vegetables', stronger inflation in unprocessed food since mid-2006 has in part been the result of increased inflation for 'Meat' related to strong increases in the prices of international agricultural meat prices over this period. Inflation in the 'Meat' sub-category reached 6.0 percent and 4.3 percent in September, in the EU and euro area, respectively, up from rates of 2.1 percent a year earlier.



3.2. The contribution of agricultural raw material prices to final consumer prices

To evaluate the contribution of agricultural raw materials to final consumer prices, a set of econometric models was estimated to assess the pass-through of a number of raw commodity prices to HICP food categories. Estimations were carried out for the HICP categories processed food, 'Bread and cereals', 'Milk, cheese and eggs', unprocessed food and 'Meat' for the EU and the euro area on a quarterly basis from Q1 1997 to Q3 2008. Most regressions included a constant, an autoregressive component (usually of order one) and control variables such as lags of oil inflation, the output gap and labour costs

(though the latter proved to be insignificant⁵). Data on raw agricultural commodity prices was provided by DG AGRI. Models were tested for structural breaks and, where confirmed, dummy variables were included to improve the fit of the regressions.

For all models, a good fit was found with most exhibiting an adjusted R-squared of larger than 0.9. The fit was, however, increased once allowance was made for a structural break in the third quarter of 2007, at the start of the consumer food price shock. Regressions for the EU and euro area took a similar form, with however some differences in the coefficients of the models.

Looking first at the results for the EU, *'Bread and cereals'* inflation was mainly driven by lags of wheat inflation, oil price inflation and the output gap and by its own lag. Pass-through from wheat inflation to consumer price inflation for *'Bread and cereals'* was shown to be around 5 percent after a year, with most of the pass-through taking place in the first quarter. While coefficient stability tests confirmed a structural break in Q3 2007, this relationship has remained stable through the current shock. The cause of the break appears largely due to a stronger impact from oil price inflation over the past year. Whereas, prior to the break pass-through of oil inflation to *'Bread and cereals'* was negligible, afterwards it increased to three percent (after 5 quarters). Consumer price inflation in *'Milk, cheese and eggs'* can largely be explained by lags of EU milk commodity price inflation, and oil prices. The pass-through from EU milk commodity price inflation to inflation in this category is about 10 percent after a year (increasing to 18 percent in the long run). Again, this relationship is stable over time but the impact of oil price inflation has increased. While before the shock, oil inflation pass-through was around 1 percent, after its onset this rose to 5 percent (lagged 6 quarters). For *processed food*, pass-through was stable at around 4 percent from milk commodity prices and 2 percent from wheat.⁶ These estimates are consistent with the estimates achieved above, as both *'Bread and cereals'* and *'Milk, cheese and eggs'* account for about a third of the processed food basket. Here again, the impact from oil has increased in the recent period, from insignificant to around 1-2 percent since Q3 2007.

'Meat' inflation in the EU was mainly driven by lagged inflation in chicken and pork commodity prices and its own lag⁷. Pass-through from chicken price inflation to meat price inflation was 7 percent (after 2 quarter) and from pork it was 10 percent (achieved after 2 quarters). Oil inflation was not significant and neither were tests for a structural break. For *unprocessed food*, pass-through was stable at 5 percent for inflation in chicken commodity prices and 9 percent for pork. Lagged oil price inflation was also significant and had a pass-through of 2 percent after 6 quarters.

Results for the euro area showed that *'Bread and cereals'* inflation was also driven by lags of wheat inflation, oil price inflation and the output gap and by its own lag. Pass-through from wheat inflation to consumer price inflation for *'Bread and cereals'* was shown to be

⁵ While, in a simple regression, inflation in unit labour costs lagged one quarter is strongly correlated with food inflation, once included in a multiple regression with an autoregressive component it become insignificant.

⁶ Here processed food is including alcohol and tobacco, in order to better enable comparison with other analysis, in particular when these models are used for projecting the outlook for consumer prices in part 4.

⁷ Beef prices were not included because of their strong negative correlation with chicken prices.

around 3 percent after 2 quarters, with most of the pass-through taking place in the first quarter. This relationship has remained stable throughout the recent shock. However, the impact of oil price inflation (lagged 6 quarters) has increased from nothing prior to the shock to about 2 percent since. Consumer price inflation in 'Milk, cheese and eggs' can largely be explained by lags of EU milk commodity price inflation, oil prices and the output gap. The pass-through from EU milk commodity price inflation to inflation in this category is about 10 percent after two quarters (increasing to 25 percent in the long run). Again, this relationship is stable over time but the impact of oil price inflation has increased. While before the shock, oil inflation pass-through was around 1 percent, after its onset this rose to 11 percent (lagged 6 quarters). For *processed food*, pass-through was stable at around 2 percent from milk commodity prices and 1 percent from wheat. These estimates are consistent with the estimates achieved above, as both 'Bread and cereals' and 'Milk, cheese and eggs' account for about a third of the processed food basket. Here again, the impact from oil has increased in the recent period, from insignificant to around 5 percent since Q3 2007.

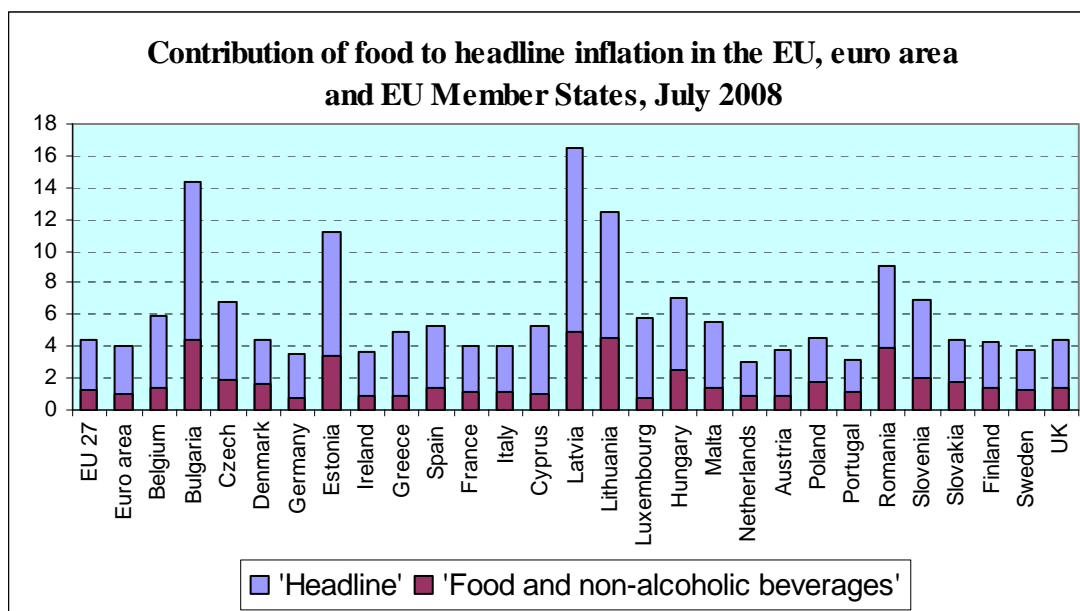
'Meat' inflation in the euro area was mainly driven by lagged inflation in chicken and pork commodity prices and its own lag. Pass-through from chicken price inflation to meat price inflation was 6 percent (after 1 quarter) and from pork it was 10 percent (achieved after 2 quarters). Oil inflation was not significant and neither were tests for a structural break. For *unprocessed food*, pass-through was stable at 3-4 percent for inflation in chicken commodity prices and 7 percent for pork. Lagged oil price inflation was also significant and had a pass-through of 3 percent after 8 quarters.

3.3. Differences in food inflation across Member States and its potential explanatory factors

The contribution of food price inflation to headline inflation varies across Member States. In July 2008, at the peak of the food price shock in the EU, the largest contributions were recorded for Latvia (4.9 pp.), Lithuania (4.5 pp.), Bulgaria (4.4 pp.), Romania (3.9 pp.) and Estonia (3.7 pp.). The smallest contributions are in Luxemburg (0.7 pp.), Germany (0.8 pp.), the Netherlands, Austria, Greece and Ireland (all 0.9 pp.).

Some of this variation can be explained by differences in the weight of food in consumer expenditure. While food accounts for an average 16 percent of consumer expenditure in the EU/ euro area, in Romania the figure is 37 percent, in Bulgaria and Latvia 24 percent, Poland and Lithuania 23 percent and Hungary 20 percent. By contrast, in the UK food represents only 11 percent of household expenditure, while in Germany and Luxemburg the figure is 12 percent and in Austria it is 13 percent.

However, rates of food price inflation have also varied substantially across the EU (see MS charts for processed and unprocessed food in annex). The highest rates of annual food price inflation in the EU have been recorded in Bulgaria (26.4 percent in September 2007), Estonia (25.2 percent in May 2008), Latvia (around 20 percent between December 2007 and July 2008), and Lithuania (18.6 percent in June 2008). In the euro area, the highest rate was recorded in Slovenia (13.5 percent in February 2008). The lowest rates of food inflation in the EU in July were in Greece (5.3 percent), Cyprus and Portugal (5.8 percent).



The varied pass-through of agricultural food price shocks to food consumer prices in the Member States can be explained by a number of factors. These factors include differences in national preferences, production structures and regulations, and competitive conditions in retail and distribution sectors. This part of the note, therefore, looks at the role of a number of these factors in determining differing responses of national consumer food price inflation to the current agricultural price shock.

Differences in food price inflation across Member States can be due to differences in the weights of different food product categories in the HICP food aggregate, which reflects differences in the weights of food items in national consumption baskets due to varied preferences. Thus, even in a situation in which the inflation rates of individual food products increased by the same amount, overall food price inflation could differ.

Looking at the weight across countries of the three largest categories (see tables in annex): *'Meat'* accounts for 49 percent of the weight of HICP unprocessed food in the EU (48 percent in the euro area), varying between 42 percent in the UK and 60 percent in Poland; the weight of *'Bread and cereals'* in processed food is 31 percent in the EU (32 percent in the euro area) and varies between 24 percent in Greece and 40 percent in Bulgaria and Romania; and the weight of *'Milk, cheese and eggs'* in processed food is 28 percent in the EU and euro area, varying between 22 percent in Ireland and 35 percent in Greece and Estonia.

Having said this, it appears that differing rates of inflation in the various food sub-categories have a larger role in explaining the variation in aggregate food price inflation across the Member States. Thus, the rest of this part of the note looks at various other explanations for differing food price inflation across the euro area.

In order to assess the relative importance of various explanatory factors for differences in food price inflation, a set of cross-country regressions were estimated for EU food price inflation and the components *'Bread and cereals'*, *'Milk, cheese and eggs'* and *'Meat'*. For *'Bread and cereals'* the results show that differences in cross-country inflation in this category can be largely explained by differences in unit labour cost growth, output gaps and relative price levels. The main outliers are Bulgaria and Denmark, which each have rates of inflation for *'Bread and cereals'* significantly larger than would be explained, and

Slovakia and Poland, for which the opposite is true. Including dummy variables for these outliers, the equation explains 95 percent of differences in inflation in this food category.

Differences in inflation in the category '*Milk, cheese and eggs*' can largely be explained by differences in unit labour costs. Here, the main outliers are Cyprus, Lithuania, Poland and Romania, which all have inflation below what would be expected, and Slovenia, which has inflation significantly above what would be expected. This equation explains about 90 percent of cross-country differences in inflation in this food category.

For the category '*Meat*', almost 90 percent of differences in inflation can be accounted for by differences in unit labour cost growth and dummies for Poland and Romania, which have lower inflation, and Lithuania and Cyprus, which have higher inflation than would be expected. With regard to overall food inflation, again most of differences across countries can be explained by differences in unit labour costs. However, the main outliers are Poland, Cyprus and Lithuania, with rates of food price inflation below expected, and Bulgaria and to a lesser extent Malta, with rates of food price inflation above expected. Including dummies for these Member States, the regression explains around 96 percent of differences in food price inflation across the EU.

4. OUTLOOK FOR THE AGRICULTURAL MARKETS AND FOOD PRICES

4.1. The outlook for agricultural markets

In spite of the major uncertainty surrounding future price developments, notably at a time of great nervousness about the economic outlook and general turbulence in the global financial system, there seems to be a consensus among various forecasting organisations⁸ that structural factors like the growth in global food demand, the development of the biofuel sector and the long-term decline in food crop productivity growth should combine to maintain prices at higher levels over the next ten years. Whereas commodity prices are projected to develop at higher levels than observed over the past decade, they would stand substantially below the most recent price hikes. However, they are expected to exhibit greater fluctuations as stock levels would stay tight over the next few years, particularly in the context of thin markets.

Over the next decade, world and EU cereal prices are projected to develop at higher levels than seen in the last decade. After a short-term fall in 2008/09 and potentially up to 2010/11 according to the OECD-FAO, world prices would trend around 40% to 50% higher than during the past decade in nominal and US \$ terms. The continuously high and increasing maize demand in the US should lead to a lasting change of relative prices in favour of coarse grains. The medium-term projections for the EU cereal markets⁹ also depict a positive outlook characterised by relatively balanced cereal markets thanks to the impact of the successive reforms of the CAP, the emerging bioethanol market, the gradual integration of the new Member States into the single market and more favourable conditions on world markets.

⁸ FAPRI, *World Agricultural Outlook*, March 2008.
OECD-FAO, *Agricultural Outlook 2008-2017*, May 2008.

⁹ European Commission, *Prospects for agricultural markets and income 2008-2015*, November 2008, Staff working document

Future developments on the rice markets are projected to be driven by the continuous growth in demand that should outpace supply, maintaining rice stocks in a rather tight situation over the coming decade. As a result, rice prices are projected to rise significantly as compared to the past ten years (between 30% and 50% in nominal and US \$ terms according to the OECD-FAO and FAPRI respectively).

The market perspectives for the oilseed complex are foreseen to be driven primarily by the increasing demand for vegetable oils, led by population and income growth as well as animal feed and the biofuel sector. As a result, the prices for oilseeds, oilseed meals and vegetable oils are anticipated to remain at high levels, developing at more than 50 % above those of the past decade (in nominal and US \$ terms). In spite of a significant increase in domestic production, the EU is projected to continue to remain a large net importer of oilseeds, in particular for vegetable oil imports which should demonstrate strong growth.

The world meat sector as a whole is forecasted to continue its long-term expansion supported by population growth and rising income, notably in developing countries. Meat prices would grow moderately and stand some 20% above the past decade levels. In the EU, the perspectives are relatively favourable, in particular for the poultry and pig meat sectors which are projected to expand, though at a slower pace than in the past decade, driven by the increase in domestic consumption and strong consumer preference. EU meat prices would stand on average over the next few years around 10% above the levels recorded in the early part of the decade (in nominal and euro terms).

World dairy markets should continue to be driven by the significant growth in the consumption of dairy products, most notably in Asia. This should contribute to sustain world dairy prices some 50 to 60% higher than in the past decade (in nominal and euro terms). In the EU, milk deliveries are projected to expand at a modest pace on account of the dairy quotas. The sectors for cheese and fresh dairy products are anticipated to exhibit the strongest expansion thanks to the rise in domestic and external demand, although their price prospects should be more moderate than on world markets. By contrast, the production of bulk dairy products (butter and skimmed milk powder) would resume declining due to the limited milk supply and the increasing production of higher value added dairy products. The prices of bulk dairy products in the EU, in particular those for butter, are projected to remain under pressure over the medium term as compared to the early years of the decade.

If the overall outlook for world and EU agricultural markets appears globally favourable over the medium term, it clearly remains subject to some important uncertainties. The latter relate mainly to future economic, market and policy developments. They concern in particular the economic outlook as the breadth and depth of the current economic recession as well as its impact on future developments in the energy and currency markets are highly uncertain with many significant downside risks. The impact of other factors such as future changes in agricultural and trade policies (including the outcome of the current Doha Development Round of trade negotiations), the policies on renewable energy, the path of technological change and future climatic conditions could also have far reaching implications for the future pattern of agricultural markets.

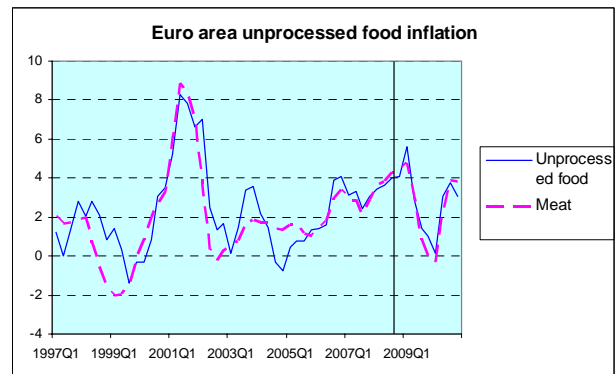
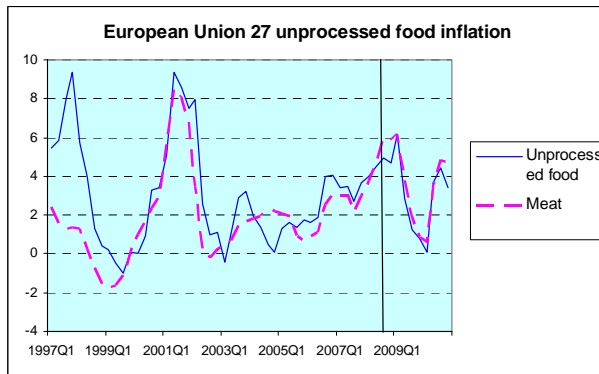
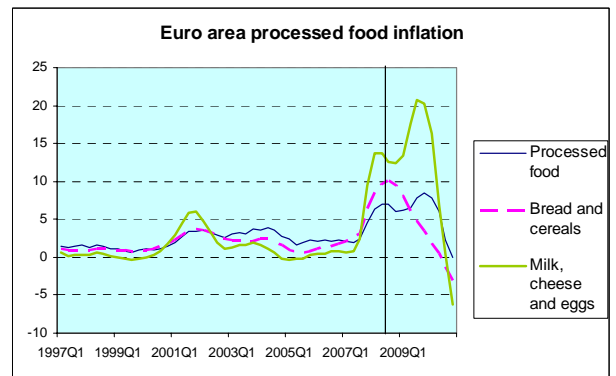
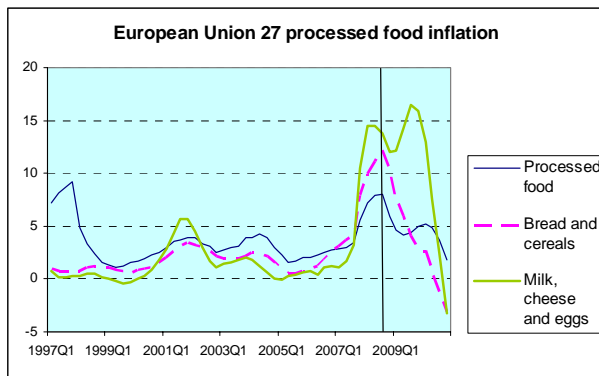
4.2. The outlook for consumer food price inflation

The charts below show the projected outlook for consumer food price inflation (for the categories processed and unprocessed food, 'Bread and cereals', 'Milk, cheese and eggs', and 'Meat') in the EU and euro area over the next two years. These projections were carried out on the basis of the estimated pass-through equations discussed in section 3.2 of this report. The commodity price assumptions were based on oil Brent futures for oil prices in mid-November and for food commodities they were based on internal Commission projections. In particular, oil prices were assumed to follow a gradual upward path from EUR 56 in Q3 2008 to EUR 64 in Q4 2010. The price of chicken was expected to increase by 1.5 percent in 2009 over 2008 and to accelerate its increase in 2010 to 2.0 percent. Pork prices were expected to fall 9.3 percent in 2009 but to increase again by 14.0 percent in 2010. Milk prices were expected to increase 4.3 percent in 2009 and 7.6 percent in 2010. Wheat prices were expected to fall substantially in both years (4.1 percent in 2009 and 7.2 percent in 2010). The output gap in the EU was expected to decline through the forecast horizon from 0.19 in Q4 2008 to -1.51 in Q4 2010. In the euro area, the output gap was expected to fall from 0.13 to -1.32 over the same period.

For *processed food*, the results show that in the EU the peak of the inflation shock has been reached and that inflation in this category should gradually fall over the next three quarters from 8 percent in Q3 2008 to 4.2 percent in Q2 2009. Thereafter, it should increase somewhat again to 5.2 percent in Q1 2010 before following a downward path to reach 1.8 percent by Q4. In the euro area, processed food inflation is projected to fall to 6.1 percent in Q1 2009 before rebounding to 8.5 percent in Q4 2009. Thereafter, it is expected to decline to zero by Q4 2010. Turning to the two processed food components analysed, inflation in '*Milk, cheese and eggs*' in the euro area is expected to fall to 12.4 percent in Q4 2008 before rebounding strongly to around 20 percent in the second half of 2009. Thereafter it should fall sharply throughout 2010 to end the year in minus territory. In the EU, inflation in this category is projected to follow a similar though less pronounced path, climbing to around 16 percent in the second half of 2009 before falling sharply thereafter. Inflation in '*Bread and cereals*' on the other hand is projected to follow a steady downward path throughout 2009/2010 in both regions, from around 9-10 percent in Q4 2008 to -3 percent in Q4 2010.

With regard to *unprocessed food*, in the EU inflation in this category should fall somewhat in Q1 2009 to 4.7 percent before increasing to 6.2 percent in Q2. Thereafter, it is projected to fall steadily to just above zero in Q1 2010. Thereafter, however, it should rebound to 4.4 percent in Q3 2010. In the euro area, unprocessed food inflation should follow a similar path, increasing to 5.6 percent in Q1 2009 before declining to 0.2 percent in Q1 2010. Thereafter, it is projected to trend up again to reach 3.8 percent in Q3 2009. As around half of unprocessed food is accounted for by 'Meat', inflation in this subcategory is projected to follow an almost identical path.

These projections suggest that processed food inflation will contribute around 0.4 pp. to headline inflation in the EU in 2009 and 0.3 pp. in 2010, while unprocessed food should contribute 0.2 pp. in both 2009 and 2010. In the euro area, processed food should contribute around 0.6 pp. to headline inflation in 2009 and 0.3 pp. in 2010, while unprocessed food should contribute 0.2 pp. in both 2009 and 2010.



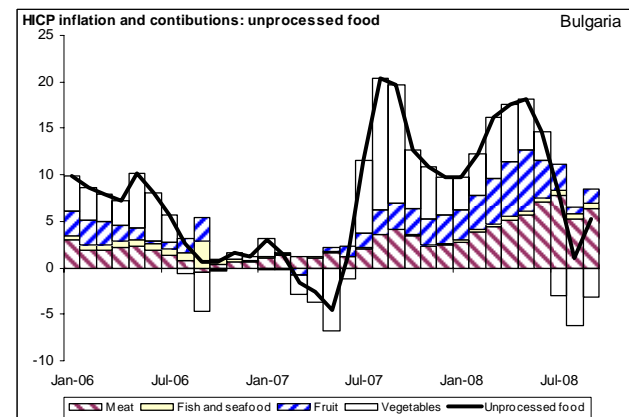
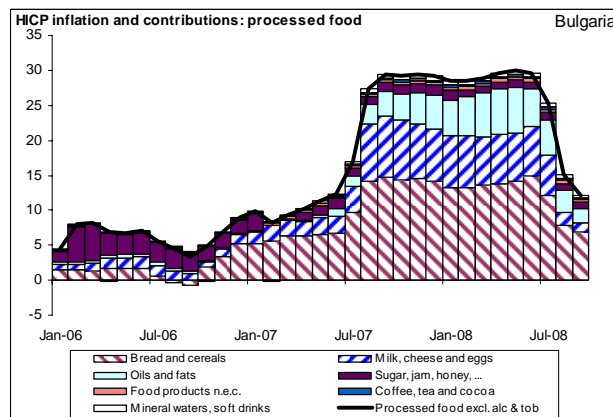
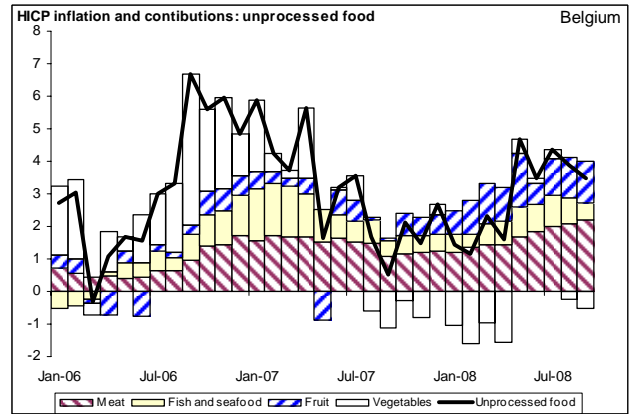
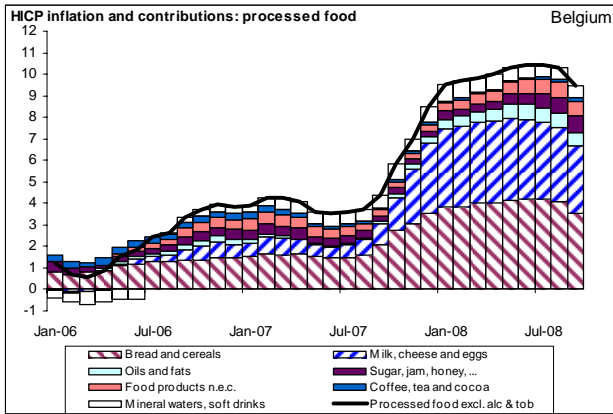
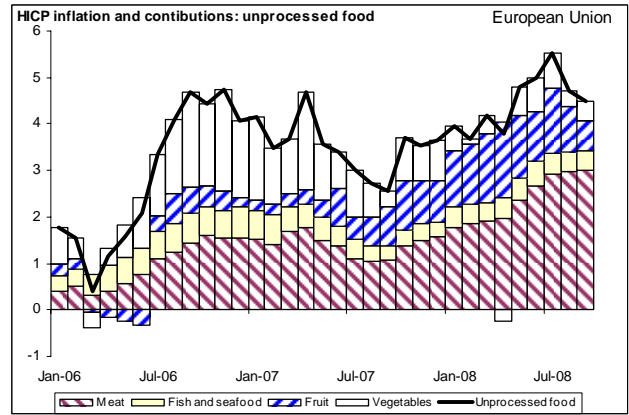
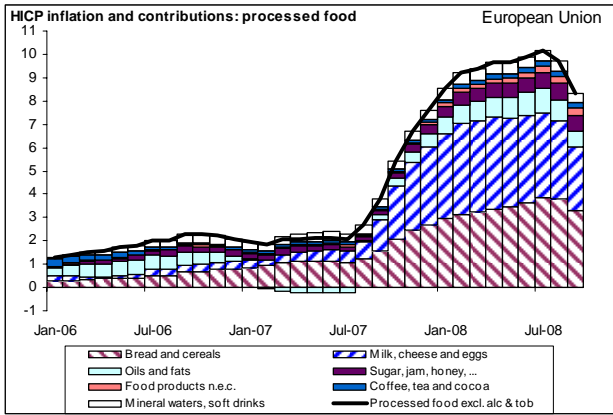
5. CONCLUSION

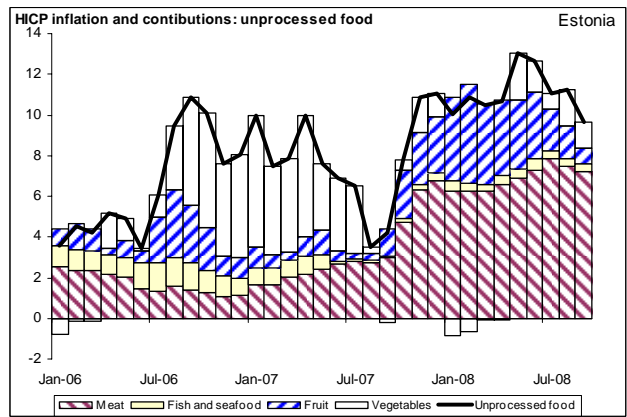
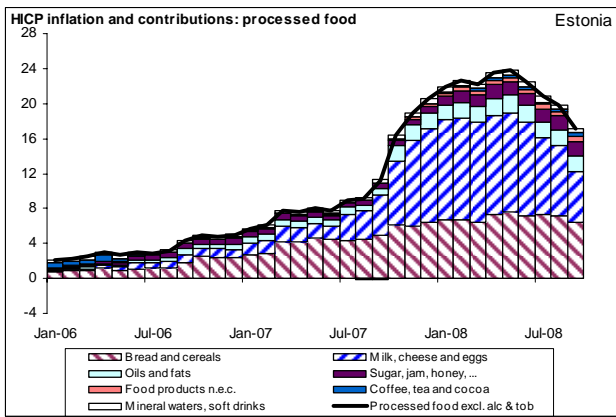
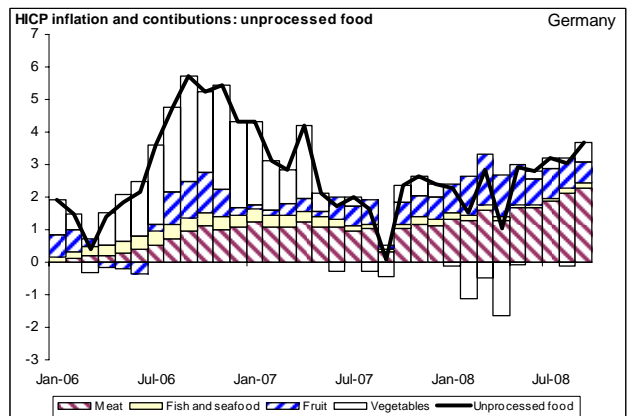
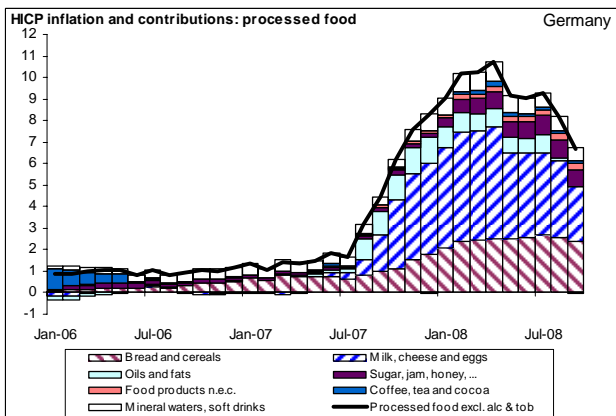
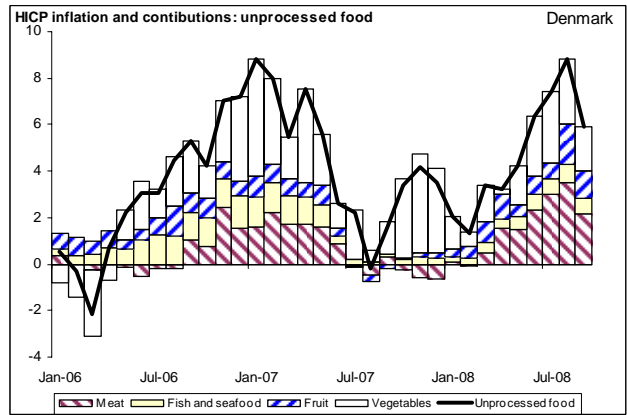
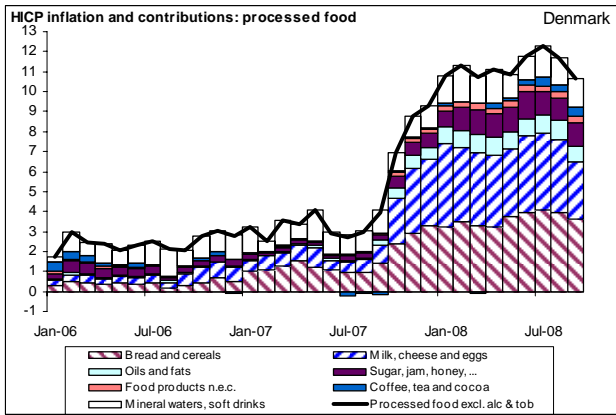
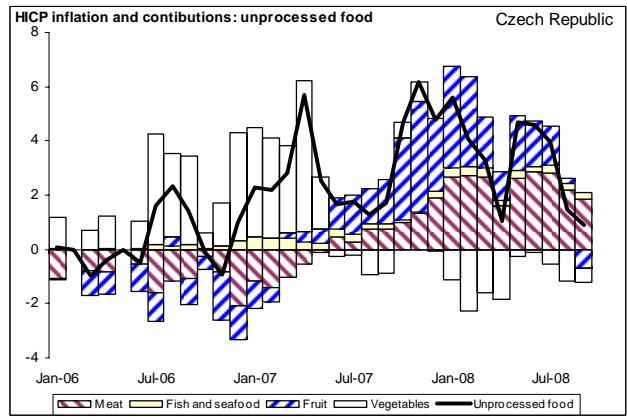
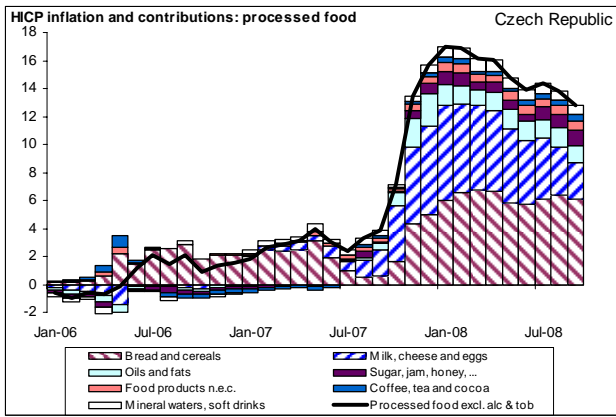
The sudden and very sharp rise in the prices of many agricultural commodities recorded during the summer 2007 and up to the first months of 2008 mainly resulted from a combination of steadily increasing demand and lagging supply or production shortfall, exacerbated by short-term economic and policy factors. Higher commodity prices generated a rapid and significant increase in food consumer prices, though at a lower pace as agricultural products are only (an increasingly declining) part of the cost components of consumer food products. **The contribution of food price inflation to headline inflation varied significantly across Member States on account of differences in the weight and composition of food in consumer expenditure, in the cost structure of the food chain, in the regulatory framework and in the competitive structure of the food chain.**

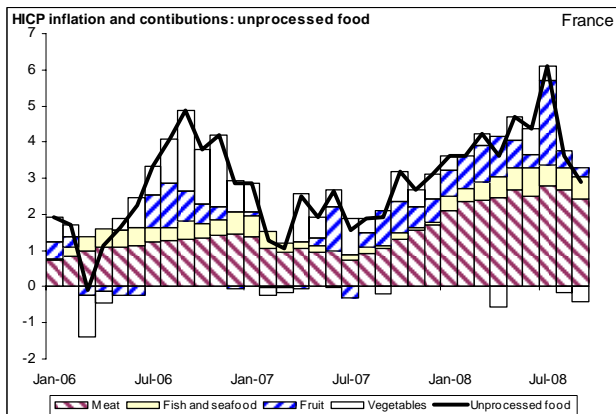
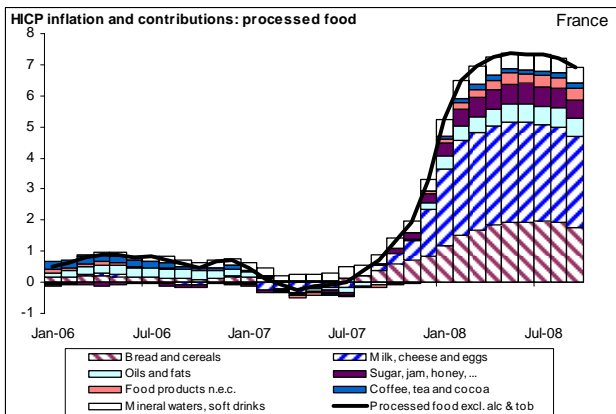
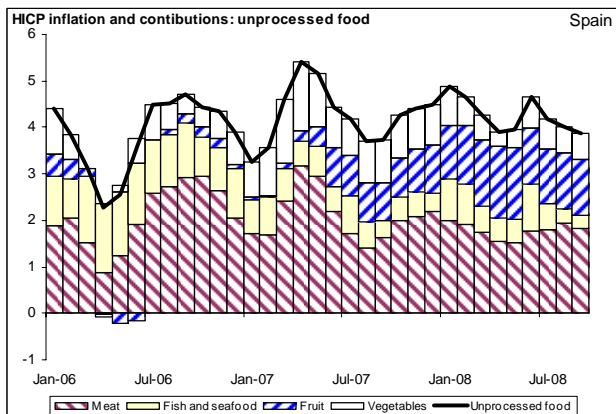
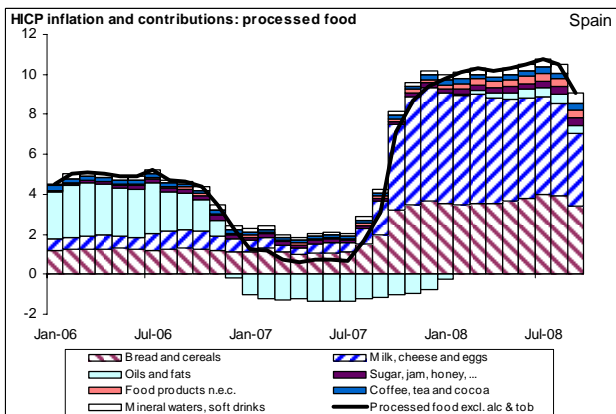
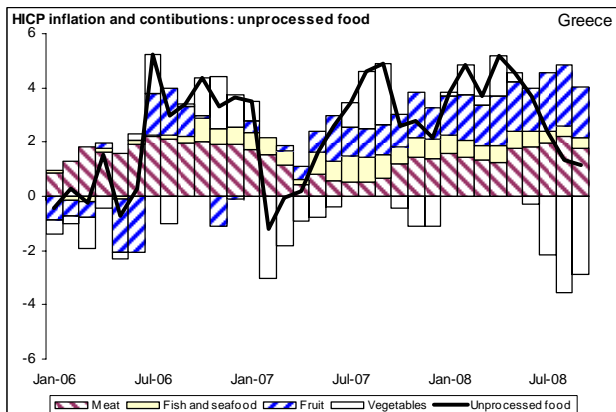
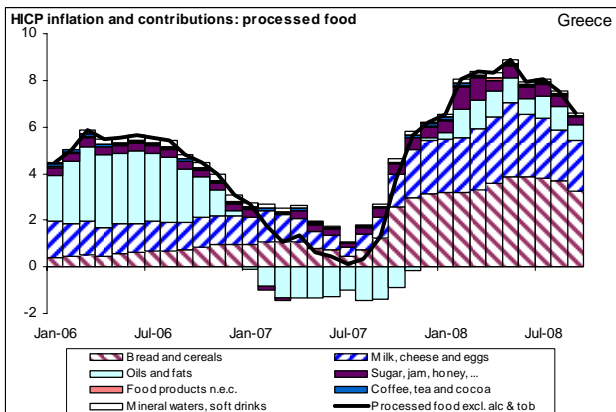
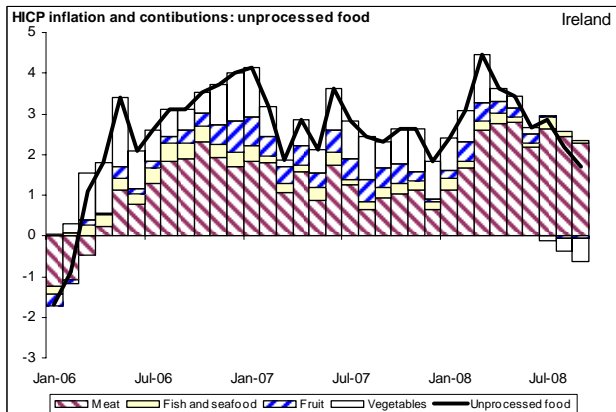
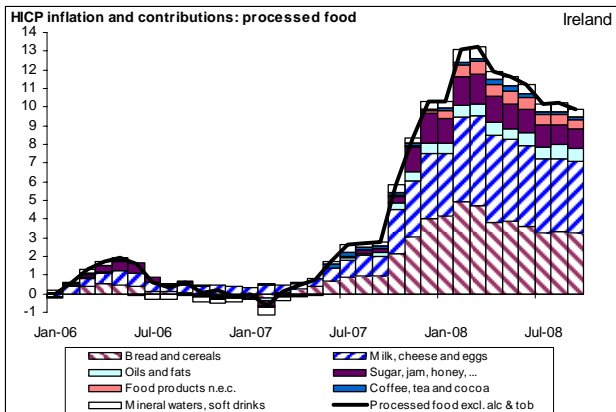
Since spring 2008, agricultural prices have trended downwards driven by a very strong producer response at global level (through the mobilisation of additional production factors and higher production intensity) stimulated by a more supportive policy environment. This price decline recently gained pace in the wake of the increased nervousness and uncertainty about the economic outlook and the general turbulence in the global financial system. It is forecast to generate a fall in food price inflation and a significant decline in the contribution of food prices to the headline inflation over the next two years.

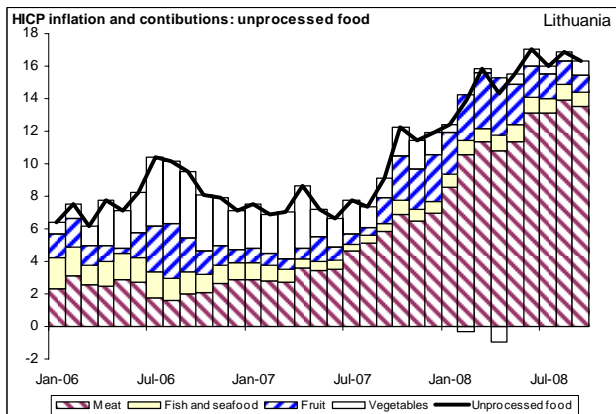
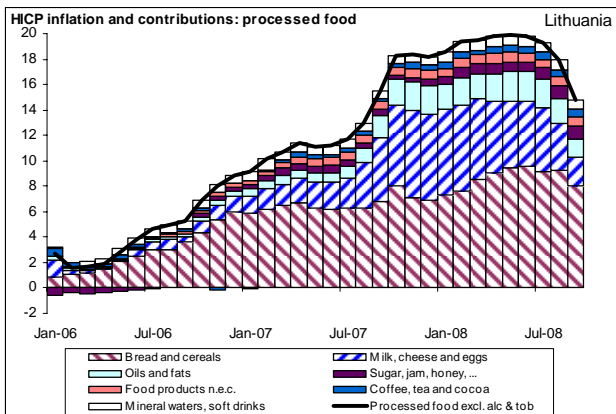
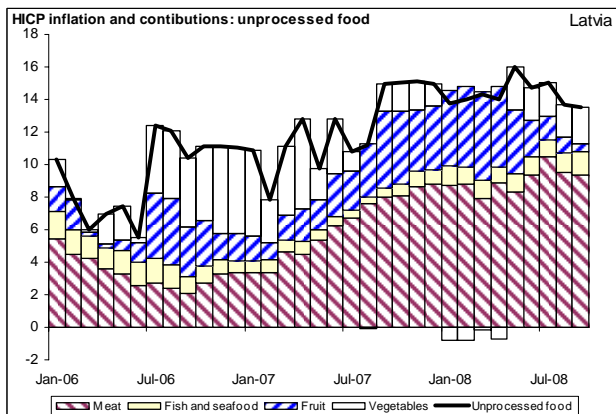
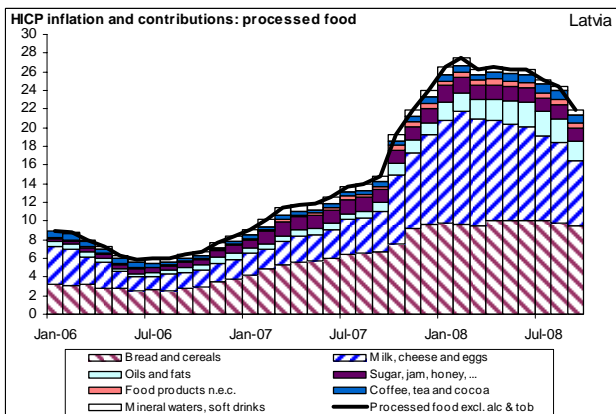
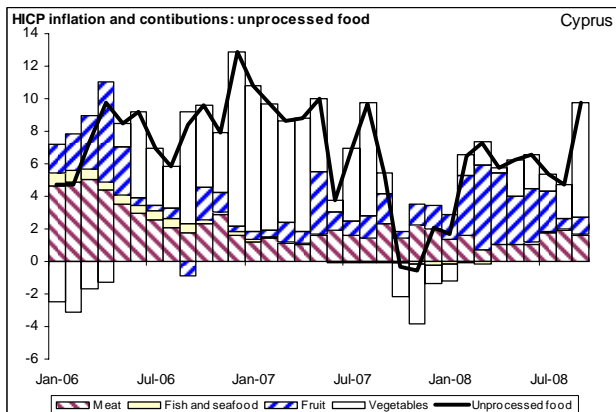
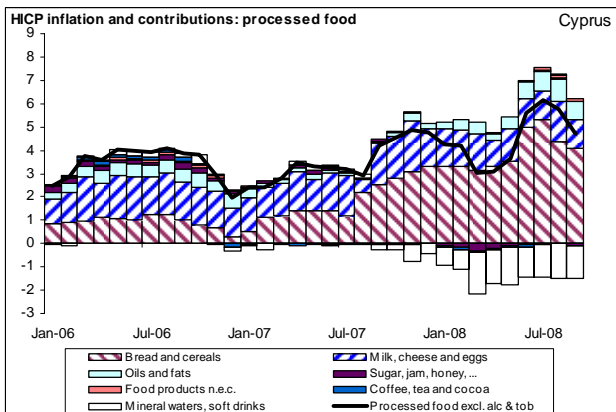
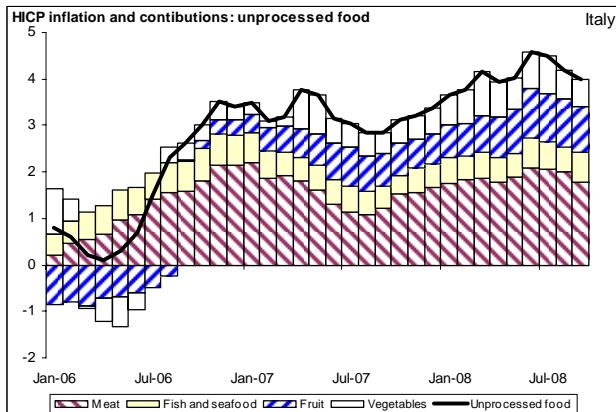
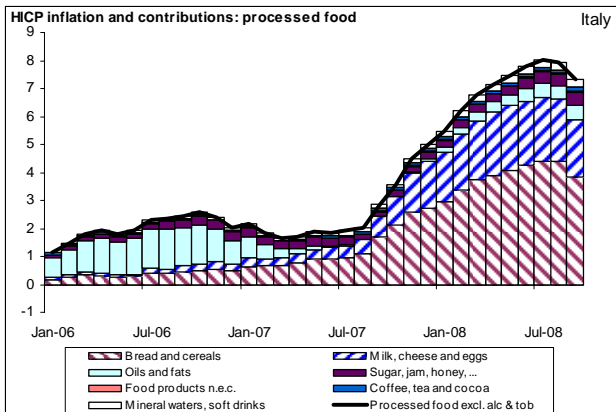
Over the medium term, in spite of the major uncertainty surrounding future price developments, there seems to be a consensus that structural factors like the growth in global food demand, the development of the biofuel sector and the long-term decline in food crop productivity growth should combine to maintain prices at relatively firm levels on average over the next ten years. However, even if commodity prices are projected to develop at higher levels than observed over the past decade, they would stand substantially below the most recent price hikes and exhibit greater fluctuations due to tight stock levels.

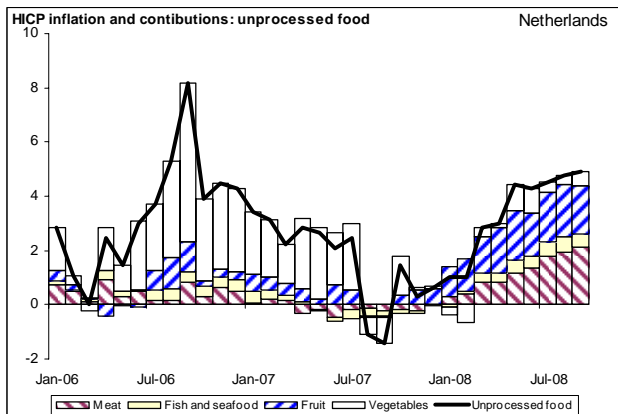
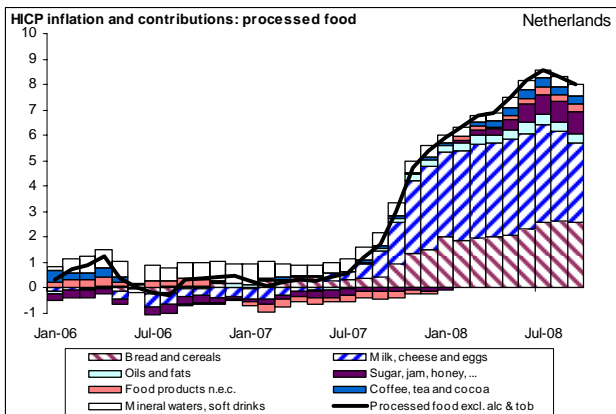
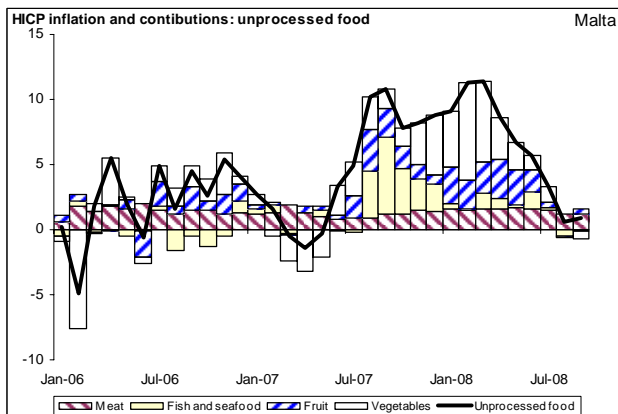
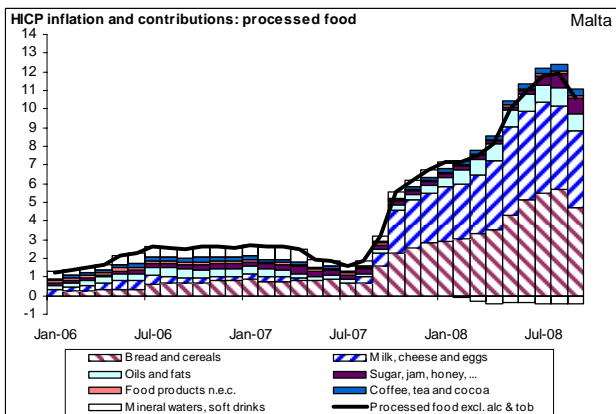
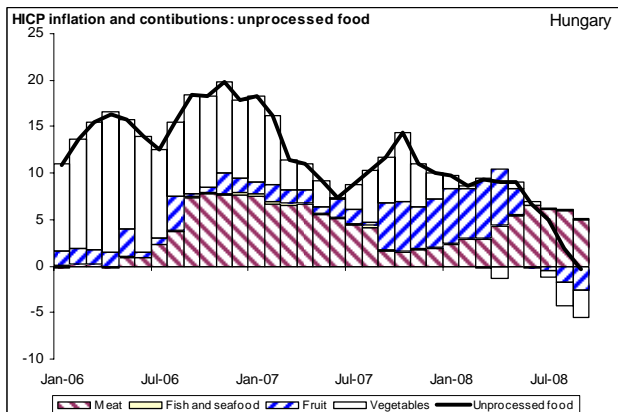
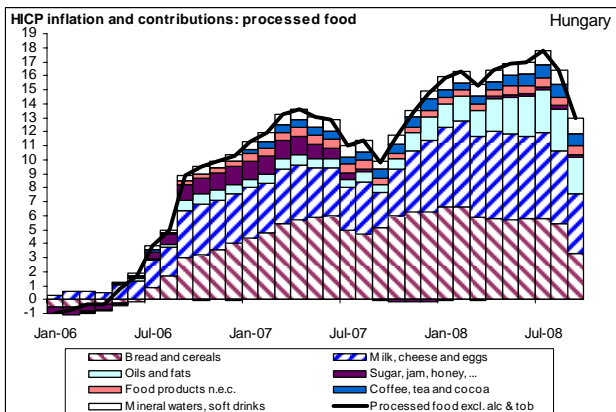
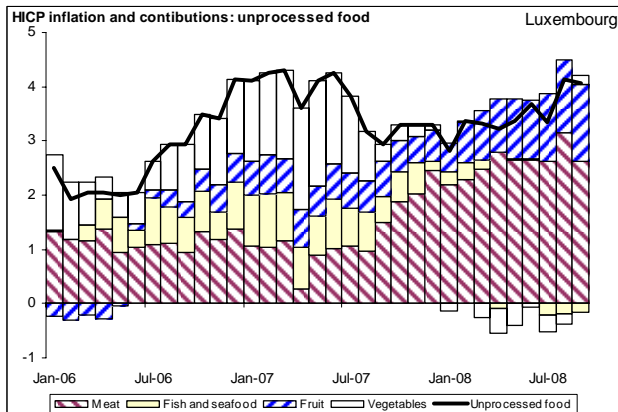
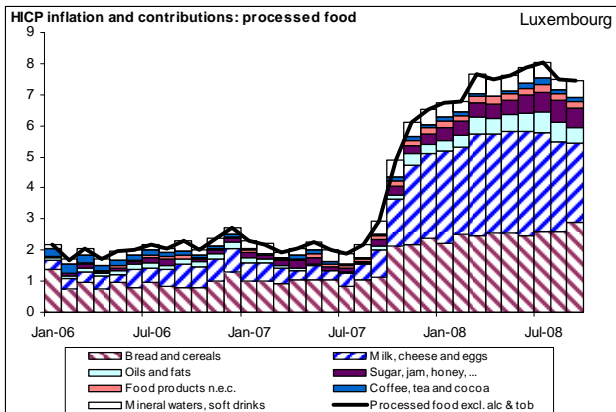
ANNEX: FOOD INFLATION AND COMPONENTS IN THE EU, EURO AREA AND MEMBER STATES

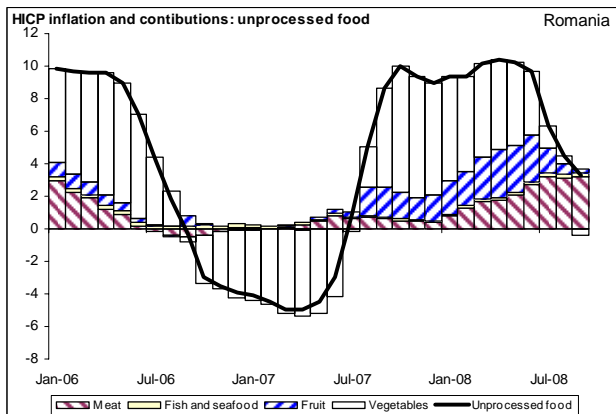
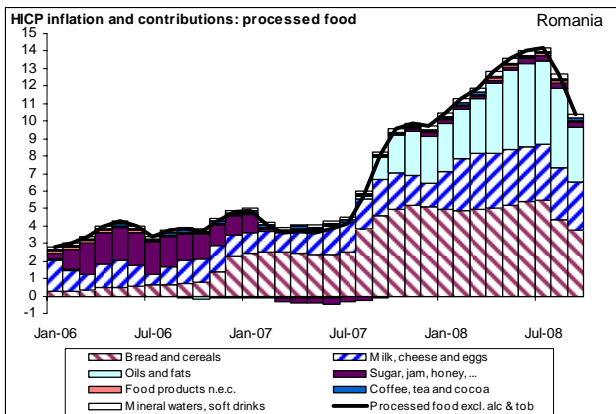
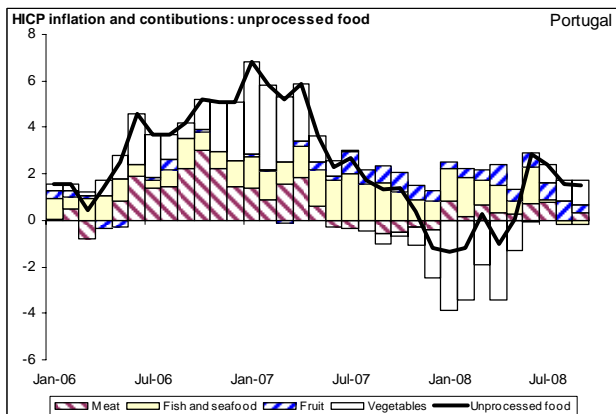
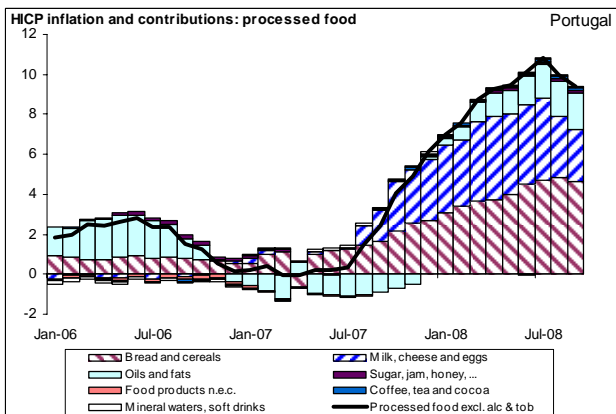
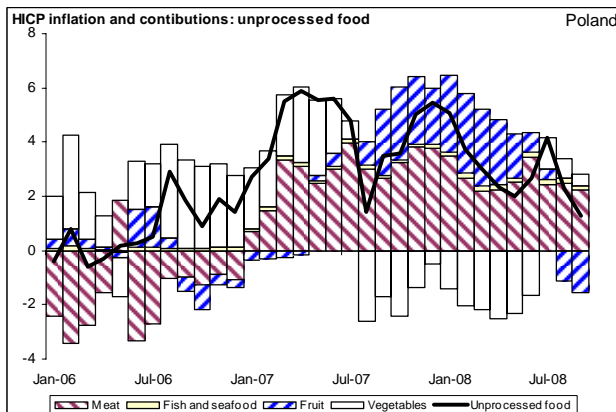
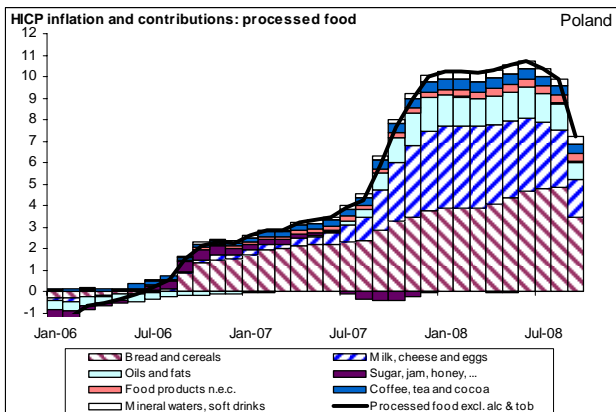
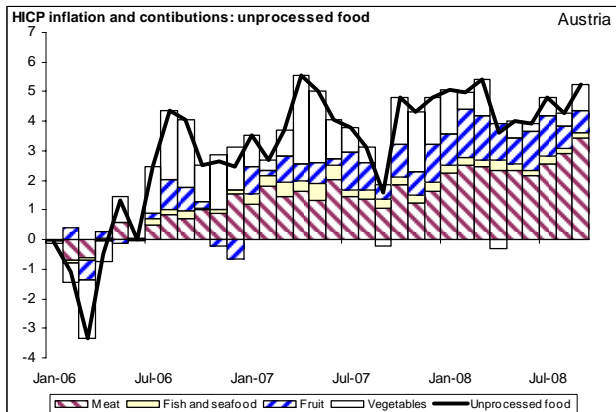
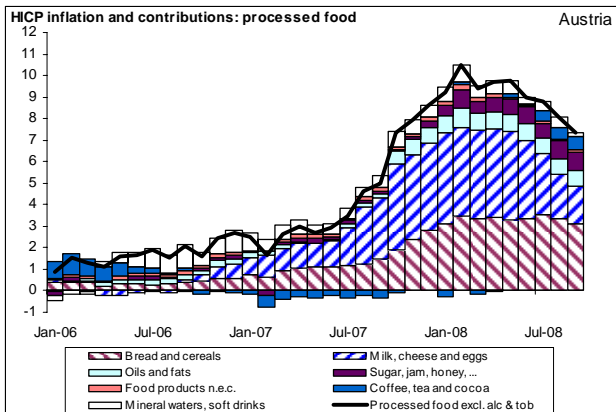


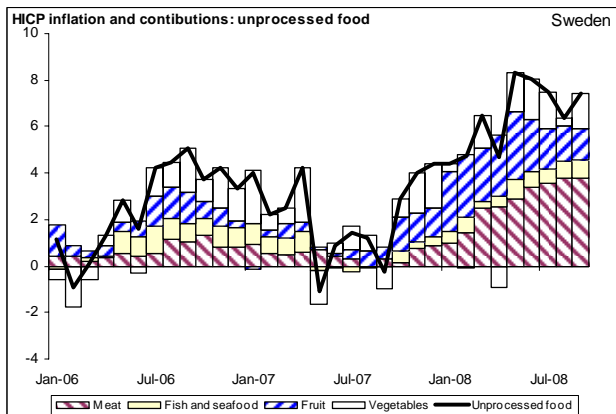
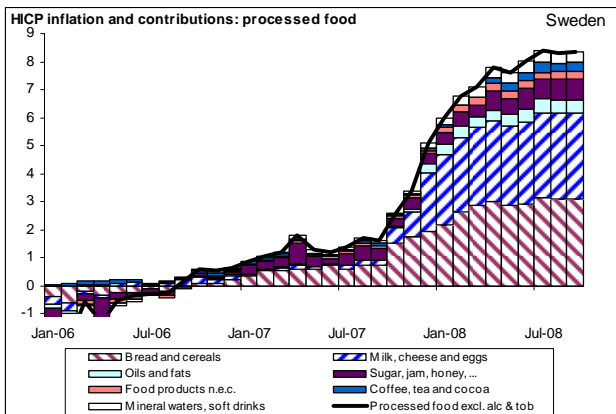
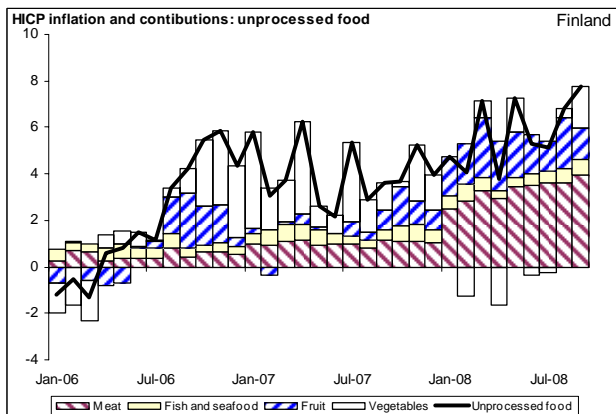
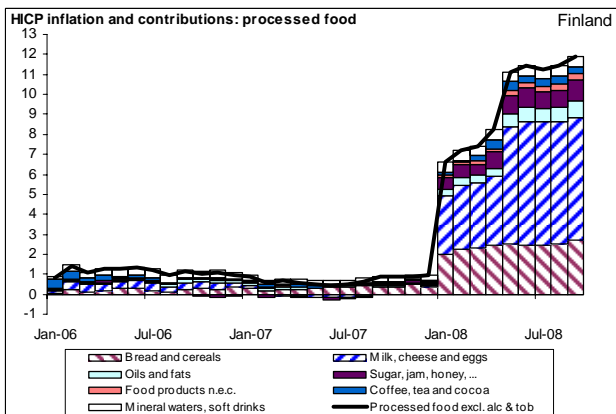
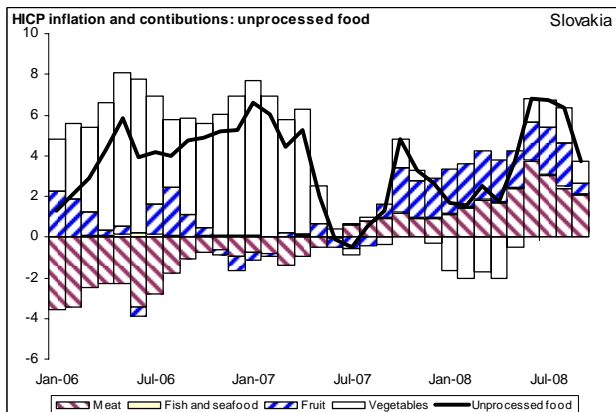
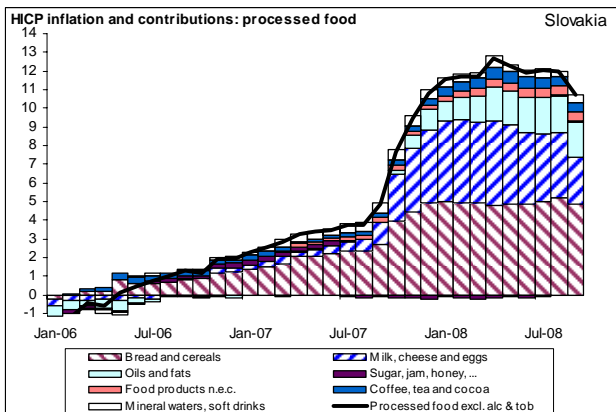
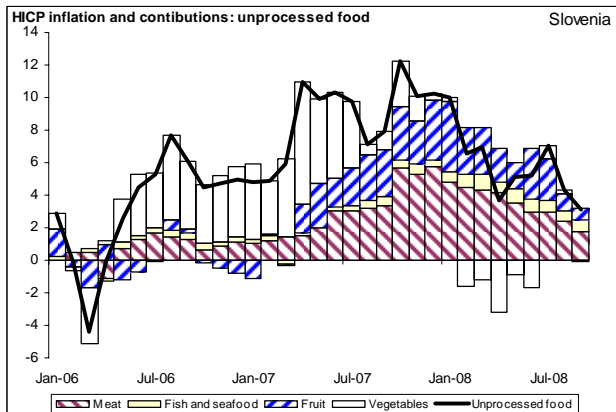
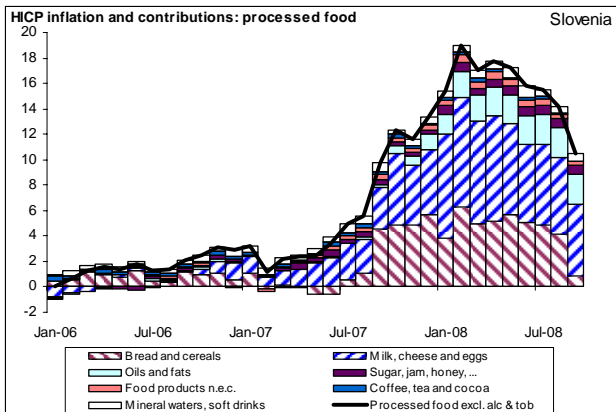


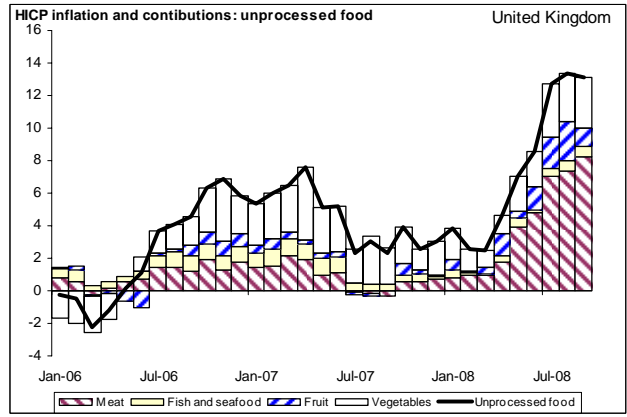
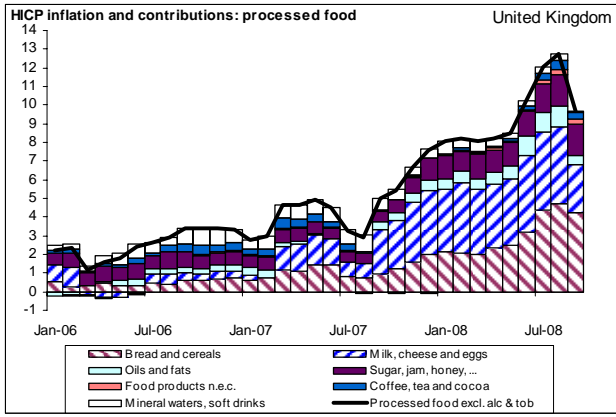












HICP inflation (% y-o-y, September 2008)

	BE	DE	IE	GR	ES	FR	IT	CY	LU	MT	NL	AT	PT	SI	FI
All-items HICP	5.5	3.0	3.2	4.7	4.6	3.3	3.9	5.0	4.8	4.9	2.8	3.7	3.2	5.6	4.7
Total food	6.6	5.3	6.0	4.0	6.1	4.9	5.7	7.0	6.1	6.0	6.8	6.4	4.7	7.3	10.2
Unprocessed food	3.5	3.7	1.7	1.2	3.9	2.9	4.0	9.7	4.1	0.9	4.9	5.2	1.5	3.1	7.8
Meat	3.9	4.7	4.7	3.7	4.1	4.6	3.7	3.5	5.2	3.2	4.4	6.4	0.9	3.2	8.2
Fish and seafood	4.1	2.0	1.1	2.6	1.1	3.7	4.4	1.3	-1.1	-0.9	5.9	2.8	-0.7	8.5	7.1
Fruit	9.3	3.5	-0.4	11.5	7.9	2.1	7.0	5.8	9.4	2.0	9.5	4.5	2.7	4.1	7.2
Vegetables	-2.7	2.7	-2.0	-11.7	3.6	-2.3	2.6	27.1	0.9	-3.0	2.4	3.7	6.9	-0.2	7.6
Processed food excluding alc & tob	9.4	6.7	9.9	6.6	9.0	6.9	7.3	4.7	7.5	10.6	8.0	7.3	9.4	10.4	11.9
Bread and cereals	10.2	7.9	10.0	13.3	9.6	6.3	10.5	13.8	9.2	14.4	8.0	10.2	11.5	2.7	9.2
Milk, cheese and eggs	13.8	10.6	18.1	6.1	11.5	10.1	7.7	3.7	11.2	15.8	14.1	6.8	8.7	22.6	20.3
Oils and fats	14.4	-0.7	16.8	3.7	4.3	11.2	5.3	12.4	11.3	15.3	13.9	12.8	17.3	39.3	21.2
Sugar, jam, honey, chocolate and confectionery	6.3	6.3	7.1	3.0	5.3	4.6	3.5	-1.2	5.0	9.6	6.0	6.2	1.5	5.5	6.5
Food products n.e.c.	9.2	3.8	3.6	3.2	9.5	4.8	5.2	4.8	3.5	3.5	2.1	2.3	1.1	5.3	7.8
Coffee, tea and cocoa	3.3	2.3	3.7	1.0	8.9	3.2	4.5	0.1	2.1	5.9	6.1	9.4	4.3	0.5	7.2
Mineral waters, soft drinks, fruit and vegetable juices	3.8	3.9	3.8	1.6	5.0	4.1	2.8	-8.3	3.3	-2.7	5.1	1.4	1.1	4.2	4.5

weights (in total for aggregates, in aggregates for items, 2008)

	BE	DE	IE	GR	ES	FR	IT	CY	LU	MT	NL	AT	PT	SI	FI
Total food	176.57	122.24	135.29	173.07	202.94	161.81	177.92	179.85	112.40	178.95	134.85	128.95	186.29	174.10	154.42
Unprocessed food	82.57	51.95	60.39	84.11	113.27	80.89	85.67	82.87	44.20	82.87	54.83	53.84	109.01	75.49	65.44
Meat	45.15	23.99	29.29	38.54	50.48	43.04	41.55	39.65	22.90	35.61	26.00	28.32	46.44	41.36	30.82
Fish and seafood	10.23	3.68	4.02	12.60	27.92	12.68	12.20	6.56	6.40	10.31	4.86	3.42	31.72	4.88	6.62
Fruit	11.29	11.00	9.36	13.15	17.23	10.75	12.67	15.67	6.60	15.34	10.09	9.15	14.89	13.80	11.87
Vegetables	15.90	13.28	17.72	19.82	17.63	14.43	19.25	20.99	8.30	21.61	13.88	12.94	15.96	15.45	16.13
Processed food excluding alcohol and tobacco	94.00	70.29	74.90	88.95	89.68	80.92	92.25	96.98	68.20	96.07	80.02	75.12	77.27	98.61	88.97
Bread and cereals	33.10	19.08	24.82	21.66	31.49	22.59	34.98	29.71	20.60	32.09	25.54	23.04	31.65	30.47	26.35
Milk, cheese and eggs	22.36	18.67	16.47	31.52	29.17	24.12	24.23	30.97	17.10	25.52	18.13	20.74	23.72	27.68	26.79
Oils and fats	3.97	3.43	3.35	16.55	7.44	3.98	8.43	5.90	3.30	5.63	2.02	4.30	7.92	6.02	3.48
Sugar, jam, honey, chocolate and confectionery	11.15	8.55	10.58	9.90	6.55	10.52	11.80	8.35	8.30	8.39	10.41	9.94	5.13	11.64	13.88
Food products n.e.c.	6.55	4.81	9.24	1.40	3.63	5.92	0.49	2.82	3.80	4.13	12.62	3.64	2.23	6.30	3.85
Coffee, tea and cocoa	3.72	4.37	2.67	2.36	3.20	4.45	2.46	3.22	3.60	4.71	3.91	4.22	1.93	5.29	4.49
Mineral waters, soft drinks, fruit and vegetable juices	13.15	11.38	7.77	5.57	8.18	9.34	9.85	16.00	11.50	15.60	7.39	9.24	4.71	11.20	10.14

HICP inflation (% y-o-y, September 2008)

	BG	CZ	DK	EE	LV	LT	HU	PL	RO	SK	SE	UK	EU-27	EA
All-items HICP	11.4	6.4	4.5	10.8	14.7	11.3	5.6	4.1	7.3	4.5	4.2	5.2	4.2	3.6
Total food	9.4	7.7	8.6	13.7	18.2	15.5	7.9	4.5	7.2	7.8	8.0	11.4	6.5	5.7
Unprocessed food	5.3	0.9	5.9	9.6	13.5	16.3	-0.3	1.3	3.3	3.8	7.4	13.1	4.5	3.6
Meat	13.0	3.8	4.4	12.9	16.9	23.0	9.4	4.2	5.5	3.1	8.5	19.1	6.0	4.3
Fish and seafood	12.5	3.8	6.9	3.4	14.1	6.9	5.9	2.8	2.7	1.7	5.8	7.5	3.3	2.7
Fruit	11.4	-4.5	7.8	5.8	3.5	9.3	-15.2	-16.7	2.4	3.0	7.1	6.2	4.1	5.5
Vegetables	-7.9	-2.7	6.9	5.9	12.5	5.5	-11.8	2.1	-1.8	3.9	6.6	10.8	2.0	1.1
Processed food excluding alc & tob	12.1	12.8	10.7	17.2	22.0	14.8	13.0	7.2	10.4	10.7	8.4	9.6	8.3	7.6
Bread and cereals	18.6	21.6	13.4	22.0	30.0	23.9	12.3	10.8	9.0	19.7	12.2	15.7	10.5	9.0
Milk, cheese and eggs	4.5	8.9	11.7	18.0	21.9	9.5	14.5	6.7	9.9	7.8	11.5	11.7	10.2	10.4
Oils and fats	25.5	16.8	19.5	29.7	32.6	21.6	33.4	8.5	37.6	23.5	11.1	15.4	10.1	6.1
Sugar, jam, honey, chocolate and confectionery	5.2	9.5	6.1	11.5	10.0	7.7	2.2	0.3	3.6	0.6	4.0	8.2	5.2	5.0
Food products n.e.c.	10.7	11.3	6.0	13.2	14.1	10.8	10.6	5.8	3.5	9.4	3.8	7.6	5.5	4.8
Coffee, tea and cocoa	5.5	7.1	8.2	6.9	10.1	8.2	11.2	6.3	2.5	6.6	6.4	6.5	4.9	4.1
Mineral waters, soft drinks, fruit and vegetable juices	7.6	6.0	9.1	6.2	12.5	10.6	8.5	4.3	3.8	3.5	3.3	0.4	3.4	3.7

weights (in total for aggregates, in aggregates for items, 2008)

	BG	CZ	DK	EE	LV	LT	HU	PL	RO	SK	SE	UK	EU-27	EA
Total food	238.61	188.91	154.91	208.08	236.70	251.61	197.70	228.96	368.99	179.35	149.99	109.00	160.08	157.81
Unprocessed food	94.71	80.44	64.60	94.72	105.07	111.89	74.62	99.06	162.65	74.62	62.59	50.00	74.95	76.03
Meat	40.40	43.68	29.57	52.13	59.17	64.57	39.99	59.88	89.19	44.96	27.29	21.00	36.68	36.76
Fish and seafood	4.17	4.56	6.17	9.33	11.08	13.68	1.53	6.79	11.35	2.50	8.66	5.00	9.85	11.46
Fruit	14.10	16.22	9.87	14.42	14.87	15.36	12.97	12.11	22.36	12.57	11.49	9.00	11.93	12.12
Vegetables	36.04	15.98	18.99	18.83	19.94	18.28	20.13	20.28	39.74	14.59	15.14	15.00	16.49	15.70
Processed food excluding alcohol and tobacco	143.89	108.47	90.31	113.36	131.63	139.72	123.08	129.91	206.34	104.72	87.40	59.00	85.13	81.78
Bread and cereals	57.12	29.87	24.70	31.85	42.90	46.06	32.49	40.71	81.70	27.61	22.08	16.00	26.60	25.90
Milk, cheese and eggs	38.89	34.72	22.52	39.88	43.70	38.67	36.16	33.79	57.02	34.01	24.85	14.00	23.55	23.02
Oils and fats	13.26	8.12	3.84	6.90	8.24	10.35	9.42	12.66	19.46	8.85	3.66	2.00	5.74	5.51
Sugar, jam, honey, chocolate and confectionery	18.04	11.80	16.41	14.33	14.81	17.27	11.67	14.71	17.88	10.72	15.96	11.00	10.58	9.62
Food products n.e.c.	6.48	5.97	4.66	4.96	5.49	7.70	7.26	8.15	6.20	5.20	6.59	2.00	4.38	4.38
Coffee, tea and cocoa	3.30	6.15	4.19	6.13	9.16	9.28	8.64	8.53	10.44	6.71	4.33	3.00	4.12	3.69
Mineral waters, soft drinks, fruit and vegetable juices	6.81	11.84	14.00	9.31	7.33	10.39	17.44	11.36	13.65	11.63	9.93	11.00	10.17	9.66