

Box 7

RECENT FOOD PRICE DEVELOPMENTS IN WORLD MARKETS AND THE EURO AREA

In recent months the marked increases in the prices of agricultural products and food in world markets have received much attention. Against this background, this box reviews recent developments in food prices, both in world markets and with reference to the unprocessed and processed food components of the euro area HICP.

Recent developments in world food prices

Food prices have increased significantly on world markets since 2001, although to a lesser extent than the prices of other raw materials. There has, however, been an acceleration in the momentum of prices in recent months, with food prices growing by about 30% in August compared with the same period last year. In terms of components, the increase has been broad-based across the three main sub-components (see Chart A).

The recent food price increases have mostly been driven by higher energy and fertiliser prices, low levels of inventories, shortfalls in certain crops – mainly caused by weather-related factors such as the drought in Australia – and strong increases in the demand for crops. The latter reflects mainly two factors. First, increasing wealth in most emerging economies, particularly China, has resulted in significant changes in food consumption patterns in these countries, leading to a higher consumption of high-protein foods such as meat and dairy products, and therefore a greater demand for the non-food use of agricultural commodities in the feeding of livestock. Second, the current high levels of energy prices and rising government incentives for the development of alternative fuels are supporting a substantial increase in demand for agricultural inputs for the production of biofuels, primarily ethanol and biodiesel. The price of corn, the main feedstock for ethanol production in the United States, rose at the beginning of the year to ten-year highs. As this encouraged US farmers to increase their corn production, they decreased the supply of other agricultural products, with a subsequent upward impact on the prices of these products in world markets.

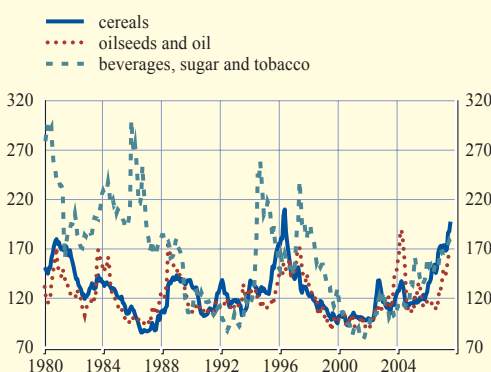
Despite the recent increases, food prices still remain below previous historical highs. Looking ahead, it is difficult at the current juncture to assess whether recent developments represent a change in the underlying trend observed in world agricultural prices. Although global demand is likely to remain buoyant, agricultural supply tends to respond more quickly to increased demand and prices than is the case in other commodity markets, such as oil and metals. The scope for price increases as seen in these markets may therefore be limited. Nevertheless, the risk of continued upward pressure on food prices remains dominant.

Euro area food price developments and their contribution to euro area HICP inflation

Changes in world commodity prices can have direct and indirect effects on overall euro area HICP inflation. The direct effects are related to the import of unprocessed and processed food which is ready for consumption, while the indirect effects stem from the use of imported commodities as an input into domestic production and supply chains. The remainder of this box, by reviewing developments in euro area unprocessed and processed food prices and their contribution to overall HICP inflation, focuses on the direct effects of world food prices on euro area developments.

Chart A Developments in food and tropical beverage prices

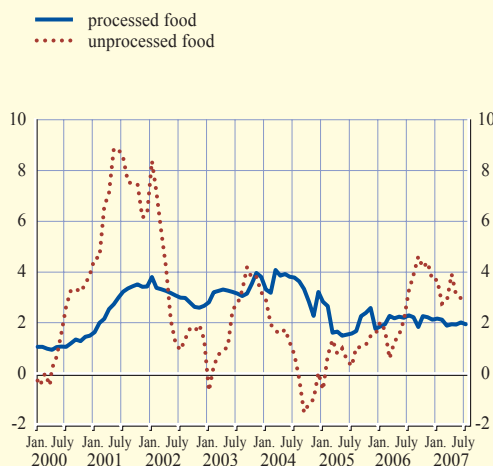
(index: 2000 = 100; in USD terms)



Sources: HWWI and ECB calculations.
Note: Latest observation refers to August 2007.

Chart B Growth in processed and unprocessed food components of euro area HICP

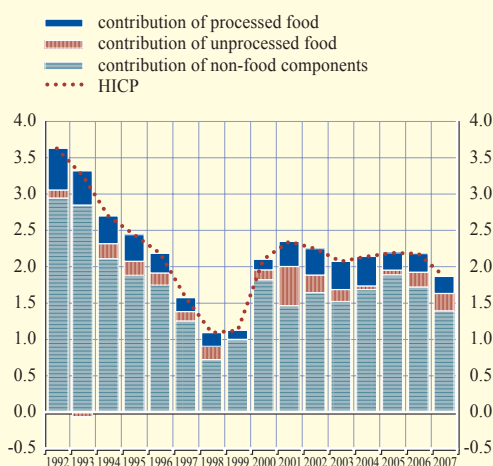
(annual percentage changes)



Source: Eurostat.
Note: Data are available up to July 2007.

Chart C Contributions to annual euro area HICP inflation

(percentage points)



Sources: Eurostat and ECB calculations.
Note: Data are available up to July 2007.

Following the spike in unprocessed food prices in 2001, which was caused to a large extent by the adverse impact of the spread of BSE and foot-and-mouth disease, prices since 2002 have occasionally been affected by unusual weather conditions in specific periods, but no overall trend can be observed (see Chart B). The gradual acceleration in unprocessed food prices observed during most of 2006 appears to have come to an end towards the end of last year, and developments in these prices appear to have normalised during the first half of 2007. Although the acceleration observed in 2006 was significant, it was far from unprecedented by historical standards, in terms of both annual growth and the associated contribution to overall HICP inflation (see Chart C).

As regards processed food prices, after gradually accelerating between 2000 and 2004, the annual growth rate has returned to levels close to the historical average. The greater stability of this component relates to a significant extent to the smaller impact that shocks such as extreme weather conditions have on processed food items as compared with unprocessed food items. However, specific shocks have also affected processed food items over recent years, notably occasional tobacco tax increases in some countries. Beyond these specific factors, no significant trend can be observed in the annual rate of change in processed food prices since 2005.

Although food prices appear to be among the most important factors affecting perceived inflation in the euro area,¹ their overall contribution to actual inflation is limited by their weight in the overall euro area HICP, which is approximately 11.9% for processed food and 7.6% for unprocessed food (in 2007). The direct contribution of unprocessed and processed food prices to overall headline inflation has thus been contained both in historical terms and during recent quarters. The annual rates of change in these components also appear to have been broadly in line with historical averages in 2007, up to July (see table). Moreover, no signs of sustained

¹ See, for example, the article entitled “Measured inflation and inflation perceptions in the euro area” in the May 2007 issue of the Monthly Bulletin.

Recent developments in the unprocessed and processed food components of euro area HICP and their main sub-components

(annual percentage changes, unless otherwise indicated)

	HICP weights (%)	Average annual growth						Average contribution to annual HICP inflation (percentage points)			
		2007	2005	2006	2007	May 07	June 07	July 07	2005	2006	2007
Unprocessed food	7.6	0.8	2.8	3.2	3.1	3.0	2.8	0.1	0.2	0.2	0.2
Meat	3.8	1.3	2.4	2.8	2.9	2.5	2.1	0.1	0.1	0.1	0.1
Fish	1.2	1.6	3.7	3.2	3.0	2.4	2.8	0.0	0.0	0.0	0.0
Fruit	1.2	-0.5	1.0	2.5	2.2	5.6	3.3	0.0	0.0	0.0	0.0
Vegetables	1.5	0.1	4.3	4.3	4.0	2.2	3.9	0.0	0.1	0.1	0.1
Processed food	11.9	2.0	2.1	2.0	1.9	2.0	1.9	0.2	0.3	0.2	0.2
Bread and cereals	2.5	0.8	1.4	2.3	2.4	2.4	2.5	0.0	0.0	0.1	0.1
Milk, cheese and eggs	2.1	-0.1	0.6	0.8	0.7	1.1	1.3	0.0	0.0	0.0	0.0
Sugar, jam, honey, chocolate and confectionery	1.0	0.0	0.9	0.9	1.0	0.9	0.9	0.0	0.0	0.0	0.0
Tobacco	2.5	7.8	3.9	5.0	4.9	4.8	4.3	0.2	0.1	0.1	0.1

Sources: Eurostat and ECB calculations.

Note: Averages for 2007 are based on data up to July 2007.

acceleration in the main sub-components of processed and unprocessed food prices have been observed during the period up to July 2007.

Overall, while international food commodity prices have risen strongly recently, this has not thus far been accompanied by a comparably strong rise in euro area food prices at the consumer level. This can be explained by various factors, including the relatively small share of agricultural products in euro area imports, the provisions of the EU's common agricultural policy which to some extent insulate euro area agricultural markets from external developments, and the gradual appreciation of the euro observed since 2001. However, anecdotal information and press reports have recently suggested the possibility of food price increases in August 2007. This relates, in particular, to significant increases in dairy and cereal products in a number of euro area countries in recent weeks, which may be related to some extent to supply and demand conditions and developments in international food commodity prices. This suggests some upward risks to euro area food prices looking ahead. However, uncertainty remains high with regard to the outlook for both world and domestic food prices. Food prices depend on a number of factors which are very difficult to predict, including technological advances and possible energy policy changes. Moreover, it is still unclear to what extent climate change may contribute to food price developments in the future.