

Box I

FOOD PRICE DEVELOPMENTS IN THE CENTRAL AND EASTERN EUROPEAN EU COUNTRIES OUTSIDE THE EURO AREA

Since 2006 the world economy has experienced a significant increase in the price of food at both the producer and consumer levels. Within the EU, the central and eastern European countries outside the euro area (CEE countries)¹ have been greatly affected by this shock, with all CEE countries reporting greater food price increases than in the euro area.

Recent developments in agricultural prices and their impact on the HICP

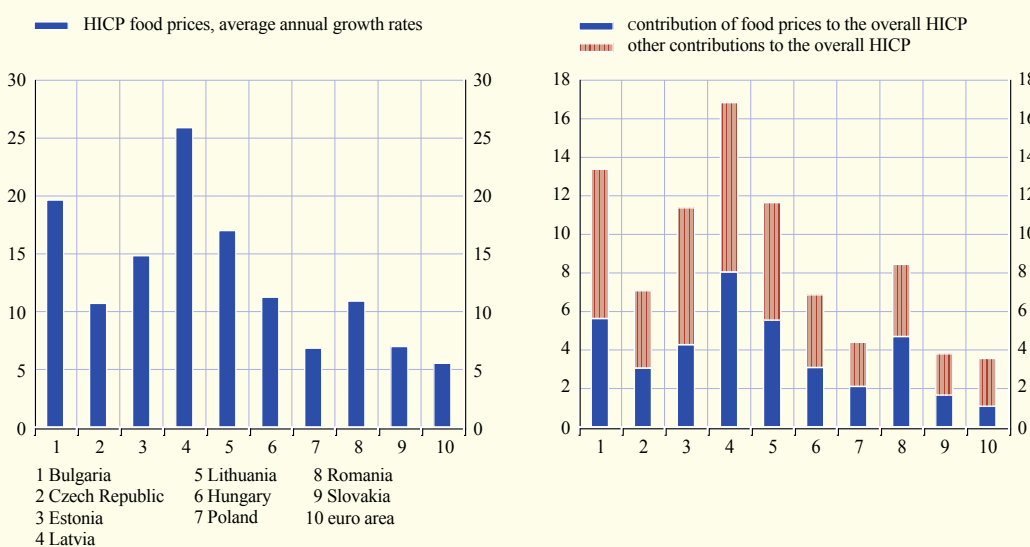
Food prices started to increase significantly in 2007 and, during the period January-July 2008, in all CEE countries the growth rate of consumer food prices and the contribution of those prices to the overall annual HICP were greater than in the euro area (see Chart A). During this period Bulgaria, Latvia and Lithuania saw the greatest increases in food prices, by 19.6%, 25.9% and 17.0% respectively. These countries also reported the largest contributions of consumer food prices to HICP inflation for the same period.

The strong contribution of food prices to HICP inflation is partly related to the high weight of food in the HICP indices in the CEE countries. In all CEE countries, the weight of (processed and unprocessed) food in 2008 is above the euro area level of around 20% (see Chart B).

1 CEE countries are those EU Member States outside the euro area that have joined the EU since May 2004.

Chart A Food price increases and contributions to the overall HICP during the period January-July 2008

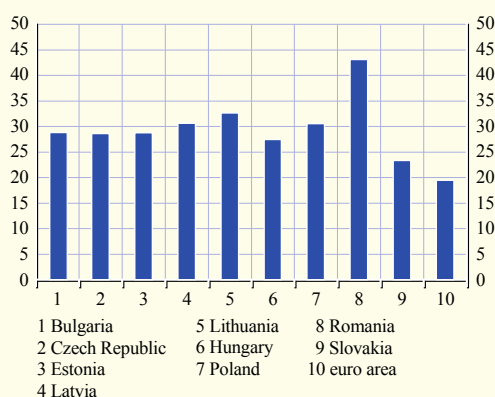
(annual percentage changes; percentage points)



Sources: Eurostat and ECB.

Chart B Weight of food in the HICP (2008)

(percentages)

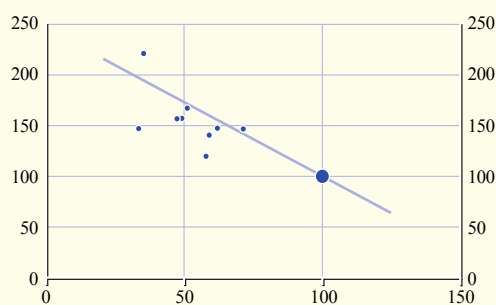


Sources: Eurostat and ECB.

Chart C Weight of food in the HICP (2008) versus GDP per capita (2007)

(euro area = 100)

x-axis: GDP per capita in purchasing power parity terms
y-axis: weight of food in the HICP



Sources: Eurostat and ECB.

Chart C shows that the weight of food in the HICP basket is closely related to the level of GDP per capita (in terms of purchasing power parity). Hence, it is not surprising that the decrease in the share of the food component in most CEE countries in recent years has been strongly correlated with their increase in per capita income. Indeed, changes in the weight of food in the HICP basket between 2003 and 2008 were heterogeneous across countries. The weight decreased in particular in the fast-growing CEE countries Latvia, Lithuania and Slovakia.

The drivers of food price increases

Food price increases at both the consumer and producer level can be explained by various temporary as well as more permanent structural factors. Food prices in all CEE countries have been affected by the increase in global food prices owing to, inter alia, the increasing demand for food in emerging economies, a greater demand for crops for the production of biofuels, and weather-related crop shortfalls.²

In addition, food prices in many CEE countries have been affected by (often temporary) country-specific factors, such as weak agricultural harvests or strong wage growth, which have contributed significantly to the rising costs and prices in the food industry and intensified the pass-through to consumer food prices. The increase in tobacco taxation (tobacco is part of the food component of the HICP) and VAT also contributed to the greater increase (in relative terms) of consumer food prices in most CEE countries than in the euro area. Moreover, energy price increases were stronger in most CEE countries than in the euro area. This, together with the fact that food production is more energy-intensive in most of the CEE countries than in the euro area, also contributed to higher production costs and prices in the food industry compared with the euro area.

² See also the box entitled "What accounts for the surge in global food prices?" in the June 2008 issue of the Monthly Bulletin.

Institutional factors have also contributed to food price increases in the CEE countries. The Common Agricultural Policy (CAP) imposes two important types of direct supply constraint: quota regimes and “set-aside” obligations. Production quotas are imposed on certain products (in particular milk and sugar) which, if exceeded, result in penalties, such as milk super-levies, which the CAP applies EU-wide. The impact of these supply constraints appears to have been particularly significant in certain CEE countries.

In most CEE countries, anecdotal evidence suggests that the level of competition in the retail food sector has not been sufficient to contain profit margins at the retail level. A further liberalisation of the food market at the retail level would help to keep consumer prices down in several countries.

Given that food products are highly tradable, food price arbitrage with the euro area appears to have played an important role in the increase of food prices in some CEE countries with initially relatively low price levels. In the CEE countries with the lowest price levels, the contribution of (unprocessed) food to the (final) retail price also tends to be greater, which leads to higher percentage increases in the retail prices.

Food price increases appear to have been more moderate in those CEE countries which have a relatively significant degree of nominal exchange rate flexibility (e.g. the Czech Republic, Poland, Romania and Slovakia). Currency appreciation appears to have had a dampening effect on food prices in those countries; first, by directly reducing the price of importing food and second, by reducing energy costs and, therefore, also the cost of producing food domestically.

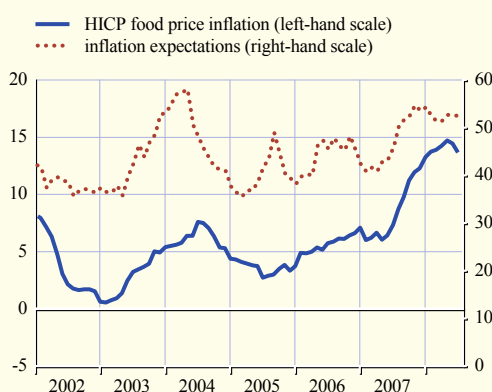
Some macroeconomic and policy implications

Turning to the macroeconomic implications of the recent strong increase in food prices, a relatively close link between food price inflation and consumers’ inflation expectations can be observed in the CEE countries (see Chart D).³ Food price inflation has also affected the information content of some traditional indicators of monetary policy. Core inflation measures, which exclude items such as food and energy, have increasingly diverged from headline inflation.⁴

The increase in food prices has had a negative impact on the purchasing power of households. Moreover, since the CEE countries have a lower GDP per capita than the euro area and – as

Chart D Inflation expectations and the HICP food component in the CEE countries

(annual percentage changes; percentage balances)



Sources: European Commission and ECB.

³ Inflation expectations reported by the European Commission correspond to the difference between the weighted proportion of respondents stating that consumer prices will rise “very much”, “quite a bit” or “a little” over the next 12 months, and the weighted proportion of respondents stating that consumer prices will “fall” or “stay broadly the same” over the same period. Hence, the indicator takes the form of a “balance statistic” and only gives qualitative information on the directional change in inflation expectations over the next 12 months.

⁴ This applies to both HICP and CPI inflation, notwithstanding some country-specific differences.

mentioned above – consumers in the CEE countries spend a higher proportion of their income on food, food price increases have a greater impact on the purchasing power of households in the CEE countries than in the euro area.

Given that the process of economic and price level convergence between the CEE countries and the euro area has not yet come to an end, the CEE countries continue to face a stronger risk of upward pressures on inflation via food prices than the euro area countries. The CEE countries' key policy challenge arising from the strong increase in food prices is to anchor inflation expectations and contain the possible second-round effects of the recent sharp increase in inflation.