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NOTE

from:	the Council (ECOFIN)
to:	the European Council
Subject:	Recent developments in food prices – main drivers and policy responses

Delegations will find attached a note on recent developments in food prices as agreed by the Council (ECOFIN) on 3 June 2008.

ANNEX

Brussels 4 June 2008

Note for the European Council

Recent developments in food prices – main drivers and policy responses

In recent years, the world economy has faced a significant commodity price boom. Whilst commodity price rises have not been uniform, the increases have been broad-based (including oil, agricultural and some metals) and taken together they have had a greater impact than individual price developments. After thirty years of falling global food prices (in real terms), this trend has been reversed dramatically since 2006 with a surge in prices for agricultural products, although despite rapid increases, today's food prices are still, in real terms, on average lower than they were for example in the 1980s. Prices for wheat and dairy products in Europe increased by 96% and 30% respectively between September 2006 and February 2008.

The acceleration in agricultural commodity prices has impacted significantly on euro area consumer food prices. Between September 2007 and March 2008 the contribution of food price inflation to euro area headline inflation increased from 0.4 percentage points to 1.0 percentage point. Processed food price inflation jumped from 1.2% to 8.2% between July 2007 and March 2008, whilst unprocessed food price inflation increased from 2.1 % in September 2007 to 3.8% in March 2008. The inflationary impact of food price increases has varied significantly across Member States depending on country-specific conditions such as the share of food in the CPI index and the degree of competition in retail markets (e.g. prices for processed food increased in France by 0.7% in 2007 whereas the increase in Slovenia was 5.7%). Limited competition at the various stages of the food supply chain in retail and distribution sectors is one candidate that may have caused this phenomenon and which has fuelled or magnified food inflation.

Despite the recent fall in (wholesale) prices for some commodities, such as wheat or certain dairy products, the agricultural markets are still tight and the risk of further price increases remains.

The **driving forces and underlying factors** behind the recent agricultural commodity price increases encompass both structural and more temporary factors and are mainly driven by factors outside the EU:

- An important **structural determinant** for tighter markets has been increasing global demand stemming primarily from income increases in emerging economies, notably China and India, which has added to the effect of global population growth. Higher oil and energy prices are also affecting agricultural prices through higher input prices for farmers, as well as higher costs for transport and food processing. A World Bank study suggests that a 10% rise in crude oil prices translates into a 1-2% increase in food prices. Furthermore, increasing global demand stemming from biofuel production, is at the same time shifting supply from crops devoted to food to fuel, with a particularly strong impact on corn/soybean prices[1]. Other structural factors reducing supply include the slowing down of growth in cereal yields, as well as the potential impact of climate change (which in the long term may have a possible negative effect on supply due to reduction in cultivatable land and in the short term increase the volatility of agricultural production due to extreme weather events).

- **Temporary supply-side factors** have also added to already tight markets. Of particular relevance have been supply shortfalls in a number of important producing and exporting countries due to bad weather conditions in 2006 and 2007 which led to exceptionally poor harvests (e.g. in Australia). Historically low levels of international stocks have meant that the surge in agricultural commodity prices has not been cushioned by stock releases. Moreover, several important producing countries have imposed export restrictions or taxes to avoid domestic shortages which further tighten international agricultural markets. Furthermore, the shift of investment portfolios towards commodities and derivative markets in the context of low interest rates and unwinding of global imbalances, including the depreciation of the US dollar, may also have contributed to increasing food prices in 2007. Notwithstanding this, the positive role a deeper and more developed financial market in the agricultural sector can play for the overall development of the agricultural economy should be acknowledged.

[1] While biofuels still account for only 1.5% of the global liquid fuels supply, they accounted for almost half of the increase in consumption of corn in 2006-07, due to corn-based ethanol production in the US. In contrast, the impact of EU biofuel policy has been rather limited so far, as biofuels currently use less than 1% of EU cereal production

Clearly further and deeper analysis of the individual drivers of agricultural commodity price increases is needed, including on the future effects of climate change on agricultural production. In the short term, it seems that the growth rates of food prices have reached a peak and are expected to moderate. However, **looking ahead**, the most likely scenario is that global demographic trends combined with rising incomes and changing food consumption patterns, notably in the emerging markets, and increasing biofuel production, will continue to increase demand for agricultural commodities.

Higher agricultural prices have been partly caused by higher oil and energy prices through higher input prices for farmers as well as higher costs for transport and food processing. The Ecofin Council expressed concern in regard to the continued surge in oil prices and discussed various ways to address their social and economic consequences. These developments underscore the need to foster energy efficiency and alternative energy sources, increase the transparency of oil markets, promote competition in energy markets and enhance the dialogue with oil producing countries. The Ecofin Council confirms the agreement reached in Manchester in 2005 that distortionary fiscal and other policy interventions should be avoided as they prevent the necessary adjustment by economic agents. Measures that can be considered to alleviate the impact of higher oil prices on the poorer sections of the population should remain short-term and targeted, and should avoid distortionary effects. The Council encourages the Commission to further review developments of commodity related markets, and consider adequate policy responses aiming at limiting price volatility.

The impact on prices is difficult to predict, as it will largely depend on supply-side responses and developments (including climate change effects), i.e. to what extent supply can match increasing demand. In addition, the agricultural sector is an area where, given specific policies and its characteristics, price signals do not fully play their role. Over the medium term, demand pressures will continue to influence price dynamics. For this reason it is important to devise appropriate supply and demand **policy responses** which can help to reduce the upward pressure on agricultural commodity and food prices in the EU by responding to market signals in the agricultural sector and improving the responsiveness of supply. These policies can be framed in terms of short and medium term measures:

Short-term measures:

- Several short-term steps have been taken in the CAP to mitigate the effects of the price increases, including the suspension of import duties on cereals and, for 2008, the obligation to set aside land, the decision to increase milk quotas and the sale of intervention stocks.

- It is also important to note the possible distributional effects of increasing food prices. A number of Member States have envisaged short-term measures to cushion the temporary impact of the recent commodity price developments for low income households. However, it is important to ensure that price signals are not distorted and to avoid broad-based second round effects on wages and prices (including through indexation schemes). In this context, and in line with the Manchester statement on oil prices, any measures should be short-term and targeted.

- The Council (Ecofin) supports the Commission intention to closely monitor developments in commodity-related markets and analyse their impact on price movements and any possible policy implications.

Mid and long-term measures:

- With the aim of increasing supply, it is important to:
  - continue to improve market orientation in agriculture in order to allow farmers to respond more quickly to price signals and to increase the efficiency of agricultural factor markets (e.g. CAP Health Check);
  - ensure the sustainability of biofuels policies in the EU and assess possible impacts on agricultural products for food and take action, if necessary, to address shortcomings;
  - increase productivity growth in agriculture (including through research and innovation) in both EU and developing countries.

- Given the varying impact of commodity price increases on consumer prices in Member States, scrutiny of the competitive structure of the food supply chain seems warranted, in particular as regards concentration and market segmentation of the food retail and distribution sectors. Competition at the national level should be strengthened and the implementation of the single market be further pursued.

Initiatives at the international level:

- It is also important to promote a stable, global macroeconomic environment and to foster co-ordination with our international partners to find consistent responses to global challenges, in particular:
  - promoting sustainable production of biofuels at international level, e.g. by encouraging the adoption of sustainability criteria and tackling climate change (including support for the efficient use of energy to reduce dependence on volatile oil markets);
  - continuing to strive for the successful conclusion of an ambitious, balanced and global agreement in the Doha Round, and to promote a better coordinated international response to food price escalation exacerbated for example by export restrictions;
  - working with the international community to provide assistance to the most affected countries and, in the longer term, support for actions aimed at reducing imbalances between supply and demand for food in the least developed countries.