



## Talking point



### Bread and butter hit the headlines

## Food price hikes: No concern for German inflation but cheap food is over globally

August 16, 2007

German shoppers have been paying more for groceries lately, up to 50% more for butter within a few days. Spending 10 cents more for a litre of milk may be noticed by individual consumers and painful for some, but the effect on the overall economy is hardly a cause for concern. Even if yearly foodstuff inflation doubled this year, this would just add 0.15 percentage points to the overall inflation rate. Moreover, the current high world prices for many agricultural commodities are partly the result of short-term factors such as recent falls in output due to drought (e.g. for grains in Australia in 2006 and currently in Europe).

Given the particularly fierce competition in the retail sector, German food prices are low compared to its European neighbours. But the big picture is that, relative to the past, food prices are expected to stay high or even move higher for structural reasons. A typical family in the developed world has been spending around 10% of their income on food, compared to 40% 50 years ago. Indeed, mechanization and the Green Revolution caused a steady fall in the real price of food. At the same time, the increase in labour productivity allowed for rising wages, hence higher spending beyond the basics. Now, consumers world-wide have to get used to spending slightly more on food: several factors are indeed converging to drive food prices up.

1. **Growth in global demand.** Not only is the global population continuing to grow, but many developing and emerging countries are starting to consume a significant amount of dairy products and meat. In 10 years from now, due to income growth and increased eagerness to adopt western lifestyles, non-OECD countries are expected to eat 60% more cheese, 30% more butter and 40% more meat (based on data from the OECD-UN Agricultural Outlook 2007-2016).

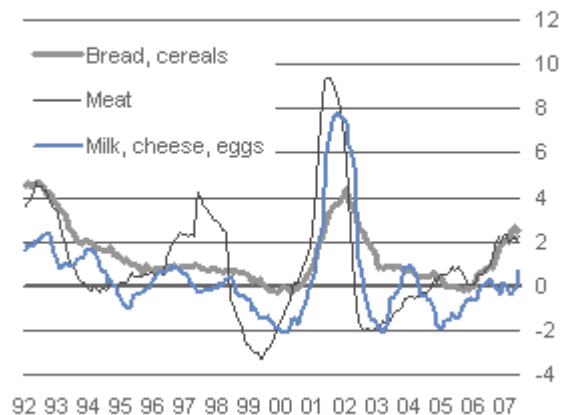
2. **The rising importance of biofuels.** In the context of renewable energy, biofuels enjoy broad-based support because they hold out the promises of countering global warming by reducing CO<sub>2</sub> emissions, and diversifying energy supplies, while providing new sources of income for farmers. The EU is increasingly turning towards ethanol, made mostly from wheat and corn, in addition to biodiesel from oilseeds. Even if part of the supply comes from imports, producing substantial amounts of wheat and rapeseed leads to tough competition for land usage. In Germany, in 2006, grain growers had to make do with 55% of the total farm land, the lowest level since 1995. Hence a rise in grain prices.

In parallel, a rise in oil prices, due to rapid economic growth in Asia, has pulled up the price of biofuels, making it even more attractive for farmers to switch from food for humans or cattle to fuel crops.

Second-generation technologies using other sources of biomass (cellulose from wood or even waste, instead of the starch of edible crops) are expected to solve the food or feed vs. fuel trade-off in maybe a decade.

### Storm in a tea cup

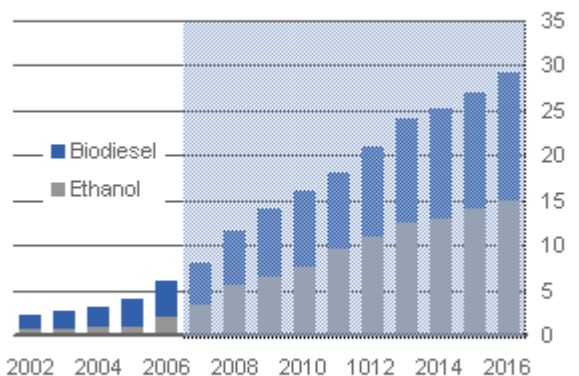
Consumer price indices, % yoy



Source: German Statistical Office

### Thirsty for biofuels

Biofuel use in the EU, billion litres



Ethanol and biodiesel data before 2006 refer to production, from 2006 to 2016 to consumption

Sources: EU Commission, OECD

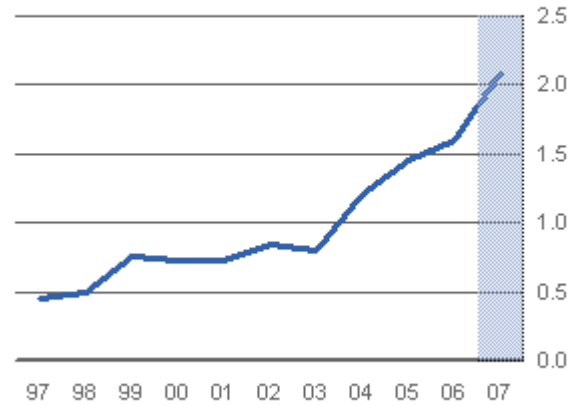


This type of debate is largely dependent on policies aiming at increasing the use of biodiesels. The EU wants biofuels to make up 10% of its fuel mix by 2020, and Ms. Merkel is looking at a 17% target.

- Policies.** Past agricultural and trade policies in industrialised countries have successfully led to the reduction of surpluses and thus contributed to higher prices. The expectation that world market prices are moving on a higher plateau may facilitate further policy reform away from price support, with less border protection (tariff reductions) and fewer output restrictions. There are currently moves within the EU to reduce the milk quotas, or even to get out of the quota system before 2015. Now is the first time since the regulation was established in 1968 that prices are again ruled by the law of supply and demand. Giving the farmers the freedom to choose how much to produce is a way to control prices in the long-term.

### Land for oil at record levels

Acreage of land for growing renewable energies in Germany, million hectares



Source: Fachagentur Nachwachsende Rohstoffe

Apart from policy reforms promoting the liberalization of agricultural markets, another factor on the supply side may exert downward pressure on prices. The Green Revolution has just started in many countries, and agricultural output is expected to rise as it unfolds, thus affecting future prices downward.

On the overall, consumers have to be prepared to spend more on staple foods. Much of the recent price increases can be explained by short-term production shocks and resulting supply/demand imbalances, but longer-term influences are also at work. Expanding food demand in developing countries as well as budding demand for biofuel crops are driving prices up until an equilibrium is reached. The FAO (Food and Agricultural Organization) expects grains and oilseed prices to fall in the medium term below current or recent peak levels, but meat and dairy prices to climb further before reaching a plateau. The timing and level of the equilibrium will be affected by the viability of cellulosic biofuels, future oil prices, as well as agricultural and trade policies. Policy-makers need to look at this debate in a holistic way as it interconnects food, energy, and the environment, while impacting the big North/South, rich/poor, urban/rural issues.



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