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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

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1. INTRODUCTION

In the second half of 2007, agricultural commodity price increases accelerated and by early 2008 reached exceptional levels. These price hikes caused a rapid increase in consumer food prices, which reduced EU household purchasing power by around one percent. Low income households were hit even harder.

In response, the Commission¹ proposed to better monitor developments in agricultural commodity and food prices; analyse the impact of speculation on agricultural commodity prices; and investigate the functioning of the food supply chain. The June 2008 European Council asked the Commission to report back on these issues by December. This Communication responds to this request.

Agricultural commodity prices have decreased sharply over the past months. However, the structural causes of the price hike, like the growth in global food demand and the decline in food crop productivity growth, remain in place. To keep the balance in the global supply and demand for food, continued efforts are needed to ensure that agricultural production responds to market signals and an open trade policy should be promoted. By agreeing the Health Check of the CAP, the European Union has taken decisive steps to facilitate farmers' responses to changing market conditions. Moreover, the Doha Round of WTO trade talks aims to open up agricultural markets to developing countries. Incentives and assistance to raise the production potential in developing countries could also contribute to increasing global food security.

At the same time, there is an increased concern about renewed price volatility. The swings in agricultural commodity prices have been accompanied by a surge of investment flows in related financial derivatives. This raises the question about the role that speculation has played in determining prices and whether misalignments from economic fundamentals have occurred. Continued surveillance of the agricultural commodity markets is required, in order to assess how excessive volatility and the build up of herd like speculative positions can best be avoided in view of the damage that these may cause.

Against the background of the economic slowdown, it is more important than ever to ensure that downwards movements in commodity prices are transmitted to consumers without delay and to raise the competitiveness of the agricultural, food processing and distribution sectors. This is fully in the spirit of the European Economic Recovery Plan put forward by the Commission on 26 November 2008, which highlights the need to swiftly stimulate demand and boost consumer and business confidence. Identifying and resolving problems in the functioning of the food supply chain in terms of regulation and competition is key to achieving this objective.

This Communication is organised as follows. Section 2 reviews developments in agricultural commodity prices and provides an outlook for the medium-term. The contribution of speculation to agricultural commodity price developments is analysed in Section 3. Section 4 investigates the functioning of the food supply chain. Section 5 sets out a roadmap to remedy problems identified and Section 6 concludes.

¹ Communication for the Commission on "Tackling the challenge of rising food prices – Directions for EU action", COM(2008)321

2. DEVELOPMENTS IN AGRICULTURAL COMMODITY AND FOOD PRICES

2.1. Developments in the market prices of agricultural products

The surge in agricultural commodity prices resulted from a combination of structural and temporary factors. Structural factors such as global population growth, rising incomes in emerging economies and the development of new market outlets have contributed to a gradual rise in world demand. Global supply was unable to keep pace due to a slowdown in the growth of food crop grain yields and the characteristics of world agricultural markets which are thin and typically constrained by the seasonality of production. Moreover, increasing production costs, due inter alia to rising energy prices, spilled over on agricultural commodity prices. The impact of these structural factors was amplified by large production shortfalls resulting from adverse weather conditions and trade restrictions imposed by several exporting countries. Exchange rate developments, growing speculative activity in the commodity derivative markets and the close relationship between agricultural and other commodity markets, such as the oil market, also affected agricultural commodity price developments. The contribution of these various factors varies between sectors. For example, changes in wheat and rice prices are largely attributable to supply-side factors while maize and soybean markets have been mainly driven by a strong growth in global demand both for meat consumption and for industrial use.

Commodity prices have sharply declined over the most recent months and have come back to levels similar to or even below those before the price spikes. Moreover, the global economic uncertainty raises concerns about possible renewed price volatility. The effect of some of the short-term drivers which amplified the increase in agricultural prices in the second half of last year has diminished due to more favourable weather conditions, declining energy prices, lifting of export restrictions. Moreover, global supply has responded swiftly and strongly to higher prices, supported by a relaxation of production constraints in the CAP, notably the suspension of mandatory set-aside of arable land and the increased milk quotas from 2008 onwards. For example, world wheat production is projected to have reached an all-time high in 2008 leading to a considerable decline in wheat prices.

2.2. Developments in the consumer prices of food products

Since agricultural commodities make up only a small proportion of the overall production costs of food, food consumer prices have increased more slowly than agricultural prices. For example, the cost of wheat in a loaf of bread represents on average less than 10% of the final consumer price.

Nevertheless, the increase in consumer food prices during the summer of 2007 and up to early 2008 was significant. Together with oil price increases, international agricultural commodity price movements have had a major impact on inflation in the EU over the past year. From August 2007 until July 2008 food price inflation (excluding alcohol and tobacco) accounted for around 1.0 percentage points (pp.) of total inflation. This contribution can largely be attributed to price developments in the processed food category (mostly driven by "bread and other cereals based" products as well as "dairy" products).

The differences observed in price developments between processed and unprocessed food appear mostly due to "composition" effects. The category "Processed food" includes food products that are produced on the basis of commodities most affected by the international price increases, notably cereals and dairy products. The input costs for the category "unprocessed food" – including meat and fish – have increased much less. Moreover, the sharp increases in fuel prices may have had a greater effect on processed food prices.

The contribution of food price inflation to headline inflation varies across Member States with the largest contributions recorded for the new Member States. Parts of this variation can be explained by differences in the weight of food in consumer expenditure, which is typically higher in countries that have lower per capita GDP. The 16% of Europeans that live below the poverty threshold appear most affected by the food price increases, because their choice of food products is limited and because food expenditure represents a significant share of their budget.

2.3. Outlook for the agricultural markets and food prices

The sharp decline in the prices of agricultural commodities over recent months 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. This suggests that the contribution of food inflation to headline inflation in the EU will normalise over the course of 2009, with food inflation contributing around 0.6 pp. to headline inflation in the EU in 2009 and 0.5 pp. in 2010.

In spite of the major uncertainty surrounding future price developments, structural factors like the growth in global food demand, the development of new market outlets and the long-term decline in food crop productivity growth are likely to hold up prices over the medium-term. This will provide incentives for increasing the production of food, including in developing countries. Prices are also expected to show greater fluctuations than observed over recent decades as stock levels remain relatively tight. As a result, any significant changes to supply or demand could quickly result in higher price volatility.

An improved capacity to adjust production through an increased market orientation combined with adequate safety nets is instrumental in facilitating farmers' response to more volatile market conditions. By agreeing the Health Check of the CAP, the European Union has taken decisive steps in this direction, notably with the abolition of arable set-aside, the gradual phasing-out of milk quotas and the conversion of market intervention into a genuine safety net. This will help agricultural producers to respond better to market signals and to benefit from new opportunities.

2.4. Increasing global production and removing trade barriers

To re-balance the global supply and demand for food, agricultural production should respond to market signals and an open trade policy should be promoted. The restrictions on agricultural exports imposed by some countries last year did more harm than good because they cut off market signals and discouraged farmers from producing more to meet the growing demand. The Doha Round of WTO trade talks promises to open up agricultural markets to developing countries. The EU remains committed to reach agreement on an ambitious and balanced outcome of the Doha

Development Agenda and will make positive contributions to achieve such an outcome.

To increase the production potential in developing countries, it is essential to improve the business environment of farmers, for instance through better access to credits, inputs and information. This requires investment in rural infrastructure, as well as reforms in agricultural policies, institutions and land management regimes. Long-term food security requires a more sustainable use of land and water, as well as the introduction of agricultural practices adapted to a changing climate. In order for agricultural supplies to keep pace with longer-term global demand trends, continued efforts to strengthen productivity growth in agriculture is also important, inter alia by enhancing agricultural research and innovation. EU development assistance will support such efforts in developing countries. This is expected to generate a positive supply response in the medium to long term.

The European Commission has also taken a major initiative by proposing the establishment of a 1 billion rapid response facility². This facility, expected to be approved by the Council and the European Parliament in the coming weeks, will focus on supporting an agricultural supply response in developing countries in the short to medium term.

3. THE ROLE OF SPECULATION IN FOOD COMMODITY PRICES

Over the past decade, the financial markets for agricultural commodities have experienced unprecedented growth as reflected by increased liquidity, wider participation, consolidation and the emergence of new exchanges and electronic trading platforms. At the same time, the range of strategies employed in commodity trading has broadened and new derivative products have been developed. Over time, investor interest in these derivatives has been growing.

Two main categories of participants can be distinguished in the markets for agricultural commodity futures: commercial players, who are the main operators involved in the purchase and sale of physical positions, and financial investors such as hedge funds, investment funds and sovereign wealth funds. While speculation based on market fundamentals helps to facilitate risk management and price discovery, the considerable increase in the activities of non-commercial players in recent years has increased the risk for speculative bubbles in agricultural commodity futures markets.

Since the beginning of 2006 there has been a surge in investment flows into these markets, as reflected in the total number of outstanding futures contracts held by market participants. In addition to the surge in commodity derivative markets there has been since 2007 a substantial increase (in the order of 30%) of derivative activity in the OTC (over the counter) market which is less transparent than the activity in agricultural commodities exchanges. The inflows to the market for agricultural commodities futures may reflect an investor withdrawal from other markets, notably for structured products, which intensified sharply with the emergence of the financial crisis in mid-2007. Similarly, the recent abrupt outflow of investment from the

² Proposal for a Regulation of the European Parliament and of the Council establishing a facility for rapid response to soaring food prices in developing countries, COM(2008) 450

agricultural commodities futures market could be indicative of a bursting speculative bubble as investors were obliged to find additional liquidity as a result of the general financial crisis.

However, given the short period, only a weak quantitative relationship can be established between the upward movement in futures prices and spot prices. A close examination of the spreads between spot prices and 12-month future prices does not provide clear evidence that rising futures prices have tended to pull spot prices higher.

In any event, in recent years there has been substantial divergence for some commodities (notably wheat, soya and maize) between spot and future prices, which may well have made it more difficult for commercial operators to use future markets for traditional hedging activities, raising questions about the efficiency of the markets in achieving price discovery and hedging opportunities.

In conclusion, while the coincidence of rising commodity prices and a surge in investment flows into related derivatives is striking, not all of the analytical evidence supports the view that speculation has played a significant role in the price formation process. It would therefore seem appropriate to continue monitoring the markets for agricultural commodities futures in the period ahead and investigate actively how excessive volatility and the build up of herd like speculative positions can best be avoided in view of the potential damage that these may cause. On this basis, the Commission will examine the possibility of taking regulatory initiatives in this field.

4. THE FUNCTIONING OF THE FOOD SUPPLY CHAIN

Global demand and supply developments have been one of the main determinants of the rapid increase in food prices observed. Nevertheless, problems in the functioning of the food supply chain, either in terms of the degree of competition or concerning regulation may have played an important role as well. In the present economic conditions, it is therefore particularly important to analyse how to improve the functioning of the food supply chain and, in particular, to better understand the transmission mechanisms linking commodity prices with producer and consumer prices. This would help identify appropriate measures in support of the consumer's purchasing power and the competitiveness of the sectors involved.

The food supply chain connects three economically important sectors: the agricultural sector, the food processing industry and the distribution sectors. These sectors account for 6% of EU value added and 12% of EU employment. As the food processing industry and the distribution sectors have many interactions with other sectors, market malfunctioning along the food supply chain can have significant repercussions. The slow productivity growth in these sectors in comparison with the US indicates that there is room for efficiency improvements. A pro-active competitiveness policy, such as currently discussed by the High Level Group on the Competitiveness of the Agro-Food Industry³, including research and innovation policies

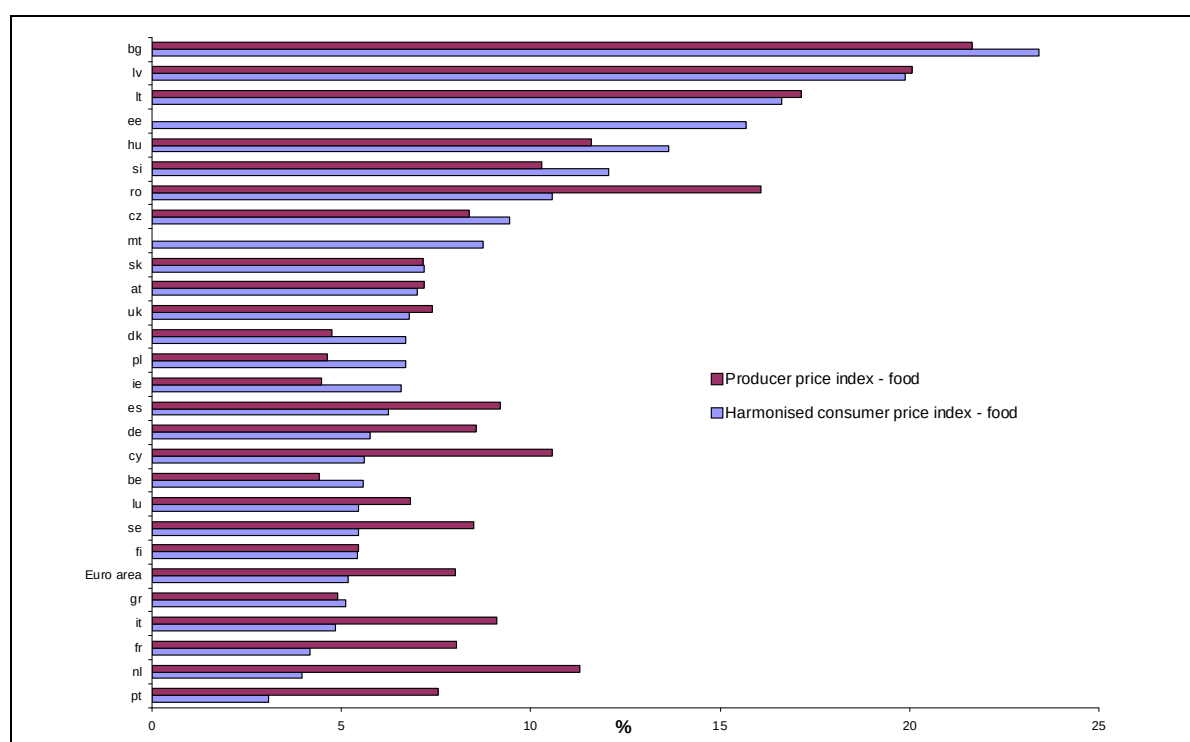
³ The High Level Group on the Competitiveness of the Agro-Food Industry, bringing together representatives from the Commission, Member States, the European Parliament, the food industry, the agricultural sector, retailers and consumers, was set up by Commission decision on 28 April 2008. Its mandate is to examine issues affecting the present and future competitiveness of the Community agro-food industry and on that basis to formulate sector-specific recommendations addressed to policy makers at the Community level

financed through the Community Framework Programmes, could contribute to such improvements.

The shock caused by the recent upsurge in agricultural commodities and energy prices has been absorbed differently across Member States, as shown by the differences in national food price increases. This is an indication that the EU market for food products is still fragmented. While in France, Poland and the UK, changes in producer prices have roughly tracked changes in input prices, albeit with a small time lag, in the other large EU Member States this seems to be much less the case, which might reflect the bargaining power of some food producers.

Looking at downstream markets, the transmission of producer price increases to consumer prices has generally been faster in the new Member States. In most euro area countries increases in consumer prices started to lag behind producer prices from mid 2007 onwards (see figure 1). This could be an indication that competitive pressures in the food retail sector in the euro area absorbed some of the increase in producer prices. Similar differences can be observed as regards price stickiness. In euro area countries, consumer food prices appear to have come down rather quickly following the recent decline in agricultural price levels whilst in the new Member States consumer prices have reacted more slowly.

Figure 1: Change in consumer and producer food prices



Source: Eurostat. August 2007 – July 2008 (yoy change).

Cross-country differences in the regulatory framework also appear to have contributed to the fragmentation of the Single Market along the food supply chain and have hampered its functioning. In particular, entry restrictions on large retailers may have led to higher prices and lower productivity. Similarly, restrictions of sales-below costs have tended to set a price floor which limits price competition and increases stock-management costs, even if such regulations were primarily designed to deter predatory behaviour to the detriment of smaller market operators. Moreover, regulations on opening hours raise retailers' costs by limiting the

possibility to sell products and by increasing operational, logistics and infrastructure costs of large retail outlets. However, one needs to bear in mind that these different regulations may have been designed to achieve other policy objectives that must not be overlooked when assessing their overall impact.

Looking at the competitive environment, the degree of bargaining power held by the firms in the respective sectors along the chain varies by product category. Food producers offering (internationally) branded products due to the 'must-have' status of such products tend to have a stronger bargaining position versus retailers. On the contrary, producers of non-differentiated products, for which brand awareness is not high, are likely to be in a much weaker position.

The asymmetry of bargaining power between agricultural producers and the rest of the supply chain has kept producer margins in the agricultural sector under strong pressure. In response, agricultural producers have adopted a wide range of strategies, including the creation of producer groups and cooperatives, the development of contractual arrangements with processors and retailers, and the development of high-value added quality products, for instance by participation in voluntary certification schemes. These schemes are useful for producers in rebalancing the asymmetry of bargaining power in the food supply chain as well as for consumers and the environment. However, the lack of mutual recognition between some of these schemes required by retailers can create entry barriers if joining several schemes involves excessive financial and administrative burdens, especially for small-scale producers.

Consolidation is taking place throughout the food supply chain. While production in some food processing sectors, such as processed fruits and vegetables, remains highly dispersed, in other sectors, such as starch, sugar and dairy products, it is more concentrated. The retail sector is increasingly dominated by large food retailers and cross-border retail chains. Consolidation can lead to efficiency gains resulting from economies of scope and scale, achieved for example through lower logistic costs, which would put downward pressure on prices.

Competition authorities at the same time need to make sure that the on-going consolidation process does not worsen upstream and downstream competition conditions at the local level to the detriment of consumers and businesses. A number of practices which may merit a closer assessment, on a case-by-case basis, always considering the context in which they take place, are:

- Cartels are hard-core restrictions of competition. Recent experience shows that cartels can occur in the food sector and that they are of varying territorial scope. Cartels constitute very serious anti-competitive behaviour which once identified should be targeted as a priority by enforcers.
- The size and number of "buying alliances" in the food sector has grown considerably throughout the EU leading to increasing concerns expressed by food producers. On the one hand, such agreements may lead to efficiency gains from economies of scale within the Single Market. On the other hand, they can be used as a tool for obstructing rivals' access to essential inputs at competitive conditions and/or for competitors to engage in collusive behaviour on downstream markets.

- On a vertical level, practices relating to resale price maintenance are considered hard-core restrictions of competition. Such practices which restrict the buyer's ability to determine its sale price mean that distributors can no longer compete on price, leading to a total elimination of intra-brand price competition
- Other vertical agreements such as single branding obligations, which require retailers to sell a single product, and certain tying practices, which make the purchase of a product conditional on the purchase of another product, may have either pro-competitive or anti-competitive effects. In terms of negative effects, the main competition risks would be the foreclosure of the market to competing and potential suppliers or a loss of in-store inter-brand competition. Similarly, the increased use of private label products by retailers may lead to foreclosure of existing and potential competing suppliers. This could reduce the number of product items on the shelves, thereby limiting consumer choice.
- Exclusive supply agreements, which oblige the supplier to sell the goods specified in the agreement to one buyer only, can lead to a foreclosure of other buyers/retailers within the food supply chain. Certification schemes can be mentioned as an example of arrangements that could indirectly compel the suppliers to sell to only one buyer.

Table 1 provides an overview of the above described practices, which may give rise to competition concerns.

Table 1: Overview of main practices that may give rise to competition concerns

Practice	Description	Main competition risk
Cartels	Agreements among competitors relating inter alia to price fixing, output restriction and market partitioning	Maintenance of high prices and stalling of innovation to the detriment of consumers. Cartels constitute very serious anti-competitive behaviour
Purchasing agreements	Agreements concluded by competing buyers for the purpose of jointly buying certain inputs	Under certain conditions, tool for foreclosing rivals' access to essential inputs at competitive conditions; collusive behaviour between competitors on downstream markets
Resale price maintenance	Restriction of the buyer's ability to determine the sale price to end consumers	Reduction of price competition
Single branding	Obligation or incentive scheme which makes the buyer purchase practically all of his requirements on a particular market from only one supplier, for a certain duration	Possible restriction of in-store inter-brand competition and/or foreclosure of the market to competing and potential suppliers
Private label products	Products made by third parties upstream in the supply chain and sold under retailers' brand	Possible foreclosure of suppliers' competing goods; restriction of in-store inter-brand competition
Tying	Purchase of a product (tying product) made conditional on purchase of other product (tied product)	Possible foreclosure on the market of tied product, and indirectly of the tying product
Exclusive supply agreements	Direct or indirect obligation causing a supplier to sell a good only to one buyer	Possible foreclosure of other buyers / retailers

Certification schemes	Requirement to comply with a number of conditions set by individual buyers	Potential risks of foreclosing competing buyers
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5. A ROADMAP TO IMPROVE THE FUNCTIONING OF THE SUPPLY CHAIN

A joint effort at Community, national and local levels is necessary to put in place framework conditions for an improved functioning of the food supply chain. This effort is necessary to ensure that the integration and consolidation of sectors along the food supply go hand in hand with fair earnings of agricultural producers, competitive prices and improved competitiveness of the food processing industry as well as greater choice, better affordability and higher quality of food products for European consumers. Moreover, unjustified regulatory constraints holding back efficiency and limiting competition should be removed.

On the basis of the above analysis, this Communication proposes a roadmap to improve the functioning of the food supply chain. The roadmap contains a variety of initiatives and should evolve over time as knowledge of the food supply chain deepens. It should also benefit from a wide consultation of relevant stakeholders. The proposed roadmap consists of four main components.

5.1. Promote the competitiveness of the food supply chain

A pro-active competitiveness policy would help to improve the efficiency along the food supply chain. The recommendations from the High Level Group on the Competitiveness of the Agro-Food Industry expected in early 2009 should help the food supply chain to improve its overall competitiveness and thus its resilience in response to price shocks.

5.2. Ensure a vigorous and coherent enforcement of competition and consumer protection rules in the food supply markets by the European Commission and National Competition and Consumer Authorities

In order to identify and address all types of potential anticompetitive practices which may lead to the malfunctioning of the food supply chain, the Commission will in the context of the European Competition Network continue a sustained dialogue with National Competition Authorities, so as to ensure a coherent and well coordinated enforcement of competition rules throughout the EU, to the benefit of European consumers. Based on the analysis of market developments, investigation should be targeted at those restrictions of competition and/or specific practices which have the highest potential to distort competition to the detriment of consumers (see table 1 for a non-exhaustive list).

Moreover, at a time of sharply fluctuating food prices, the risk of misleading price advertising increases. For example, consumers may be misled by suppliers altering pack size or contents in order to apparently maintain the same price for the relevant product. It is particularly important for consumers to be able to compare the unit price accurately. National consumer protections authorities should therefore pay particular attention to the enforcement of the Directives on unfair commercial practices and unit pricing.

5.3. Review at national and/or EU level, as appropriate, regulations that have been identified as potentially problematic for the functioning of the food supply chain

Several types of regulation have been identified as potentially problematic. First, regulations that restrict entry of new companies into the market need to be scrutinised and removed where appropriate, while keeping in mind their environmental and social goals. Such screening will be carried out in the context of the retail market monitoring and the transposition of the Services Directive. Second, regulations which restrict business' ability to compete on prices should be examined at a national level. Third, practices which distort the relationship between suppliers and retailers should be discouraged. This is for example the case for late payments, unjustified or excessive fees paid by suppliers for services provided by retailers or tempting consumers with misleading offers. In this context, the introduction of codes of conduct would be welcome as an expression of retailers' social responsibility and national codes of conduct should be reviewed. Finally, and more generally, regulations on shop opening hours could deserve examination at national level in view of their impact on food prices, based on consultations of social partners and taking into consideration their social and environmental effects.

5.4. Provide better information to consumers, public authorities and market operators by setting up a permanent European monitoring of food prices and the supply chain

This monitoring tool should address the lack of transparency of prices and improve the knowledge of the impact of regulation along the food supply chain.

The continued monitoring of producer and consumer prices of a set of selected and comparable consumer goods would reveal price differentials across Europe and help identify cases of market fragmentation. There appears to be a lack of sufficient comparable price and quality information that would empower consumers to make better-informed choices. In this context, the pilot project currently run by Eurostat and the National Statistical Offices to collect detailed consumer prices data should be evaluated and developed.

Within the framework of its market monitoring exercise the Commission is reviewing regulations impacting the functioning of the retail markets. The issues identified above are likely to affect retail sub-sectors other than food and will thus be treated in more general terms. Details on the implementation and functioning of this monitoring tool will be developed in the follow-up of the current exercise in 2009. In developing this tool, consideration should be given to services and information offered by existing public and private price monitoring resources, national or international ones.

5.5. Examine measures to discourage speculation to the detriment of commercial operators in agricultural commodity markets

The Commission considers that there is a need to avoid the effects that excessive speculation has on food prices. In particular, the Commission is of the opinion that such a degree of volatility as the one observed during the recent months benefits neither producers nor consumers. For this reason, the Commission will examine, together with the regulators of commodity markets and in close contact with other

non-EU regulatory authorities (in particular the US where the most important exchanges are located), what measures contributing to a reduction in price volatility in agricultural commodity markets could be taken. The Commission will take into account for this work, as appropriate, the results of the on-going in-depth review of the supervisory and regulatory framework that is applied to all significant financial market actors, including hedge funds and private equity, with a particular focus on capital requirements, risk management and transparency. The Commission will present initiatives, as appropriate, by summer 2009.

6. CONCLUSION

The sharp fluctuations in agricultural commodity and food prices at a time of great uncertainty about the economic outlook illustrate the need to improve the functioning of the European food supply chain with a view to enhancing its efficiency and competitiveness. Better regulation and ensuring a vigorous and coherent enforcement of competition and consumer protection rules will contribute to limiting price increases for the benefit of European consumers, in particular lower income households. Moreover, it will also help overcome the present fragmentation of the food supply chain and remove artificial entry barriers for producers, which will help European consumers benefit from the widest possible choice of quality food products. Additionally, this could help rebalancing the bargaining power in the food supply chain.

This Communication proposes a roadmap to be implemented both at Member State and EU level with the active involvement of all relevant stakeholders. On the basis of this work programme and related measures, the Commission will examine the possibility of taking further action and proposes that the European Council revisit this matter in December 2009.

In order to re-balance the global supply and demand for food, efforts to stimulate agricultural research and innovation and open up international markets should be strengthened. An improved capacity to adjust agricultural production through an increased market orientation combined with adequate safety nets is instrumental in facilitating farmers' response to more volatile market conditions. By agreeing the Health Check of the CAP, the European Union has taken decisive steps in this direction that will help agricultural producers to respond better to market signals and to benefit from new opportunities. Given the uncertainties about the evolution of agricultural commodity prices, continued monitoring of the behaviour and performance of markets in the period ahead will be required.