

## Macro Keys

### Food price inflation – is there reason to worry?

#### Economics & Macro Strategy

Global

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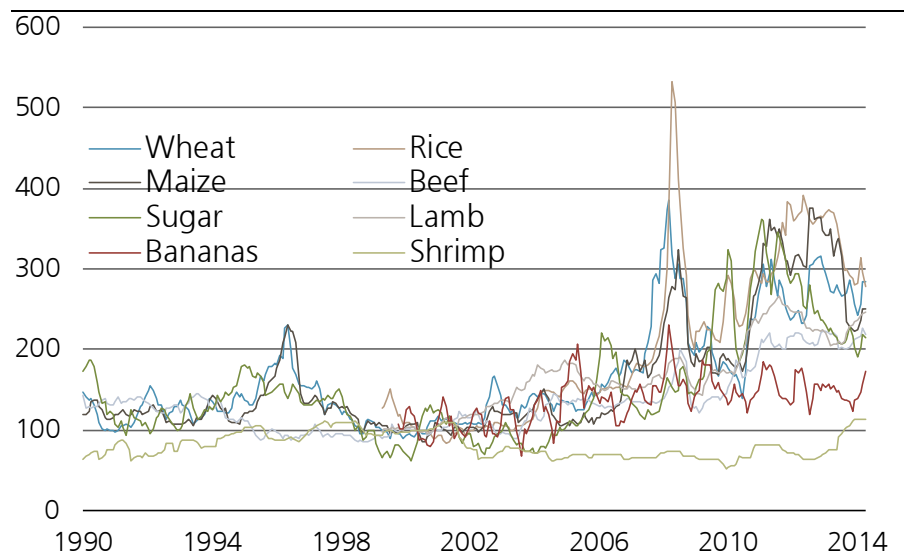
Global Macro Team

Food price inflation is always a highly sensitive political topic. It is also a concept that matters disproportionately in economic terms. Because food is a high frequency purchase, it carries an excessive weight in determining consumers' inflation perceptions. Because the forward looking, inflation predicting talents of consumers are not great, inflation perceptions are disproportionately important in shaping inflation expectations. Thus food (and the other high frequency purchase of fuel) will have a significant impact on consumer inflation expectations.

This means that food price inflation matters, even in OECD economies where food typically approximates between 8% and 15% of the consumer price basket. Consumers' overemphasis of food price inflation means that it is pertinent.

As the following chart shows (albeit in a somewhat messy fashion) there has been a slight upward drift in agricultural commodity prices in the course of the past few months. For some agricultural commodities this is little more than the cessation of price deflation (as with sugar, for instance). For other commodities there seems to be a more noticeable increase in price.

**Assorted agricultural commodity prices in USD terms**



Source: World Bank, Haver

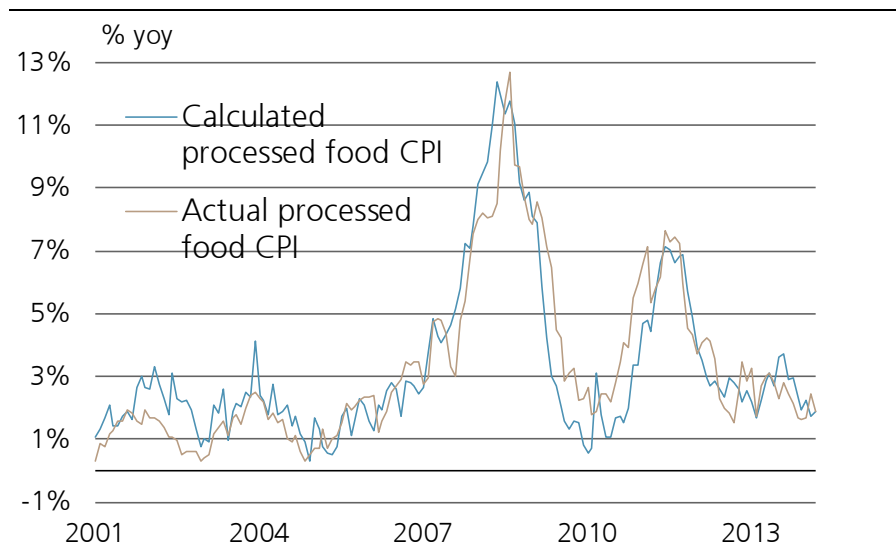
Nonetheless, commodity price inflation is not terribly relevant to OECD economies. This is because so much food consumed within the OECD is processed food, which means that labour costs (involved in processing and distributing food) completely overwhelm agricultural costs in the breakdown of food CPI. Broadly speaking food inflation in the OECD is between 70% and 80% labour costs, with only around 20% from agricultural commodities. The ending of deflation and even the onset of

inflation in agricultural commodity prices is therefore only a minor consideration in assessing food price inflation risks.

A crude way of modelling food price pressures in the OECD is therefore to focus on processed foodstuffs, and to look at the relationship between food retail prices and the costs (including labour costs) that a food retailer faces. This presents a somewhat more varied picture across several economies.

In the UK the price of processed food has actually tracked the model relatively well over the course of the past couple of years. This compares very favourably to the 2010-2011 period when opportunistic pricing meant that food retailers were raising prices noticeably faster than their cost base. With a general election due in May 2015, politics may act to prevent food price inflation rising (at least, rising more rapidly than a cost-based model would imply); increases in food prices in this way would risk provoking unwelcome political attention.

#### UK processed food prices: inflation compared to cost-based model

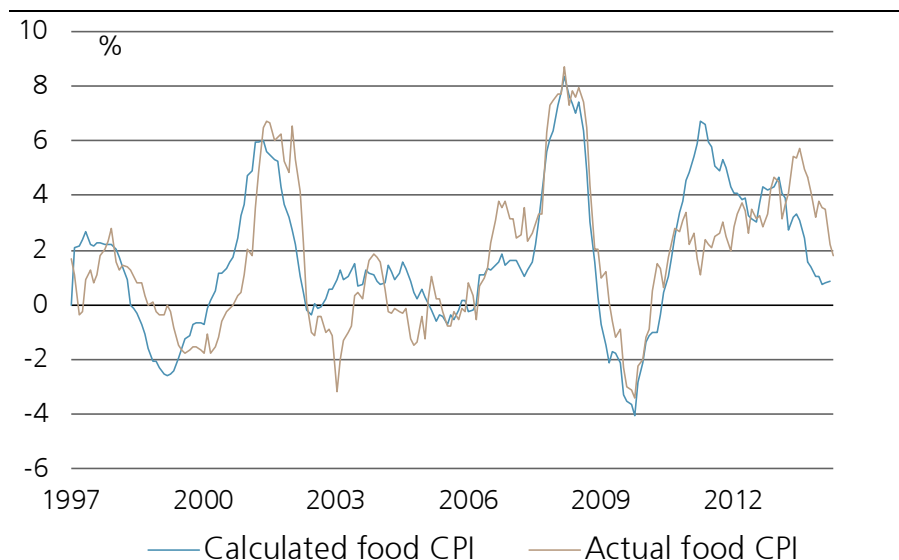


Source: UBS

In Germany food price inflation should be decelerating. This is in part due to the strength of the Euro, acting on the small proportion of food prices that is due to commodity prices. The German model uses total CPI, rather than the narrower processed food CPI, and as such the importance of commodities and thus the importance of a stronger Euro are somewhat more significant.

However, labour costs have also been relatively subdued in the retail sector, and the lower labour costs has had a considerable impact on food price disinflation. In spite of this, processed food prices are not falling as fast in Germany as the costs of food retailers would imply. The full effects of lower wages are not being passed onto the consumer.

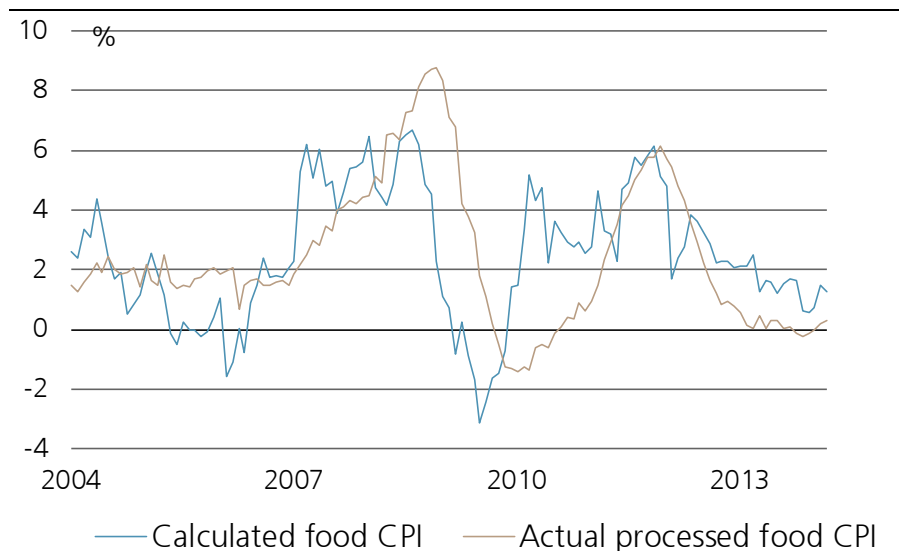
### Germany: total food prices: inflation compared to cost-based model



Source: UBS

In the US there is a contrast again, in that the model of food prices suggests a higher level of inflation (marginally) than is currently being experienced. The food retail sector has been reluctant to pass on higher dollar denominated agricultural commodity prices. Retail sector labour costs have been very restrained.

### US: processed food prices: inflation compared to cost-based model



Source: UBS

Why do food prices in these three particular countries matter? They matter because inflation perceptions and inflation expectations from consumers will have an economic impact when labour markets tighten. Germany, the UK and the US all have relatively tight labour markets. If food price inflation increases inflation perceptions on the part of the consumer then there is a risk of higher wage demands coming through, which will then potentially feed through into higher inflation or squeezed margins in a broader range of economic sectors than food alone.

Of the three countries the UK is perhaps the least vulnerable. Whether because of political sensitivity or increased competition, food prices have been relatively well

behaved relative to the model of food prices. Commodity increases in sterling terms have been muted, and wage pressures limited.

The German economy has more vulnerability as there appears to have been some opportunistic pricing (food prices have risen faster than the model would suggest). It is worth observing that German inflation expectations and perceptions have been relatively elevated compared to the average of the past decade. This is unusual in that it has taken place in the absence of commodity price inflation in Euro terms. If the Euro weakens in an environment where opportunistic pricing has become established then the perception of inflation may rise more rapidly via perceptions of food prices – a fact that may be somewhat disquieting for the ECB and its credibility within Germany, if it is pursuing a more aggressive monetary policy after June.

The United States is the reverse picture of Germany, with retailers keeping prices lower than would normally be the case. This would suggest, however, that any future reduction in agricultural commodity prices in dollar terms is unlikely to be passed onto the consumer. The question is the extent to which higher raw material or labour costs could be passed on in the future, as retailers seek to catch up on the more limited pricing power that they seem to be experiencing today. It is noticeable, for instance, that the price of food measured by the output price of producers (rather than retailers) has risen sharply of late.

Food price inflation is therefore something to monitor, in both an economic and (less directly) a political sense. Both Germany and the US present some interesting possibilities in the recent behaviour of their food prices; in both countries, though for different reasons, there is the potential for upward pressure on food prices, and via that for upward pressure on consumer inflation perceptions.

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