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European Commission

August 2008

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# **MACRO-ECONOMIC POLICY REACTIONS TO SOARING FOOD PRICES IN MEDITERRANEAN COUNTRIES, RUSSIA, THE CIS AND THE GCC**

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August 2008

## **Abstract**

The aim of this study is to analyse the price developments and to compare national macro-economic policies in response to the consumer prices that started to soar in 2007 across the European Neighbourhood Policy countries, the other Barcelona countries<sup>2</sup>, Russia, the Gulf Cooperation Council countries and the euro area. The analyses focus primarily on ag-fla-tion, but we analyse also the capital inflows in view of income levels in the EU's neighbour countries. The analyses unambiguously show that food inflation was pushing up total inflation, even despite the provision of food subsidies by national authorities.

## 1. Introduction

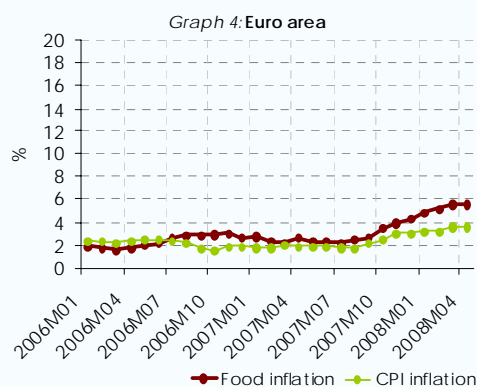
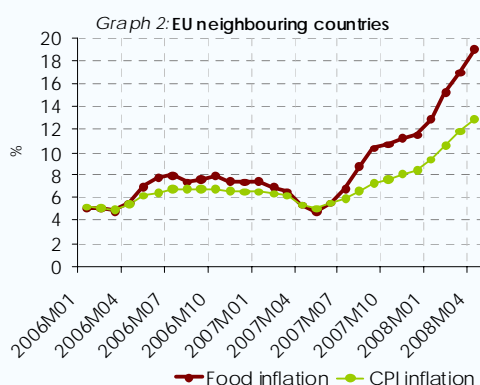
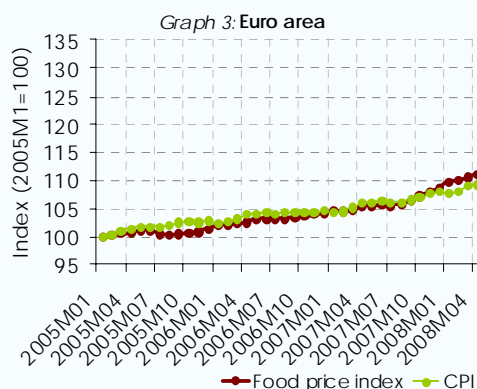
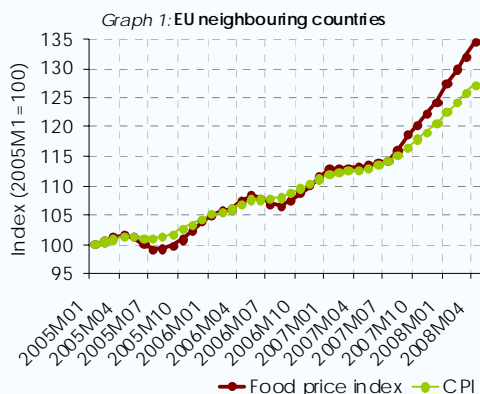
A strong upward trend in inflation started to emerge worldwide in the course of 2007. Consumer prices have been pushed up by soaring energy prices, exacerbated also by fixed exchange rate regimes in combination with huge capital inflows.

Food prices have also surged. The observed price movements are the result of a complex combination of both structural and temporary factors. In a nutshell, an increasing world population, a growing demand for higher "value added" food (including meat and dairy products) in emerging economies and the emergence of alternative market outlets, in particular biofuels, have contributed to dynamic demand for agricultural commodities outstripping the growth in global supply. This has led to tighter agricultural markets than in the past with historically low levels of international stocks that have apparently been unable to absorb major weather-related supply shortfalls in important producing countries. Further contributing factors have been the surge in energy prices, export restrictions imposed by a number of countries to avoid domestic shortages and the depreciation of the US dollar. Speculation has also been mentioned as a potential factor, although there is no conclusive evidence on its impact on food prices so far.

Almost all European Neighbourhood Policy (ENP) and Barcelona process countries are suffering from the higher food prices. Being by and large middle income countries they spend a relatively large share of their income on food. In some countries the situation has been difficult. Shortages on the primary food product markets (such as bread and rice) immediately and drastically have been affecting the ability of households under the poverty line to meet their basic needs. In addition to these problems, the soaring consumer prices force countries to make strategic policy choices.

The inflation of agricultural commodities ("ag-flation") has macroeconomic policy implications for all EU neighbour countries. Firstly, those fiscal authorities that subsidise agricultural commodities (such as bread and rice) are facing higher fiscal expenditures due to the higher cost of these primary food products. These additional outlays worsen their fiscal balances. Secondly, monetary authorities with a price stability mandate are pushed towards monetary tightening. If the increasing inflationary pressures are mainly caused by rising food prices, this policy may not be effective due to the fact that it is hard to reduce spending on primary food products.

### Box 1.1.1: EU neighbours & euro area – Price developments



The average price indices (graph 1) and average inflation (graph 2) are calculated as the simple averages of the national price index and inflation of EU neighbouring countries, respectively. The underlying national indices and inflation rates are presented in Box 1.1.2 and Box 1.1.3. Here, 13 countries are included where prices for the full period from January 2005 until and including April 2008 were available at the moment of this publication: Albania, Algeria, Belarus, Egypt, Georgia, Israel, Jordan, Moldova, oPt, Russia, Saudi Arabia, Tunisia and Ukraine. The measurement of “food” here mostly includes non-alcoholic beverages, but excludes alcoholic beverages and tobacco.

The coefficient of variation for the CPI inflation is 51-55% and for food inflation 42-53% in the first four months of 2008.

Sources: National Offices of Statistics of the respective EU neighbour countries and the Consultation and Research Institute (Lebanon).

The price index for the euro area is the official Harmonised Index of Consumer Prices (HICP) for the whole euro area (with currently 15 countries). Food prices include both unprocessed and processed food.

The coefficient of variation for the CPI inflation is 26-28% in the first four months of 2008.

Source: ECB.

The aim of this study is to analyse the price developments and to compare national macro-economic policies in response to the soaring prices across the ENP-countries, the other Barcelona countries<sup>3</sup>, Russia, the Gulf Cooperation Council (GCC) countries and the euro area. In our analyses we focus primarily on ag-flation, but we analyse also the capital inflows in view of income levels in the EU's neighbour countries.

Our analyses unambiguously show that food inflation is currently considerably higher than in previous years (2005-2006). Agricultural commodity price inflation is evidently pushing up total inflation, even despite the provision of food subsidies by national authorities.

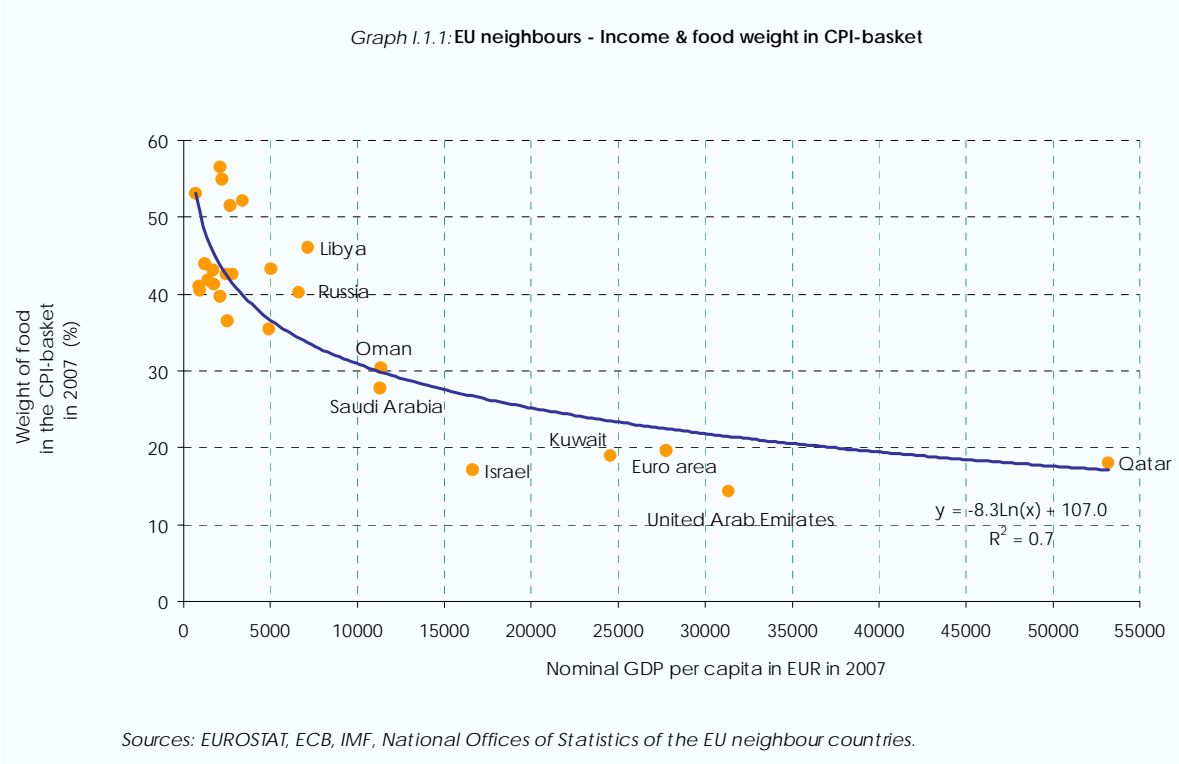
With the exception of Kazakhstan, all EU neighbour countries under consideration in our analyses face severe inflation of which well over 50% was due to food inflation at the beginning of 2008. This holds for the countries that import agricultural commodities (such as Egypt and the occupied Palestinian territories (oPt)) as well as for most of the countries that export agricultural commodities (for example Ukraine and Russia). The countries with a fixed currency regime seem to be suffering even more from inflation under the current circumstances (Jordan, Lebanon, GCC apart from Kuwait). Also, countries differ in their macro-economic policy reactions in response to similar developments (e.g. Egypt and Tunisia). Some countries ease the fiscal stance and tighten monetary policy (Egypt). Some exporting countries resort to price ceilings or agricultural commodity export bans (Kazakhstan, Ukraine).

The outline of this chapter is as follows. Section 2 presents stylised facts of price developments at the national level, such as the contribution of food to total inflation, the income level and the balance of payment characteristics. Section 3 outlines the macro-economic policy reactions in some of the EU neighbour countries. Finally, section 4 summarises findings and overviews the macro-economic policy options that are available, at both the national and the global levels.

## 2. Stylised facts

We observe a general increase in headline or total inflation, usually measured by the growth rate of the consumer price index (CPI).<sup>4</sup> At the same time there is a growing wedge between the developments in the total/headline inflation and the “core” inflation, that excludes the (volatile) energy and food prices. These two features are shared by the EU neighbour countries and the euro area.

In particular, average total inflation in the EU neighbour countries was just above 6% in July 2007 and it increased to 13% in April 2008. This was caused by the sharp rise in food prices from almost 7% to 19% during this 10-months period (Box I.1.1.). Due to the transition that the EU neighbour countries are undergoing, they face a far higher economic growth as well as higher inflation than the euro area. Headline consumer price inflation in the euro area also doubled in the same period from 1.8% to 3.6% while the increase in food inflation more than doubled, from 2.3% to 5.6%.



While agricultural commodity prices are rising sharply in the euro area as well as in the EU neighbour countries, there are visible divergences in price developments across the latter. Food prices in Egypt, Georgia, Israel, Jordan, Lebanon and the oPt have shown stronger increases (Box I.1.2). In these countries, net food-importers, a large share of disposable income is spent on food; these countries are therefore directly affected by the current supply shortages on the world markets. High government subsidies on food products (among others Egypt, Morocco and Tunisia) are masking the actual underlying price developments. So, actual agricultural commodity prices will have soared even more than is visible in Box I.1.3.

Some big agricultural commodity producers (like Russia and Ukraine) have restricted their exports of agricultural commodities, hoping that this would keep domestic food prices at a reasonable level.

Nonetheless, the agricultural commodity exporters Russia and Ukraine have been experiencing soaring national inflation (see Box I.1.2). All in all, the EU neighbour countries under consideration with the exception of Kazakhstan are facing sharply rising food prices. Kazakhstan has been suffering far less from food inflation due to direct price controls.

As stated before, the extent to which food price inflation translates into total inflation depends partly on the share of food in the total basket of goods and services. Most EU neighbour countries spend 35 to 55% of their total expenses on food (Graph I.1.1)<sup>5</sup>. The exceptions are Israel and some GCC countries that spend around 20%, which is similar to the euro area. Food prices pushed up total consumer prices significantly during the last year (see Box I.1.3). At the beginning of 2008, between 60% and 80% of total inflation could be ascribed to food inflation in Albania, Algeria, Belarus, Egypt, Lebanon, Mauritania, Morocco, oPt, Tunisia and Ukraine. In Algeria and Ukraine this percentage reached even 85% in April 2008.

Other factors that have currently been pushing total inflation upwards are the soaring energy prices, the weak dollar (as it concerns non-dollar imports) and capital inflows. Energy price developments have a direct impact on food prices, like on most other goods, due to higher costs for agricultural inputs, transportation and processing. However, the share of food in the CPI-basket that is the direct pass-through, is more than double the share of energy for all these countries. The continuing sharp upward trend of the current food price developments is in general therefore more prominent. It is also more worrying, as the high food prices are directly connected with food shortages (i.e. humanitarian first needs).

For those countries that have their domestic currency pegged to the US dollar (notably the GCC countries except Kuwait, but also Jordan, Lebanon, and until recently *de facto* Ukraine) the weak dollar makes imported goods in other currencies more expensive. Moreover, the

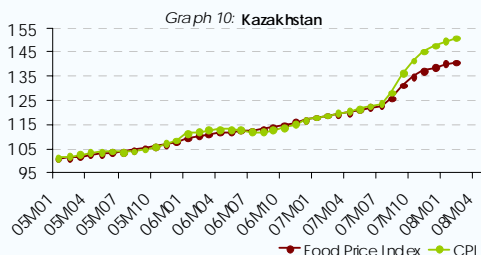
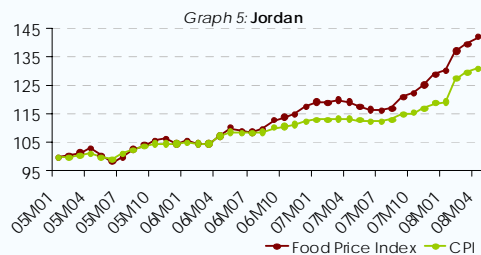
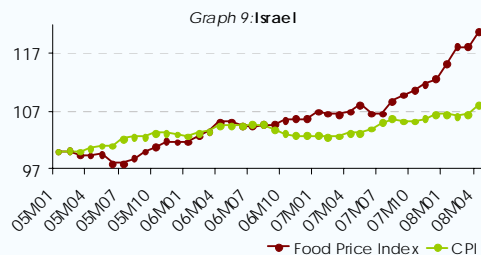
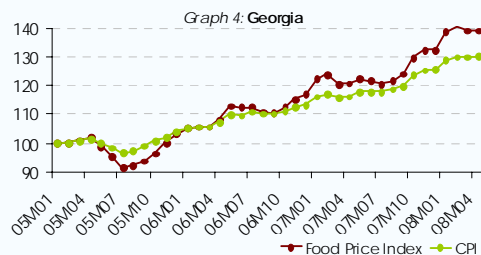
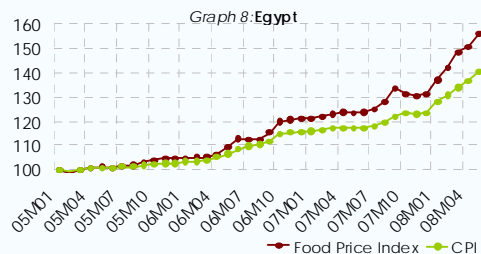
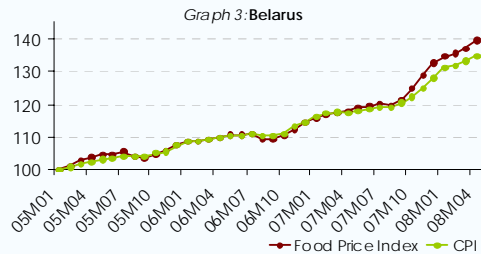
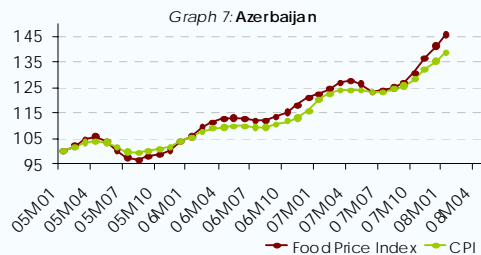
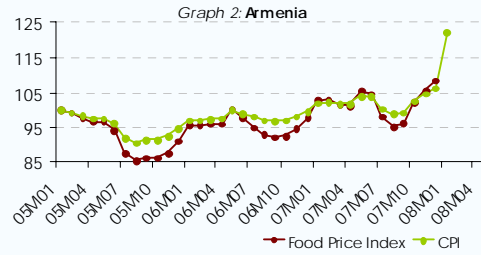
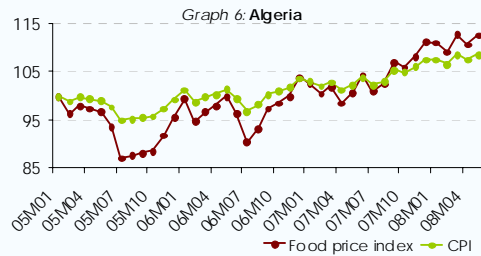
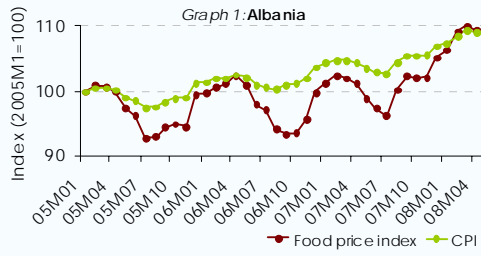
monetary easing in the US has forced them to lower interest rates domestically, which stimulates domestic demand and further fuels price rises. In addition to food price inflation, this causes additional pressure on consumer prices (see Table I.1.1).

While imbalances can be caused by the surge in energy prices and currency pegs in combination with capital inflows, it is soaring agricultural commodity prices that have profound economic and social consequences for societies with high poverty rates. In countries where on average 50% of disposable income is spent on food, the majority of the population live below the poverty line. This part of the population spends even a greater share of income on food. As agricultural commodities are daily needs, the steep upward trend in agricultural prices makes it vital that governments act fast.

Moreover, it is likely that higher food and thus higher total inflation will have second round effects in the EU neighbour countries. These effects will be stronger than in the euro area, due to the lower credibility of central banks. Indeed, price stability is not necessarily the primary objective in some of the EU neighbour countries. In this case there is a risk of second round effects such as wage-price spiralling.

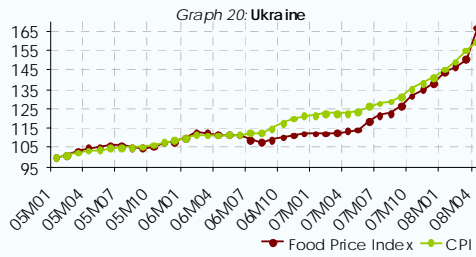
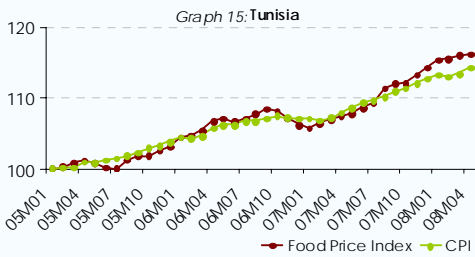
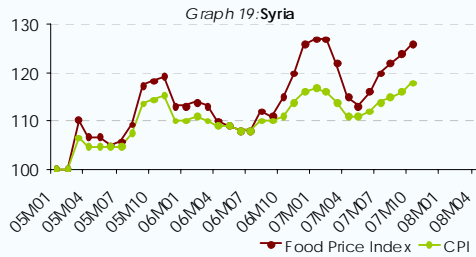
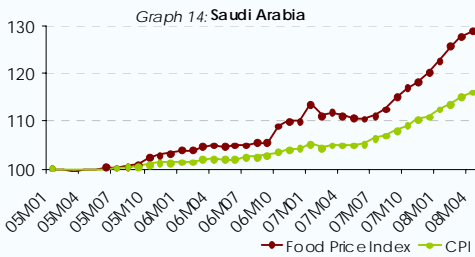
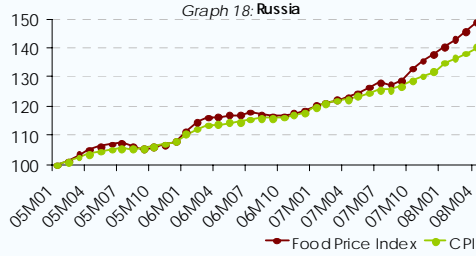
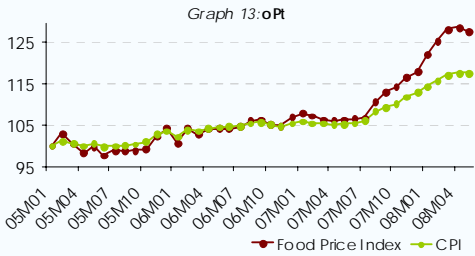
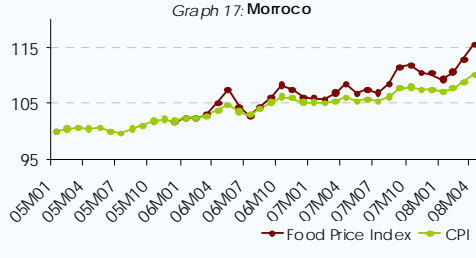
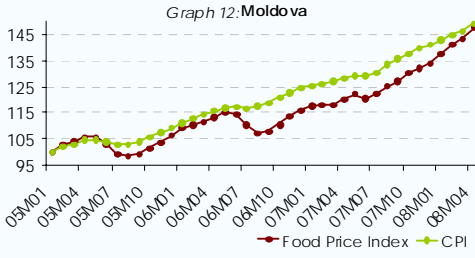
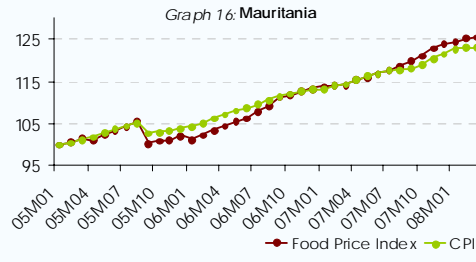
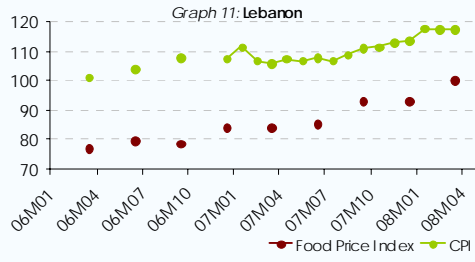


Box I.1.2:EU neighbours – Price developments per country



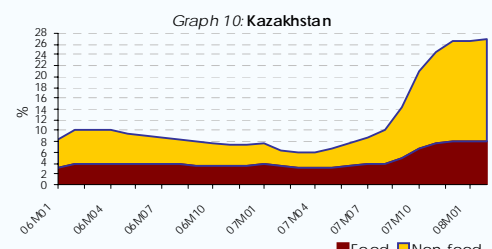
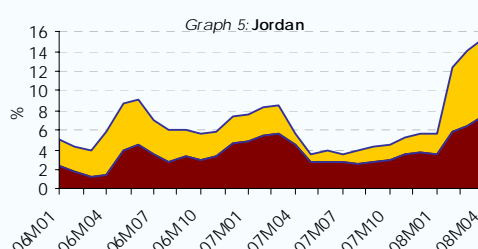
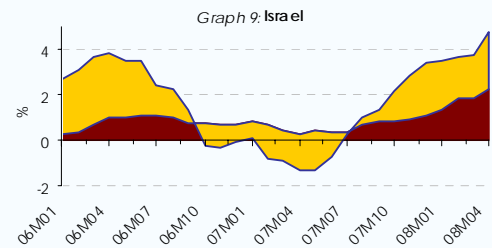
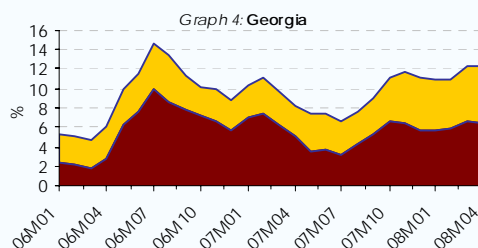
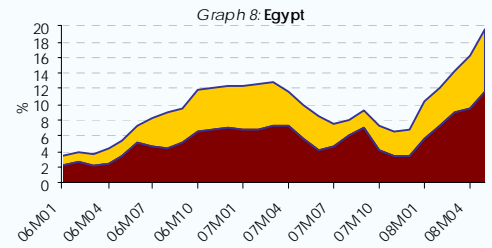
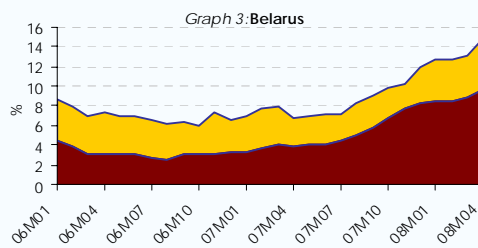
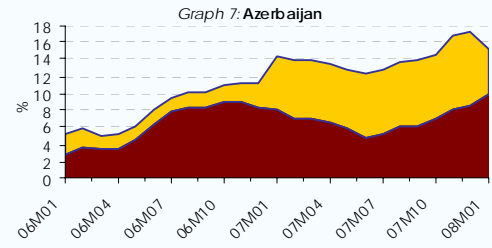
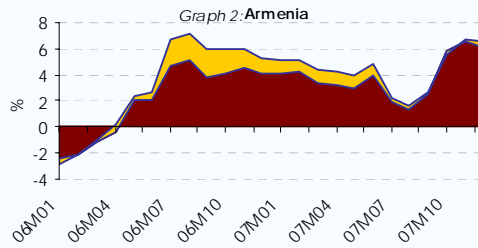
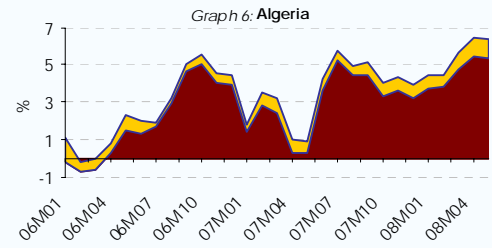
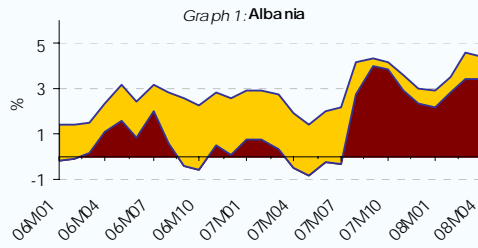
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Box (continued)



Sources: National Offices of Statistics of the respective EU-Neighbour Countries and the Consultation and Research Institute (Lebanon).

**Box 1.1.3: EU neighbours - Food contribution to inflation**

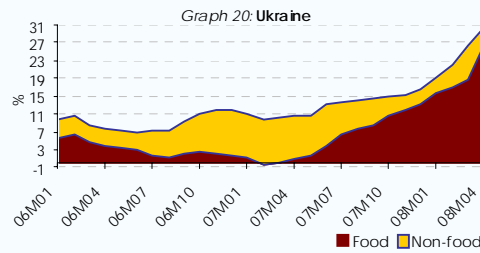
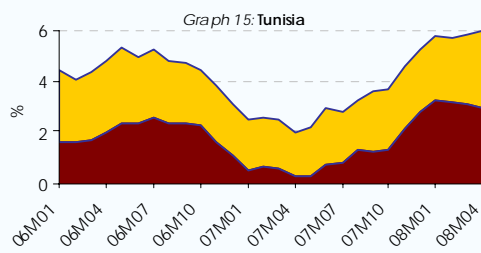
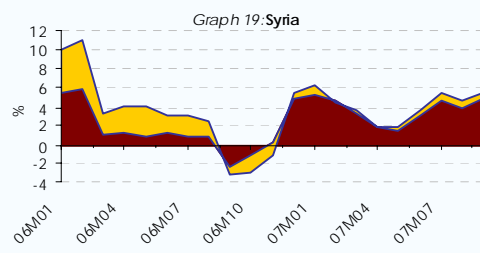
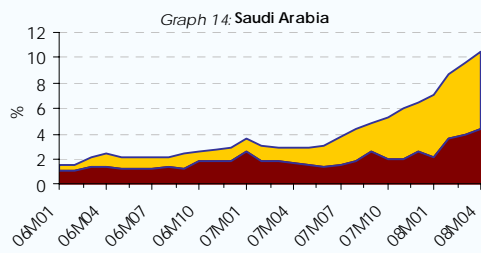
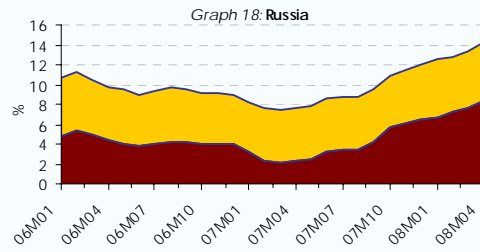
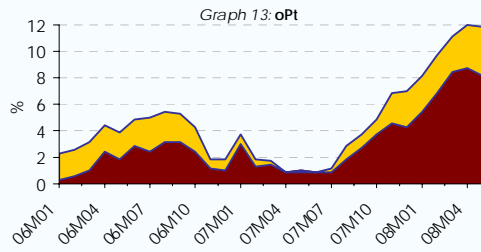
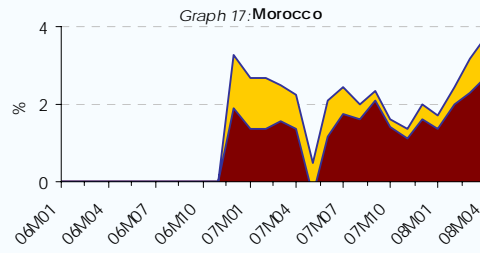
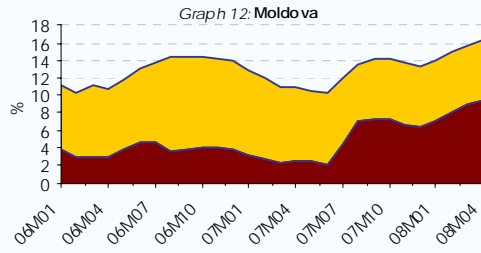
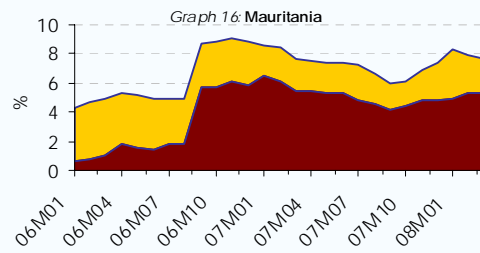
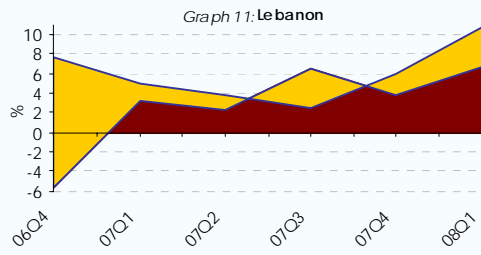


■ Food ■ Non-food

Source: Eurostat, monthly inflation (and CPI) in food and non-food categories in EU countries, the category of food in the basket is defined in Graph 1.

(Continued on the next page)

Box (continued)



■ Food ■ Non-food

Sources: EC Staff calculations from CPIs and food price indices as presented in Box 1.1.2. with the weights of food in the basket as presented in Graph 1.

Table I.1.1:

## EU neighbours - Overview exchange rate policies

	Income group	Exchange rate regime as of January 2008	Current account % GDP, 2007	Capital/financial % GDP, 2007
<b>ENP-Mediterranean countries</b>				
Algeria	lower middle	managed float	<b>23.6</b>	-1.1
Egypt	lower middle	full float	1.4	3.7
Israel	high	flexible	3.6	-3.2
Jordan	lower middle	fixed peg to USD	-14.0	9.6
Lebanon	upper middle	fixed peg to USD	-10.7	
Libya	upper middle	fixed peg to SDR-basket	<b>33.2</b>	1.3
Morocco	lower middle	fixed peg to basket	-0.1	
oPt	lower middle	fixed peg to shekel	-7.7	
Syria	lower middle	fixed peg to SDR basket	-5.8	0.9
Tunisia	lower middle	peg to basket (euro has 2/3rd)	-2.5	5.1
<b>ENP-CIS and Russia</b>				
Armenia	lower middle	managed float	-6.2	
Azerbaijan	lower middle	managed float	<b>24.6</b>	
Belarus	lower middle	fixed peg to USD	-5.0	
Georgia	lower middle	managed float	-19.7	
Moldova	lower middle	flexible	-17.0	
Russia	upper middle	managed float	5.9	
Ukraine	lower middle	<i>de facto</i> peg to USD	-4.2	
<b>Non-ENP CIS</b>				
Kazakhstan	upper middle	managed float		
<b>GCC</b>				
Bahrain	high	fixed peg to USD		
Kuwait	high	peg to basket	<b>47.4</b>	
Oman	upper middle	fixed peg to USD		
Qatar	high	fixed peg to USD		
Saudi Arabia	high	fixed peg to USD	<b>26.8</b>	
United Arab Emirates	high	fixed peg to USD	<b>21.6</b>	
<b>(Other) Barcelona process countries</b>				
Albania	lower middle	float	-9.5	<b>9.3</b>
Mauritania	low	fixed peg		

Sources: National authorities, IMF and EIU - see also the MEI-tables in the country articles

### 3. Current macro-economic policy responses at the national level

EU neighbour countries have directly or indirectly taken action to fight inflation, in particular food inflation. The following direct policy reactions can be listed:

- *Monetary tightening;*
- *Imposing price controls by setting a ceiling for the selling prices of final agricultural products;*
- *Temporarily increasing the supply of certain final products by offering (qualitatively lower) substitutes at lower prices;*
- *Temporarily increasing subsidies for low-income consumers on final agricultural products;*
- *Diminishing or abolishing import tariffs on grains;*
- *Temporarily imposing an export tax on grains produced domestically;*
- *Temporarily banning the exports of certain grains produced domestically;*
- *Temporarily banning the exports of non-agricultural products produced domestically;*
- *Subsidising the agricultural production of basic grains for the longer-term;*
- *Allowing the domestic currency to float more freely vis-à-vis foreign currencies;*
- *Allowing the domestic currency to appreciate faster (by interventions in the foreign exchange market, i.e. buying domestic currency in exchange for foreign currency);*
- *Increasing wages (in the public sector)*

Below follows a concise description of measures that have been taken at the national level in some of the EU neighbour countries.<sup>6</sup>

#### *Egypt*

Egypt relies heavily on imported grains, such as wheat. At the beginning of 2008 bread riots resulted in several deaths. The army was immediately requisitioned to bake and distribute extra loaves in 300 locations across the country. The Egyptian authorities also took a number of other steps in response to the surge in food and notably wheat prices. A plan was adopted to stimulate domestic wheat production. Local wheat prices are gradually raised to the levels comparable to global prices. This creates incentives for local production, decreasing dependency on foreign wheat imports. To this end, the Egyptian Ministry of Agriculture, the Ministry of Finance, the Ministry of Trade and the Ministry of Social Insurance agreed on a mechanism to define the minimum price for purchasing wheat from small farmers. The

government also slashed import tariffs on foodstuffs and intensified food subsidies. In addition, it imposed temporary controls on exports of certain goods, notably rice but also cement, to meet the seasonal increase in demand for construction materials during the summer. It can thus be seen that intervention in the food market is triggering intervention in non-food markets.

In a reaction to the loss in purchasing power due to high inflation, the president ordered a 30% pay rise for all government officials and public sector employees. In reply to this, in order to raise fiscal revenues to compensate the additional government outlays, the fiscal authorities raised taxes on fuel and cigarettes, increased the payments for car licenses, and cancelled the tax exemption on free zone hydrocarbon. In this way, the government maintains the objective of limiting the general government deficit in the fiscal year 2008 of 6.9% of GDP.

The Central Bank of Egypt reacted early to the surge in inflation by tightening monetary policy, in view of its mandate to achieve and maintain price stability. However, raising interest rates and thus making borrowing more expensive may alleviate inflationary pressures by curbing demand (apart from the demand for the very basic food products) - may at the same time damage growth opportunities. The high inflation also triggered the switch in the exchange rate policy towards a fully flexible regime that should help alleviate domestic inflation, while allowing for the strengthening of the domestic currency.

### *Kazakhstan*

Kazakhstan, the world's sixth largest wheat exporter, is (also) a key grain supplier in the Central Asian region. Last year, unlike other grain exporters, Kazakhstan did not suffer from a poor harvest. To combat rising domestic prices, authorities of several Central Asian countries set up stabilisation funds to purchase grain and manage supplies, and local officials have been ordered to monitor prices. In September 2007 Kazakhstan moved to control exports, introducing a licensing system. Exports have slowed since, hitting its neighbour countries, in particular Central Asian countries dependent on Kazakh grain exports. This led to sporadic protests and riots, for instance in Uzbekistan.

Kazakhstan suffers from a high inflation, where relatively little comes from food because of the cheap food policies of the government. Substantial parts of the price increase come from high energy prices and the domestic credit boom. As a reaction to the high inflation the central bank revalued the official exchange rate.

There is a need for agricultural reforms in order to make the Kazakh farms more adequately equipped with modern machinery. Also, the policies concerning the State Food Corporation should be reconsidered. This Corporation maintains strategic reserves of grain that are sold at below-market prices. The delivery process by farmers to this Corporation is reportedly distorted by corruption. The time seems ripe to liberalise the grain market, where prices will be fully determined by market supply and demand forces.

### *Russia*

The largest share of total CPI increases observed in Russia during the past few years is indeed attributable to food price increases. Nevertheless, this is, to a degree, an "artefact" arising from the large share of food in the Russian CPI basket, which, as indicated above, considerably exceeds what should be expected given its GDP per capita level. In terms of *actual* CPI increases, services surpassed food in the period January 2006-April 2008 (a cumulative 40% raise, as opposed to 36%), driven largely by energy-related costs (gas and electricity, up respectively 66% and 48% during the same period). In any case, food price increases led to some short run administrative measures (a largely ineffective agreement with several large food retailers to freeze prices in some basic foodstuffs –milk, eggs, oil, bread– initially introduced in October 2007 and abandoned in May 2008, the reduction of import taxes and the increase in export taxes for some agricultural products). As to wheat, the Russian Government decided not to renew the export taxes after May 2008. In the ongoing policy debate within the Russian government of "(high) inflation versus (high) growth" (which opposes the traditionally more conservative Ministry of Finance to the –equally traditionally more spendthrift– Ministry of Economic Development), the politically dominant Russian Ministry of Finance seems to focus on the monetary and fiscal causes of inflation (and, therefore, on monetary and fiscal solutions), supported in this by the Central Bank of Russia.

On the one hand, there is arguably a significant relationship in Russia between the dynamics of *monetary aggregates* (which are themselves driven by the external surpluses, regardless of the origin of those surpluses, i.e., either capital or the current account) and CPI inflation. A look at the correlations between CPI developments for both the periods 2001-2008 and 2007-2008 shows that there is a almost 92% correlation between the monthly year-on-year (yoy) growth of CPI and the lagged monthly yoy growth of money supply, money, money plus quasi-money and M2 (this peak correlation is obtained by money plus quasi-money lagged between 9 and 12 months, and is only slightly smaller for larger monetary aggregates like



M2). These results are also mostly supported by "naive" regressions of CPI inflation and different monetary aggregates and also by Granger causality tests. On the other hand, the relationship between *fiscal expenditures* and inflation (measured by the quarterly growth rates of nominal government expenditure and the CPI quarterly changes) seems not to be so straightforward, with simple correlations indicating a strong positive relationship, if one uses time series for the period 2001-2008 (+52%), but a negative one if just the last two years are used (-30%).

### *Saudi Arabia and the GCC*

Saudi Arabia has huge revenue from its oil exports. In order to mitigate the volatility of government revenues, Saudi Arabia pegs its domestic currency (riyal) to the US dollar. Annual inflation reached 9.6% in March 2008, which is in sharp contrast to figures of less than 1% during the previous five years. Much of the current inflationary pressure is caused by strong monetary growth, stemming from the government that injects large parts of the country's record oil export revenues into the local economy. In fact, the money supply has continued to rise sharply with broad money and demand deposits (M1), rising by 26% year-on-year in February 2008. The fixed exchange rate to the depreciating US dollar has aggravated the situation. Foreign capital inflows have increased also in line with expectations for an exchange rate revaluation.

Although not the main reason for the increasing prices in Saudi Arabia, food prices have contributed to the high inflation figure in the country. Local factors such as structural shifts in patterns of consumption and use of agricultural products, a cut in agricultural subsidies, higher fertilizer prices and cold winters have contributed to increased food prices. Higher global commodity prices, yet, was the main reason for the rise in food prices.

National authorities have already committed to large-scale investments in infrastructure, education and health, which would make it politically difficult to rein in spending significantly. Anchoring inflationary expectations also seems difficult: the government has agreed to give public sector workers and state pension recipients a new cost of living allowance equivalent to 5% of their annual salary during 2008, 2009 and 2010. As a reaction to the high inflation the government cut the customs duties payable by importers on 180 items, including food and beverages and building materials.

Last, but not least, supply bottlenecks have contributed to the high prices in the country. This holds in particular for housing and the construction sector. Also skilled labour supply shortages have contributed to the price surge in Saudi Arabia.

The other GCC-countries - Bahrain, Kuwait, Qatar, Oman and United Arab Emirates (UAE) - show similar features as Saudi Arabia. Also in these countries consumer prices have been soaring lately, because of large capital inflows, higher food prices and prices of other imported goods, higher fuel prices, and the developments in the real estate and construction sector. The countries suffer also from imported inflation because of the fixed exchange rate regime. This holds even for Kuwait that unlike the other GCC-countries does not have a fixed peg to the US dollar, but to a currency basket (in which the US dollar is represented). GCC policy reactions to the high inflation range from increasing subsidies, to raising wages and to lifting import duties.

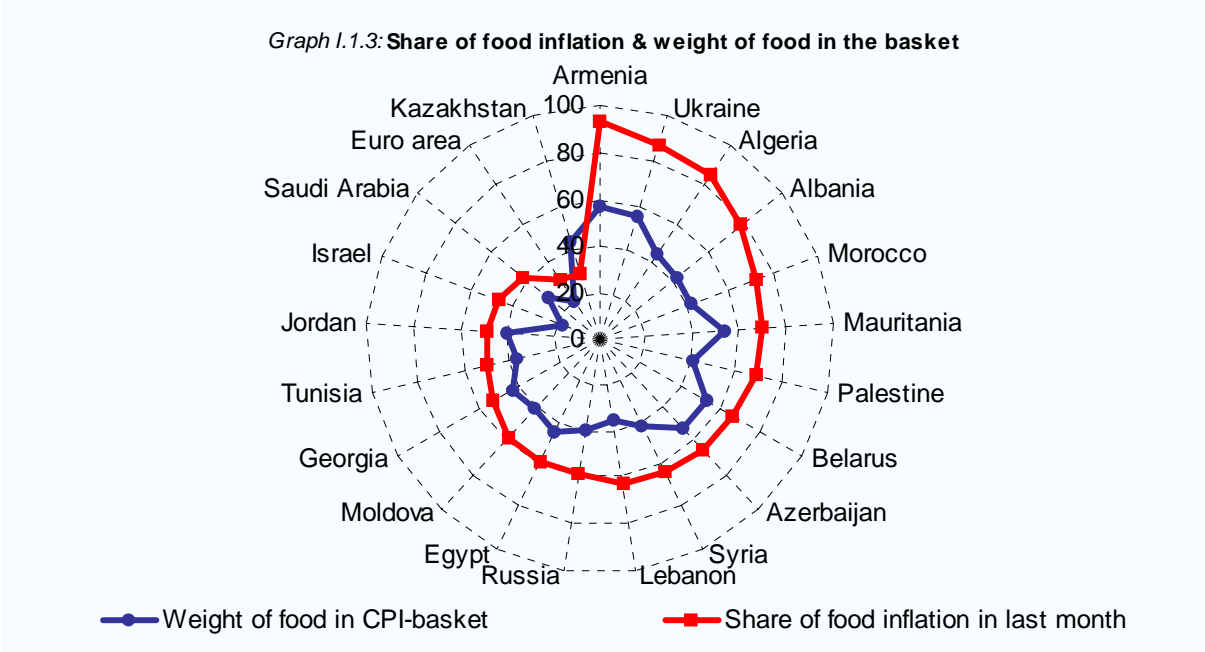
### *Tunisia*

The agricultural sector is one of the most important sectors in the economy, accounting for roughly 12% of its GDP and employing half of its workforce. Food is the main component of Tunisia's CPI (36.5%). Local food costs have been soaring due to the high costs of imported agricultural commodities. The Tunisian government has reacted to the higher inflation by providing incentives to increase production and raising subsidies, while attempting to stick to the budget deficit target of 3.0%. Prices are nonetheless expected to increase by 6.9% on average in 2008, assuming that domestic harvest will not be negatively affected by weather conditions. Although agriculture is prominent in the Tunisian economy, this sector lacks modern infrastructure and is rain-fed. This also holds for wheat and barley.

### *Ukraine*

Ukraine is traditionally a net grain exporter, among the top ten exporters globally. Since late 2006 Ukraine has, however, resorted to export quotas on wheat, barley and maize which in fact constituted an export ban until May 2008 when remaining restrictions on grains were lifted in the expectation of a record high 2008 harvest. Other restrictions include an export tax on sunflower seeds and an export quota on sunflower oil. Export restrictions were badly managed, damaging both producers and traders, and tainting the general business climate. Traders reportedly had to dump in the Black Sea some USD 100 million worth of grain that could not be exported and had begun to rot. Ukraine's WTO accession (May 2008) and the negotiations on a free trade area with the EU (launched in February 2008) are instrumental in promoting globally responsible trade policies in Ukraine, but unfortunately the currently difficult political co-habitation is not conducive to policy-making, especially in the presence of vested interests.

The export restrictions had little if any impact on food price inflation. The CPI increased by 30.2% year-on-year in April 2008, including soaring food prices at 47.2%. Monetary policy is geared toward maintaining a *de facto* peg to the US dollar. Therefore, in the face of strong inflows of foreign capital (mostly to the banking sector) fuelling credit growth, the National Bank of Ukraine has had few effective tools to control money supply as growth in money demand seems to be saturating. A revaluation of the hryvnia by about 4% was decided in May 2008 after a pause in the Central Bank's interventions in the foreign exchange market. Fiscal spending on the other hand is on the increase given the political instability and election promises. With no political consensus to support a tightening of the fiscal spending, administrative controls on humanitarian important goods such as bread have been the government's policy response to growing inflation. The lack of competition, especially at a local level, is also receiving some attention from the authorities. Although the impact would not be immediate, structural reforms in the agricultural sector, including functioning land markets, are a necessity.<sup>7</sup> In a sense, Ukraine is now paying the price for the delays in agricultural and energy sector reforms.



#### 4. Summary and macro-economic policy options

There has been a steep upward trend in consumer prices in Mediterranean countries, in Russia, in the CIS-countries and in the GCC region. Soaring agricultural commodity prices have fuelled total inflation. Even despite the high and increasing food subsidies that the governments have been providing in many of the countries covered in this study, we clearly observe soaring food prices. Our analysis shows that in most EU neighbour countries much more than 60% of domestic inflation is attributable to food prices.

At the national level, policy makers in the EU neighbour countries started reacting to these new developments in various ways. In some countries the soaring food prices gave rise to humanitarian aid (Egypt), which led the national government to temporarily provide food by increasing supply of cheap food, subsidise basic commodities for low income groups and abolish import tariffs. Some agricultural commodity exporting countries, on the other hand, imposed taxes or even banned the exports of some agricultural commodities to mitigate the additional price rises at the national level (Kazakhstan, Russia and Ukraine). The monetary authorities in some countries increased the interest rate or revalued their currency to combat inflation. Some governments even raised wages in the public sector.

Both net food exporters and importers among the EU neighbour countries took protective measures applying to other commodities than agricultural commodities. From an international perspective these direct interventions in commodity markets, either on quantities or on prices are not ideal. Export taxes or bans further reduce supply of (agricultural) commodities on the world market and accelerate international price rises. If agricultural commodity exporting countries attempt to secure stable domestic prices by *beggar-thy-neighbour policies*, agricultural commodity importing countries will necessarily suffer as a result. Furthermore, market interventions like export restrictions distort price signals and reduce incentives for domestic farmers to expand production. Moreover, protective measures in some segments of the markets could spill over to other segments leading to more and more shortages on the international goods markets.

Part of the solution to the mismatch in demand and supply of agricultural commodities lies at the international level. Population growth and the expected continuing strong upward trend in the demand in emerging economies for added value products means a continuing demand for agricultural commodities. To meet this growing demand an enhanced sustainable productivity growth in agriculture will be needed, for example through sufficient investment in agricultural research and innovation. Furthermore, policies pursuing environmental objectives can only be

sustainable if they also reflect social and humanitarian needs. Thus, biomass-based energy should preferably be based on feedstock that is less demanding for arable land and therefore less in direct competition with food production such as second-generation biofuels.

Another part of the solution to the mismatch on the agricultural commodity markets lies at national levels. Resolving domestic market imperfections, further liberalising domestic product markets and breaking import monopolies will significantly reduce the pressure on market prices. Prices have, so far, been high because of the absence of a fair and level playing field on the agricultural commodity markets. New suppliers should have easy access to the domestic markets. As to the stimulation of agriculture, as mentioned earlier in the international context, national governments should adhere to the international approach to stimulate agriculture. Kazakhstan, Ukraine and Russia, among others, could benefit vastly from the international market situation as they have potential to quickly increase the amount of land under cultivation (for grain in particular). There is also considerable scope for improving land productivity. These agricultural commodity exporting countries could transform themselves from losers to winners in this situation and even enjoy windfall gains. In addition, national governments should refrain from intervening in the trade of agricultural commodities domestically – as long as there are no humanitarian reasons to do so - and across borders. All export bans should be lifted. In general terms, national governments should aim at an efficient functioning of the food supply chain and abolish any existing distortions.

In addition, for those countries facing high inflation due not only to soaring food price, but also to capital inflows, under the current circumstances, there may be scope for a reconsideration of their currency regime (notable all the GCC countries except for Kuwait). The domestic currencies of most of these countries are undervalued, and would appreciate under a more flexible exchange rate regime. Imported goods would consequently become cheaper and this would result in less domestic inflation.

Last but not least, fiscal authorities that currently fight for lower prices for such agricultural commodities as bread and rice by way of price subsidies and that already face high fiscal expenditures because of the higher prices of these primary food products, should gear as much as possible these subsidies towards the expansion of the production and targeted social safety nets. Only these structural solutions will stimulate agricultural commodity production in the medium to longer term. The phasing out of the government price subsidies should remain the ultimate objective, if the humanitarian and economic situation permits.

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<sup>1</sup> ECFIN.D3 “Economies of the Mediterranean Countries, the GCC, Russia, the New Independent States and EFTA countries”, Email: Marga.Peeters@ec.europa.eu. Office: Avenue de Beaulieu/Beaulieulaan 24, 1160 Brussels – Belgium. This paper was written benefitting of input from Stylianos Dendrinis, Maria Inmaculada Montero Luque, Agnieszka Skuratowicz, Sirpa Tulla and Lúcio Vinhas de Souza. We are grateful to Anja Nielsen for editorial support. All errors are ours. This paper was part of a larger study on the European Neighbourhood Policy, see European Commission, Occasional Papers on ENP, annual series. Disclaimer: The views presented are those of the authors and do not necessarily reflect those of the European Commission.

<sup>2</sup> We include here Albania and Mauritania that became part of the Barcelona process in 2007.

<sup>3</sup> We include here Albania and Mauritania that became part of the Barcelona process in 2007.

<sup>4</sup> The EU neighbour countries often use the term “total” inflation while the euro area uses the term “headline” inflation.

<sup>5</sup> The countries that are shown in Graph I.1.1 with GDP per capita less than EUR 6 000 that spend more than 30% of their total expenses on food are Albania, Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Jordan, Kazakhstan, Lebanon, Libya, Mauritania, Moldova, Morocco, OPT, Syria, Tunisia and Ukraine. Bahrain is not included.

<sup>6</sup> For more elaborate descriptions of recent policy actions, see the country chapters.

<sup>7</sup> Ukraine's has potential to significantly increase net exports of agricultural commodities – if appropriate structural reforms are pursued. See EBRD/FAO (2008) *Fighting Food Inflation through sustainable Investment*. World Bank (2008) *Competitive agriculture or state control: Ukraine's response to the global food crisis*.