



Drought-induced crop failures and inflation

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The extraordinarily hot and dry summer weather will cause severe crop shortfalls in Germany, according to experts' estimates. Due to the adverse weather conditions, the crop outlook for European neighbouring countries, as well as other large food producers such as the USA or Australia, is quite poor, too. Over the past weeks, wheat prices for delivery in December 2018 were up by just under 20%.

Wheat Futures



Source: Bloomberg

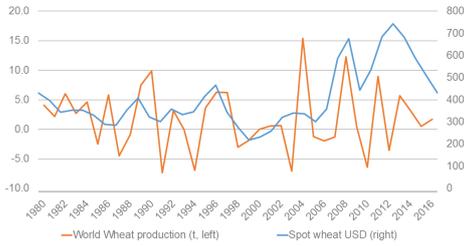
At the Leipzig commodity futures exchange, the price of potatoes (delivery February 2019) even doubled temporarily. Broader food price indices, on the other hand, are clearly pointing to the downside – at least for the time being (FAO World Food Price Index -5.7% year-over-year or HWWI food on euro basis -8.4%, each July). For consumers in Germany, food price inflation has also cooled visibly in recent months, after driving inflation in 2017 (food +2.7% yoy, headline inflation +1.7%). Although food has a weight of just 9.8 per cent in the German inflation rate, it is of particular interest with respect to "perceived" / discussed inflation, not only during the ongoing holiday season with its dearth of other interesting topics. So, what's next?

In the months ahead, price momentum ought to remain subdued, owing to partially very abundant fruit crops and declining prices for milk products. Given long-term delivery contracts, commodity price inflation only feeds through into higher food prices at the supermarkets after a certain time lag. Moreover, the global market tends to have a dampening effect on prices, not least thanks to the different crop seasons in the northern and southern hemisphere. At 237 million tonnes (more than one-third of an annual crop), global wheat inventories, in particular, are well-stocked at present. For many foodstuffs that we buy at the supermarkets, the share of commodity costs is just around 40%. Transport, labour, packaging and rents represent the larger cost block. This also has a dampening effect on price movements, as is clearly illustrated by longer-term commodity and food price inflation at the various processing stages. The closer the consumer level, the smaller the price spikes. As regards wheat, the correlation between global production and the world market price has been very weak, especially over the past years. Nor is there a particularly tight relationship between German wheat prices and the consumer prices for bread and wheat products.



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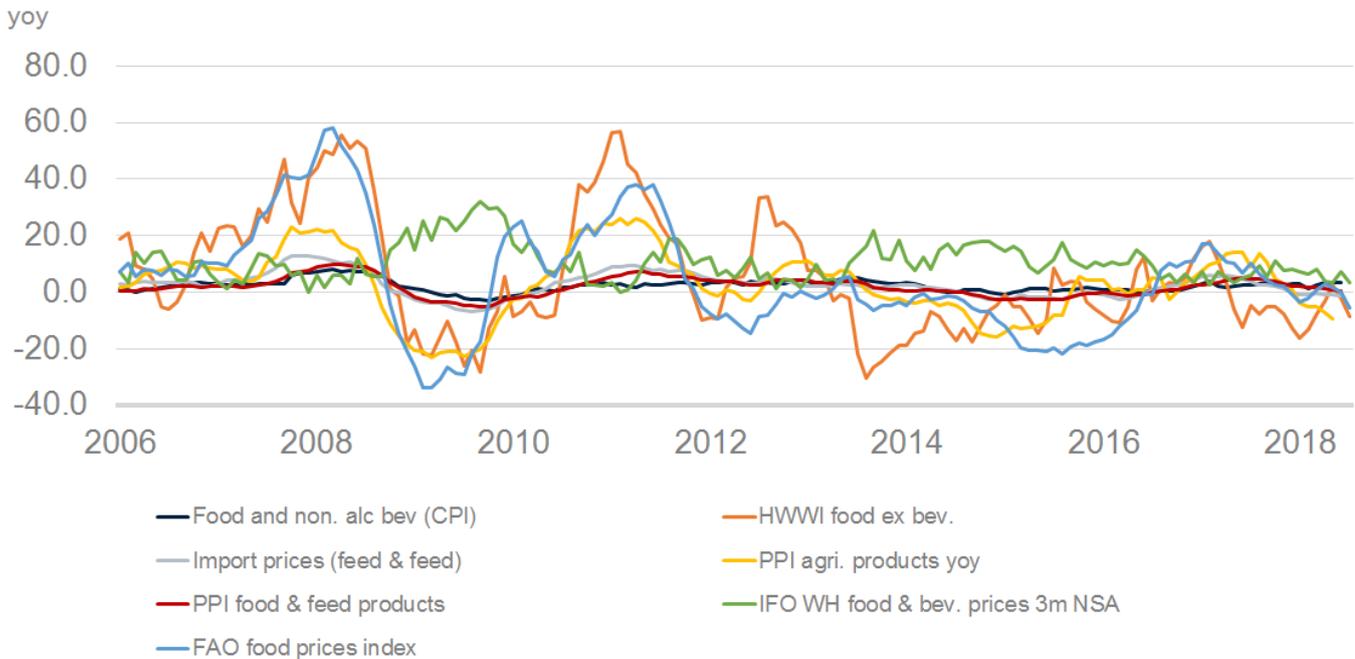
Global wheat production and spot prices



Source: FAO July report

In 2019, at the latest, food prices should nonetheless pick up again, exceeding, for instance, the Bundesbank's June expectations of a long-term average rate of just 1.5%. But even if food prices rose at the 2008 record rate of 6%, the highest increase since 1991 - which is not (yet) in sight - headline inflation is likely to increase by only 0.4% compared with the probably outdated assumption of the Bundesbank. Even in this scenario, the annual German inflation rate is unlikely to exceed 2 ¼%, unless energy prices rise sharply and / or the euro exchange declines visibly. Like for food prices, it is hard to make accurate predictions about these two factors. The forecaster has to rely on assumptions, which - regrettably - often turn out to be wrong in retrospect.

Food prices – limited pass through



Sources: ifo, FAO, Federal Statistical Office

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