Food inflation finally cools in Europe after a long hot summer

Food price rises are finally subsiding in Europe. We saw the first Month-on-Month decline in almost two years in July. Many branded food manufacturers, however, are reporting lower sales as shoppers turn to more affordable goods. And a combination of high food prices and sluggish growth means those volumes won't be returning anytime soon

Food price inflation is finally easing across Europe

-0.2% EU food inflation, July

MoM. First decrease in almost 2 years

Extraordinary rally in consumer food prices comes to an end

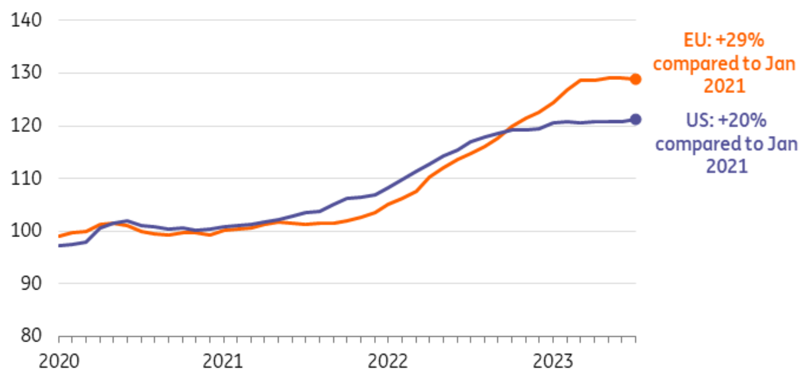
Food inflation rates have been cooling for the past couple of months, and July's inflation figures even showed a small Month-on-Month decrease in the European Union. That said, food prices remain at high levels. A typical EU consumer currently pays almost 30% more for groceries compared to the start of 2021, with some considerable differences across the continent.

In Hungary, prices have gone up by more than 60% since January 2021, while food prices in Ireland went up by 'only' 19%. Across Europe, consumers reacted by buying less, shopping more at discount supermarkets and favouring private label products over brands.

The trend in the US looks fairly similar. The main difference is that 'cooling down' set in a little earlier, and the relative increase was lower compared to Europe. That's partly explained by the fact that US food makers are less exposed to the energy price shock compared to their peers in Europe. American food prices started to move sideways in the first quarter of this year; a typical American consumer currently pays 20% more for groceries compared to the start of 2021.

Food inflation reaches a plateau in the EU and the US

Consumer price index for food, 2020 = 100



Source: Eurostat, BLS, ING Research

Is Germany really leading the way on prices?

Within the eurozone, Germany has been the only country seeing consumer food prices drop for several months in a row. According to Eurostat data, prices of food and non-alcoholic beverages in Germany were 1.4% lower in July compared to their peak in March this year. This is largely the result of lower prices for dairy products, fresh vegetables, margarine and sunflower oil.

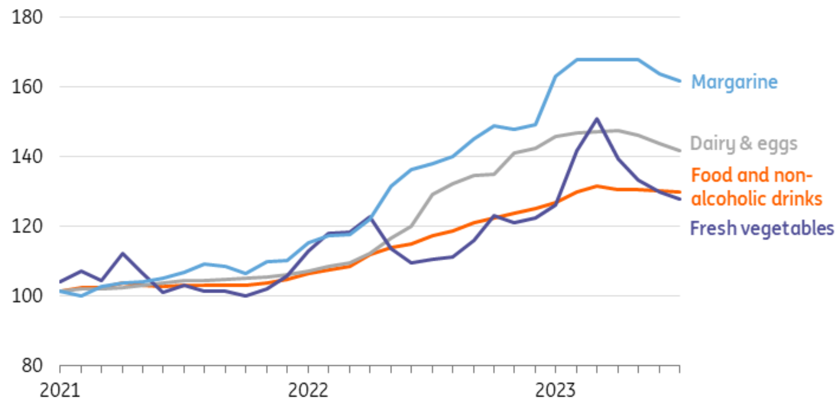
> *German discounters have a relatively large market share*

What distinguishes the German food retail market from most other European countries is that discounters have a relatively large market share. Schwarz Group (Lidl) and Aldi have a combined market share of around 30%, and other major retailers such as Edeka and Rewe also own discount subsidiaries. Given the large and competitive German market, food retailers seem to have negotiated more strongly with suppliers than their counterparts in other European countries, even at the risk of losing those suppliers. As a result, retail food prices started to drop earlier. Also, the highly competitive market delivered special sales offers for consumers since the spring.

For now, German consumers are benefiting from a reversal of the price trend, and consumers in other European countries might experience a similar trend in the months ahead. However, we believe that consumers shouldn't get their hopes up too high given that some inflationary trends in the cost base of food manufacturers and retailers are still present. That's also why we deem it too early to forecast a prolonged period of decreasing food prices.

Modest drop in German consumer prices due to lower dairy, vegetables and margarine prices

Consumer price index, 2020 = 100



Source: Destatis, ING Research

Underlying costs for food manufacturers show a mixed picture

Throughout 2022, almost all of the costs for food manufacturers moved in one direction, and that was up. That picture has changed when we look at some important types of costs.

> *Prices for agricultural inputs are moving in different directions*

Input costs are by far the most important cost category, and agricultural commodities are a major part of these inputs. Prices for agricultural inputs are moving in different directions. World market prices for wheat, corn, meat, dairy and a range of vegetable oils are down year on year, which is partly on the back of reduced uncertainty around the war in Ukraine. However, prices for commodities such as sugar and cocoa rallied considerably in 2023. The prospects of the El Niño weather effect potentially upsetting the production of commodities like coffee and palm oil in Southeast Asia alongside India's partial export ban on rice have given rise to new concerns.

We estimate that energy costs make up about 3 to 5% of the costs of food manufacturing, but this will also depend on the subsector and the type of energy contracts. Current energy prices in Europe are much lower compared to their peak in 2022, but they are still much higher compared to their pre-Covid levels. Volatility continues to linger, in part because more exposure to global LNG (Liquified National Gas) markets makes European gas markets more susceptible to price fluctuations. Uncertainty about where energy costs will be headed over winter can make food manufacturers more reluctant to reduce prices.

Continuing services price inflation means companies along the food supply chain will face higher fees for the services they contract, such as accounting services and corporate travel.

Wages will be an important driver for production costs for many months

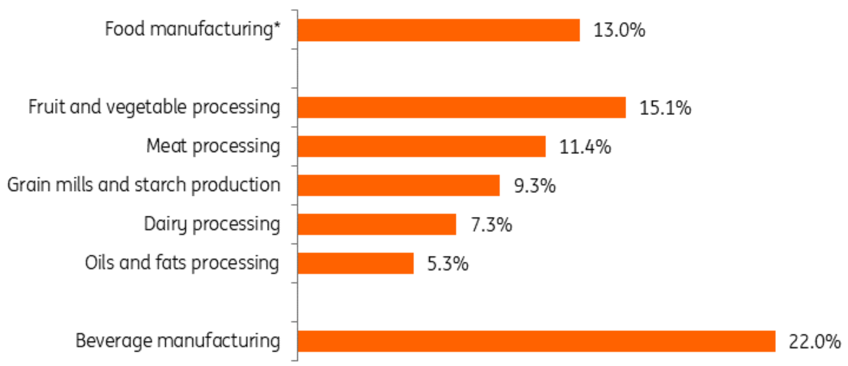
Wages account for a bit more than 10% of the costs of a typical food manufacturer in the EU (excluding social security costs). Both the spike in inflation in 2022 and 2023 and the continued tightness in labour markets are leading to a series of wage increases in food manufacturing and food retail. In our view, wages will be an important driver for the production costs of food and for consumer prices over the next 18 months, given that wages go up in subsequent steps.

Examples of wage increases in the food industry

- In the German confectionery industry, 60,000 employees get an inflation compensation of €500 in 2023 and 2024 on top of a 10-15% increase in regular wages. We see similar patterns for wage agreements at individual companies, such as for the German branch of Coca-Cola Europacific Partners.
- In the Dutch dairy industry, wages will increase by 8% in 2023 and another 2.65% in 2024, while the collective labour agreement in the Dutch meat industry contains a three-tiered increase of 12.25% in total between March 2023 and 2024.
- In France, it's expected that average wages in the commercial sector will rise by 5.5% in 2023 and 4.2% in 2024. This also gives an indication for wage development in industries such as food manufacturing.

Wages make up 13% of German food manufacturers' costs with some variation between subsectors

Wage costs as a percentage of total costs, 2020



Source: Eurostat, ING Research, *excluding artisanal and industrial bakeries

Adverse weather pushes up prices for potatoes and olive oil

Following the warmest July on record, it’s evident that people are wondering to what extent weather will push up food inflation in the months ahead. The most recent monthly crop bulletin from the European Commission notes that weather conditions were on balance negative for the yield outlook of many crops and thus supportive for prices. Although the picture can be different from crop to crop and from region to region, there are certain food products where inflation is accelerating due to weather.

One of the biggest victims of unfavourable weather in Europe this year is olive oil. The continued drought in Spain, and particularly a lack of rain during spring, leads to estimates that olive oil production will be down by 40% this marketing year. It will be quite difficult to find enough alternative supplies outside the bloc, given that the EU is the top exporter of olive oil. This is also the case for potatoes and potato products. Here, a wet start of the year in northwestern Europe followed by dry weather in May and June and abundant rain in July means conditions have been very unfavourable for potato yields and quality.

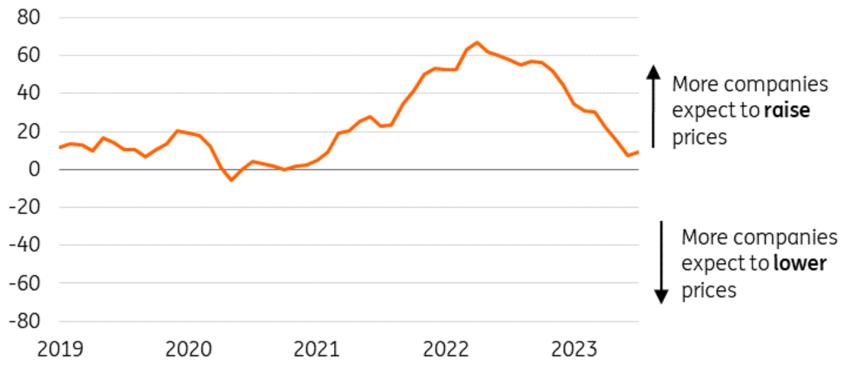
Food prices are likely to hover around their current levels for a while

The developments in underlying costs for food producers lead us to the view that consumer food prices will likely hover around their summer levels for a while. When there are decreases in general prices, those will be the result of trends in specific categories, such as dairy, rather than being widely supported across all categories. This view is also supported by business surveys which show that sales price expectations of food manufacturers are now clearly past their peak, as you can see in the chart below.

Multiple major food companies, including Danone, Heineken and Lotus Bakeries, have signalled in their second-quarter earnings calls that there will be less pricing action in the second half of this year. However, some companies are indicating that they're not yet done with pricing through their input cost inflation. Unilever, for example, reported that we should expect moderate inflation in ice cream in the second half of the year, for instance. In any case, we do see a likely increase in promotional activity as brands step up their efforts to re-attract consumers and boost volume growth. But given the elevated price levels and the muted macro-economic outlook, it's likely to take a while before volumes fully recover.

European food manufacturers expect fewer price increases in the months ahead

Sales price expectations for the months ahead, balance of responses



Source: Eurostat, ING Research

Price negotiations remain tense

Food manufacturers have fought an uphill battle to get their higher sales prices accepted by their customers, such as food retailers. Negotiations in the current phase won't be easy either because food and beverage makers will be heavily pushed by major retailers to reduce prices. Retailers that lost market share will be especially looking to secure better prices in a bid to re-attract consumers.

Whether there is room for price reductions will vary from manufacturer to manufacturer depending on the agricultural commodities they rely on, the energy contracts they have and cross-country differences in wage developments. As such, explaining why prices still need to go up, cannot go down (yet) or can only go down by so much will be a significant task for food manufacturers in the coming months.

Author

Thijs Geijer
Senior Sector Economist, Commodities, Food & Agri
thijs.geijer@ing.com