



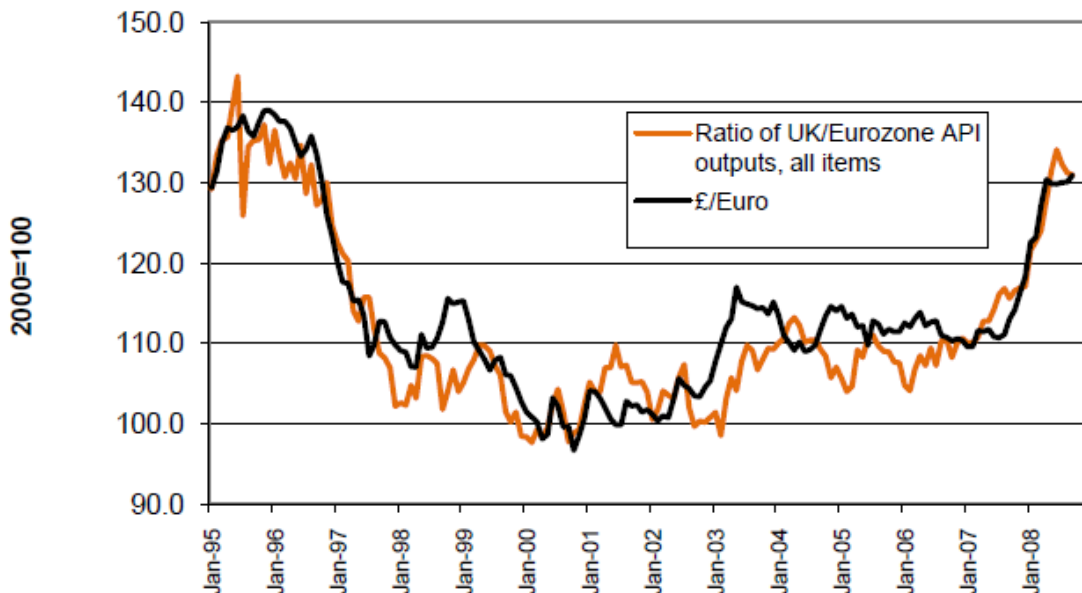
### Food inflation and the weak euro

Large quantities of farm products are traded between the UK and the rest of the EU, especially with those countries that form the Eurozone. In 2007 over \$442bn worth of goods and services were exported with over 50 percent of these being exported to the Eurozone. As discussed above, when the Pound weakens relative to the Euro, the cost of importing becomes more expensive and the prospects for exporters become more attractive, and because of the amount of trade done with the Eurozone there are important implications.

Many commodities, including farm goods are traded internationally and therefore in single market zone like the EU, they tend to have the same prices (i.e a tonne of butter will have a similar price throughout the EU). When the Pound weakens, UK sourced farm products benefit because they become more competitive than the same goods sourced from overseas. This tends to improve the relative demand for farm goods purchased in the UK as well as abroad. This in turn translates into a higher price at the farmgate, leaving aside other relevant factors.

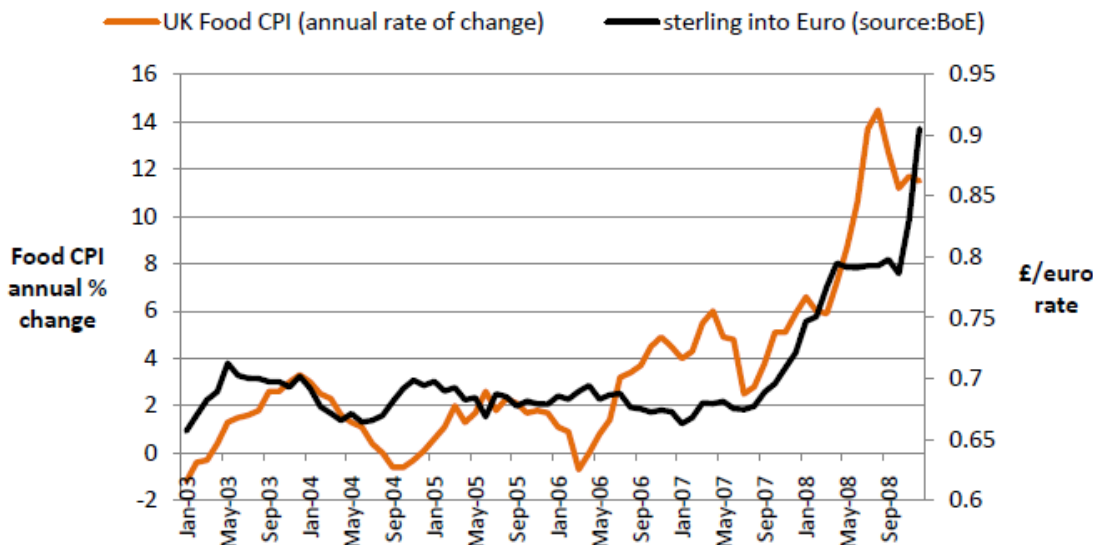
The graph below shows the relationship between farm gate prices and the exchange rate.

**Comparison of relative UK to Eurozone farmgate output prices (all items) with the £/Euro exchange rate**



The relationship between farmgate and retail prices varies considerably and depends on many factors including the amount of manufacturing a product goes through and distribution of power in the supply chain. However, an increase in farm gate prices usually has an impact further down the supply chain as the higher raw material costs are passed onto customers through an increase in the price of the final product. In addition to this, around a third of food consumed in the UK is imported. As Sterling falls, the price of those goods rises and is normally passed on by retailers to consumers. This relationship is highlighted by the graph below.

UK food inflation and £/euro rate

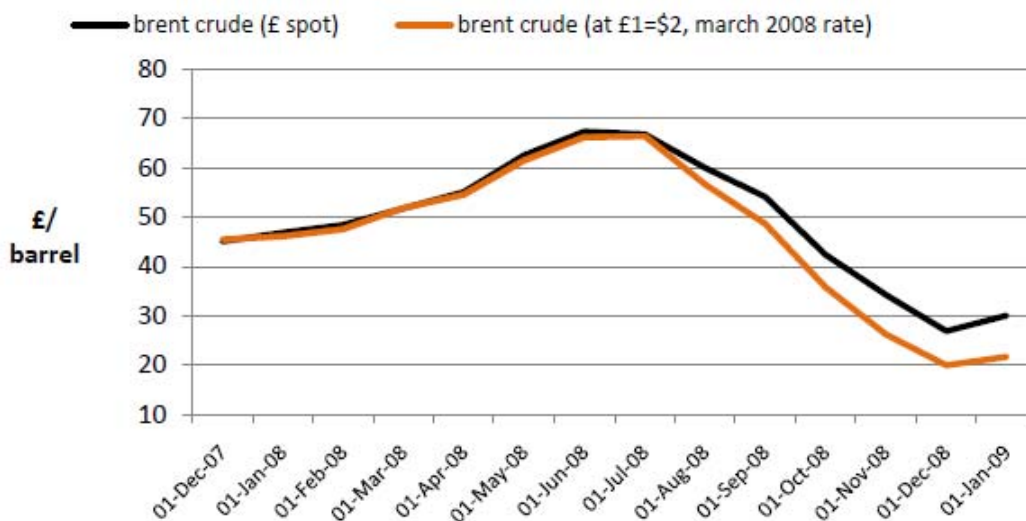


The impact on farmers as consumers of farm inputs

Farmers and growers also need to purchase inputs in order to produce the final product. There are a diversity of farm inputs, but the most prominent forms include energy, fuel, fertilisers and feed. Although some of these inputs are procured domestically, many are also sourced overseas.

Oil prices are a major driver in farm input costs. Crude oil prices bear a direct relationship to fuel (red diesel) prices and indirectly affect the price of some crops and energy. In addition, oil prices have historically underpinned the price of gas used in the manufacture of artificial fertilisers. Crude oil prices are set in US Dollars making this exchange rate highly relevant to not only the direct cost of fuel, but also the indirect cost of some other inputs. The graph below sets out the price of oil under two different scenarios, with the orange line setting out the price in Sterling if the exchange rate was £1=\$2, and the black line showing a truer picture, where the price in Sterling is determined by the spot exchange rate. Since July 08 sterling has fallen in value. The difference between the two graphs highlights the difference in the price of oil that a weak pound has made.

Impact of weakening sterling on oil prices



### The impact on EU direct payments

The £/€ exchange rate has a substantial bearing on the value of direct payments received by farmers in the UK. This is because the total pot of money that the UK has to pay in relation to direct payments to farmers is set in Euros. The exchange rate used to calculate the Sterling value of entitlements is that on the 30 September in the scheme year in question (or the nearest following working day). Therefore, in terms of the Single Payment Scheme (SPS), a strong Euro relative to the Pound translates into a higher Sterling SPS payment for farmers. Those receiving SPS have the option to receive it in Pounds or Euros, the relative merits are discussed further on.

Exchange rates may have an impact on rural development funds also, however this is more difficult to predict because of the nature of the rural development programmes and their funding arrangements which take a combination of funds directly allocated to the UK from the EU budget and modulation. The budget for the Rural Development Programme for England (RDPE) was fixed in Euros at the start of the 7 year programme period 2007-2013 and are drawn down annually from the EU budget. Over the lifetime of the programme, exchange rates can go up as well as down and this has to be factored in to the budget in Sterling for expenditure. In addition expenditure rules allow any monies unspent in one year to carry over for a further two years. Therefore unlike annual SPS payments, the calculation of rural development budgets does not provide an immediate windfall to the UK government although were exchange rates to remain weak for a prolonged period this might generate additional sums for expenditure on the RDPE.

### Overall impact on farmers

Given the farmers are both producers and consumers, and receive EU direct payments, it is important to get an understanding of the overall impact of a weak pound on agriculture. The graph below shows the relationship between the Total Income from Farming (TIFF), and the exchange rate. The graph clearly shows that as the strength of sterling falls, incomes rise.

