

FOOD IS BACK IN THE SPOTLIGHT

⌘ Agriculture accounts for an increasingly small portion of the economy, but it is now making its presence felt in economic trends, through the surge in agro-food prices.

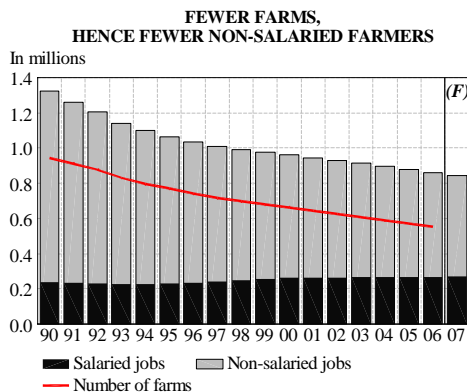
⌘ World prices are at record levels, thus increasing the food component's contribution to consumer prices increase. With prices this high and likely to spread to the rest of the economy through a spreading effect, food excluding perishables will drive the increase in inflation over the next few months.

⌘ After summer 2008, the agro-food price outlook will depend on harvest volumes, as demand will be supported by medium- and long-term favourable fundamentals (expanded production of biofuels, changing food habits with higher standards of living in emerging countries in particular).

Agriculture in the French economy

The farming sector is still gradually remaking itself, as the changes brought on by the industrial revolution endure.

- **Farm employment has declined**, as farms have become more concentrated and more modern. France had 2.3 million farms in 1955, 0.95 million in 1990 and 0.55 million in 2006. Retiring and early-retiring farmers still outnumber new farmers. Farming jobs have declined by almost 3% annually since 1978, but the pace has recently slowed down (to -1.9% in 2007, to 861,000 jobs, or 3.4% of total domestic employment). Non-salaried employment (farmers and their spouses, which account for 68% of farming jobs) fell sharply (-2.8% in 2007). Meanwhile, salaried employment is on a sustained, but moderate upward trend, thanks, among other things, to the development of agri-business companies under which the heads of establishments can declare themselves salaried workers of their own farms.



- On top of short-term fluctuations brought on by bad weather, epizootics, consumer food scares, etc., **agriculture's share in the economy continues to shrink**. Volume output has risen appreciably less than the French economy as a whole since 1978 (respectively, 1.3% and 2.4%). Over a long period, agriculture's added value has been rising slightly less than the economy as a whole (respectively, 2.0% and 2.2% in volume, on average between 1978 and 2006) but more than the agro-food industry (1.2%). Productivity gains and the opening up of markets have led to a decline in relative prices. While the net value added at factors costs has been rising less rapidly in agriculture than in the economy as a whole, when compared to the number of full-time equivalents, its rise has been much more sustained.

A SECTOR THAT IS LESS AND LESS PROMINENT

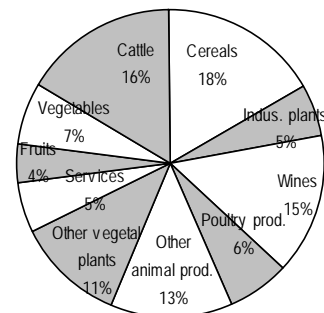
(As % of total)		1978		1990		2006	
		Output	Added value	Output	Added value	Output	Added value
Agriculture	Value	5.1	5.4	4.0	4.0	2.4	2.0
	Volume	3.6	2.8	3.4	3.0	2.6	2.5
Agro-food	Value	6.1	2.7	5.3	2.4	3.8	1.8
	Volume	5.0	2.7	4.9	2.5	3.9	2.0

Source: Insee - Annual national accounts

- **High labour productivity gains**, resulting from a combination of greater added value and lower employment, have been made possible by the increasing substitution of labour with capital, through more modern, industrial means of production (machinery, fertilizers, crop-protection and pesticides, cattle feed), as well as through the selection of high-yielding varieties and species. Another factor has been the rationalization in the use of factors, through farm-machinery use cooperatives and agri-business set-ups allowing equipment to be shared.

- France has a **wide range of output** that is relatively well balanced. The structure of output has been heavily influenced by the Common Agricultural Policy, as farmers have sought to maximise their income through the offered financial assistance and the situation of their respective markets (inventories, prices, etc.)

BREAKDOWN IN AGRICULTURAL OUTPUT IN 2007, IN VALUE



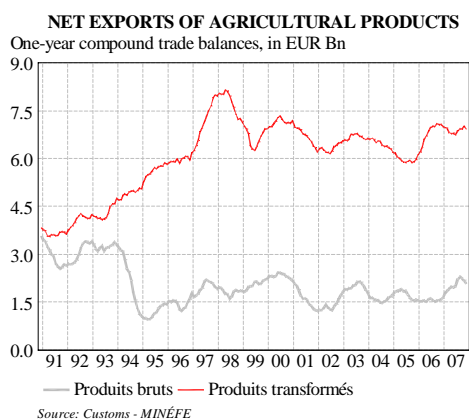
Source: Insee, Projected agricultural accounts - Excluding subsidies

A key export sector

Once it had achieved food self-sufficiency, France became a net exporter of (processed and unprocessed) agro-food products in 1980. Its trade surplus rose until 1998, when it reached EUR 10 billion, before slipping back until 2005. The reason for this is cumulative circumstances: in late 2000, the BSE-related almost total embargo on beef; in early 2001, healthcare measures to contain the epidemic of foot and mouth disease; and, in 2001 and 2003, poor grain harvests. Moreover, the French agro-food industry has been structurally losing market share on its key markets, owing to the rise of new, low-cost producers since the mid-1990s for beef (Brazil), sugar (Brazil), poultry (Brazil, Thailand), milk (New Zealand, Australia), cereals (Russia, Ukraine), wine (US, Australia, Chile, South Africa).

Hence, according to the International Organisation of Vine and Wine, France's share of exported volumes of wine fell from 29% in the second half of the 1980s to 18% in 2006. At the same time, Spain's market share rose from 11% to 17%, and Oceania's, from 1% to 11%. South America and the US, which each accounted for just 1% of global volumes, today account for, respectively, 9% and 5% of world sales. France is nonetheless winning market share in higher-value, further-processed goods such as chocolate or yogurt.

Since 2005, the trade surplus has moved back up slightly, to EUR 9 billion in 2007, 77% of which is accounted for by processed goods (meat, milk, wine and champagne) and 23% by unprocessed goods (cereals, live animals). Agro-food trade is mainly with the rest of the European Union. Over the last 12 months to November 2007, the EU took in 73.2% of French agro-food exports in value terms, vs. 65% for all goods together.



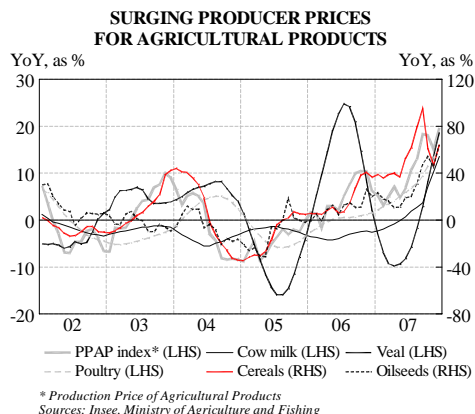
The situation varies markedly from sector to sector

In 2007, agricultural output dipped by 0.8% because of a contraction in output of cereals, fruits and vegetables (including potatoes) and wine. This was due to various factors, weather-related ones in particular (see table below). However, agricultural output in value terms (excluding subsidies) rose sharply (+8%, or +EUR 4.7 billion), driven by surging prices for cereals and oilseeds (see below); oilseed output increased by EUR 4.1 billion, in value terms.

As output grew faster than intermediate consumption in value terms, the added value of the agro-food sector rose sharply (+13%). When combined with the shrinking farm worker population, net farming income per non-salaried worker increased for the second consecutive year (+12.1% in real terms), thus bringing seven years of declines to an end. The average farming income

thus moved back up to its level of 1998. Nevertheless, performances are quite uneven from one farm to another, owing to the sharp skewing in relative prices.

On the whole, 2007 was characterised by a sudden surge in agro-food producer prices, which rose by almost 10%, vs. 0.1% per year on average since 1990.



The leap in cereal and oilseed prices, which has led to higher income for producers, has also resulted in higher costs for livestock farmers, in the form of higher feed costs for non-pastured livestock raised in particular (e.g., poultry and pork). Farming input prices have risen sharply (+5.4%); half of this is due to higher feed prices (+13.6%). Another factor has been the increase in crop-protection and fertilizer costs (respectively, +6% and +5%). However, the price of domestic fuel, which is the main source of energy consumed in farming, declined slightly on an annual average, which helped stabilise the energy bill for the year (-0.5%).

Sharp increase in agro-food prices

Last year, the combination of five factors fed sharp imbalances between supply and demand for certain agro-food products:

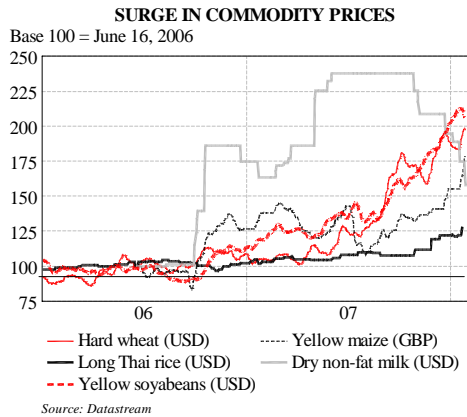
1- Supply, which is by nature uncertain, was insufficient: *i)* global warming and increasingly frequent natural catastrophes (droughts and conversely floods) have pulled down global output; moreover,

AGRICULTURAL OUTPUT IN 2007: -0.8% IN VOLUME BUT +8% IN VALUE

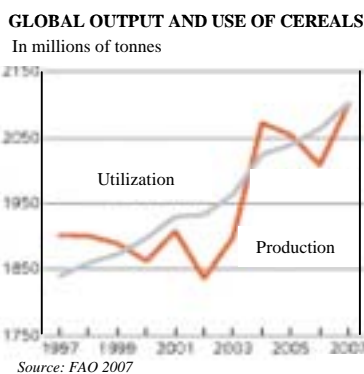
Cereals Vol: -3.7% - Val: 47.9%	Bad weather: summer rains in Europe and in the USA, which brought down yields (except for maize); drought in Australia; severe cold in Ukraine and Russia World stocks at their lowest levels in 30 years Sustained demand: China, India, biofuels (maize for ethanol production), maize in place of wheat for animal feed
Oilseeds Vol: 2.6% - Val: 40.7%	Lower rapeseed yields, but more land planted hence boosting output Less land planted with sunflowers and strong demand, hence surging prices Third consecutive year of declining output of protein crops, leading to surging prices Demand sustained by soya-based biodiesel production
Industrial beets Vol: 6% - Val: -3.5%	Reform of the sugar market in 2006 (common organization of markets) => lower outputs and lower prices for sugar beets, but aligning with world prices Sharp increase in other beets
Fruits, vegetables Vol: -2.7% - Val: -6.6%	Bad weather, leading to a sharply lower output (cherries, apricots) Less land planted, thus capping output (strawberries, peaches, cucumbers) Potato output sustained by rains, thus bringing prices down
Wine Vol: -1.4% - Val: 6.6%	Bad weather, leading to mildew outbreaks: third consecutive year of lower outputs Only champagne rose in volume Fewer resources available and stronger foreign demand led to higher prices
Cattle (cows, pigs, etc.) Vol: -0.1% - Val: -4.6%	Health measures (foot and mouth disease, bluetongue) dragged down exports and led to culling Fewer milk cows, which dragged down veal production Surplus of pigs, pulling down prices, while higher cereal prices led to higher feed costs
Poultry, eggs Vol: 2.8% - Val: 13.7%	Rebound in poultry output (chickens) after a dip in 2006 due to bird flu Across-the-board increase in producer prices, owing to poultry feed Further decline in egg production
Milk and other livestock products Vol: -0.8% - Val: 4.5%	Fewer milk cows, leading to a decline in milk collection, while world prices surged (Chinese and Russian demand, European production quotas, droughts in producing countries) Fourth consecutive year that milk production quotas were not met Higher milk prices, owing to the repricing agreement of the second half of 2007

Source: Insee - Projected agricultural accounts, compiled in November 2007 - Excluding subsidies

based on the French Senate report of December 2007 by P. Lafitte and C. Saunier, we are on the verge of a major biological shock, due to the decline in the diversity of species; *ii*) available stocks are historically low, due, among other things, to years of under-production, when compared to needs, and to the decision by the US and China to draw on their stocks in order to limit their imports. Cereal inventories reached at an all time low when compared to output, according to the FAO; *iii*) geopolitical crises have limited output in some regions.



2- Demand is exploding. First of all, new uses of agricultural commodities are taking on greater prominence, including the production of maize-based (bio-ethanol) and soya-based (biodiesel, oil) biofuels. In 2007, half of the Brazilian sugar crop and 20% of the US maize crop were dedicated to the production of ethanol. In the past, these crops would have been exported. Almost 30% of US output may be allocated to ethanol¹. In Europe, 20% of rapeseed output was used to produce biodiesel. Financial assistance to biofuel producers has driven farmers away from crops such as wheat, soya and rice, thus exacerbating the imbalance between supply and demand.



Another factor has been the increase in living standards in major emerging markets, led by China and India. The increase in per capital GDP has implied greater meat consumption by households and, thus, a surge in cereal demand for livestock feed. However, this change in diet has not had a significant impact on actual household consumption of cereal products, which is correlated to population increase. Also playing a role here has been the exploding global demand for milk, with the emergence of non-producing consuming countries (such as China or Russia).

3- European regulations have skewed the market. The Common Agricultural Policy (CAP) remains an essential component of French agriculture, although the reforms implemented since 1992 have reduced the weight of subsidies received. Direct aid to farmers has replaced price supports; mechanisms affecting international trade (export restitutions, tariffs) are now less prominent. The latest reform of the CAP entered force in France in 2006. Under this reform, some subsidies over products have been replaced by direct financial assistance by farm called "single farm payments", which is based on the subsidies that had been received previously. In 2007, subsidies over products remained almost flat, at EUR 2.5 billion, while farm subsidies fell by 4.3% down to EUR 7.2 billion. Lower assistance combined with surging prices have led to a significant decline in their contribution to the net income of agri-businesses, from 77% in 2006 to 67% in 2007.

By steering European output, the CAP has influenced farm prices. Given the system of production quotas and of more or less incentive aides, European farmers have been seeking to maximise their revenues.

Milk provides a good illustration of the consecutive market distortions. Since quotas were adopted in 1984 to prevent past over-production, European milk output has been declining. For example, French milk cow production has fallen by 44% in 20 years, while their average yield has risen 53%, thanks to better selection of breeds and better feed. The fact that European farmers have been discouraged away from milk cow breeding now prevents them from meeting booming global demand.

Meanwhile, European prices are gradually approaching world prices. Hence, future farm price fluctuations could be stimulated by the phase-out of European regulatory tools.

4- The growing role of speculative funds (in particular on the cereal market) against a backdrop of risk (weakened banks, a less certain outlook for real-estate and growth in the OECD). Their investments in these diversification assets have led to a growing decorrelation of their prices with their fundamentals.

5- Second round effects are gradually showing up in prices through the dissemination of higher input prices. Whereas agricultural producer prices are closely correlated to harvest volume, prices of agriculture intermediate goods can depend on various factors; i.e., while the price of cereals used as inputs tracks their production prices, fertilisers and energy are set by world prices, the price of the barrel of Brent in particular. Indeed, oil is involved at various stages of primary production, either in the form of fertilizers derived from gas or oil, the plastic used for farming or fuel for farm machinery (fishing, farming, road transport to processing centres), as seen in the insert box below. Today, the two factors (tight supply and inflation in inputs) are driving prices up and suggesting that world prices will remain high. As this increase in raw material prices cannot be offset by productivity gains, the French statistics office (Insee) believes that agro-food producer prices may be up 6%, year-on-year, in June 2008, compared to 2.3% last November.

Volume of oil needed to produce:

- one kilo of New Zealand lamb (transport included): 7.9 litres
- one kilo of beef: 2 litres
- one tonne of nitrogen for crop fertiliser: 1.5 litre
- one kilo of greenhouse cucumbers: 0.6 litre
- one kilo of chicken: 0.2 litre

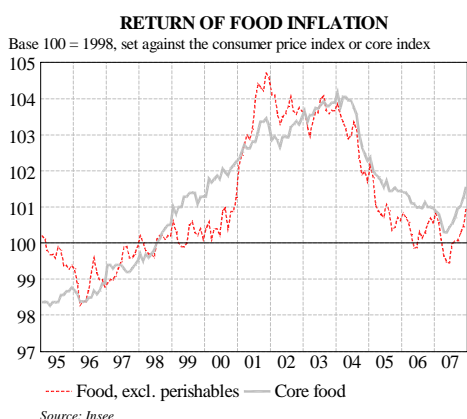
Source: BeCitizen

¹ *Rising food prices and what that means*, Gary Becker 10/2007, http://www.becker-posner-blog.com/archives/2007/10/rising_food_pri.html

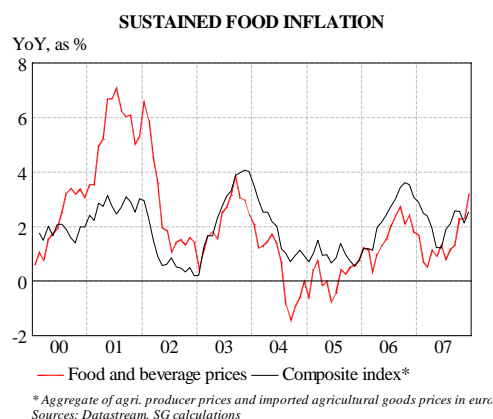
Food prices are significantly contributing to the current flush of inflation

While the surge in agro-food prices is, on the whole, supporting farmer income, this transfer of income is penalising consumers through higher consumption prices for processed and non-processed food, as the agro-food industry gradually passes on their higher supply prices. In 2005, agro-food products thus accounted for one third of the agro-food industry's intermediate consumption and one quarter of the value of its output. In particular, 30% of the retail price of poultry and 65% of pork production costs come from cereals.

In 2006, the "food" component accounted for 16.6% of the consumer price index and 11.7% of households' actual consumption in value terms. Higher food prices are more hardly hitting low income earners, for whom food accounts for a greater-than-average share of their budget.



In December 2007, prices for food and non-alcoholic beverages rose by 3.2%, year-on-year, with the increase coming to 1.4% on an annual average. This is the biggest rise in food prices since October 2003. Food prices contributed by 0.3 point to inflation in December.



When looking at details (see table below), we can see that, whereas price trends for unprocessed or minimally processed food (eggs, milk, bread) reversed themselves last summer and are now surging, prices of processed foods did not begin to accelerated until later, in the fourth quarter. The diffusion effect of higher agro-food prices will continue since agro-food prices lag three months behind prices of their inputs. In December, the increase in food import prices in euros once again accelerated, reaching 52.5%, year-on-year. The 2% tax on fish will begin to show up in January. All in all, given the uncertainties in the most volatile component in food prices (fruit and vegetables in particular), the increase in food prices will gather steam until the end of spring 2008, when it will range from 4 to 5%, year-on-year. INSEE's forecast is in the lower end of this range, thus bringing down farm commodities' contribution to inflation up to 0.4 points in June, all other factors being equal.

This forecast remains contingent on how the agro-food industry sets its margins, as well as on possible reforms in major retailing and how that sector sets its margin, in particular regarding the thresholds of selling at a loss. Beyond summer, the main driver factors will be harvest volumes and weather trends. Demand, however, will remain structurally high.

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BREAKDOWN IN FOOD TREND SINCE JULY 2007: CEREALS, MILK, EGGS AND DERIVATIVES

	Avg. since 1999	Avg. 2006	Avg. 2007	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07
Food and non-alcoholic beverages	1.9	1.7	1.4	1.7	0.7	0.5	1.1	0.9	1.3	0.8	1.1	1.3	2.2	2.3	3.2
Food products	1.9	1.7	1.4	1.7	0.6	0.4	1.1	0.8	1.3	0.7	1.1	1.3	2.2	2.3	3.2
Bread	2.4	1.9	2.9	2.4	2.4	2.2	2.2	2.2	2.1	2.1	3.0	3.7	4.2	4.4	4.3
Fresh pastries, including breakfast pastries	2.0	1.5	1.9	1.5	1.0	0.8	1.1	1.3	1.3	1.8	1.9	2.3	2.9	3.4	3.6
Cakes and industrial pastries	1.7	-0.1	-0.6	0.2	0.0	-1.3	-1.8	-1.8	-1.6	-1.6	-1.6	-0.6	0.4	1.0	1.6
Cereals	0.3	-1.5	-1.4	-2.4	-2.6	-2.3	-2.4	-2.5	-2.3	-1.9	-1.5	-1.1	-0.3	0.6	2.0
Milk and cream	1.5	0.2	1.7	0.4	0.1	-0.1	-0.1	0.1	0.4	0.5	0.8	1.8	2.8	4.6	8.8
Yogurt and dairy-based desserts	0.6	-0.2	-1.2	-1.7	-2.9	-2.4	-2.9	-2.2	-2.0	-1.6	-1.4	-0.8	-0.3	-0.1	3.5
Cheese	1.5	0.1	0.3	0.4	-0.3	-0.4	-0.9	-0.5	-0.4	-0.4	0.0	0.2	0.7	1.2	3.5
Eggs	0.6	-2.1	1.6	-0.9	-1.8	-1.8	-1.7	-2.1	-1.5	0.3	2.5	2.9	4.5	7.6	11.5
Butter	1.5	-0.3	1.0	0.6	-0.4	0.0	-0.3	-0.9	-0.4	-0.3	0.2	0.8	1.7	3.4	7.7
Oil and margarine	2.3	10.2	-1.3	5.0	2.1	-0.5	-1.7	-2.3	-3.4	-3.7	-3.7	-3.6	-2.8	-1.0	0.7
Sugar-based goods	1.5	-0.8	0.1	-0.8	-0.9	-0.7	-0.1	-0.1	-0.4	-0.2	0.4	0.4	0.9	1.0	1.8
Chocolate-based goods	1.7	0.7	0.9	0.5	0.6	0.3	0.3	0.5	0.0	0.4	0.5	0.7	1.4	2.2	2.9
Ice cream and sorbets	0.5	-2.4	-1.7	-2.5	-2.3	-2.4	-3.0	-3.5	-3.3	-3.0	-1.8	-0.9	0.4	0.2	1.5
Meat	2.3	2.1	2.1	2.5	2.0	1.8	2.0	1.7	1.7	1.4	1.7	2.0	2.5	2.9	3.2
Fish and shellfish	2.1	2.7	1.4	3.9	3.1	2.0	1.3	1.2	-0.1	0.9	1.1	0.6	1.2	0.6	0.7
Fruit	2.4	2.6	2.8	0.7	-0.1	-0.1	-0.3	1.8	8.9	-2.5	3.0	7.4	6.2	4.1	4.6
Vegetables	2.4	4.5	2.7	4.6	-1.6	-1.2	7.0	3.2	2.4	6.1	2.4	-1.4	4.5	2.3	3.6
Salt, spices and sauces, etc.	2.2	0.5	-0.6	-0.7	-0.5	-0.3	-1.0	-1.3	-0.7	-0.6	-0.7	-0.9	-0.8	-0.3	1.0
Non-alcoholic beverages	1.0	1.8	1.9	1.8	1.7	1.4	1.7	1.8	1.8	1.5	1.8	1.7	2.1	2.3	2.5
Alcoholic beverages	1.2	0.4	1.1	0.7	0.8	0.8	0.9	1.0	1.2	1.2	1.3	1.3	1.2	1.5	1.6
Brandy and liqueurs	0.4	0.6	0.2	0.6	0.4	0.1	0.0	0.0	0.0	0.1	0.2	0.3	0.2	0.4	0.7
Wine	1.2	-0.4	0.8	0.2	0.5	0.5	0.7	0.8	1.0	1.0	0.9	0.8	0.8	1.2	1.1
Champagne, sparkling wine and cider	2.5	1.7	2.7	1.3	1.6	2.0	2.3	2.3	3.0	2.7	3.1	3.3	3.1	3.7	4.2
Beer	1.3	1.3	2.1	2.2	2.1	1.9	2.2	2.0	2.2	2.2	2.6	2.4	2.3	1.9	1.6

Source: Insee, SG calculations

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