The Future of Market Measures and Risk Management Schemes

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OUTLINE

1. Price instability: the CAP in international context
2. The 2014-16 dairy crisis: simulations, analysis, and first lessons
3. Taking stocks at CAP tools to address price and income instability
4. „Technical“ and institutional proposals

1. Price instability: a growing issue in EU

Changes in farm structures make farm incomes more sensitive to price instability

- Larger sizes & higher share of purchased inputs: income is a smaller share of turnover, price instability has amplified effects on incomes

EU agriculture is more integrated into world markets

- World price fluctuations are fuelled into internal markets
- Being large producer and a net the EU is a determinant factor of world prices; the use of market measures is highly constrained due to leakages of benefits

1. International aspects

International Commodity Agreements have all failed

The USA has developed a complex and extensive set of tools to stabilise incomes

- Commodity programmes, “Insurances” programmes, etc.
- US producers are overly sheltered from risk (specialisation)
- US Analysts point inefficiencies, and excessive costs
- Important: Benefits of programmes are often conditioned on risk management schemes subscription : self reinforcement

2. The 2014-16 dairy crisis

The dairy crisis was for the most part endogenously caused

- Supply increases (>2/3), Russian Embargo(<1/3)

Policy reaction was slow and gave wrong signals

- The Reserve for crises should have been used, and
- Levies for quota overshoot not postponed
- Crisis envelopes distributed mostly according to farm size

2. The 2014-16 dairy crisis

Simulations tell us that

- March 2016-type intervention could have reduced price shock relative to **2013** by more than 1/3
- Aggregate demand for dairy products inelastic. Price falls by 3% for a 1% supply increase (and shoot up when supply is short, 2013)

2. The 2014-16 dairy crisis

Mandatory supply reduction (e.g. yield reduction) could have delivered benefits similar to intervention at no budget cost

- Supply reduction by 1.6% would have restored prices as much as intervention (March 2016 decisions, 2.5 mion tonnes MEQ)
- Mandatory (no subsidy) reduction ensures Gross Margin Over Feed Costs similar to intervention, at no cost to the budget
- "Voluntary" subsidised reduction (219 € /t) of <u>same</u> magnitude leads to overcompensation and costs similar to intervention

2. The 2014-16 dairy crisis

March 2016 voluntary reduction left to subsidiarity was ill-conceived

- Supply reduction left to POs and MS (as in March 2016) would not occur without subsidy (free riding hence prisoner's dilemma, and cooperation failure between Member States).
- National subsidisation hurts the single market + GNP loss
- Hence, the logic of corrective July 2016 EU-wide programme of reduction, eventually viewed as necessary

2. The 2014-16 dairy crisis

March 2016 voluntary reduction left to subsidiarity was ill-conceived

- Only EU-wide programme could deliver untapped benefits of King effect. Subsidies are unnecessary since price hikes are 3 times larger than supply reduction
- Common price and the single market are "public goods" for all producers, hence subsidiarity in Market measures tends to fuel free riding, and policy failures

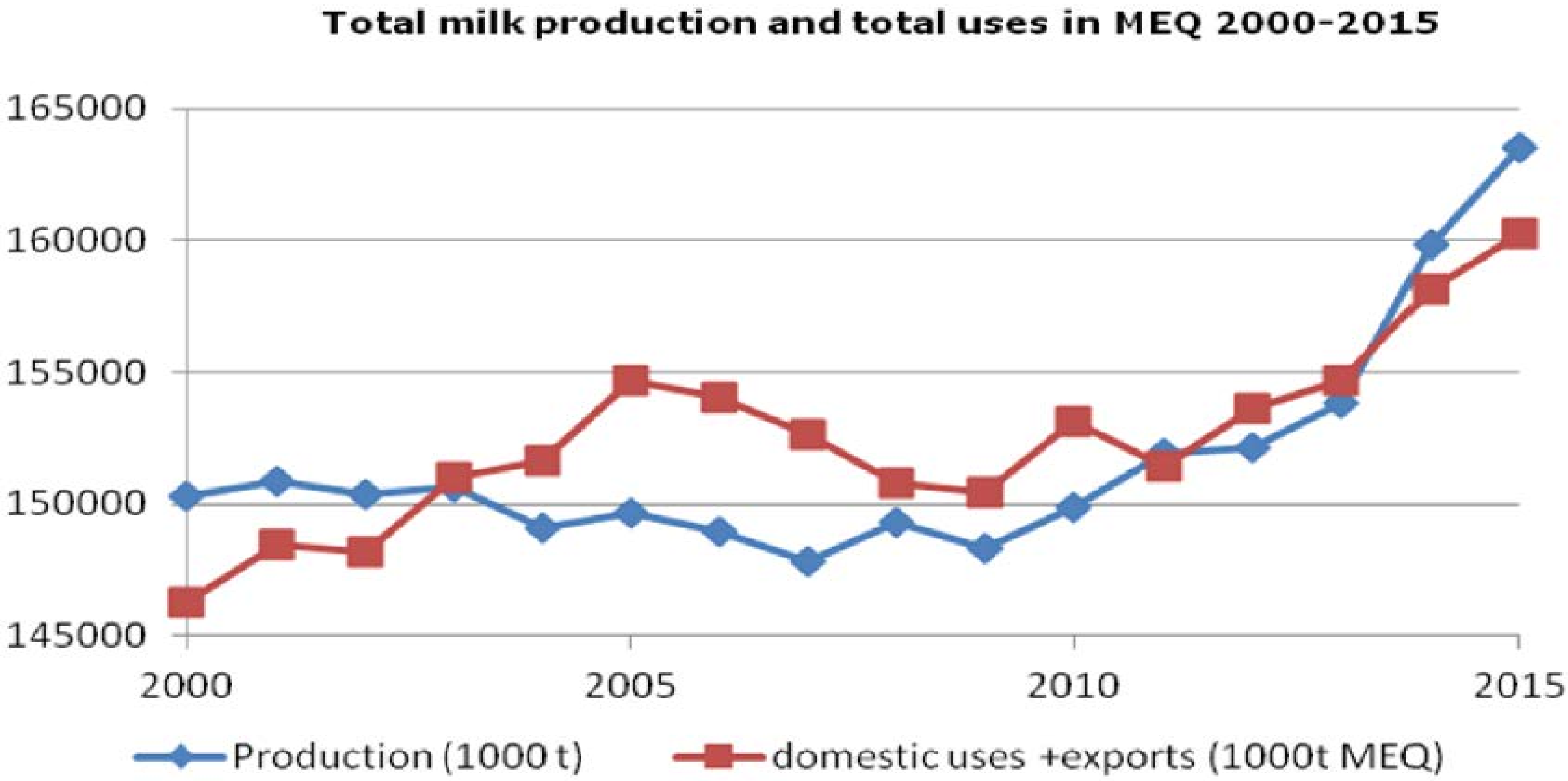
2. The 2014-16 dairy crisis

The 2016 crisis compared to a benchmark year

- With benchmark (price average 336€/t) : Gross revenues in 2015 are €2.7 bn below benchmark (not €7.3).
- What happened to the €5 billion exceptional receipts of 2013?
- Policy scenarios (2,3,4) restore gross revenues to benchmark
- But Gross margins are still lower meaning that
  - The crisis was serious, even relative to benchmark
  - *Ex post* curative measures cannot be best option
- Simulations show that preventive policies needs exploration :
  - *ex ante* supply containment (limited to 4% growth) planned in 2013 restores GMOFC at benchmark, at least cost
  - Cumulating intervention and “July package” applied in 2015 would have entailed revenues and GMOFC >benchmark

2. The 2014-16 dairy crisis

The market fundamentals in 2013 suggested that the crisis was brewing



3. Taking stock at CAP tools to address price and income instability

Price disturbances have amplified effects on incomes

- Input prices are sticky; price booms trigger investment, borrowings, including in land (2008-9)

Stakeholders demand for intervention is asymmetric over the production cycle

- The real concern is for low prices rather than volatility
- The design of the CMO is biased in favour of *ex post* curative measures to alleviate crises = price collapses
- Price booms are not properly dealt with (time consistency)

3. CAP tools to address income instability

Direct Payments as safety net

- Provide a buffer for income, do not change the variance
- Concentration on larger farms: provide financial leverage to invest in periods of booms
- Give counter incentives for precautionary savings

Reserve for crises needs more legal security

- Permanent drawing from basic payments necessary
- Distribution of emergency envelopes excessively focused on <u>rescue</u> approach; gives farmers signal similar to "*too big to fail*". Need to discourage risks-loving business plans

3. CAP tools to address income instability

Market measures can be effective but costly

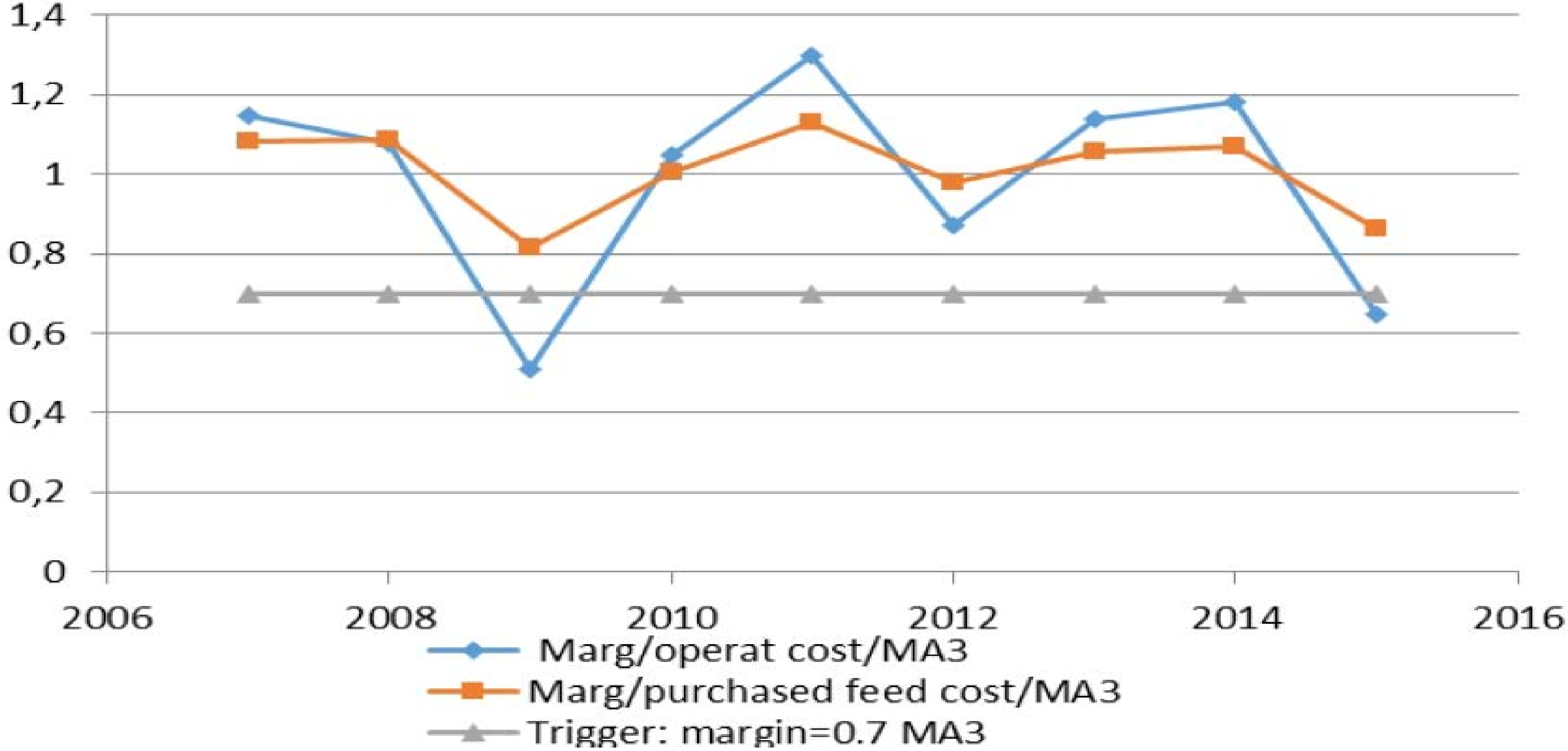
- Intervention by public storage has major weaknesses
  - Without export subsidy stocks must come back on markets
  - Due to EU international positions, EU supports world prices and loses exports ("seen" in the dairy simulations)
  - Public storage <u>should not be a lasting outlet</u> for low cost
- Food aid is undeveloped but offers only marginal potential in crises
- Promotion outlays call for doubts and need scrutiny
- Private Storage could offer more long run benefits in terms of market developments; evaluation of ultimate beneficiaries is in need

3. CAP tools to address income instability

Schemes coping with price risks left to subsidiarity and clearly undeveloped

- Price risks, contrary to most natural risks, are systemic
- Risk pooling is not possible, hence “Mutual ” funds is a misleading for price risks. “Matching funds” with EU contribution are more adequate
- Notion of “income” as in Art 39 prone to create problems : Reference to actual incomes implies a heavy administrative burden; subscribed coverage income and market indicators : more parsimonious and expedite; IST schemes likely heterogeneous across farms and MS; Unequal distribution of benefits possible+ single market distortion

Notion of income covered by IST and likelihood of trigger



3. CAP tools to address income instability

Integration of all policy tools affecting income stability is necessary

- To ensure consistency of instruments :
  - Market measures affect prices; hence, likelihood of IST trigger. Market measures, the Reserve and the Monitoring of IST should be part of EU level competence and in the same pillar
- To provide the right incentives (the bank system crisis),
  - EU subsidisation should favour risk avoiding behaviour and penalise risk exposure (cf F&V CMO)

Introduce "*Crisis prevention cross compliance*"

- Eligibility for Basic Payments should be conditioned on enrolment in ISTs, such as Matching funds, precautionary savings etc.

3. CAP tools to address income instability

Time consistency, symmetric intervention, parsimony in public funds, require new institutional arrangements

- Political institutions should focus on rules and objectives written under the "veil of ignorance" to ensure fairness
- A large part of the single CMO could be part of a "mandate" for the length of MFF
- An independent Authority (e.g. ECB, Competition authorities) would implement the rules
- These conditions are necessary to adopt **preventive strategies,** to avert or reduce market crises and to mitigate their impact on farmers

4. Institutional and "Technical" proposals

A new pillar structure: competence level and scope of public goods should match better:

- Pillar 1: for Global and European Public goods
- Pillar 2: for "Quasi-local Commons" (close to AEM of current pillar 2)
- Pillar 3: Market Measures, Price risk management schemes and support to the farm sector (B Payments …)

Reorganise direct payments

- Move Basic Payments to Pillar 3 and limit per "family worker" to average MS income per capita
- The rest is moved to the Reserve for crises, which becomes multiannual (EGF)

4. Institutional and "Technical" proposals

Separate competences for objectives definition and rules design from implementation

- The political institutions of the Trilogue lay down the mandate for the MFF duration (public fairness of rules)
- An independent authority (European Market Moderation Agency) applies the rules to fullfill the stated objectives
  - Rules do not change with market conditions, predictable
  - Private strategies to cope with risk can develop
  - Predictable environment for Price risk Management schemes
  - Market measures and regulation can be time consistent
  - Crisis prevention can be undertaken

4. Institutional and "Technical" proposals

Make IST incentive compatible; impose crisis prevention cross compliance to Basic Payment

- Revise of Art39 for ISTs to ensure equal opportunities to farmers and Member States
- Design IST rules to induce risk avoidance
- Make eligibility to Basic Payments (and to possible emergency aids from the Reserve) conditioned on
  - Price Risk Management schemes participation
  - And other precautionary devices to be developed
  - To participation in crisis prevention programmes launched by EMMA, such as (ex ante) supply containment during bubbles

4. Institutional and "Technical" proposals

Improve value creation and value sharing in the food chain

- Balance of market power not ensured by contracts
- Make independent assessment of which levels of the food chain benefit from price collapse at farm gate and wholesale levels

Closer supervision of the working of the single market : regular evaluation of impacts of distorting MS policies necessary; description is not adequate

Final word

Preventive measures and strong policy tools such as cross compliance are necessary to discipline coordination failures

Rescue as a single approach to crises management, or the ’too stressed to fail ’ principle only, will produce same results as the bank crises (repetition)

Rules for action must be designed under the veil of ignorance to ensure fairness, and to curtail opportunism at taxpayers cost.

Final word

Failure to implement soft ruling of agricultural markets will end up in <u>problem solution by crises</u>, failures, or public money spoilage,

Keeping rules in CAP benefits distribution prone to opportunism undermines its legitimacy,

Mistrust in the European project will grow