COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT

ON

THE USE OF THE EUROPEAN UNIT OF ACCOUNT

IN THE COMMON AGRICULTURAL POLICY

(Communication from the Commission)

Summary

1. In its declaration on Monetary Compensatory Amounts (MCAs) the Commission told the Council that it was carrying out a detailed examination of whether it would be opportune to use the European Unit of Account (EUA) for the mechanisms of the common agricultural policy (COM(77) 190 final of May 11, 1977).

2. The unit of account presently used in the CAP was designed at a time of stable exchange rate relations between all Member States. Its value is now linked to the Snake currencies and, as these currencies have continously revalued against the Community average, the orientation level for agricultural production and consumption given by common prices in units of account has risen. The EUA, being designed on the basis of changing exchange rate relations would have reflected correctly the average economic and monetary reality in the Community.

3. But the use of the EUA in the common agricultural policy would not by itself result in any fundamental change in the impact of monetary instability on the common agricultural policy. It could not remove the existing 40% gap between national price levels and it would not eliminate the need for MCAs, but future MCAs would be distributed in a different fashion.

4. In view of the advantages it would bring, the Commission favours in principle the introduction of the EUA to the common agricultural policy.

5. However, the Commission considers that, under present circumstances, the introduction of the EUA would raise fundamental questions concerning the common agricultural policy. Its implications require further examination, and the Commission is not submitting a proposal at the present stage. It intends to continue its examination of the question, in liaison with the Member States, and reserves the possibility of submitting a proposal to the Council at a later stage.

I. THE AGRICULTURAL UNIT OF ACCOUNT AND MONETARY DEVELOPMENT

6. Since 1962, a unit of account has been used in the common agricultural policy to express common agricultural prices and amounts. These are then converted into national currencies by means of a set of conversion rates, which were intended to reflect currency parities.

7. The single agricultural market - achieved in this way - was jeopardized by the devaluation of the French franc in August 1969 and, two months later, by the revaluation of the German D-Mark. The governments concerned found it difficult to accept the consequences of an immediate increase in agricultural prices expressed in French francs or an immediate fall in prices expressed in D-marks.

Both parity adjustments were regarded as exceptional occurences, and it was decided that common prices expressed in French francs and in D-marks would not be adjusted for a given period (three months for the D-mark, and two years for the French franc). In order not to distort trade and the functioning of the intervention mechanisms, it was necessary to introduce, during that period, monetary compensatory amounts (MCAs) to cover the gap between common prices and national prices effective on the market. The single agricultural market was to be restored by the end of the period in question.

8. The 1971 dollar crisis led to a general floating of Member States' currencies. The Community decided to retain existing conversion rates used for the purposes of the common agricultural policy (IMF parity) and thus to maintain the level of agricultural prices expressed in national currencies. It therefore introduced non-compulsory MCAs. The level of MCAs for each Member State was determined by the movement of its currency against the dollar; there was no Community financing. Since July 1972 (for trade with non-member countries) and January 1973 (for intra-Community trade) compulsory MCAs have been introduced for most products and are financed by the Community.

9. In February 1973 representative rates were introduced into the common agricultural policy as the means of converting from units of account into national moneys. MCAs are no longer calculated by reference to movements in the dollar rate but by reference to the average movement of the Snake currencies.

10. The Community has adjusted the representative rates towards market or central rates both during the marketing year and at the annual price reviews. But, in spite of these adjustments, monetary events have widened differences for most currencies between representative rates and market or central rates and this has, in turn, meant a widening gap between national prices.

11. The Commission proposed last year a system for realigning present national prices on the common price by means of the phased reduction of MCAs. This has now been revised and is being re-submitted to the Council (COM(77) 432). The Commission will also present a report on the economic and financial effects of MCAs.

II. THE CONSEQUENCES OF ADOPTING THE EUROPEAN UNIT OF ACCOUNT IN THE COMMON AGRICULTURAL POLICY

12. Since 1975, the Community has pursued a policy of standardizing the units of account used in the different spheres of Community activity by adopting the European Unit of Account (EUA) for the European Investment Bank, European Development Fund, the European Coal and Steel Community and, soon, the budget. Consideration must, therefore, be given to whether the EUA should also be applied in the common agricultural policy.

13. As part of its study of the problems arising from the introduction of the EUA into the common agricultural policy, the Commission has investigated the problems arising from the Switchover itself, from the evolution of the value of the EUA after Switchover and from the introduction of the EUA into the annual price review. It also investigated the budgetary impact of the introduction of the EUA. In order to assess some of these problems, the Commission carried out simulations based on recent data.

The EUA and the Problem of the Common Price Level

14. Since 1973 the value of the Agricultural Unit of Account (AUA) has been related to the Community Snake currencies (1). Monetary divergence has made these currencies less and less representative of the economic and monetary

(1) The Community currencies presently party to the Snake or joint float agreement are the D-Mark, the Dutch Florin, the Belgian-Luxembourg franc and the Danish crown. The French franc left the Snake in March 1976 having rejoined it in June 1975.

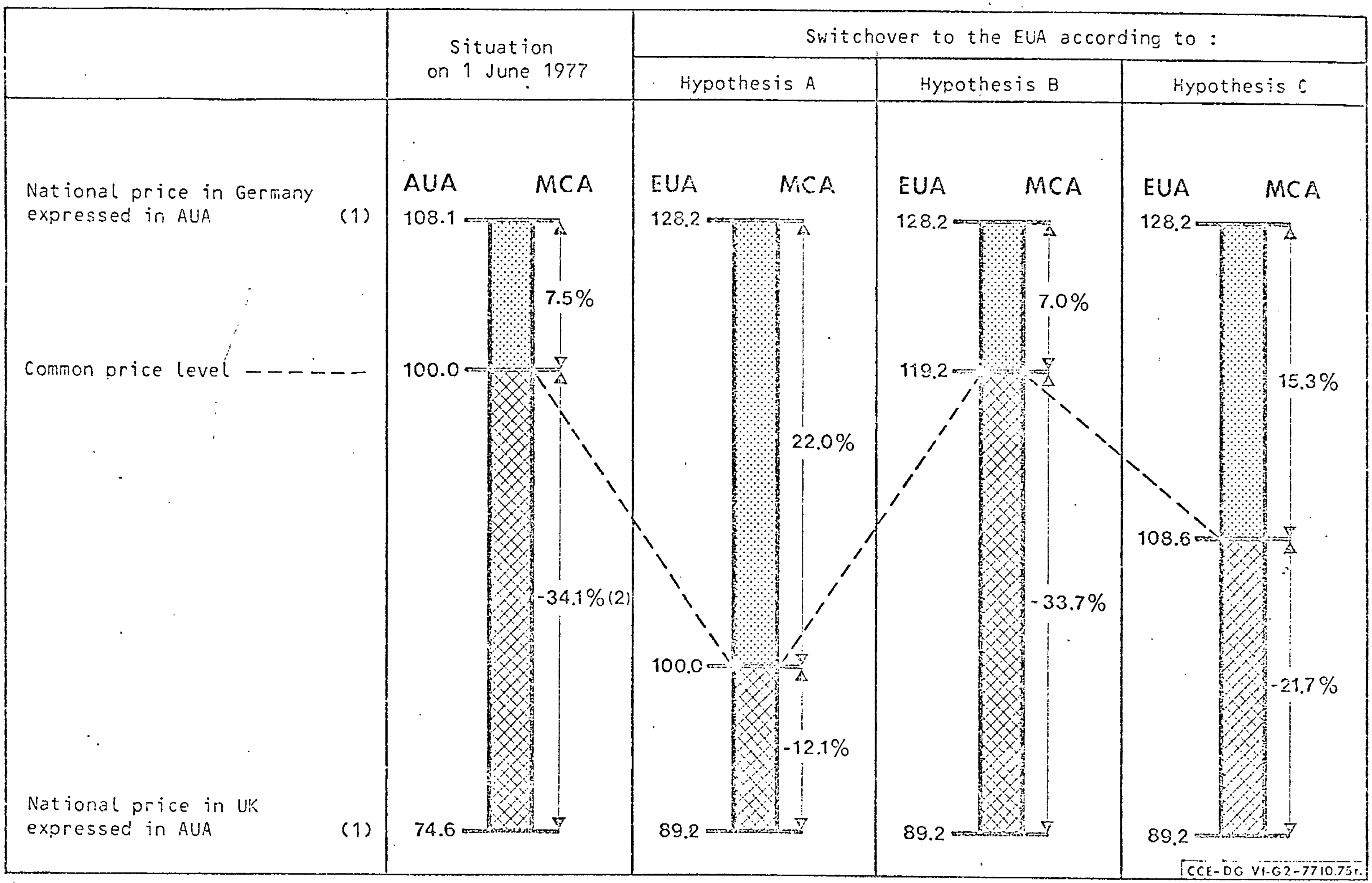
performance of the Community. The combined weight of the Snake economies in Community production and trade is less than 50%, the Snake currency countries now represent only 37% of the Community agricultural production, 35% of the Community population and about 60% of intra-Community agricultural trade. Furthermore, the use of a unit of account, based only on the Snake, makes it impossible to correctly express the movement of Snake currencies with respect to other Community currencies. Therefore, a part of the recorded depreciation of the weaker currencies can be considered as an appreciation by the Snake itself. Another way of expressing this phenomenon is that the average level of price support expressed in some national currencies has increased more rapidly than the common price in units of account. The evolution of the common price is not therefore an accurate indicator of the effective level of common price support in the Community.

The value of the EUA, on the other hand, reflects the average current economic and monetary performance of the Community. Its use therefore would more closely reflect economic and monetary realities in relation to the common agricultural policy but its introduction would require a decision affecting the level of common agricultural prices.

15. Common prices and amounts fixed in units of account are a main element of the Community's economic policy in the field of agriculture. They are intended to direct the evolution of agricultural production and food consumption and to influence the development and level of income in the agricultural sector. The generalisation of agricultural representative rates that are different from market exchange rates has limited the effect of the common price system. Indeed production, consumption and incomes in the agricultural sector are more and more influenced by different national expressions of the common price, these "national" prices being higher than the common price in countries with appreciated currencies (those with positive MCAs) and lower in countries with depreciated currencies (those with negative MCAs). Denmark is the only Member State where the "national" price and common price are the same. The gap between the highest and lowest national expressions of the common price is now about 40 % (see Figure 1).

But, even if different national prices have become a part of economic reality, common prices remain the fundamental element of the Community's price policy, because, they remain the cornerstone of the annual price decisions and because they still determine most of the price relationships between agricultural commodities in each of the national markets. It is Community policy to realign the different "national" prices by eliminating MCAs.

FIGURE I : ILLUSTRATION OF THE EFFECTS ON THE COMMON PRICE LEVEL OF THREE HYPOTHESES CONCERNING THE CONVERSION RATES BETWEEN THE AUA AND THE EUA



(1) For the purposes of this graph it has been assumed that on the day of Switchover to the EUA MCA's are refixed so that the existing national prices are maintained.

(2) Real monetary gap, the applied gap being 32,3 % (See Table 1)

A decision to adopt the EUA would mean that, after the day of Switchover, common prices and amounts would be expressed in EUA. The differences in national money values between the AUA and the EUA would necessitate a decision on the conversion rate to be used at the moment of Switchover. This would raise the question of the level of the common price to which Member States would converge as MCAs were eliminated in the future. On the day of the Switchover, assuming unchanged prices in national currencies, this problem would present itself as a possible redistribution of MCAs (see Figure 1).

16. Different conversion rates could be chosen to effect the Switchover. At one extreme, the conversion rate could be chosen so that the common price - i.e. that price to which all national prices tended as MCAs were phased out - was fixed at the level of the present German price. At the other extreme, the conversion rate could be chosen so that the common price was fixed at the level of the present United Kingdom price. The effect of the first conversion rate would be to reduce the German MCA to zero and to redistribute other MCAs so that they all became negative, the effect of the second to reduce the United Kingdom MCA to zero and to redistribute other MCAs so that they all became positive.

17. The Commission developed three hypotheses lying between these two extremes to investigate the problem of the conversion rate and its effect on the common price level. Simulations of the Switchover were carried out on the basis of data for June 1 1976 and the results have been analysed to show:

(a) The effect on the value of the AUA prices expressed in national currencies at central or market rates. This is the level to which national prices would tend as MCAs were eliminated.

(b) The effect on common prices and amounts expressed as the weighted average of existing national prices in all member states, i.e. prices converted on the basis of existing representative rates.

<u>Hypothesis A</u> in the simulations merely substitutes an equal quantity of EUAs for a given quantity of AUAs. The results of this would be :

a) Common prices and amounts expressed in EUA would be nominally the same as in AUA. For example, a price of 100 AUA would become on the day of Switchover 100 EUA. But the money value of the AUA prices would fall by 16 % because the EUA is worth less. If the Switchover had been made in June 1973 the loss of value would have been practically nil because at that time the AUA and the EUA had an equal worth.

b) The value of the level of common prices defined as the weighted average of existing national prices would fall by 7,9 %.

<u>Hypothesis B</u> in the simulations in effect keeps almost unchanged the weighted average of national prices that would exist if green and central rates and green and market rates were aligned just before the Switchover. The coefficient of conversion between the AUA and EUA has been calculated as the weighted average difference between EUA rates and central rates in the Snake currency countries.

a) The common prices and amounts expressed in EUA would nominally be 19,2 % greater than in AUA. For example, a price of 100 AUA would become on the day of Switchover 119,2 EUA. But, due to the lower value of the EUA, the money value of AUA prices would nevertheless remain almost unchanged.

b) The value of the level of common prices and amounts defined as the weighted average of existing national prices would rise by 9,8 %.

Hypothesis C in the simulations keeps unchanged the weighted average of national prices existing on the day of Switchover. The result of this would be :

a) The common prices and amounts expressed in EUA would nominally be 8,6 % greater than in AUA. For example, a price of 100 AUA would become on the day of Switchover 108,6 EUA. But, due to the lower value of the EUA, the money value would fall by 8,9 %.

b) The value of the level of common prices defined as the weighted average of existing national prices would remain unchanged.

18. These simulations demonstrate the critical nature for the common price level of the conversion rate to be used between the AUA and the EUA. The difficulties surrounding the choice of this conversion rate arise from the fact that there is no single economic relationship between the two units of account that is applicable to the whole Community. The difficulties could only be resolved by a political decision taking fully into account the effects that the different possible levels of common prices could finally have on agricultural prices, production income and the budget.

19. However prices in national moneys need not immediately be affected by the common price level implicit in the chosen conversion rate. Prices in national moneys existing at the moment of Switchover could temporarily be maintained by an appropriate set of green rates.

In this light, the choice of the conversion rate would amount to a decision on the redistribution of the stock of MCAs existing just prior to the moment of Switchover.

The EUA and Monetary Compensatory Amounts

20. Monetary instability - as experienced since 1973 - disturbs one of the fundamental principles of the common agricultural policy, namely the single market established through a set of common prices and amounts. This is true whichever unit of account is used to express common prices. Price stability in this single market is one of the objectives of the common agricultural policy : abrupt price changes caused by exchange rate movements would be unacceptable to farmers and consumers.

In order to preserve price stability at a time of monetary upheaval, the common agricultural policy - as already described in Part I - has introduced as its own constant conversion rates and this has implied the payment of MCAs in trade. The need for constant conversion rates and the resulting MCAs is not altered by the nature of the unit of account used in the common agricultural policy.

The adoption of the EUA, therefore, cannot by itself remove the impact of monetary instability on the common agricultural policy. But it could affect the distribution of the stock of MCAs existing on the day of Switchover (§ 21) and it would affect the flow of new MCAs afterwards (§ 22). The modalities of the MCAs themselves would also change (§ 23).

21. The choice of the conversion rate between the AUA and the EUA could have an immediate effect on the distribution of MCAs existing at the moment of Switchover. This was also studied in the simulations and the results are summarised in the following table. This compares the distribution of MCAs that existed on 1.6.1977 with those obtained from the conversion rates used in the three hypotheses.

Table 1 : Actual MCAs and MCAs resulting from the introduction of the EUA on June 1, 1977

Member State	Applied MCAs on 1.6.1977	MCAs resulting from the application of the EUA		
		Hypothesis A	Hypothesis B	Hypothesis C
Germany	+ 7,5	22,0	7,0	15,3
Netherlands	+ 1,4	18,1	2,4	11,1
Belgium-Lux.	+ 1,4	17,4	1,6	10,3
France	- 14,5	3,3	- 15,2	- 5,0
Ireland	- 4,6	11,1	- 6,0	3,4
Italy	- 14,8	2,9	- 15,8	- 5,5
Denmark	0	16,5	0,5	9,3
United Kingdom	- 32,3	- 12,1	- 33,7	- 21,7

22. The simulations demonstrated that the flow of new MCAs resulting from the evolution of the EUA - i.e. the dynamic effect of the EUA on the price level - would be the same whatever the conversion rate chosen for the Switchover. The distribution between Member States would however be more balanced and there would be a greater number of MCA changes compared with the evolution actually observed over this period on the basis of the AUA (see Table 2).

The creation of greater positive MCAs in the period of the simulation reflects the appreciation of the Snake currencies against the Community average during that period.

Table 2 : Hypothetical monetary gaps resulting after the adoption of the European Unit of Account on January 1 1976 without taking account of the stock of MCAs at the moment of Switchover (1)

Member States	Simulated monetary gap using EUA :								Simulated Monetary gap on 19.9.77 using AUA (2)
	1975	1976				1977			
	31.12	31.3	30.6	30.9	31.12	31.3	30.6	19.9	
Germany	0	+ 6	+ 7	+ 11	+ 12	+ 12	+ 13	+ 13	+ 2
Netherlands	0	+ 3	+ 4	+ 8	+ 11	+ 10	+ 10	+ 10	0
Belgium-Lux.	0	+ 4	+ 6	+ 9	+ 11	+ 11	+ 11	+ 11	0
France	0	0	0	- 5	- 7	- 7	- 7	- 7	- 20
Ireland	0	- 2	- 8	- 15	- 16	- 13	- 14	- 14	- 28
Italy	0	- 18	- 16	- 19	- 24	- 24	- 25	- 26	- 43
Denmark	0	+ 4	+ 6	+ 9	+ 9	+ 9	+ 5	+ 3	- 13
United Kingdom	0	- 2	- 8	- 15	- 16	- 13	- 14	- 14	- 28

(1) Table established assuming a franchise of 2% and modifications of the monetary gap each time the calculated new gap differs 1% from the old one. It is assumed that no green rate adaptations have taken place since January 1, 1976.

(2) To provide a comparison with the simulation, it has been assumed that the actual stock of MCAs on January 1 1976 was zero and that no green rate adaptations have since taken place.

23. MCAs are calculated with reference to the Snake currencies. Therefore MCAs for those Community currencies in the Snake are fixed and those for freely floating currencies are variable. As the introduction of the EUA would not alter the need to fix MCAs, the persistence of monetary instability beyond the day of the Switchover would, together with the desire for stability on agricultural markets, create a flow of new MCAs modifying the existing stocks. The application of the EUA would - since no currency has a fixed relationship with it - result in MCAs that were variable for all currencies because a variation in the value of one currency would affect the MCAs of all currencies.

This change would affect the 14 % of Community agricultural and food imports (intra and from third countries) and 27 % of exports at present taking place under fixed MCAs. The rest of the trade already takes place under the present system with variable MCAs or without MCAs.

24. Representative rates are currently brought more in line with market exchange rates through ad-hoc decisions by the Council. All these decisions have been taken as part of the annual price fixing or as a result of desired green rate changes during the course of a campaign. This pragmatic approach has now resulted in the build-up of a large stock of MCAs because of insufficient adjustment. But the problem of adapting representative rates to market exchange rates exists whatever unit of account is used in the agricultural policy. Although the use of the EUA could provide a more balanced reference point for regular adjustments of representative rates, a different distribution of MCAs between Member States would not necessarily resolve the political and economic difficulties inherent in the process of adjustment.

The EUA and the annual price review

25. The introduction of the European Unit of Account into the agricultural policy would require that the same unit of account was used in the annual price fixing. In the recent period of monetary instability, the Snake currencies showed a more substantial appreciation against the EUA than against the AUA. This means that a given price rise in national currencies is shown as a lower price rise in the common price level expressed in AUA than if it were expressed in EUA. For example the "objective method" used in the annual price round to calculate the "needs" for price rises to maintain the relative income of farmers, indicated a 0.4 % price rise in AUA for the campaign year 1977/78. Had the EUA been used, in this case the same price adjustments in national currencies would have required an 11 % price rise in EUA. It is difficult to assess the possible impact of these purely presentational differences in the results of the two systems. It should be clear, however, that given price rises decided in AUA in the past few years appeared much less substantial than they would have seemed if they had been expresses in EUA. If, on the other hand, the evolution of the Community currencies in future were to follow a different course in relation to each other, the application of the EUA in agriculture would have a different effect. The essential feature of the EUA is that, whatever the relative movements of the Community currencies, it would provide a unit of value more representative of the economic and monetary performance of the Community.

The EUA and the Community budget

26. The introduction of the EUA for agriculture would have no immediate effect on FEOGA guarantee expenditure, since it is effectively determined by the prices ruling in national currencies which by definition remain unchanged. There would, however, be some redistribution of this unchanged total between the Member States.

27. When MCAs are phased out, however, the budgetary position would vary considerably depending on the rate of conversion between the AUA and the EUA used when the EUA was adopted. Under Hypothesis A not only would the budgetary cost of MCAs disappear, but there would be in addition a budgetary saving on interventions and refunds as a result of the lower average price level in national currencies, assuming that the phasing out of high positive MCAs did not involve an increase in unit of account prices. Under Hypothesis B, the 10% average price rise in national currencies will lead to increased expenditure on interventions and refunds which will to some extent offset the saving on MCAs. (This corresponds roughly with the situation arising when MCAs are phased out under the existing AUA-based system.) Under Hypothesis C, on the other hand, the resulting variations in expenditure on refunds and intervention are likely to be very limited.

28. Analysis of the differences between the hypotheses must also take account of the dynamic effects of the different price levels involved.

29. As regards food aid, the export refund element will be affected in the same way as FEOGA guarantee expenditure (see above). The part corresponding to the value at world market prices will in any case be expressed in EUA from

1 January 1978, as a result of the adoption of this unit for the purposes of the Budget. Consequently this latter expenditure will be unaffected by the adoption of the EUA for agriculture.

30. As regards expenditure under the EAGGF Guidance Section, there are two possibilities. For fixed amounts, the effects will be analogous to these observed above for EAGGF Guarantee expenditure. In the case of maximum amounts, however, the effect is difficult to ascertain, because it will depend on the extent to which the amounts granted by Member States approach the maximum.

III. CONCLUSIONS

31. The present Agricultural Unit of Account (AUA) was designed at a time of stable exchange rate relations between all Member States. Its value is now linked only to the Snake currencies, which have appreciated against the Community average since 1973. The Commission's analyses show that the use of the EUA would have the advantage of reflecting the average economic and monetary evolution of the Community as a whole and would make it possible to take account of the evolution of all the Community currencies instead of giving a special role to the Snake currencies. Its use would also enable the annual fixing of common prices, which under the present system are no longer an accurate indicator of the effective level of price support in the Community, to be carried out in a more transparent manner.

32. Use of the EUA would also have the institutional advantage of harmonizing the different units of account used by the Community, leading to greater administrative simplicity.

33. The adoption of the EUA would have no immediate effect on the total of Community expenditure on agriculture, but the long-term effect would depend on the dynamic effect of future price levels.

34. The Commission's analyses also reveal that the main questions raised by the introduction of a new unit of account to the common agricultural policy relate to its impact on the common price level and therefore on the distribution of MCAs, and on the nature of MCAs themselves.

a) A decision to adopt the EUA in place of the present AUA would mean that, after the day of Switchover, common prices would be expressed in EUA. The differences in national money values between the AUA and the EUA would necessitate a decision on the conversion rate to be used at the moment of Switchover. This would require a decision affecting the level of common agricultural prices and of the distribution of existing MCAs.

   Several options for converting the AUA to the EUA are open, each implying different common price levels. Choice between these options would be a matter for political decision.

b) The introduction of the EUA would not remove the need to fix and modify MCAs in relation to monetary changes.

   Continued monetary instability beyond the day of Switchover would, together with the desire for price stability on agricultural markets, create a flow of new MCAs modifying the existing stock. The application of the EUA would result in MCAs that were variable for all currencies.

35. In view of the advantages it would bring, the Commission favours in principle the introduction of the EUA into the common agricultural policy.

36. However the Commission considers that, under present circumstances, the introduction of the EUA would raise fundamental questions concerning the common agricultural policy. Its implications require further examination and the Commission is not submitting a proposal at the present stage. It intends to continue its examination of the question, in liaison with the Member States, and reserves the possibility of submitting a proposal to the Council at a later stage.