

Price Formation in the CAP: Agrapolitical Success and Economic Failure

By

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Introduction

The distractions of the creation of the EC's Single Market and the struggle for ratification of the Treaty of Maastricht were instrumental in allowing the CAP to be reformed. Nevertheless, the "success" of the CAP in producing agricultural surpluses may not be reduced unless there is a GATT agreement in agriculture or a single currency is established within the EC's Single Market.

Unfortunately, the drive to a single currency and a single market has perversely allowed CAP prices to surreptitiously rise in the short term in spite of mounting budgetary costs and claims of lower prices. Continued overproduction of agricultural products because of high prices and subsidization of surpluses onto the world market not only distorts the EC's economy but blunts economic growth in its more agrarian-based neighbors to the east. Hence, the CAP not only fouls its own economy but prevents its own trading partners in Europe from prospering which would help the EC economy recover from another bout of Eurosclerosis.

Price Formation in the CAP: The Myth of Common Prices

The charade of maintaining common prices for agricultural products in the EC began in 1969 when the French Franc (FF) was devalued and the German Deutschmark (DM) was revalued and exchange rates for agricultural products were introduced which differed from official exchange rates. The fiction of common prices in the CAP continues today and the infamous agrimonetary system is even more non-transparent than ever.

The EC Commission proposed a radical reform of the EC's agrimonetary system by January 1, 1993 which could have led to decreases in CAP prices in national currencies. However, turbulence in EC exchange rate markets and opposition from strong currency countries led to a system which led to rapid rises in CAP prices in national currencies and increases the likelihood of further price inflation for CAP products in the next few years.

The results of the new system could seriously undermine attempts to lower CAP prices to the levels approved in the CAP Reform of May 1992. As long as the EC tries to maintain a common price in the face of variable exchange rates and a strong intervention system, CAP prices in national terms will rise relative to prices denominated in ECU's. This fact is guaranteed by the linking of the FF and the DM.

The Root of the Price Problem

A principal goal of the CAP has been to establish common prices throughout the EC. CAP prices are set in a common numeraire (the unit of account, or UA initially, and later the European Currency Unit, or ECU in 1979) which is then converted into national currencies at the appropriate exchange rate. However, when the official exchange rate in an EC member state moved against other member states and thus against the numeraire, farm prices in national currencies would change.

For example, if the FF fell 10 percent against the UA or the ECU (a devaluation of the FF), French farmers would receive a 10 percent increase in prices. For example, a CAP price of 2 ECU per bushel of wheat with 1 ECU equal to 5 FF gives a price of 10 FF per bushel. A 10 percent FF devaluation makes 1 ECU worth 5.5 FF and the French farmer then receives 11 FF per bushel in national currency even though the CAP "common price" remains at 2 ECU per bushel.

Conversely, if the DM rose 10 percent against the ECU (a revaluation of the DM) then German farmers would suffer a 10 percent decline in domestic CAP prices. The same bushel of wheat equal to 2 ECU per bushel with 1 ECU equal to 2 DM originally gave the German farmer 4 DM per bushel; the 10% revaluation lowers the value of 1 ECU to 1.8 DM and the German wheat price is thus reduced to 3.6 DM per bushel.

The reluctance of France and Germany to allow exchange rate fluctuations to be fully transmitted into domestic agricultural prices led to the creation of special exchange rates for agricultural products covered by the CAP.^{1/} France officially devalued the FF in 1969, but maintained the old exchange rate to convert CAP prices into FF. In so doing, French policymakers prevented a rise in farm prices, but most importantly for them, they prevented a strong rise in food prices which would have exacerbated an already high rate of inflation. A few months later, Germany revalued the DM but maintained the old exchange rate to convert CAP prices into domestic prices in order to prevent lower farm prices, a political priority for German policymakers.

Because these agricultural exchange rates (later called green rates) were relatively fixed (member states were allowed to change their green rates occasionally) and differed from official exchange rates, significant price differences surfaced between member states. Consequently, French farmers, for example could have sold their CAP products in Germany at higher prices. From the simplified example above, the official cross exchange rate

^{1/} In reality the special rates used to convert CAP prices into national prices should be viewed as anti-exchange rates because they are employed to counter the effect of fluctuations in official exchange rates between EC member states.

between France and Germany would have moved from 1ECU=5FF=2DM to 1ECU=5.5FF=1.8DM. By maintaining the old rates as agricultural exchange rates, a French farmer could have sold a bushel of wheat into German intervention for 4DM and converted into FF at the official exchange rate of 1.8DM=5.5DM and received 12.22FF per bushel instead of the 10FF per bushel offered at the French intervention price. All French wheat then would have been sold into German intervention.

The problem with allowing price differentials between EC member states was that the intervention system of the CAP guarantees purchase of all quantities of CAP products offered at the intervention price. This would have meant that most or all CAP commodities would have been sold to the intervention agency in the member state with the highest price as noted in the example cited above. In practice, this would have meant that the German intervention system would have been flooded with CAP commodities from other member states because the DM was consistently revalued in the 1970's and 1980's, which led to Germany having the highest CAP prices in the EC.

Introduction of Border Taxes and Subsidies

To prevent trade resulting from the price differentials between EC member states, border taxes and subsidies, called monetary compensatory amounts, or MCA's, were levied to offset the price differentials. The MCA's were intended as temporary measures in 1969 but they have continued to the present in part because they allow member states to control national prices through manipulation of green rates.

EC countries with devaluing currencies maintained green rates at lower ECU rates than the official exchange rate while member states with revaluing currencies maintained green rates higher than the official ECU exchange rate. In EC parlance, the MCA's in weak currency countries were called "negative MCA's" and their exports were taxed and imports subsidized to equalize prices with other EC members. In countries with strong currencies, MCA's were called "positive MCA's" which meant that their CAP exports to member countries were subsidized and imports were taxed.^{2/}

Reduction of negative MCA's required a devaluation of the green rate, which means a price increase for farmers in national currency while reduction of positive MCA's required a revaluation of the green rate, a price reduction for farmers in local currency. The rate at which MCA's were reduced became the focal point of negotiations in the EC Council of Agriculture Ministers.

^{2/} The detailed complexities and rules of the system are ignored in this article for the sake of brevity and simplicity.

In effect, annual price negotiations in the EC centered around devaluations and revaluations of green rates rather than setting common prices in ECU's. Price divergence between member states increased substantially to the point that a grain price differential of over 60 percent between the U.K. and Germany developed in the late 1970's. At this point, the setting of common prices in a numeraire was no longer an accurate indication of EC farm prices as indicated in table 1.

Complicating matters even further, EC member states were allowed to establish different green rates for different commodities. This precedent allowed some countries to develop a comparative advantage in livestock feeding, for example, by maintaining a lower green rate for cereals than for meat. This development allowed French farmers to feed at lower costs relative to German livestock feeders because the French green rate for grains was lower than the green rate for pork. Over 40 different green rates were functioning in the EC in the early 1980's, further reflecting the degree of national control over farm prices.

The extraordinary complexity of the system and the nature of its mechanisms, as it evolved, contributed significant pressure for CAP prices to rise. The so-called CAP "common price" in ECU's rose by 26.5 percentage points from 1980 to 1992, when prices to farmers actually rose 50.6 percentage points in national currencies (table 1). In 5 of the years the EC claimed to have lowered "common prices" in ECU's when prices in reality increased because of conversion into national currencies through the green rates. The recent turbulence in the EMS has added even more percentage points to the rise in prices in national currencies.

The overall effect of the agrimonetary system over the past two decades has been to distort production, consumption, and trade patterns of EC food and agricultural products (Josling and Gardiner). Its complexity has also led to significant fraud (Swinbank).

The Role of the European Monetary System (EMS)

When the Bretton Woods system of relatively fixed exchange rates collapsed in the early 1970's, all EC member states adopted agricultural or green exchange rates leading to price differentials between all EC member states. Member states such as Germany and the Netherlands had strong currencies and therefore had higher farm prices than countries with weak currencies such as France and the U.K.

The European Monetary System (EMS) was introduced to stabilize exchange rates between EC member states in 1979. The EMS established the ECU, a basket of all EC currencies, the value of which is based on each member state's rate against the U.S. dollar and weighted by a 5-year average of gross national product and trade shares between member states.

Table 1: Changes in CAP prices since 1980

	Common prices in ECU (a)	Prices in national currencies (b)	Price disparity (b-a)
1980/81	4.8	5.7	0.9
1981/82	9.2	10.9	1.7
1982/83	10.4	12.2	1.8
1983/84	4.2	6.9	2.7
1984/85	-0.5	3.3	3.8
1985/86	0.1	1.8	1.7
1986/87	-0.3	2.2	2.5
1987/88	-0.2	3.3	3.5
1988/89	0.0	1.6	1.6
1989/90	-0.2	1.3	1.5
1990/91	-1.1	0.2	1.3
1991/92	0.0	0.5	0.5
1992/93 ¹⁾	0.1	0.3	0.2

Source: EC Commission.

¹⁾ Estimate

Stability between EC currencies is preserved by the Exchange Rate Mechanism (ERM), which defines in percentage terms (or bands) how much a currency can fluctuate against the ECU. All member countries must maintain a 2.25-percent band around the ECU central rate with the exception of the U.K., Spain, and Portugal, which participated in a 6-percent band. However, in September 1992, the Italian lira and the U.K. pound were forced out of the ERM and devalued because of economic disparities within the EC that resulted in severe speculation against the U.K. and Italian currencies ^{3/}. Greece does not participate in the ERM.

The EMS did help stabilize exchange rates as EC member states adjusted their monetary and fiscal policies and coordinated intervention on currency markets to keep currency fluctuations within the ERM bands. Realignment within the EMS occurred but at less frequent intervals from 1987 until the recent problem. This is reflected in column three of table 1, which shows a decline in the disparity between the CAP's ECU price and the price in local currencies since 1987. Notwithstanding the relative stabilizing influence of the EMS, a political problem surfaced for Germany as DM revaluations resulted in pressure to lower German farm prices throughout the 1970's and 1980's.

Introduction of the Switchover Coefficient

Every year at the agricultural price negotiations in Brussels, German policymakers were under pressure to reduce their accumulated positive MCA's by revaluing the German green rates, which meant lower prices for German farmers. Beleaguered by both their EC colleagues to lower prices and by their farmers, who protested that they were the only EC farmers whose prices were lowered, led the German policymakers to propose a way of abolishing positive MCA's (Tangermann and Kelch).

The German proposal that was accepted in 1984 introduced a "switchover" coefficient which prevents the creation of new positive MCA's after a realignment in the EMS. The switchover coefficient is simply a mechanism whereby a corrective factor equivalent to the revaluation of the strongest currency (traditionally the DM) against the ECU is applied to the ECU central rate to create a green ECU central rate for all EC currencies. In this way the "green" ECU was created. With the creation of the switchover coefficient, German farm prices remain unchanged because the German green rate is unchanged and no positive MCA's are created. Here the rule of unanimity in EC decisionmaking applied as the Germans were prepared to invoke the "Luxembourg Compromise" to prevent German farm prices from falling.

^{3/} The U.K. pound and the Italian lira are expected to return to the ERM but it is not known when this will occur or at what rate or in which currency band.

However, the switchover coefficient is applied to the ECU central rates of all member states and new larger negative MCA's are thus created in member states with weak currencies. Reduction of negative MCA's then results in higher prices for all member states not aligned with the DM. The switchover coefficient effectively raises CAP prices to the level of the member state with the highest prices. Since 1984, the switchover coefficient had increased to 1.145 as of September 1, 1992 because of realignments in the EMS. The exchange rate fluctuations in late 1992 and early 1993 pushed the switchover coefficient to 1.205 by February 1 4/. Convergence of prices in ECU's and national currencies since 1987 is demonstrated in column "c" of table 1. However, the gap will widen for 1992/93 and 1993/94 because of the rise in the switchover coefficient.

The system complicates price formation, and calculation of MCA's at EC border posts adds significant cost for commercial traders of agricultural bulk commodities. Processed food traders in the EC also suffer losses in transactions costs, because MCA's must be calculated and collected at intra-EC borders proportional to the content of the CAP product contained in the processed product. Calculation and collection of MCA's is considered a significant transaction cost in intra-EC food and agricultural trade (EC Commission, The Costs of Non-Europe).

The Single Market and the Single Currency

The advent of the EC's single market on January 1, 1993, and the move to a single EC currency led the EC Commission to propose a new system. These proposals, if they had been adopted, would have made price formation in the CAP much more transparent and remove most of its price-inflating mechanisms. However, Germany and France led the way to adopting those rules that would protect strong currency countries and jettisoned rules that would have led to lower prices for most member states.

The passage of the Single European Act in 1987, and the deadline of January 1, 1993, to complete the single market has been a driving force to abolish all technical, fiscal, and physical barriers to intra-EC trade. Consequently, the EC abolished border posts between EC member states by the end of 1992. The dilemma this presents for the agrimonetary system is that border posts are the only practical place to collect MCA's, and without MCA's the entire pricing system could collapse.

From 1987 until recently, developments in the EC monetary sector had encouraged the elimination of MCA's. There had not been any substantial realignments in the EC since 1987 until the last 2 weeks of September 1992 because of strict adherence to the ERM. However, speculation against weak currencies in the EMS exploded in September of 1992 and have continued since then.

4/ The switchover coefficient applies not only to agricultural prices but to calculation of producer aids and trade with non-EC countries.

The Maastricht Treaty on European Union signed in December 1991 includes the establishment of an economic and monetary union (EMU) with a single EC currency by 1997 or 1999. If an EMU is created, or if the EC established fixed exchange rates, currency realignments could not occur and an agrimonetary system would not be needed. The combination of the completion of the EC's single market by the end of 1992 and plans for a single currency through an EMU led the EC Commission to propose a radical reform of the current agrimonetary system.

The New Agrimonetary System

The EC Commission had proposed abolishing the switchover coefficient and MCA's. However, the switchover coefficient was retained until the end of 1994. The countries with strong currencies such as Germany, France, the Netherlands, Denmark, Belgium, and Luxembourg would not allow the abolition of the switchover coefficient. This is in part due to the possible formation of a two-tiered EC within the EMS with strong currency countries in one tier and weaker currency countries in another. Without the switchover coefficient, any future realignments would effectively mean price decreases for countries in the strong-currency tier. The French policy of a *franc fort* was a key to this decision since the FF is aligned with the DM and French farmers would suffer price declines along with German farmers if the switchover coefficient were not retained.

MCA's were in fact disposed of and all monetary gaps between EC member states above 4 percent were to be abolished in 3 stages over the following 30 days. The method of preventing the creation of MCA's in the face of exchange rate fluctuations in the EMS resides in the rule that the total spread between positive and negative monetary gaps cannot exceed 4 percentage points. If the 4 percentage point gap is breached then the gap must be eliminated through devaluation of the weak currency's green rate in 3 installments (once every 10 days) during the month.

The relatively rapid closing of monetary gaps above 4 percent between member states leads to more common prices but also leads to a more rapid rise in prices than before. Previously, most member states devalued or revalued their green currencies on an annual basis and there was more discretion in the extent of devaluations and revaluations which led to greater price differentials than is now possible under the current system. The current system requires the requisite devaluations and revaluations almost immediately.

Typically, there were "sweeteners" proposed by the Commission in order to gain agreement to eliminate the switchover coefficient. Typically, these "sweeteners" were adopted even though the switchover coefficient was retained. For example, compensatory aids can be increased by the amount of the largest revaluation by a currency during the previous 12 months.

Implications for European and World Agricultural Trade

The agrimonetary system of the CAP has been called the greatest source of economic distortion in the CAP (Franklin). Recent estimates indicate that the CAP lowers the GDP of the EC by 1.5 percent annually through budget and consumer costs and the misallocation of resources (Winters). That distortion is now guaranteed to continue within the EC and will be transmitted to other European countries as they join the EC to the degree that such a distortion does not already exist. Retaining the switchover coefficient over the next few years will be reinforced by EC enlargement that is likely to include strong currency countries such as Austria.

Countries not in the EC will suffer the distortion that is manifested in subsidized EC exports that compete directly with their production and exports in addition to lowering world prices. It has been estimated that the CAP has displaced a cumulative 300 million metric tons of grain from grain exporting nations, principally the United States, from 1977 to 1990 (USDA, 1990). The newly independent and democratic states of Central and Eastern Europe have found, much to their dismay, that EC markets are largely closed to their exports while they must erect trade barriers themselves to protect their own markets against subsidized EC agricultural exports.

It is generally recognized that the CEE countries and the United States have a comparative advantage in agricultural production. The United States would benefit from reduced EC subsidization because farm incomes would increase and the budget deficit would be alleviated. CEE countries are in desperate need of hard currency they could earn by expanding agricultural exports. By increasing export earnings the CEE countries could turn into customers for EC manufactured goods and services and promote economic recovery in Europe.

CAP Reform could also be diluted by the new agrimonetary system because prices reduced in ECU terms will be offset to the extent prices in national currencies will rise when the switchover coefficient is increased through realignments in the EMS. It is unlikely that CAP Reform will have a significant effect on EC production without a GATT agreement in agriculture because of the myriad ways the CAP, via its agrimonetary system and other methods, can offset the price decreases agreed in May of 1992.

Two aspects of retaining the switchover coefficient holds some hope for lower price increases. The most important is that retaining the switchover coefficient will increase the budget costs of the CAP by an estimated 1.5 billion ECU's in 1993/94 and by billions more over the next few years unless exchange rates are fixed between member states or a single currency is established. Significantly, it has traditionally been budget costs that have forced the EC to attempt various reforms of the CAP (Moyers and Josling).

The other factor is that 25 percent of the increase in the switchover coefficient must be deducted from the ECU price of CAP products. This means that CAP prices in ECU's will be reduced by approximately 1.5 percent for the 1993/94 marketing year. However, this reduction in price can be compensated by national governments and to some degree by the EC although in a way that will not provide incentives to produce. This price reduction in ECU's will appear to the outside world to be an effective reduction in CAP prices but one must always remember that farmers are paid in national currencies which will likely have increased, perhaps substantially.

Conclusions

The current agrimonetary system is in some senses more pernicious in obscuring the price inflationary aspects than the former system because price increases take effect more quickly than before and price formation is even less transparent than before. The direct effects are to mitigate to some extent the negative price effects of CAP Reform or perhaps of a GATT agreement in agriculture- if such an event were to occur. The ultimate effects are to lower EC economic growth, stifle agricultural exports from Central and Eastern Europe, lower world agricultural prices, and retard world economic growth.

The ability of farm groups to control agricultural policy in the EC may be diminished in light of other more important issues in European unity but the web of influence that has been created over 30 years in the Brussel's bureaucracy continues to be obliquely, but effectively manifested to the close observer. While this influence may represent agricultural "successes" in the EC, it is a primary factor in the economic failure that is on display in Europe in the form of low economic growth, high unemployment, and a succession of agricultural trade cases that confounds and debilitates international efforts to expand world trade and promote world economic growth.

Ironically, it is the move to a common currency that has allowed the CAP to continue the opaque nature of price formation in the CAP. If a common currency were effectively implemented, common prices in agriculture would exist for the first time since 1969, and it is agriculture that would be most resistant to such an event since common prices would effectively result in lower prices because price formation would be exposed for the whole world- including the EC member states' finance ministers.

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