momagri
mouvement pour une organisation mondiale de l'agriculture

A NEW STRATEGIC COURSE FOR THE CAP

EXECUTIVE SUMMARY / WHITE PAPER

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1. The think tank Momagri's position on the CAP reform

The new CAP that just went into effect at the start of 2015 must be viewed in a turbulent international background and a difficult economic context, which have raised awareness to the need to provide the European agricultural policy with a new strategic direction.

In fact, we can no longer justify dismantling the European mechanisms to manage agricultural crisis:

- ✓ Based on the WTO regulations that do not include food security and that are by-passed by the major agricultural powers;
- ✓ Grounded on the trust in bullish agricultural price trends, without accounting for price volatility.

This represents a fundamental policy error that ignores both price volatility and agricultural crises.
Indeed, the European agricultural policy no longer includes regulation tools to intervene in cases of market instability. The CAP "tool box" may well include many mechanisms, but not a single one is tailored to tackle the consequences of price volatility.

In this respect, Momagri reminds us that such volatility is not only still strong, but that upward and downward extreme occurrences tend to intensify, especially resulting from growing speculation.

The Momagri economic model proves it, on the basis of recognized scientific foundations: Agricultural markets are subjected to multiple risks whose adverse effects on price stability are aggravated by the uncontrolled liberalization of agricultural markets.

Let's remember that demand is price-inelastic, even for a small fluctuation of the agricultural demand—a 1 to 2 percent variation in global production can generate variations between 50 to 100 percent.

As with the fluctuations experienced since 2007, agricultural prices will be subjected to a high degree of upward and downward volatility in the coming years.

Meanwhile, the United States, Brazil and China and others have strengthened their support systems to prevent their farmers to "sink in negative territory" during times of collapsing agricultural prices. In these nations, agriculture and food processing are considered as strategic assets.

In this spirit, these governments are designing agricultural policies as intervention measures when agricultural price volatility threatens farmers, and consequently the sustainability of agricultural production.

Surprisingly, the crisis occurring in the European Union might generate a new CAP capable to efficiently fight the bane of price volatility and foster agricultural production, both in quantitative and qualitative terms.

At risk is the CAP added value to intervene when markets are failing and to have adequate budget leeway to implement a policy that prevents and manages crises.

All major agricultural powers have wisely integrated the price volatility issue in their agricultural policies, except the European Union, which is the only one to have opted for decoupled support systems that, by definition, have no "counter-cyclical impact" on farmers' incomes.

Yet, it is precisely when markets are collapsing that farmers need support. Hence the interest in counter-cyclical or anti-cyclical systems that allow allocating European resources in case of crisis.

This is the reason why Momagri urges to begin thinking about improving the CAP, so that crisis management systems and a new budget approach are included.

It is indeed crucial that the CAP reform include some economic and budgetary flexibility to:

- Guarantee more stable revenues for farmers by providing them with better long-term prominence,

- Improve the competitiveness of European agricultural and agribusiness production that represent considerable employment potential,

- Meet Europe's strategic challenges in terms of food security and renewable commodities,

- While benefiting European consumers both in terms of quantity and quality,

2. The founding principles of the Momagri proposal

A. The assumptions and the options

In accordance with the spirit of the CAP founding principles included in the Rome Treaty, the Momagri proposal relies on the realization that agriculture is a specific and strategic activity to meet the needs of consumers, and ensure the competitiveness of its related agribusinesses. As it is crucial to Europe's economy, it requires a regulation policy that is adapted to the multiple risks to which it is confronted.

In view of the fact that:

- Markets—especially agricultural markets—do not self-regulate. The recent economic, financial and food crises have proved it.

- Price volatility is a structural component of agricultural markets. Beyond their exposure to climate hazards and epizootic diseases, they are impacted by the irreversible nature of production and investment decisions, and the low elasticity of prices to demand and supply.

- The unregulated liberalization of international agricultural trade generates systemic risks, and thus increases the probability of global sharp price downturns.

- The unilateral decisions of some agricultural exporting nations—such as Russia—are amplifying price swings in international markets.

- The growing financialization of agriculture and, since 2000, the speculation on major global agricultural output, which are mostly conducted through opaque OTC transactions, have amplified agricultural price volatility.

The alternative CAP project advocated by Momagri was designed to improve the competitiveness and the operations of European agricultural markets. Based on a rational of Equilibriate price s, the project is vital to promote both the quantity and quality of European output, while improving the added value of related budget means. It builds on a European governance system that can provide:

- Better prevention and management of the various risks, especially market risks that confront farmers,

- Regulatory mechanisms to provide farmers with an adequate profile and adequate compensation for their work,

- An effective treatment of market imbalances,

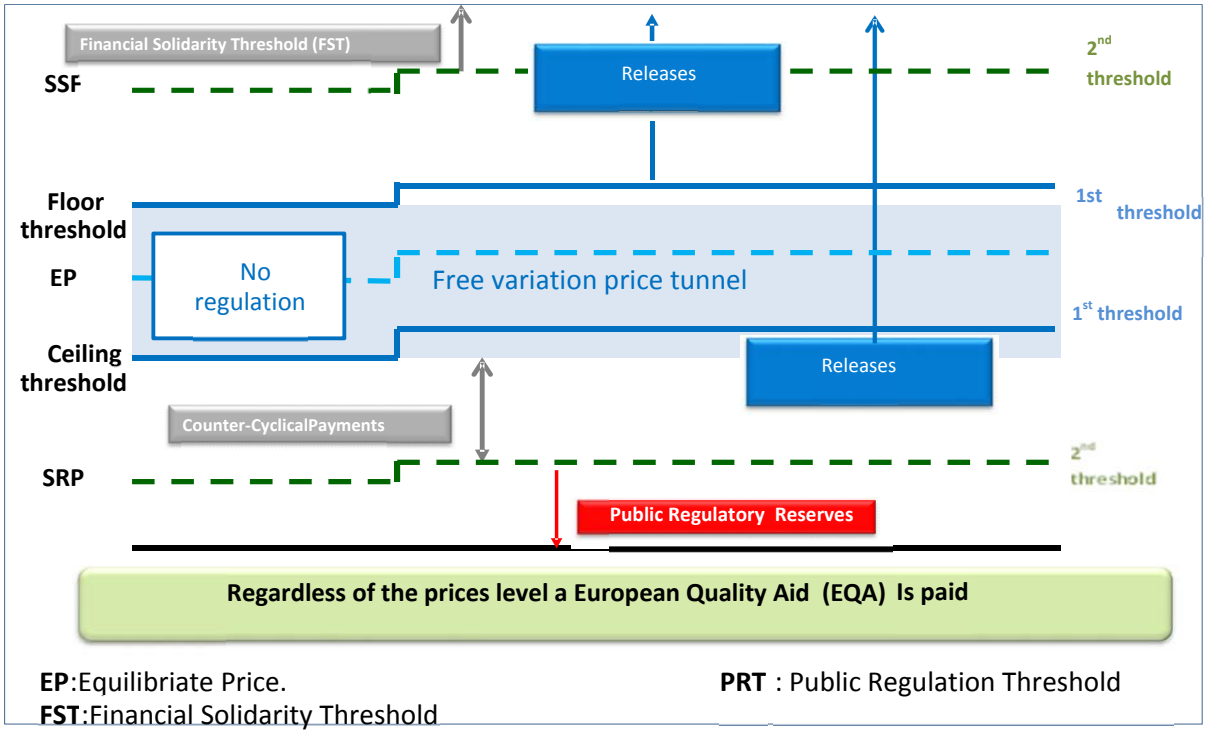
- An efficient management of agricultural budgets.

Against this background, Momagri advocates another CAP that is still organized around two pillars but whose a share of the budget—including that currently allocated to BPSs and green payments—is redeployed toward management tools to manage agricultural markets according to a counter-cyclical rationale.

B. The operating practices of the CAP proposed by Momagri

The Momagri CAP would be based on an Equilibriate price serving as the key benchmark of a regulatory system around which a price tunnel would be designed. The tunnel would no longer include subsidies paid to farmers. A counter-cyclical support system would be initiated in situations below the floor price, and further strengthened by a public regulation threshold implementing a public reserve capped at four percent of annual output.

Conversely, beyond a financial solidarity threshold, a levy on financial transactions would be made to prevent occurrences of excessive speculation. A single subsidy of €75 per hectare––the European Quality Aid (EQA)—would be paid to farmers. Its objective is to offset the efforts imposed to farmers regarding environmental and land management issues.
Such operating diagram can be applied to the grain, dairy and oilseed sector, as well as meat to a certain extent. The first simulations that were conducted include the grain and dairy sectors.



EP:Equilibriate Price. **PRT** : Public Regulation Threshold
FST:Financial Solidarity Threshold

➢ A free fluctuation price tunnel around an equilibriate price (EP)

For each major commodity, an Equilibriate price (EP) corresponding to the average cost price recorded in the EU can be calculated. This Equilibriate price, which is the key component of the system, can be adjusted in line with cost fluctuations.

A free fluctuation tunnel, in which price oscillate without any public intervention, is determined according to an assessment process corresponding to market regulation needs around this equilibriate price. It is the principle of the « snake in the tunnel ».

For grain and milk, the average cost price was computed by weighting the annual average cost price of producing member states against the share of volume production in the total European Union for the 2006-2011 years (source RICA and European Commission).

By convention, the Equilibriate price is the annual average cost price, and floor and ceiling prices are set according to the average cost price dispersion observed in member states (gap-type=): Floor price = Equilibriate price - 1σ and Ceiling price = Equilibriate price + 1σ.

➢ Payment of a flat rate per hectare European Quality Aid (EQA)

The European Quality Aid (EQA) is a subsidy that aims to remedy the economic impact of costs created by the European agricultural model (family farming and qualitative, sanitary and environmental requirements). It is estimated at an average of €75/hectare.

In case of prices outside the tunnel, the European Union would automatically trigger regulatory measures on physical and financial markets based on pre-approved procedures by the EU Council. Two thresholds would condition the implementation of these regulatory measures.

➢ Counter-cyclical payments and regulation reserves

When prices are outside the tunnel and are below the floor price, farmers are collecting counter-cyclical payments.

Based on the gap between regularly monitored market prices and floor prices (bottom of the tunnel), this aid will be applicable for almost the entire production. If prices decline to reach a second threshold defined by the EU as the threshold of governmental regulation, public regulation purchases will be made. They could represent up to four percent of annual output (regulatory reserves), and will supplement a food security permanent strategic reserve representing two percent of the annual output.

The EU will be entitled to make reserve and release operations of public regulation in controlled proportions, with again the stated goal of converging toward the equilibriate price. These transactions will balance over time and therefore will not build up reserves.

This risk will be all the more limited, as the growth of non-food industrial outlets will provide sustainable solutions. This mechanism should be sufficiently strong to rapidly bring prices in the tunnel, by preventing speculative behaviors in markets.

In case of emergency, when food aid has to be strengthened, or when contracts concerning nations plagued by unrelenting food crises have to be fulfilled, the European Council could authorize additional public reserve releases.

➢ The financial solidarity tax and the multi-annual reserve fund

When prices are outside the tunnel and beyond the ceiling—that is to sat beyond a financial solidarity threshold set by the EU—a variable solidarity tax will be initiated on all agricultural, financial and physical transactions concerning commodities traded. Revenues from this financial solidarity tax will go to the crisis management reserve fund.

The CAP annual budgets (1st pillar) might fluctuate from one year to the next according to market regulation needs within the multi-annual limitation provided by financial prospects.

A reserve fund thus will ensure the requisite pooling of EU expenditures over time. It will be financed or used over time depending on market conditions.

3. The budget impact on the CAP of the regulatory mechanisms proposed by Momagri

A.Underlying assumptions of regulation variables

Budget simulations were carried out on the following two periods: 2007-2013 and 2014-2020.

The budget reorganized for the following analysis covers market interventions (excluding export refunds) and all direct aid for two sectors: grain and dairy products.

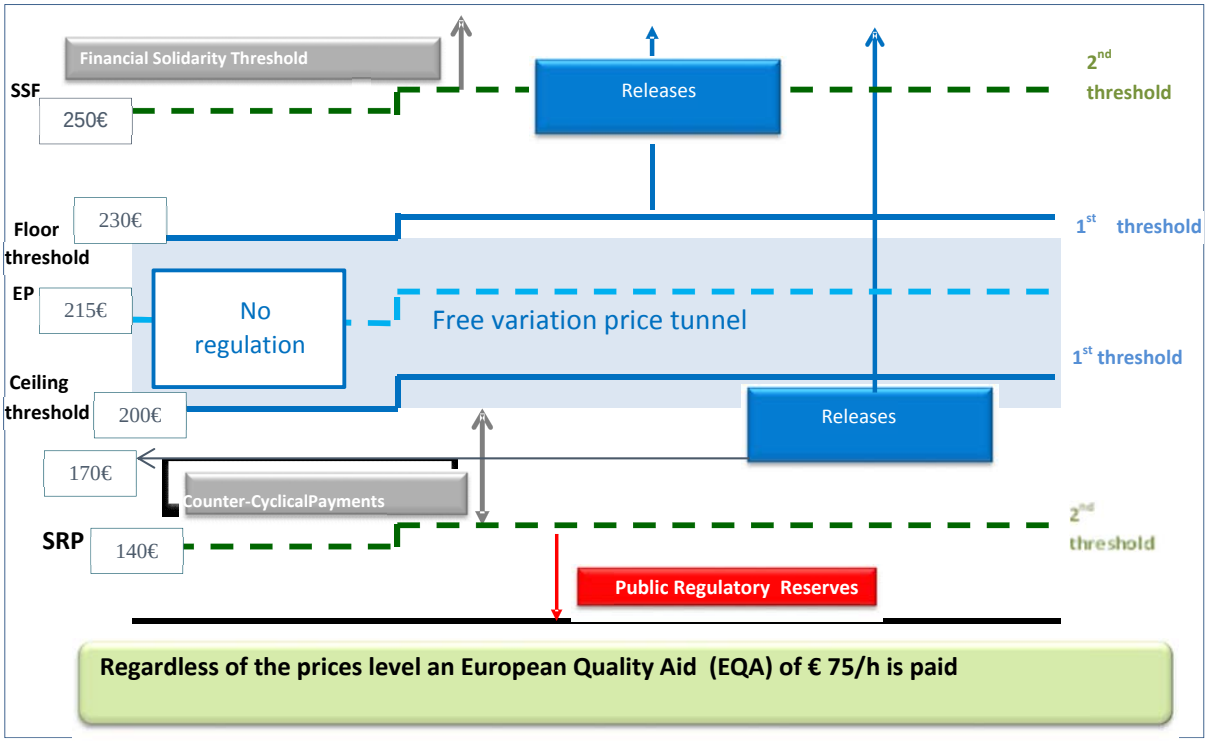
This budget accounted for about 60 percent of the 1st pillar in 2013.

Over 50 simulations were made to test the resistance level of the proposed system according to various agricultural price scenarios and assumptions on the level of regulation variables of the system.

The values used for cereals and for milk are given in the two diagrams below. The EP and the floor and ceiling values of the tunnel will be set by the Council of Ministers on a proposal from the European commission.

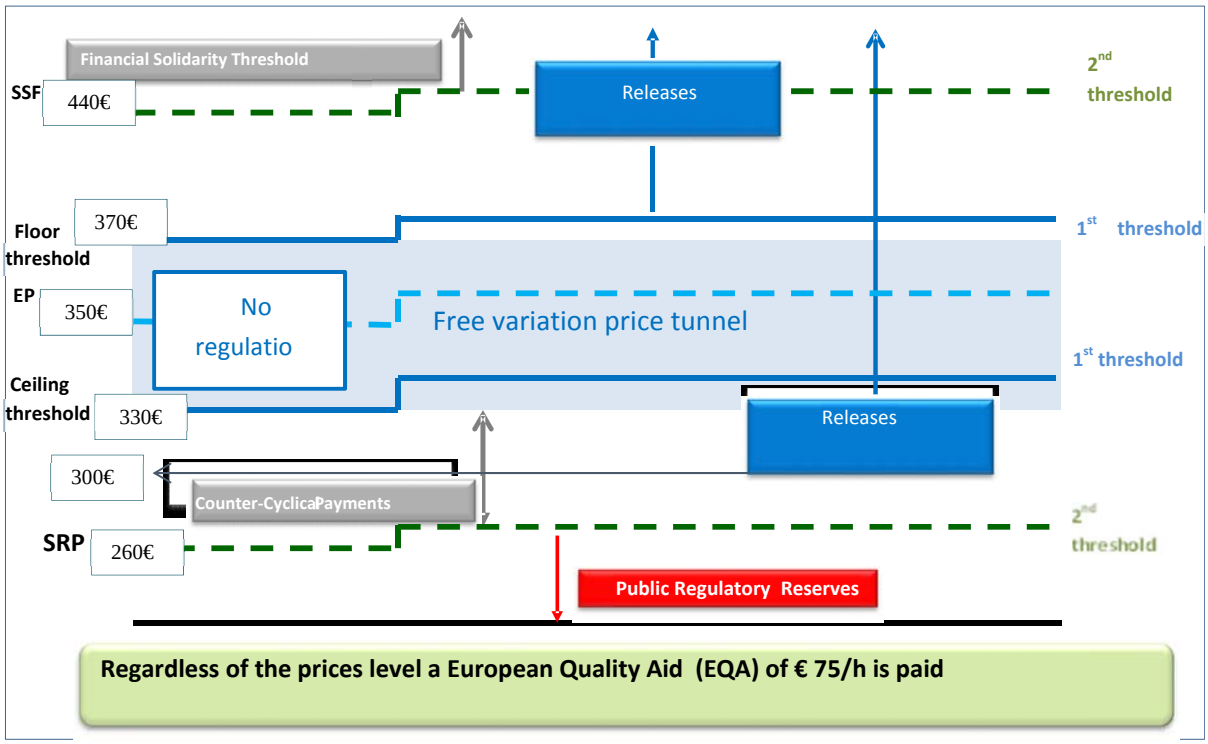
The monitoring of market prices and equilibriate prices will be made by the management committee. Adjustments will be made on the equilibriate prices when their evolution will be higher than a percentage defined in advance by the Council of Ministers.

For reference, the case of grain



EP:Equilibriate **PRT** : Public Regulation Threshold
FST:Financial Solidarity

For reference, the case of milk



EP:Equilibriate Price. **PRT** : Public Regulation Threshold
FST:Financial Solidarity

B. Comparative results of total costs for the current CAP and for the alternative CAP proposed by Momagri

➡ Significant budget savings

Between 2007 and 2013, budget costs might have been lower than actual expenditures. The average even showed a cumulative saving of €61 billion (€8.7 billion/year), or 15 percent of the budget for the same period. A share of the generated savings might have funded the reserve fund and used during the 2007/2008 and 2010/2011 crises.

➡ Optimal EU budget management in line with market conditions

The observed differential is based on the counter-cyclical rationale of the scheme proposed by Momagri. In effect, in the case of prices higher or equal to the tunnel lower limit (floor), the public expenditure is reduced to the European Quality Aid (AQE).

Yet during the 2007-2013 years, grain and milk prices were strongly impacted by volatility and reached average levels that were equal or higher than the lower limit of the proposed tunnel.

➡ A long-term effective system

In addition, budget simulations were conducted, based on price projections generated by the Momagri model for the 2014-2020 years. Here again, in the proposed alternative framework, the budget for these years is about ten percent lower than the budget planned by the current reform of the CAP.

➡ An effective system to fight volatility

Momagri also calculated the impact of implementing this alternative CAP on an average farm sales[1].

By comparing the Momagri proposal with the current system for the years 2007-2013 and the years 2014-2020, the sales for grain producers and milk products would have been slightly lower or identical, but far less volatile, thus stabilizing the outlook for the whole agricultural sector and processing operations.

[1] Sales are meant as "operating revenue" and therefore include sales of crops and the subsidies paid to farmers by the EU budget.

➡ A WTO-compatible project

Momagri assessed the WTO-compatibility of its project for the years 2007-2020, in view of the internal support classification of the WTO, of the ceiling thresholds in force for the EU-27 for support said to be distortive in the blue or orange boxes, and of the latest notifications issued by the EU-27.

Considering that European Quality Aid is filed in the green box[2] and that counter-cyclical payments are filed in the orange box[3], as it is the case for public regulatory placement and release operations, one concludes that the CAP-Momagri project is not only WTO-compatible but also that there is ample room to manoeuver in the green, blue and orange boxes.

In conclusion, thanks to a counter-cyclical approach and market management mechanisms, the CAP-Momagri can:

1. Provide a long-lasting stabilization of farmers' sales at levels that are quite close to the average observed or projected under the current CAP, without income jolts and with a guarantee;

2. Cut the CAP budget significantly due to a regulation scheme directed toward market management;

3. Limit excessive upward and downward price fluctuations, since the proposed mechanisms will create a price convergence drive toward the free fluctuation price tunnel, thus toward equilibriate prices;

4. Improve the effectiveness of EU public expenditures while meeting the issues of agricultural activities that are considered as a strategic asset to meet the challenges of the 21st century.

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Our team is at your disposal for any further information.

[2] It includes non-distortive support and is not capped.
[3] It includes support considered as distortive. It is capped at €39 billion. However, a share of counter-cyclical payments might be filed in the blue box, if concerned crops are below the 85 percent threshold of the basic production level.