The new tools proposed by the Commission

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CAN THE CAP MANAGE WITHOUT MARKET REGULATION AFTER 2013?

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Caveat

- I do not speak on behalf of the commission
  - So far, no proposal from the commission
  - But a number of ideas are conveyed by commentators, in general liberal ones, regarding price, yield and income variability prevention
- I shall only present and discuss these ideas.
Plan of exposition

1/ A reminder of the « old CAP »
   - successes and failures of the 1960 CAP
2/ A description of the risk avoiding devices in the new CAP
   - How the 1992 CAP envisage farmers will cope with risks
3/ A macro economic point of view regarding risk avoidance policies
From inception till 1992: the diagnostic

- Yield and price variability are bad
  - For consumer (food security) (e.g. the 1973 crisis, with embargo on US soybean exports)
  - For farmer
    - Shocks on income
    - Prevents loan by banks, therefore, investments

- Possible remedies
  - Yields can be insured (except large catastrophes); Price not!
  - Price fluctuations come from market failures
  - Hence: the government should replace market by administered prices, and cope with catastrophes, letting insurance to market

- A true macroeconomic vision!
From inception till 1992: the solutions

- Yield insurance left to market (if feasible)
- Catastrophe funds
  - developed by member state according to specific situations
- Domestic price fixed
  - Hence:
    - variable levies,
    - stockpiling
    - subsidizing exports if overproduction
- Fixed prices should not cost anything
From inception till 1992:

the outcome

- Catastrophes not a real problem
- Yield insurance not very much developed (except for hail, etc...)
  - because there exist technical alternatives for suppressing risk instead of sharing it
- Main commodity prices stabilized (with side effects on non stabilized)
- Production increase; capital substituted to manpower
- Overproduction
  - Budgetary cost for stockpiling and disposal
  - Pollutions
  - Voice against dumping from developing countries
- Something had to be done!
After 1992 : the diagnostic:

- **Overproduction is the problem!**
- **Then:**
  - let market manage production (will automatically match supply and demand!)
  - Let it also manage risk at farm level
    - there exist market instruments for that!
  - Let private storage and trade manage food security
  - Keep intervention as « safety net », but don’t use it!
  - Pay farmers a fixed income
    - A transition to help them adapting to new conditions
    - Accessorily, will stabilize farm income (but not the main purpose!)
    - Will encourage extensification
  - Develop a pseudo market for « externalities » (amenities and pollutions)
    - In the hope of improving environment
- **We shall here focus on risk management**
Market solution for coping with risk: Insurance

- Not made to remove risk
  - just to share it between lucky and unluky
  - Entirely based on the « Law of Large Numbers »
  - Fails as soon as the Law of Large Numbers does not work
    - Because of correlation between risks (e.g., a drought is lowering yield over the whole geographic area of insurance company operations)
    - Because of « moral hazard » (e.g.: no incentive for work if yield is guaranteed)
    - Because of indirect effects (e.g.: because price is guaranteed, supply increases, which tends to depress price)

- Hence, a real but limited capacity:
  - Works for some technical risks; No price or income insurance feasible
  - Even with technical risk:
    - high administrative cost (losses evaluation? Enforcing good practices?)
    - No direct yield insurance, but proxies (e.g. meteorological events)
    - The subsidization problem: will be examined later on.
Market solution for coping with risk: Cat bonds

- A device to insure *non insurable technical risks*
  - Catastrophes not insurable because not « small » in the sense of the theory of the Law of Large Numbers
  - Hence, not allowing sharing risk between contemporaneous agents
  - But financial arrangements allow *intertemporal* or *geographical sharing* of risk

- Hence, the catbonds:
  - Bonds sold on financial markets; payed back with high return only if a specific (meteorological) event does not occurs, kept by issuer as indemnity otherwise

- Operationnna for a variety of meteorological risk
  - Not suppressing risk, but allows computing the benefit of alternative solutions
  - Good for the rich, not for the poor (poorer than they feel !)
Market solution for coping with risk: integration contracts

- A price risk management device and more
- Secure prices in the mutual interest of sellers and buyers:
  - Just as farmers, processing industries tired of floating prices
  - In fact, replaces market by a bureaucratic substitute (Cf Coase)
- In addition of securing price:
  - Allows a strict quality control
  - Avoids overproduction
- Main obstacle:
  - Enforcement of contracts often problematic (e.g. : US biofuels )
  - Viable only because of the (partial) monopoly power of the integrating firm (avoids taking too much risk), at a cost for the consumer
  - The farmer’s subordination to « big capital » and the monopoly power of large food firms.
- Certainly a promising development of such arrangements to be expected in the absence of other public involvement in commodity price management !
Market solution for coping with risk: futures markets

- Price risk management device only
- Same as integration, but through organized market:
  - Allow to be sure of price a farmer will get
  - Allows a processor to be sure of the price it will pay
  - Organized futures markets avoid any possibility of cheating
  - Obviously useful (as above)
- Yet:
  - Only for standard commodity
  - Do not remove risk (e.g.: I sell my harvest, and the price eventually rise!)
  - A very high cost: The «normal backwardation»
    - Precludes long run contracts which would be necessary for farmers
    - The difficulty of access
- Not very common for farmer, probably even not mainly made use of for security purposes; widely used by merchants (the right time horizon)
Market solution for coping with risk: Diversification and Savings

- **Diversification** allows *contemporaneous risk sharing* between crops
  - Not without a cost (Sure loss of income and of efficiency)
- **Savings** allows *intertemporal risk sharing* between years
  - The cost: opportunity cost of liquidity: often enormous and underestimated!
- Both of them widely made use of by farmers
- But clearly not sufficient!
Pseudo market solutions

- **Subsidized insurances** for technical risks
  - Help the poor
  - In reality, exactly the same as a direct subsidy to crop production
    (not for WTO : just demonstrates the low level of economic culture in WTO’s !)

- **The income insurance**
  - Farmer pays a subscription, gets a guarantee of income, whatever happens (price crunch or lost harvest)
  - All combined difficulties already examined with technical and price risk
  - Heavily subsidized
  - A perfect swindle, which holds only because :
    - (provisionally) allowed by WTO (for unknown reasons)
    - Hence a mean of disguising direct subsidies
Is that sufficient?

- **At farm level:**
  - Most farmers neglect these instruments (except if subsidized...!). There must be a reason (and a social cost!)
    - Because still too many non liberal devices?
    - Because they are not adapted to real problems?
- **In the long run, do they match consumer and citizens expectations?**
- **Answering this question requires looking, beyond farm level, at the macroeconomic consequences of risk, in the spirit of the founders of the original CAP**
The cost of farm level risk

- Obviously, farmers benefit from a lower risk exposition
  - This is a reason to let them pay for that!
- But consumers also are involved:
  - Food shortage is a tragedy!
  - In the long run, would not a safe environment for farmer guaranty a lower cost for food? There are reasons for that:
    - No risk premium
    - Gains in producing efficiency easier with a more predictable world
    - Adjustment more difficult in case of long run commitments
      - (Hence the alleged superiority of instant market adjustments)
    - But few benefits to be expected from a market adjustment when consumption and tastes almost constant
- and empirical clues:
Example 1:
NZ liberal – NL submitted to CAP...

Ratio of food over general consumer price index,
Netherland and New Zealand, 1972-2008
Example 2: Food prices in France

France: Prix alimentaires / prix à la consommation, 1960-2008

Decreased more during the 1960 than during the 1992 CAP!
Suggests at least that the old CAP was not so bad! Why did it fail?
Why did the 1960 CAP fail?

- The 1960 CAP was based on a wider and better vision of the role of risk in agriculture than the present and contemplated versions.
- It let market play its role whenever possible, while substituting administered to market prices when market failed.
- It failed because of unexpected disequilibrium between supply and demand:
  - The Government guaranteed price was the perfect price insurance, at no cost, ... if government knew where the equilibrium was!
  - Unfortunately, nobody knows in advance precisely where equilibrium stay - !
- The main flaw in the old CAP!
- Was it not possible to correct it? Is coming back to market the only solution?
Back to market: the consequences

Market not a new solution! Will just reproduce conditions prevailing before large scale state intervention!

US Wheat Price (Constant yr 2000 $ / bushel), 1841-2007
How to avoid market and overproduction?

- The dismissed risk management device: guaranteed price for a limited quantity (quota)
- Same as a futures market, but with the government as the counterpart
- Compatible with residual markets
- Might stabilise international markets
- Not internationally distortive
  - if total quota less than domestic consumption
    (not the case for milk and sugar quotas in EC)
- Allows for environmental policies
  (e.g. : mountain milk quota in France)
- The irony of the only efficient device not take into consideration by the UE commission!
In summary

- Market solutions for risk management as envisaged by the Commission:
  - Not new (rather, old fashionned)
  - No factual proof of efficiency
  - Attest low level of economic analysis at micro and macro level
- Old CAP was based on a better analysis of situation and a smarter economic theory
  - Should have been reformed, not abandonned!
Thank you for your attention! Ready to answer questions!