Agricultural Market Stability in the Future Common Agricultural Policy

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Abstract: *Market stability represents one of the general objectives of the Common Agricultural Policy (CAP), reconfirmed by the Lisbon Treaty. The purpose of this paper is to study the impact of market stability in the context of price volatility for the post-2013 CAP. The political and economical context in Europe highlights the need for a new approach to cope with market volatility in order to create a stable business environment. The research method is the analysis of data with a view to express a personal opinion in this regard. Price volatility depends on several determinants like: balance between supply and demand, interlink between food and energy markets, trade liberalization, environment and climate change. The negative effects generated by instability in the agricultural markets can be reduced through the development of the existing instruments, the use of new mechanisms to stabilize supply, price and income, market transparency and cooperation. Farmers should adjust their business to market conditions and have to be protected against extreme volatility, innovation, education and training being important in this way. A special attention should be given to the interaction between the objectives of Agenda 2020 and the CAP. The results of the research point out that market stability is important for the CAP post-2013 and can be promoted using a combination of instruments like: modern technologies to stabilize yields, contracts, hedging, insurance systems.*

Keywords: *market stability, price volatility, agricultural market management, safety net, Common Agricultural Policy*

1. Introduction

Fifty years after it was set up in 1962, the general objectives of the Common Agricultural Policy (CAP), - increasing productivity by promoting technical progress and ensuring the optimum use of the factors of production, in particularly labor, ensuring a fair standard of living for the agricultural community, stabilizing markets, securing availability of supplies, providing consumers with food at reasonable prices - were reconfirmed by the Lisbon Treaty. These objectives were implemented gradually during 1958-1968. First products were subject to Common Market regulations in 1962 and common prices have been applied since 1968. The means of achieving these objectives have evolved taking into consideration the new demands. Even if CAP has evolved in more than half of century, further changes are still necessary in the context of globalization growth and rising price volatility in order to respond to new challenges, mainly: European and global food security, market orientation, competitiveness, environmental sustainability, climate and environmental change, diversity of EU farm structures and production systems, landscape conservation, biodiversity, viability of rural areas, support of CAP for member states and active farmers. There are reasons to explain why market instability has become such a hot topic in the agricultural debate on the CAP post-2013.

2. Literature Review

Being an important objective for the CAP, agriculture market stability has been a subject deeply debated in different international publications, seminars, conferences as well as by international organizations.

Von Witzke, Noleppa and Schwarz (2009) emphasized the determinants of food supply and demand growth as well as international agricultural markets in a further period of time. Vrolijk et al. (2009) analyzed the reasons and development of incomes' volatility in EU agriculture. International Food Policy Research Institute - IFPRI (2009) made some proposals in order to prevent damaging price-spikes and the lack of confidence in the international grain market.

Council of the EU (2010) in the notes or papers issued from the Belgian and Spanish presidency, highlighted that the providing of safety nets can compensate price changes faced by farmers and emphasized the importance of market management in the single common market organization. In its Communication regarding CAP towards 2020, European Commission (2010) underlined that a 'risk management toolkit' should be included to deal better with income uncertainties and market volatility that hamper the possibility of agricultural sector to invest in competitiveness.

Food and Agriculture Organization - FAO (2010) revealed that volatility in agricultural markets seems to have increased, extreme price movements of agricultural commodities are a threat to world food security and policy measures should improve market functioning and increase countries' resilience to shocks. Among the proposals regarding the

future CAP, Franco-German position (2010) referred to adapted market instruments needed to strengthen the competitiveness of European agriculture (the current market instruments should be part of a safety net, more transparency is needed taking into account increasing price volatility on agricultural markets, instruments like: insurance and mutual funds might stabilize farmers income). European Landowners' Organization (2010) underlined that current direct payments and residual safety net intervention system are policy elements providing surety and stability. Matthews (2010) proposed an extended role for member states to address agricultural income instability through enhanced income insurance or income safety net schemes.

Opera Research Center (2011) started from facts and realities surrounding the agricultural market instability and identified the factors and directions for promoting market stability. Centre for European Policy Studies - CEPS (2011) organized a lecture at high level regarding food security and development where debates referred to high volatility registered in agricultural markets recent years as being a major concern not only for poor countries but also for the developed ones.

3. The Political Context and the Importance of Market Stability

Successive CAP reforms gradually switched support from market and price management to direct payments which, since 2005, are largely decoupled. The decoupled single payment scheme provides a significant and stable contribution to farm income. However, differences are remarkable among countries and farms according to the historical distribution of support between different sectors of agricultural production. EU embarked on a move to greater market orientation in its agricultural policy. A more market oriented CAP means much more responsibility for farmers in managing risks formerly absorbed by market and price support policies. The result of trade liberalization is the increased exposure to price fluctuations of EU agriculture (Matthews, 2010).

One of the points of concern in analyzing the CAP is the efficiency of the market management mechanisms and instruments. But the question is whether markets are functioning well enough or they need a system to ensure market stability. The answer is that there is compulsory need for market stabilization mechanisms. In the context of the high price volatility registered in the agricultural markets in 2007-2008 and 2010, the future CAP has to ensure economic stability for farmers business and also for their incomes. The dairy market crisis during 2009 emphasized the insecure climate as well as the concerns for an increase in the food prices over the next 20/30 years and highlighted the important role that existing mechanisms play in supporting the market in times of crisis. The epidemic caused by Escherichia Coli in 2011 caused big lose for those EU member states big producers of vegetables. There is a global interest in preventing such events from recurring. The episodes highlight the need to modify the architecture of international financial and agricultural markets to address the problem of price spikes, especially their effects on the livelihoods of the poor. It is to be expected that the increase in demand will lead to more volatility in the markets. Recent years have shown that an adapted regulatory framework is needed to ease devastating effects of growing price volatility and market crisis. The important changes in the domestic and trade policy are some of the factors behind the increase in price volatility and implied a major reorientation of EU domestic prices for agricultural products.

In September 2010, at the Informal meeting of the Council for Agriculture and Fisheries, ministers sustained that the 'unbearable market volatility' of raw materials must be counteracted by a strong measures system. Spanish presidency paper stated, in February 2010, that EU must have an agricultural model with the tools necessary to stabilize markets and deal with price volatility. The Communication of the European Commission 'The CAP towards 2020' issued in November 2010 foresees in the field of market measures that some adaptations are necessary especially in streamlining and simplifying actual instruments as well as in introducing new policy elements regarding the functioning of the food chain (European Commission, 2010). Underlying the link with the Europe 2020 Strategy, it was stated that reform of the CAP must also continue to promote competitiveness, efficient use of taxpayer resources, the purpose being to build a more sustainable, smarter and inclusive growth. In March 2011, at the meeting of the Council for Agriculture and Fisheries, different aspects of the future CAP were discussed like: direct income support, market management measures and rural development policy during five successive presidencies. The Presidency conclusions were the result of a detailed analysis of the member states of the policy orientations outlined in the Commission's Communication as part of the institutional debate on the CAP towards 2020. The main idea was that EU agriculture must continue its market orientation, gain competitiveness and undertake to provide farmers with adequate tools to address increasing risks regarding price volatility and income fluctuations.

In the position issued in 2010 regarding the reform of the CAP, the European Parliament underlined (as Art.39 of the Lisbon Treaty suggests) that agriculture is exposed to market volatility, natural disasters, risks, lack of demand elasticity; farmers are 'price-takers' rather than 'price-makers' in the food supply chain. Then, in 2011, in a meeting held in

Strasbourg, it was stated that in agriculture price volatility is permanent having in view the disproportional response of prices to small variations in the production's level, often as a result of speculation.

World Trade Organization's (WTO) negotiations revealed that global market has to function in a more liberal way. High prices of European production makes difficult to find outlets for surpluses. Inevitably, world food price volatility will have a great impact on the internal EU prices. Deeper integration of global and regional markets, better defined safeguard mechanisms and improvements in the competitive environment will bring increased trade volume and more suppliers and buyers to markets that are currently very shallow. Local or regional supply shocks could more easily be absorbed leading to lower volatility on domestic and international markets and food could more easily flow from surplus areas to rapidly urbanizing food-importing areas.

At the first high level Lecture on Food Security and Development held in Tervuren/Belgium on November 2011, Shenggen Fan, General Director of IFPRI pointed out that price volatility has increased in recent years, plays a critical role in food security and hurts the poor, whether consumers or producers; food producers will only benefit from high prices if they are net sellers of food and if input costs do not rise in parallel. Concerning the ongoing debate surrounding financial speculation and its relationship to price volatility, he raised the question of whether price volatility in agricultural markets has attracted speculators or whether it was speculation itself that caused high price volatility. As a conclusion, Shenggen Fan noted the increasing influence of non-agricultural factors on food security (energy, global warming, demographic changes, etc.) and recalled the opportunities that the current challenging context offers, especially for emerging countries. He argued that these opportunities are contingent upon a policy move towards business as unusual: promoting smallholders' productivity, improving their resilience, investing in productive social protection programs, reforming the global food architecture, and investing in regional and local capacity building. Johan Swinnen[1] highlighted the intriguing paradox that most food insecure people in the world are food producers themselves; when prices go up, food security for those producers should, in theory, increase as well.

Dacian Ciolos, EU Commissioner for Agriculture and Rural Development, underlined that food security is not only a problem in developing countries but also a priority political issue in Europe and therefore needs to be dealt with in a coherent and coordinated manner at the international level. In this global context, the European Commission has proposed to maintain a strong budget for the CAP, with three core priorities: ensuring food security, managing natural resources in a sustainable way and maintaining rural vitality. The goal of the Commission is to make sure that European agriculture becomes economically but also ecologically competitive. On the impacts of direct payments on developing countries, Commissioner Ciolos insisted that CAP is not a dumping policy anymore, as support has been decoupled from production and as export subsidies have been almost completely abolished (representing only 1% of the current CAP budget). He finally emphasized the new role played by research and innovation in meeting future challenges, and called upon the FAO to go beyond its current mandate to endorse a more important role and ensure a better coordination of agricultural policies around the world.

The situation of agriculture varies among member states and even among regions of the same states. While in the majority of western member states the structures and necessary infrastructure for proper market functioning may be in place, central and eastern European member states are in a continuous development, the situation of agricultural markets being different.

The European and global political and economic context highlights the need for a new approach to cope with market volatility in order to create a stable business environment without distorting effects on the markets.

4. Risks in Agriculture and Causes of Agricultural Market Instability

Agriculture is subject to many risks, market instability being one of them. In agriculture, damages produced by unpredictable weather can lead to loses; crop pest infestation can affect the performance of crops while animal disease outbreaks have a negative influence towards the performance of livestock. All these translate into production risks. The uncertainty regarding the price of output, sometimes input can cause market risks. While different ways and methods used to finance farm business lead to financial risks, the government's ways of action lead to institutional risks. Uncertain life events like illness, divorce or death lead to personal risks.

[1] Johan Swinnen is director at LICOS Centre for Institutions and Economic Performance within the Faculty of Business and Economics at the University of Leuven/Belgium and senior research fellow at the Centre for European Policy Studies (CEPS) in Brussels/Belgium, being the author of several papers regarding CAP

Price volatility depends on how variable its determinants are. Some of the most important are: population and income growth (by 2050 the global population is expected to have reached 9 billion people and the demand for food to have increased between 70% and 100%), correlation between agricultural commodity prices and oil prices, climate change, policy measures, trade liberalization, depreciation of USD (trade in many agricultural commodities being denominated in USD), low stocks (once they have been depleted supply can no longer be increased until new production comes on board), investment in financial derivatives markets.

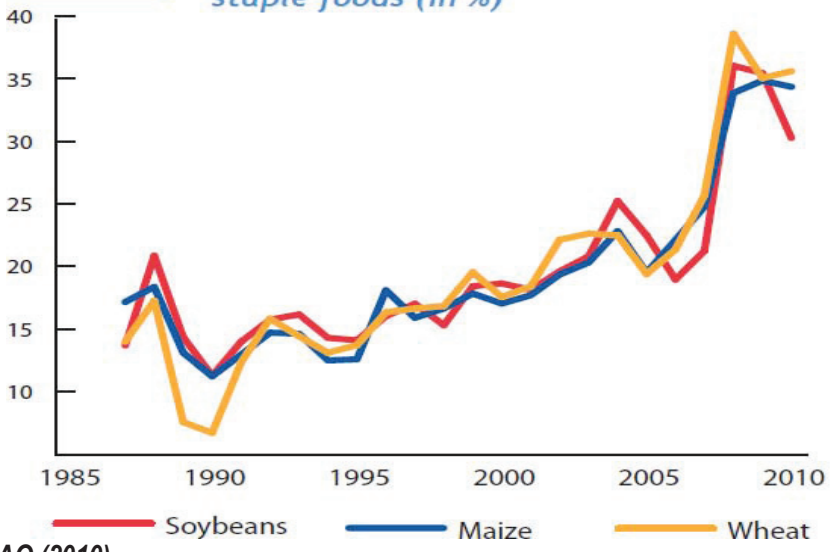
Agriculture does not react fast enough with an increasing food production because of the low level of investments in research, technology, infrastructure and the commercial protectionist policies for agriculture. The increase in price hits the poor countries so the import of food products becomes more expensive. Some solutions for decreasing volatility in agricultural markets might be: a better coordination of policies in international trade with food products, the cut of subsidies in rich countries, more information of high quality to ensure transparency, the safety nets in poor countries in times of crisis.

The behavior of exchange rates and the increased ease of price transmission across EU borders lead to a lower impact of world price volatility towards European farmers. In the future, world market price change will be stronger transmitted to the EU domestic market where farm prices are protected only by constant tariffs on imports. Farmers' vulnerability against price volatility might increase while their production flexibility regarding price changes might decrease because of greater specialization and larger investments. Increased volatility in incomes is a result of fluctuating prices of products combined with a smaller margin and a higher production volume per farm.

Volatility indicates how much and how quickly a value changes over time. In economic theory, volatility connotes two principal concepts: *variability* (overall movement) and *uncertainty* (unpredictable movement). Implied volatility represents the market's expectation of how much a price of a commodity might move in the future and 'is measured as a percentage of the deviation in the future prices (six month ahead) from underlying expected value. Increases in implied volatility reflect how market conditions and unpredictable events translate to higher uncertainty ahead for traders and other market participants' (FAO et al., 2011, p.7).

As figure 1 indicates, since 1990, the implied volatility for major crops has increased significantly. Starting with 2006 we can speak about the beginning of a period of extreme volatility. Prices increased sharply in 2006, peaking in the second half of 2007 or in the first half of 2008. In the second half of 2008 prices fell sharply even if most of them remained at or above the level in the period just before the run-up began. Market tensions emerged again in 2010 and there have been sharp rises in some food prices. By early 2011 food price index was again at the level reached at the peak of the crisis in 2007/2008. The rise in food prices caused hard problems among the poor and was a major factor in the increased number of hungry people to over one billion.

Figure 1: Implied price volatility of selected staple foods (in %)



Source: FAO (2010)

In a competitive economy, price fluctuations are normal. For commodities, **scarcity** means increase in price, fall in consumption and more investment in production. Uncertainties and extreme changes in price movements lead to lower

efficiency of the price system. Extreme price volatility makes the global food system more vulnerable. Having in view that markets are more integrated in the world economy, shocks at global level propagate to domestic markets much quicker than before (FAO, 2010).

5. Instruments Used for Market Stability

The post-2013 CAP has to find the appropriate instruments to promote the use of modern technologies, innovation, improved market transparency, long-term contracts, hedging, insurance systems in order to ensure stability at farm level.

In order to reduce the negative effects generated by the instability in the agricultural markets, the main ways of action can be:

- ***Development of the existing CAP instruments***

In order that agriculture becomes more responsive to market signals, major changes have been made in the CAP like: the measures taken to balance expenditure on direct payments and market measures, the increased role of Rural Development in obtaining more competitive agricultural products (EU being more exposed to competition worldwide), increased attention for the need and importance of producer organizations and subsidiaries on the product, growing concerns for the mechanisms of the whole food supply chain.

'The existing market management system in the single Common Market Organization can be summarized as follows:

-**internal market** - intervention measures: public intervention and private storage, special intervention measures, production limitation systems, specific aid schemes (abolished or phased out)
- provisions concerning marketing and production: marketing standards and production conditions, producer organizations, operator and inter-branch organizations;

-**trade with third countries**: import, export currently constrained by Uruguay Round obligations;

-**competition rules**: rules applying to undertakings in agriculture, state aid rules (Council of the EU, 2010: p.9);

- ***Supply stability***

The increasing scarcity of natural resources represents a threat not only to future food supplies but also to global stability and prosperity. Food and agricultural systems should serve the well-being and quality of life of all stakeholders involved. According to FAO estimations, in order to meet growing food and feed demand determined by population growth, global crop production will have to increase at least by 70%.

Agricultural output is subject to severe losses because of weather conditions, crop pest infestation or animal disease outbreaks. Technology and innovation can contribute to reducing yield volatility, ensuring price stability and to facilitating the delivery of public goods. The use of public intervention and private storage are measures which have influenced the supply in the actual CAP. Quotas and set-aside (abolished through Health Check decisions) are production limitation mechanisms with a decreasing importance. Better horizontal policy integration and a better cooperation in the public-private sector are needed in order to reach stabilization of markets and farmers income.

The interaction between the objectives of Agenda 2020 and the reform of the CAP must be taken into account. CAP has to respond to several challenges and, in this way, will contribute to the EU 2020 Strategy in terms of smart, sustainable and inclusive growth;

- ***Reducing price and income volatility***

a). 'price and income safety net' should address directly the issue of the excessive volatility of agricultural commodity prices (intervention purchasing and withdrawals, aid for private storage, subsidies designed to promote internal consumption, state aids, income safety net, creation of mutual funds);

b). 'risk reduction' should address the production and income related risks so as to reduce the exposure of the farmer to the abnormal variations of the market and to ensure income stability (forward contracting, futures markets have an important role in price discovery as well as allowing producers and processors to hedge their price risk, revenue or income insurance – Health Check only provides for production risk insurance -, mutual funds); however, in EU total farmers welfare benefits more from direct payments than from insurance subsidies (Opera Research Center, 2011);

- ***Market transparency***

In order to remain competitive and fair, transparency is needed in the food supply chain. In the same time, high safety and quality standards have to be uphold. Farmers complain of unjustified practices in food chain that affect the proper functioning of trade flows in the internal market, potentially increasing price levels and volatility for consumers. On the internal market, instability has its roots in local, regional or national imbalances in supply and demand. Sometimes, relevant disparities in marketing and food safety standards hinder the proper functioning of trade flows. Guidelines of good commercial practices would increase the fluidity along the chain. To improve transparency, one of the main tools

could be price monitoring at different stages. For the future CAP, more frequent systematic projections on food prices, transparent for the public and farmers are needed as well as competition law guidelines over competition policy;

- ***Cooperation***

In order to promote cooperation and integration in the food chain, the CAP has to develop several mechanisms. The future CAP must improve the relationship among producers-traders-processors-supermarkets-consumers.

In the CAP post-2013 it would appear necessary to find a balance between market orientation and a full guarantee of the viability of agricultural activity. Extreme volatility should be avoided considering its negative impact on agricultural incomes but also on the industry, distribution, consumers and the economy as a whole. In this way, CAP will better respond to the expectations of EU farmers.

6. Conclusions

Market stability must be a priority for the CAP post-2013. Having in view that price volatility is expected to remain high and the level of input prices in agriculture is likely to remain higher than its historical trends, the future CAP should put in place instruments to protect farmers of extreme volatility. Rural Development measures should provide the tools and the economic framework in order to increase competitiveness and stabilize agricultural incomes, providing income insurance. Safety net schemes represent a solution to extreme price volatility. Research, innovation and modern technologies are essential. Training and education is important for farmers who can reduce the volatility of their incomes by using market-based risk management instruments and should adjust their business to market conditions, market transparency being necessary in the whole food supply chain. EU should avoid that reduction in domestic agricultural prices to be reflected in high global prices.

Serious imbalances on world markets can cause major crisis in some EU agricultural sectors that require market management interventions. In the context of the CAP post-2013, it is important to ensure that rapid and efficient management is not restricted by a lack of financial resources.

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