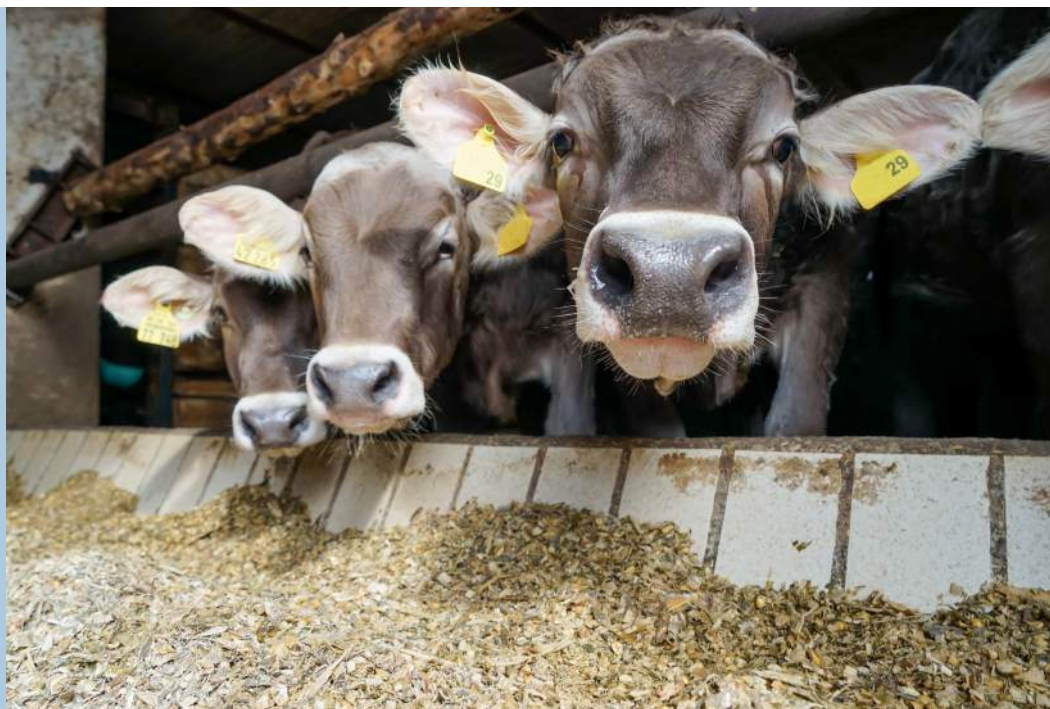




Food & Farming

Focus on Market Safety Nets

December 2015



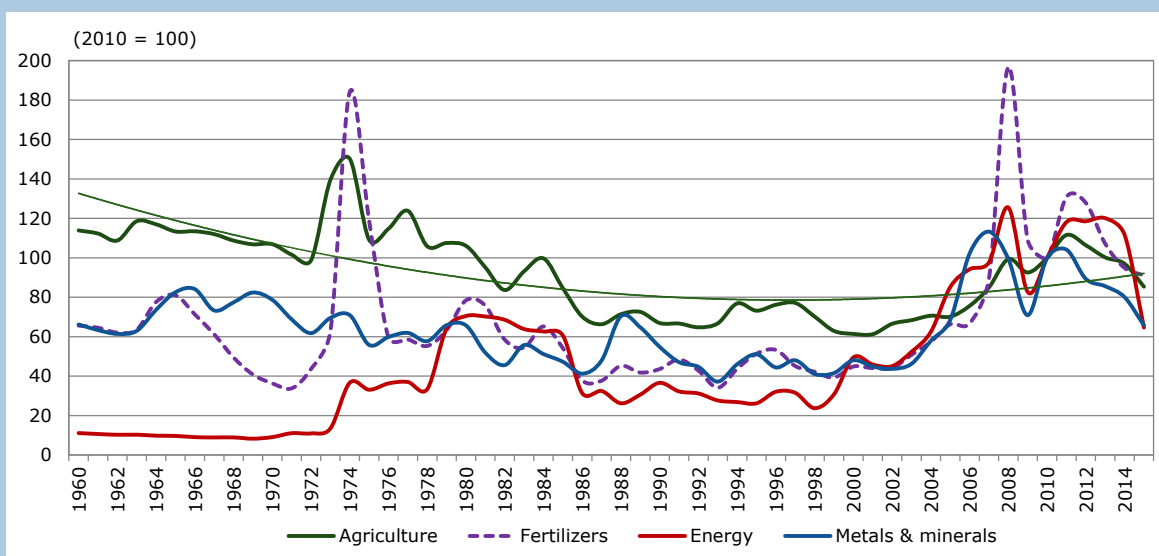
AGRICULTURAL MARKETS AS A DRIVER FOR EUROPEAN AGRICULTURE

The agricultural markets and their prices have evolved substantially during the last decade. World trade in agricultural goods has soared from the combined influence of strong population growth, changing diets and increasing income levels in developing countries. Agricultural prices have followed trade growth along this path, albeit with significant ups and downs often linked to developments in other commodity markets, especially in energy. Yet the decline of farm prices in recent

years, coupled with uncertainties about their expected level in the future and the apparent end of what was termed the “commodity super-cycle”, has raised questions about the appropriate policy response to provide the necessary “safety net” supporting farm income.

Price evolution has been accompanied by a shift in focus, and in measures, from an inward-looking European agricultural policy towards strong market orientation. The exposure of agricultural producers to market signals has created opportunities for the sector to produce and export worldwide, responding to

Trends in real commodity prices



Source: World Bank

growing global demand. The transformation of the EU into a net agricultural exporter, while at the same time it has continued to be the largest agricultural importer, reflects this policy shift. The most recent example, the abolition of milk quotas, should result in strong dairy exports to growing markets in Asia and create value added for the European food sector.

Data show that global agri-food markets have become more volatile in recent years. **Price volatility** (whether real or perceived) is a major issue as it colours short-run producer decisions, frequently in contrast to long term strategies on investments that depend more on expectations about **future demand growth and price levels**.

The latter are uncertain by nature as a result of the inherent drivers of agricultural prices such as stock-to-use-ratios, population growth, consumer preferences, environmental constraints and technical progress. Evidence seems to suggest that both volatility and price

levels are increasingly influenced by factors external to agriculture, especially by the **co-movement of farm prices** with other commodities and with energy prices, and by the link with other **macro-economic drivers** such as worldwide exchange rates and growth.

Finally factors outside economic markets can also create a disruptive effect on agricultural prices and production. The risk of animal diseases, loss of consumer confidence in case of a food scare or changed trade policies are all realities that will persist and could even increase with further trade integration or climate change.



WHAT DOES THE EUROPEAN SAFETY NET LOOK LIKE?

Market signals help producers, and the agricultural sector, in orienting their production decisions, but markets are not perfect. With a short-sighted interpretation of price signals, the economic cost of agricultural production may be minimized but farming may not be kept sustainable for the long term in a resource constrained world. This was the basic reason why European agricultural policy has shifted from strong market management with high support prices towards a flexible system consisting of **direct payments** complemented by a **market safety net**. (This gradual policy shift of the last two decades is illustrated by the graph below showing the evolution of EU expenditure in its different instruments.)

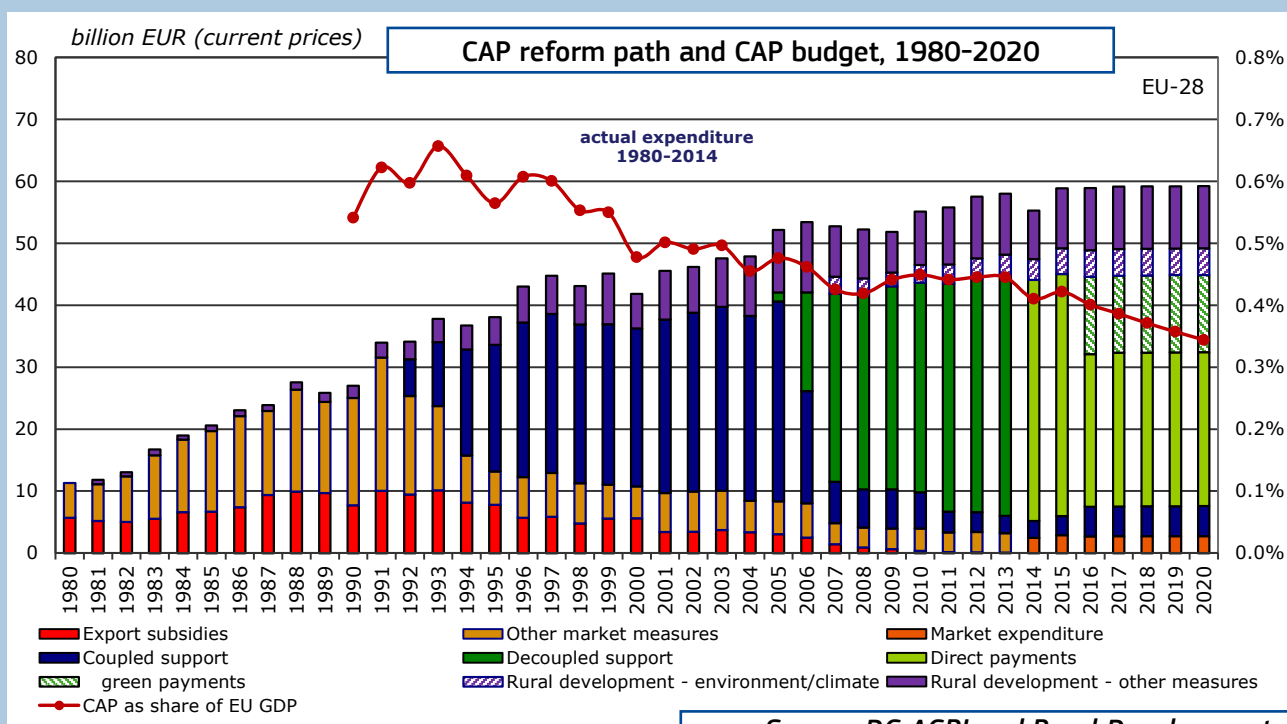
This shift in the CAP reflects a policy choice as a response to a long-standing farm policy dilemma: which is better, to support farm income directly, or do so indirectly via price support? With the lion's share of current support fully decoupled from production, the EU's policy response has been gradual, but clear and consistent. **Direct payments** provide farmers with a stable income layer that is independent from market fluctuations. Decoupled from production decisions, these payments create an incentive for agriculture to provide a combination both of private and public goods, with the latter further enhanced in the more recent reform by making 30% of the payment conditional on greening practices.

Direct payments allow the clear transmission of market signals, a key element for the competitiveness of the agricultural sector. **Market measures**, which used to be the most important tool of the CAP in the past,

now play a role of last resort, when market conditions become adverse and prices collapse. Use of public intervention and public support for private storage is the exception rather than the rule. Thus the policy has gradually shifted from the concept of a safety net based on targeting price signals towards one targeting farm income, and the recent measures in support of the dairy sector reflect this.

Farmers are also encouraged to share responsibility in **managing specific on-farm risks**. Member States have the possibility to design tools to support farmers in this process through support for insurance premiums, mutual funds or an income stabilisation tool. But also private initiatives are being promoted that share the risks between farmers and processors or within producer organisations. For this, the improvement in the transmission of price signals along **the supply chain** and better farm organisation will be essential to assure a fair distribution of risks along the chain and the viability of the agricultural sector in the agri-food sector.

This policy approach sets the CAP apart as a comprehensive tool to meet the challenge of market volatility in the short, medium and long term. It also reflects the unique institutional framework in which the CAP is grounded, a common policy implemented across a multi-level governance structure. The most important change in the CAP in the past 25 years is the reorientation to a philosophy of policy support away from price support. In practice, targeting prices implicitly increases prices, thus providing incentives for over-production, which leads to further price declines and, at the end of this vicious circle, demands for volume controls. This recipe may temporarily work for small or isolated countries; but it fails to stabilise income in more open economies.



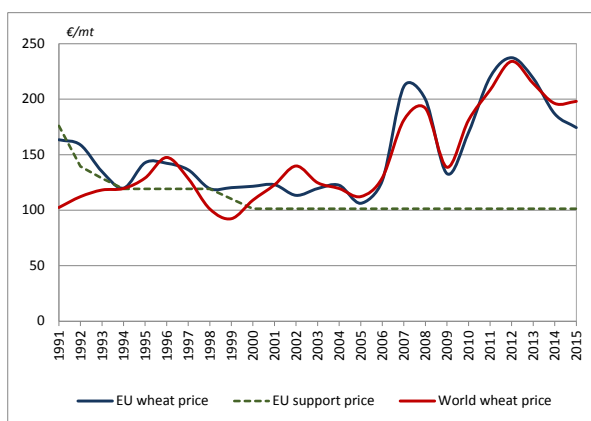
Source: DG AGRI and Rural Development



WHAT IMPACT FROM THE CAP'S SAFETY NET ON EU AGRICULTURE

It is interesting to see how the preference of the EU for a safety net targeting income more than prices has impacted upon EU's agriculture by focusing on three sectors that were reformed over different periods, but concern production in all Member States.

Comparison of Wheat Prices



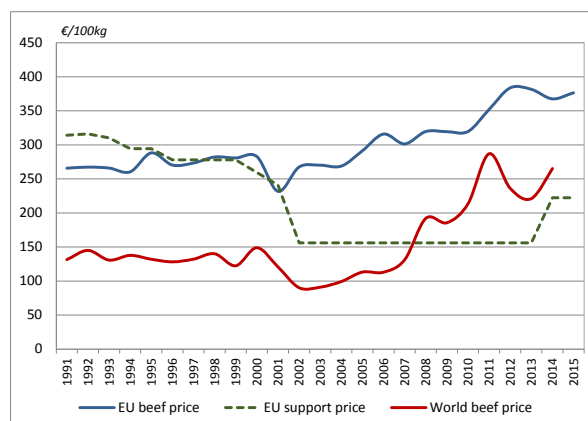
Source: DG AGRI and Rural Development

The **cereals sector** was the first to be directed towards more market orientation. Price support decreased since the early nineties and since the beginning of this millennium EU prices have been developing in line with world prices. This process has been gradual, and has included asymmetric support price declines,

or even the abolition of support price, based on the competitiveness of different cereals. Production adjustment has also been gradual, but in the end this decrease in cereal price support has contributed to the competitiveness of both the EU's cereal and live-stock sectors, has increased feed demand and has turned the EU into a net exporter of cereals. With a share of about 20% of total wheat exports the **EU is the second largest wheat trader** in the world.

The **beef sector**, which was hampered by more acute problems of competitiveness, significant volumes and costly disposal of public stocks, as well as food safety crises, was also subject to a reduction in price support

Comparison of Beef Prices

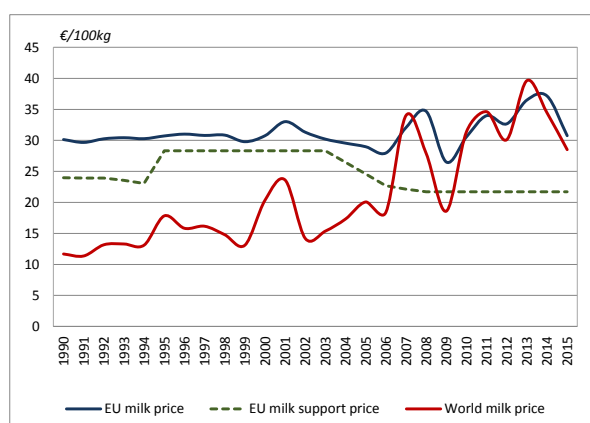


Source: DG AGRI and Rural Development

that was even more marked than those faced by cereals. Beef production, especially in an extensive manner, is a sensitive sector with few or no alternative opportunities and potentially creating a significant negative environmental impact if extensive grazing is abandoned. The impact of reform in this sector has been to reduce overproduction, but improve both product quality and price with respect to the pre-reform situation.

The **dairy** sector went through the reform at a slower pace, and although price support has been reduced significantly since 2003, **production quotas were only withdrawn in April 2015**. EU and world prices have been aligned since 2007, boosting EU dairy ex-

Comparison of Milk prices

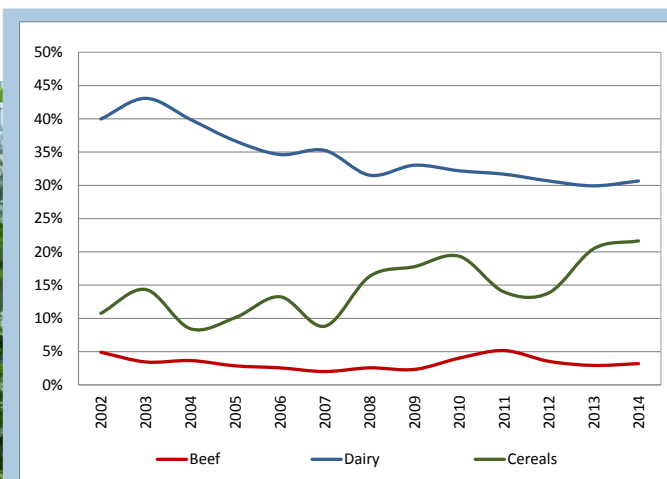


Source: DG AGRI and Rural Development

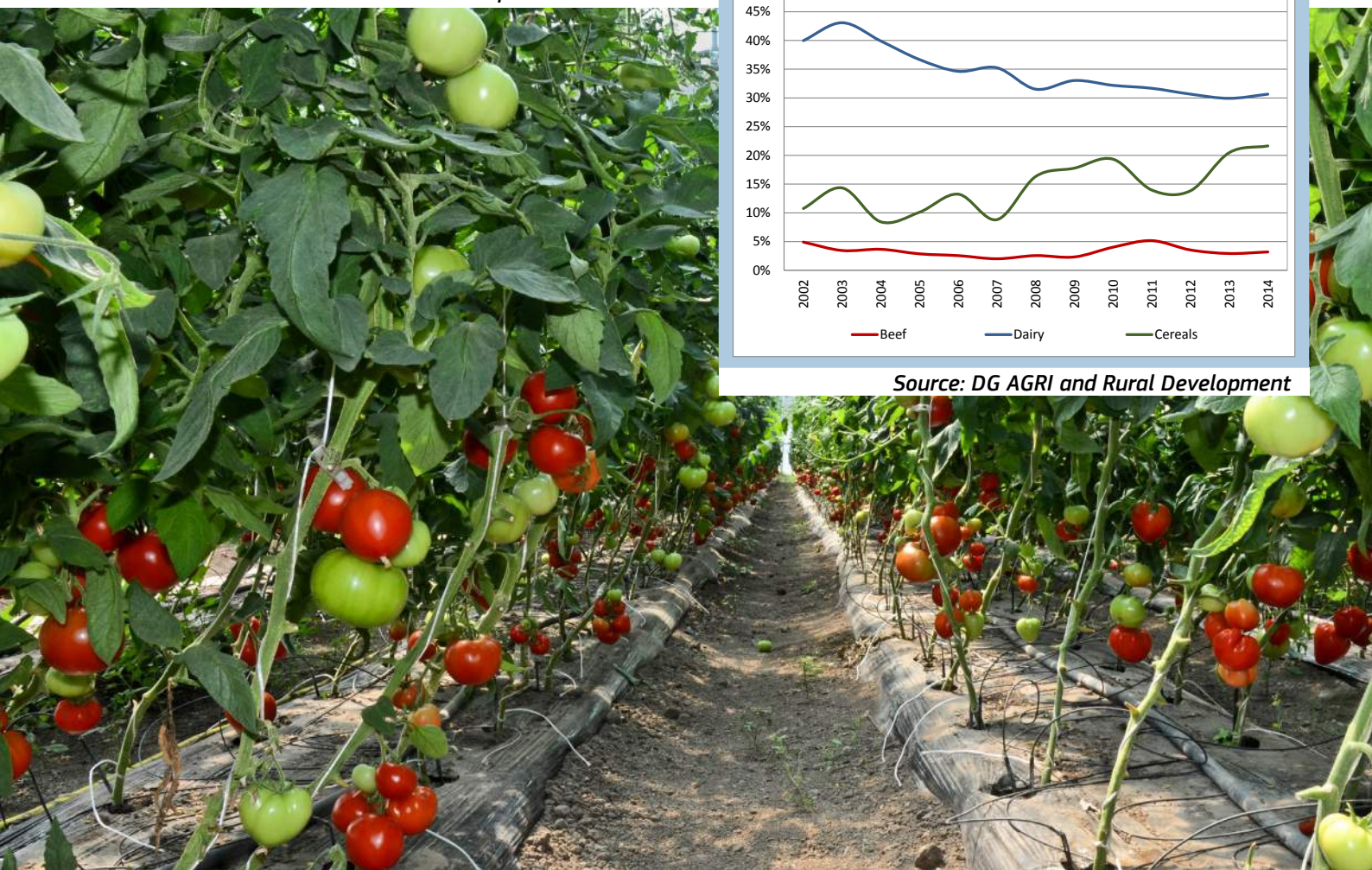
ports and increasing the search for value added in the sector. The recent challenges faced by the sector raised the question of how present market challenges relate to the long-term priorities of the sector, especially since multiple causes lie behind the recent dairy crisis. Three factors explain most of the difficulties, even if the debate about which weighs more heavily may linger for a while. The increase, in both 2013 and 2014, of the EU dairy herd reversed a very long downward trend and led to a higher milk production. This additional production would have exerted less or even no downward pressure on prices had it not coincided with the Russian ban - which deprived the EU of its largest export market- and with the slowdown in the world economy.

The EU's policy response has focused on targeting income by addressing immediately the cash-flow difficulties farmers are facing, by stabilising markets, by maximising the use of existing measures, and by raising issues about the functioning of the supply chain. Equally, the EU's policy response has stressed the need of not replacing market signals. If prices are raised artificially when there is oversupply, production will not adjust to the needs of the market, downward pressure on prices will remain, the long-term competitiveness of the sector will suffer and the CAP will be less market-oriented.

EU value share in World Exports

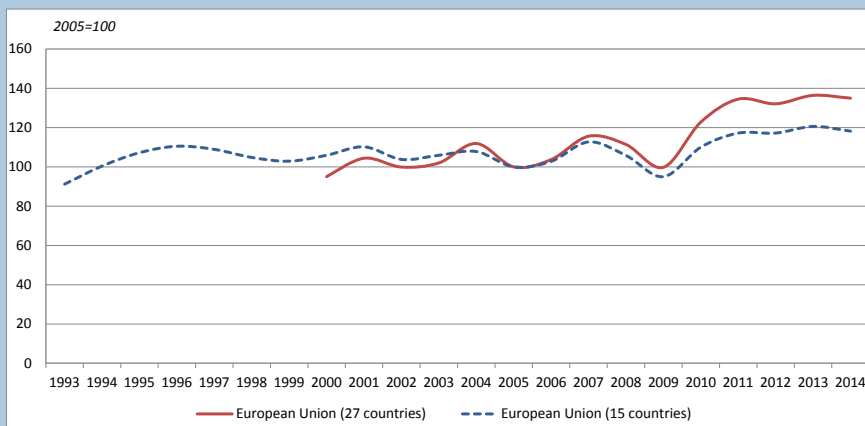


Source: DG AGRI and Rural Development





Real Factor Income in EU Agriculture per annual work unit



Source: DG AGRI and Rural Development

THE CAP SAFETY NET: THE WAY AHEAD

Assessing the broader impact of the sequential CAP reforms of the safety net should be made at the level of farmers' income. Here, two distinctive patterns are noticeable. The introduction of direct payments after the Mac-Sharry reform in 1992 brought the average income to a higher level. Secondly, the shift towards the fully decoupled direct payments by the 2003 reform confirmed the overall trend of increasing income. The most important driver for these developments is the significant gain in labour productivity driven by structural adjustments in the sector.

However, with prices of inputs increasing faster than those of output the need for farmers to further focus on risk management and cooperate horizontally and vertically in the supply chain remains crucial.

The policy response of the EU on the dairy crisis also reflects the broader orientation of European agriculture providing high-quality products to its citizens and being able to profit from market opportunities in an ever changing global market. To do so, the sector has to be competitive and dynamic. This can be achieved by a focus on market orientation and a fair and sustainable relationship along the whole supply chain.

Higher price support does not contribute to the long-term competitiveness of European farmers. Market measures create distortions that inhibit the sector from playing to its strengths and to rationalising its struc-

ture. Farmers are however not left alone, but receive a different type of support. If severe markets disruptions take place, the European Commission is ready to apply the market measures available to assure the livelihood of European farmers. Moreover, the decoupling of support from production decisions allows farmers to be paid for the delivery of public goods. Linking direct payments to land and wider environmental benefits highlights two further important justifications for the added value of the CAP. The novel greening concept is central to this approach.

Above all, farmers should be supported in the management of their own specific on-farm risks. A variety of tools, from insurances over income stabilisation up to future markets, are available to achieve this goal. However risk management goes beyond the farm gate into the supply chain. The policy framework should ensure a transparent price formation and risk-sharing mechanism throughout the chain. Producer organisations and the milk package represent two important instruments designed to achieve such a goal.

With the CAP as an effective safety net, EU agriculture can continue to blossom as a competitive and dynamic sector, providing affordable, high quality food to Europe and the world, in a sustainable way. The creation of value added along the chain contributes to growth and jobs in rural areas and in the broader economy, to the benefit of all.

"We have made the political choice in favour of a market-oriented farm policy. However, we must also provide the mechanisms to help the sector to live with market volatility, in terms of anticipating developments and providing a safety net when necessary."

Phil Hogan, European Commissioner for Agriculture & Rural Development



This, and two other publications, were prepared for the "EU Agricultural Outlook Conference" taking place in Brussels on 1-2 December 2015.

#EU_AgriOutlook

More information on the Conference and links to the publications are available at http://ec.europa.eu/agriculture/events/2015-outlook-conference_en.htm



Food & Farming: Focus on Land



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