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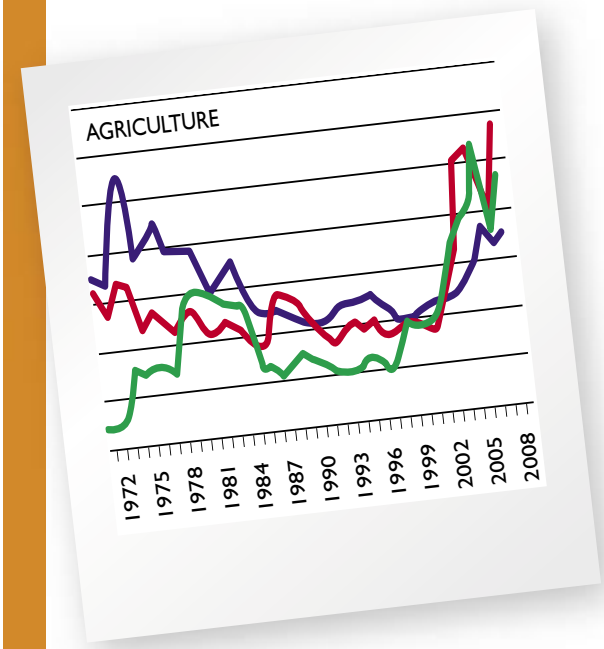
Agricultural Market Stabilization System policy instruments to be included in the CAP

Policy Recommendation Paper



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Bridging science and policy

The OPERA policy recommendation paper presented herewith has benefited from the contributions and the review of the members of the OPERA Agricultural Markets Working Group. However the content only reflects the opinion of OPERA and should not be seen as reflecting, totally or in part, individual opinions or approaches.

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Bridging science and policy

OPERA is a young, growing think tank and a research centre of the Università Cattolica del Sacro Cuore, a major European private university.

It is an independent, non-profit scientific organization, committed in supporting the successful implementation of the agri-environmental measures within the European legislation.

The fundamental contribution of OPERA is to use the potential of existing scientific researches as well as the existing expertise and knowledge to support the stakeholders in their political and technical decisions concerning agriculture, and particularly the management of agricultural risks relating to pesticides and the environment. One objective is to provide a series of pragmatic recommendations to policy makers to bridge the interest and objectives of agriculture and environment as well as to ensure efficient implementation of the agriculture related policies in the EU.

FORWARD

With great pleasure I accepted the invitation of OPERA Research Center to introduce the paper of "Agricultural Market Stabilization System – policy instruments to be included in the CAP" that is produced by a group of outstanding scientists. A platform at EU level that could bring together scientists, policy makers and stakeholders and deliver valuable insight is undeniably needed. The initiative and contribution of OPERA in this direction is, hence very much welcomed.

Lately, a scenario of great uncertainties has been manifested itself in the agricultural markets. The climate instability, the market speculation, the protectionist reactions, the calamitous events are some of the variables that contributed to volatility. It is very much likely that similar situations will continue to affect prices of the agricultural products also in the future. Since the bargaining power of the agricultural markets, especially in the primary sector has been reduced, the need of market stabilization arises.

The Common Agricultural Policy (CAP) results as a response to the need of the insurance of the food self-sufficiency and security within the European Community. The two main intervention areas of the CAP are the market policies and the policy for structures.

The ability of the farmers to manage uncertainty will affect the stability of their incomes. Hence, there is a need to ensure that farmers are provided with the necessary tools and supporting systems and instruments to face production and commercialization risks.

The greatest challenge that Europe faces nowadays is the development of the framework that would support the building of a more efficient and diversified market of risk management instruments. The market should respect the needs of the agricultural economies of each Member State and furthermore, should map a common framework of rules able to minimize the gaps that appear due to the differences among the Member States. Furthermore, the development and the strengthening of contractual mechanisms in order to ensure the market stability appear high importance.

The target of Europe today should be the support of a system of incentives for the systematic action, as well as the creation of a framework of guarantees in order that all the participant parties are being protected from any opportunistic behavior. In the future, the continuous dialogue within the production chain should be reinforced, since this will bring more stability to the agricultural businesses.

Apart of the enhancement of the production, the aim of the policy should be to ensure the framework for its constant provision on the markets and thus the market stability to be established within a regulatory framework compatible with antitrust laws.

It is now the time to thoroughly debate on meaningful and efficient solutions to reach these goals within the next CAP. Shaping the new policy to deliver food security for consumers; reasonable incomes for the farmers and public goods for the whole of the society it is a duty for scientist and policy makers alike.

Paolo De Castro
Chairman of the Committee for
Agriculture and Rural Development
European Parliament

EXECUTIVE SUMMARY

Fifty years after it was set up, the general objectives of the CAP were reconfirmed by the Lisbon Treaty. The CAP instruments to ensure market stability played an important role as they provided for a better environment to develop farming and a greater appetite for investment in innovative technologies and their application.

The paper starts from the identified realities and commonly accepted facts surrounding the agricultural markets instability and to build for the CAP a pragmatic and applicable system of instruments which can positively impact on the issue.

As for the **cause of this volatility,** there is a broad range of opinions on the issue. As the OECD has recently emphasized, agriculture is subject to many risks, and it distinguishes between production, market, institutional, personal and financial risks.

Price volatility depends on how variable its determinants will be. Among the relevant determinants are: **global balance between supply and demand; Climate change; Trade liberalization; Food markets increasingly interlinked with energy markets.**

A system for market stability

Market stability can be further promoted by a combination of a number of factors. Our approach is to address the issue from the perspective of five main directions for policy action so as to reduce the negative effects generated by the instability in the agricultural markets, as follows:

- **The development of existing CAP instruments**
- **Production stabilization mechanisms**
- **Price and income stabilization instruments**
- **Market transparency**
- **Cooperation and structural issues.**

Supply stability

We should address in the CAP the issue of production risk from losses due to weather damage, crop pest infestation, or animal disease outbreaks.

The **role of technology is paramount in managing the risks associated with the production** process. Effective technologies for pest and disease management can help **reduce yield volatility.** The added threat of global climate change clearly makes even more imperative the need for the uptake in production technologies and proper crop management to address future threats to agricultural production.

From a long term perspective, developments in markets have always been influenced by **innovation**. It is important that the **potential of innovation is taken into account when considering the requirements for supply stability.**

If these lead to a stabilization of supply, they will implicitly lead also to stabilization of markets and of farmers' income. For this to be achieved, better horizontal policy integration is required, as well as an intensification of public-private sector cooperation.

Reducing price and income volatility

Price and income volatility has to be addressed in the CAP with two mechanisms. The first component, "Price and income safety net" should address directly the issue of the excessive volatility of agricultural commodity prices. The second component, "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.

A Price and income safety net

The mix of instruments to be used in the price safety net should be built on the existing instruments, adapted to better respond to extraordinary market situations.

Intervention purchasing and withdrawals: Public intervention should operate more as a safety net. The use of automatic triggering mechanisms and fixed prices for intervention should be avoided. The instrument should be flexible and easy to use by the Commission when required.

Aid for private storage (APS): Depending on the state of the market, the Community authorities should have the option of encouraging additional private storage, through targeted aid. Such schemes could be used in combination with the alternative: public intervention.

Subsidies designed to promote internal consumption: As a general principle it should be avoided that these measures lead to the re emergence of intervention as a regular market outlet.

State aids: These provisions should remain virtually unchanged. The primary role of this instrument is to stabilize the income of the farmers in exceptional economically difficult situations.

Income safety net: An instrument should be made accessible, under the rural development instrument, so that Member States may provide farmers with financial compensation for significant reduction of their income. The instrument should be compatible with WTO rules.

Various options such as the creation of mutual funds need to play a greater role in the CAP.

B Risk reduction- Market based risk management instruments

Market driven instruments are in place to help farmers to reduce their exposure to risks associated to production and the risks for their income. In addition new instruments should be promoted to reduce farmer exposure to risks related to the volatility of their production and income.

Forward contracting: Promoting long term contracts as a measure to reduce volatility, will also have a positive impact on the competitiveness of the whole food chain. The CAP needs to develop a system of incentives, including financial ones; to promote vertical integration and the new framework for Rural Development can be the place to do it.

Futures markets play an important role in price discovery as well as allowing producers and processors to hedge their price risk. Futures markets have a number of drawbacks which may limit participation: basic risks and trading costs; markets not available for all commodities; quantities specified in the contracts may too large for many producers; they are more useful in addressing within year volatility rather than cyclical price fluctuations; lack of understanding due to inadequate information and training.

The EU can promote their development by ensuring an appropriate and effective regulatory and supervision environment; by ensuring the availability of high quality, timely and reliable market information; and by encouraging and supporting training and education in the use of these risk management tools.

Revenue or income insurance: While doubts were expressed on the low transfer efficiency of such instruments in terms of income support as compared to direct payments, insurance subsidies may be more effective in reducing income variability.

However, in Europe total farmers' welfare is found to benefit more from direct payments than from insurance subsidies. Hence, from the perspective of maintaining farmer income at a reasonable level compared to other sectors, direct payments should be maintained in the CAP.

Mutual funds: The policy should take a pro-active attitude in supporting the development of such mechanisms wherever they are appropriate and feasible.

Market transparency

Increasingly, farmers complain of **unjustified practices in the food chain,** imposing unnecessary production conditions above and beyond those mandatory in food safety legislation or environment protection legislation, to support marketing campaigns. These affect the proper functioning of trade flows in the internal market potentially increasing price levels and volatility for consumers.

On the internal market, we often observe that market instability has its roots in **local, regional or national imbalances** in supply and demand. This is relevant particularly in certain regions with insufficiently developed transport infrastructure. In other cases, the proper functioning of trade flows to regulate supply and demand is hindered by significant disparities in marketing and food safety standards.

Price monitoring at different stages could be one of the major tools to better understand markets so that we can improve transparency. The most suitable solution is to provide public support for the setting up and development of **independent price monitoring structures**, in parallel with the official collection of relevant information and statistical data. The model of coordinated price observatories seems suitable for this purpose.

The future CAP needs to actively promote more frequent **systematic projections on food prices** which are transparent to the public and farmers. Such an instrument is an essential tool to help farmers to address the price risk and to increase the effectiveness of market mechanisms in regulating imbalances.

Competition law, it has become evident that more usable guidelines over competition policy are needed to clarify these aspects and also to act as a catalyst for associates to enter into forms of cooperation that have been deemed unattractive in the past.

Cooperation and structural issues

Cooperation on a variety of layers has shown to be an effective tool to boost the negotiation power of the agricultural sector with the rest of the food chain. **The CAP needs to develop pro-active mechanisms to promote cooperation and integration on the food chain.** This is one possible solution to empower farmers to be able to respond to a rapidly changing market.

There is still very little dialogue between farmers, traders, processors and supermarkets. **Improving the producer-processor-consumer relationship** is a must for the future policy. The transfer of information along the whole food chain helps farmers and processors to better respond to consumer demands while consumers are able to conceptualize the roles in food production and assign a value to agricultural products.

The global dimension for food security

At global level the EU should avoid that the reduction in domestic price volatility translates into increased volatility of international prices. It should actively participate in developing effective solutions, on a multilateral basis, to reduce the volatility of the international agricultural markets and address food security issues.

Agricultural Market Stabilization System policy instruments to be included in the CAP

BACKGROUND AND SCOPE

Fifty years after it was set up, the general objectives of the CAP were reconfirmed by the Lisbon Treaty (increasing agricultural productivity, ensuring a fair standard of living for producers, stabilizing markets, guaranteeing the availability of supplies and ensuring supplies at reasonable prices). However, the means of achieving these objectives has evolved, adapting to new demands from society as regards: competitiveness, market orientation, environmental sustainability, public health, animal welfare, landscape conservation, viability of rural areas and biodiversity, as well as contributing to combating climate change.

> *"This initiative would review the policy and technological options to address market stability. The system aims at ensuring predictability and economic stability for farming businesses as well as contributing to income stabilization for farmers."*

The CAP instruments to ensure market stability played an important role as they provided for a better environment to develop farming and a greater appetite for investment in innovative technologies and their application.

TheCAP has gradually switched support from market and price management to direct payments. This more market oriented CAP means that farmers must take responsibility for managing those risks that were formerly absorbed by market and price support policies. Fluctuations on markets influence the incomes of farmers and therefore their future production decisions. This policy recommendation paper is not meant to make an exhaustive evaluation of the environment generating market instability or the general economic and political context.

The paper starts from the identified realities and commonly accepted facts surrounding the agricultural markets instability and tries to build for the CAP a pragmatic and applicable system of instruments which can positively impact on the issue.

The **benefits of stable agricultural markets go beyond the agricultural and food sector** as it improves the stability of the whole European economy, especially today when we are fighting towards stabilization and growth. It is also essential to contribute to combating rising food insecurity and its many economic, political and social consequences worldwide. Many of todays crisis, such as political instability in certain countries or the immigration problems in Europe, find their root in deficient agriculture systems and policies. A stable economic environment can contribute to long-run investment planning in agriculture and the food sector that will bring growth, technological and quality benefits tothe food market.

POLITICAL CONTEXT AND THE IMPORTANCE OF MARKET STABILITY IN THE FUTURE CAP

In evaluating the current CAP, one of the points of concern is the efficiency and effectiveness of the market management mechanisms and instruments. Moreover questions were asked if the EU would also need in the future a system to ensure agricultural market stability, or if markets are functioning well enough to be left alone.

The strong response was a positive one: the need for market stabilization mechanisms had been demonstrated by the high price volatility registered in the agricultural markets during 2007/2008 and again in 2010. Also the strong view of the farming community is to have in place a policy which will ensure economic stability for their businesses and consequently stability for their incomes. The sentiment of insecurity has been very much re-enforced by the relatively recent milk crisis as well as the future prospects for an increase in the food prices over the next 20-30 years (see Annex I).

The communication of the **Commission "The CAP towards 2020: Meeting the food, natural resources and territorial challenges of the future"**, issued on the 17th of November 2010, states on the issue of market measures that "some specific adaptations appear necessary, most notably in streamlining and simplifying instruments currently in place, as well as in introducing new policy elements with respect to the functioning of the food chain".

> *There is a need to maintain market s tabilization mechanisms in the CAP, due to the high price volatility registered in the recent years and the similar prospects for the future.*

At the Informal meeting of the Council for Agriculture and Fisheries, organized under the Belgian Presidency (19-21 of September 2010) voices of the Ministers were heard supporting a vigorous and robust system of measures to counteract the "unbearable market volatility" of raw materials.

The **European Parliament** in the position issued in 2010 on the reform of the CAP "Recalls, as Article 39 of the Lisbon Treaty rightly suggests, that agriculture is a specific sector which suffers from a long-term production cycle and several types of market failure such as high market volatility, great exposure to natural disasters, a high level of risk, lack of demand elasticity, and the fact that farmers are 'price-takers' rather than 'price-makers' in the food supply-chain"

Developments in the **WTO negotiations** have made it clear that the era of direct and indirect support for exports has gone. The global market has to function in a more liberal way. Seeing the situation from the point of view of European production, which is generally characterized by high production costs, this means that it will be more difficult to find outlets for surpluses in European supply. Inevitably world food price volatility will have a greater impact on internal EU prices.

Among the main factors behind the increase in price volatility in EU agricultural markets is the significant domestic and trade policy changes which have occurred, which brought a major reorientation of EU domestic prices for agricultural products.

The political and economic context in Europe and the world highlight the need for a new approach to cope with market volatility. Such approach should be robust enough to create a stable business environment, but also to be able to deliver this without creating distorting effects on the internal and global markets.

ASSUMPTIONS

> *The budget construction provides the background to any discussion of future systems to stabilize markets.*

The evaluations of the current situation on the volatility of agricultural markets as well as the solutions examined in the paper are based on a series of assumptions. Without them the scope would have needed to be broader and the analysis to cover a significantly more complex area.

The budget construction provides the background to any discussion of future systems to stabilize European markets, since costly systems for managing markets as deployed in the past are not likely to be accepted by either the Council or the European Parliament. In the longer term, the budget available for the CAP may continue to develop in one or more of the following three ways:

A following the pattern of recent financial guidelines which implies modest nominal increases in the ceiling but continued shrinking funding for market measures in order to increase funding for Direct Payments and Rural Development – the central scenario;

B a more generous set of financial guidelines which would nevertheless be unlikely to permit a return to the market management actions of the past – unlikely in the current economic climate;

C a more restrictive set of financial guidelines which would preclude the Commission intervening to stabilize markets if there were several severe disturbances in the same budget year.

The proposal is based on the existing CAP system for market stability which needs to be improved and not radically reformed. The paer has taken into consideration from the Commission Communication on The CAP towards 2020: **Meeting the food, natural resources and territorial challenges of the future**, that the most probable scenario for reform would entail the maintenance of several market stabilization instruments.

> *Most EU15 member states have the agricultural structures and the necessary infrastructure for proper market functioning while most EU12 member states are in an ongoing process of development.*

It is also assumed that there is a fundamental need to increase global production in order to feed an increasing world population and that this will impact on the volatility of the markets. As economic growth continues in developing countries there is increasing demand for the high value added processed products for which Europe is a recognized world leader.

The situation of agriculture and of the agricultural markets varies between member states and even between regions of the same state. While in **the majority of western member states**, the structures and the necessary infrastructure for proper market functioning may be in place, **central and eastern European member states** are in a continuous process of development. In future, greater emphasis should be put on the development of cooperative structures and/or of market related infrastructure (including transport infrastructure) in the majority of the new member states. In other member states, market forces are very active in counteracting temporary imbalances. In some member states, notably some new Member States, certain agricultural markets are excessively locally or regionally oriented.

Relevant aspects for the analysis

> *High EU standards are welcomed from the environmental and health perspective. However, often the application of such standards and the administrative burdens may affect the proper market functioning.*

It has to be underlined that there are deficiencies in the **proper functioning of the internal market** for certain agricultural products; also some European markets are not fully integrated in the world market. The issue of the different application of environmental, human and animal health standards plays an important part.

The EU environmental, human and animal health standards are among the highest in the world, if not the highest. From a health or environmental point of view, this is to be welcomed and supported. But it does increase production costs for farmers, both the standards themselves and the administrative burdens which accompany them.

On the other hand, high standards can offer a marketing advantage, in particular in certain sectors (e.g. fruits and vegetables, dairy, meat). The high quality of Europe's food produce is recognized the world over and in an increasingly demanding consumer market it can offer a competitive advantage, despite a higher price as a result of higher production costs.

But it is unclear if farmers themselves also **benefit from their more sophisticated production methods or if the benefits appear only further down the food chain.** This can be further acerbated by the introduction of various additional requirements in the food chain, which have no scientific basis. They serve primarily as marketing and public relations instruments in the competitive battles among other sectors at the end of the food chain.

The high EU standards could equally be achieved by different methods (such as taking the WHO Pesticides Evaluation System as a basis and adding on EU requirements) which would facilitate the functioning of global markets.

CAUSES OF MARKET INSTABILITY

As for the **cause of volatility**, there is a broad range of opinions on the issue. At the outset, we should recognize that, as the OECD has recently emphasized, agriculture is subject to many risks, of which market instability is just one (OECD 2009). These risks can be categorized in various ways. The OECD distinguishes between production, market, institutional, personal and financial risks.

Production risk is due to unpredictable weather and performance of crops and livestock. Moreover, the influence of climate change adds to this.

Market risk is related to uncertainty about the price of outputs, and sometimes also inputs, at the time production decisions are taken.

Institutional risk is due to unforeseen government actions and change in rules such as laws on the use of pesticides, tax provisions and payments, new production standards, etc.

> *"Relevant determinants for volatility are: global balance between supply and demand; climate change; trade liberalization; link with energy markets."*

Financial risk results from the use of borrowed funds, which means that interest charges have to be met before equity is rewarded. Additionally there is financial risk when interest rates rise or loans become unavailable.

In addition, the food chain as a whole can face severe risks such as the rapid loss of market confidence due to perceptions of a food safety incident (e.g. BSE crisis; avian flu crisis).

In the results from a number of producer surveys, the output price risk is ranked either first or second in every study.

Price volatility depends on how variable its determinants will be. Among the relevant determinants are:

- The **global balance between supply and demand** has tightened and global stocks for many commodities are at historically low levels.
- **Climate change** is expected to increase market volatility because of the greater frequency of extreme climatic events.
- **Trade liberalization** traditionally was expected to contribute to greater world price stability.
- **Food markets are increasingly interlinked with energy markets.** One particular impact is expected from the policy on biofuel, with objectives expressed in volume terms. Such quantitative targets reduce the price elasticity of demand for agricultural feed stocks and exacerbate volatility in the relevant food markets.

In future, other factors may have an increasing influence, such as rising transport and distribution costs, actions to combat climate change and reduce the CO2 footprint, growth or decline in agricultural markets in developing countries depending on technological innovation and new agricultural policies.

In the EU, the market orientation of the CAP has not advanced all the way since high peaks of the food price fluctuations are not transmitted fully to production activity. Hence their influence on the production decisions does not reflect market trends, reducing farmers' capacity to take advantage or respond to market fluctuations.

For EU farmers, the impact of world price volatility is attenuated by the behaviour of exchange rates (in particular the USD EUR exchange rate given that most agricultural commodities are traded in US dollars) as well as by the increased ease of price transmission across EU borders. The USD EUR exchange rate has experienced significant fluctuations since the introduction of the EURO, and this seems likely to continue.

Further changes to CAP border policies mean that world market price changes will be transmitted more strongly to the EU domestic market in the future.

Farmers' vulnerability in the face of price volatility may also be greater in the future. Greater specialization, as farmers seek production efficiencies through economies of scale and, larger sector specific investments may reduce their production flexibility in the face of relative price changes.

Also, the income margin per unit of product is decreasing, partly because farm prices do not follow the general development of prices (inflation) (Vrolijk et al., 2009).

Thus there are good reasons to explain why market instability has become such a hot topic in the agricultural policy debate on the CAP post 2013.

A SYSTEM FOR MARKET STABILITY

Market stability can be further promoted by a combination of a number of factors. Cooperation, long term contracts , improved market transparency, wider use of tools such as "hedging" and more generally insurance systems (both for production related and income fluctuation risks), the use of modern technologies to stabilize yields, etc., may all make a positive contribution to market and income stability. Therefore the new CAP needs to find the right instruments to promote them as solutions which would deliver finally the desired stability at farm level.

Our approach is to address the issue from the perspective of five main directions for policy action so as to reduce the negative effects generated by the instability in the agricultural markets, as follows:

- **The development of the existing CAP instruments**
- **Supply stabilization mechanisms**
- **Price and income stabilization instruments**
- **Market transparency**
- **Cooperation and structural issues.**

Review of the existing instruments

The last twenty years have seen a number of major step changes in the CAP with its intention for Agriculture to become more responsive to market signals:

A the creation of effective budgetary discipline, putting an agreed ceiling on annual expenditure on direct payments and on market measures. While the direct payments constantly increase due to the phasing in mechanism for EU12, the share for market measures is shrinking;

B international obligations stemming from the Uruguay round, and presumably in due course the Doha Round, expose the EU market to greater competition;

C the creation of a Rural Development policy to enhance competitiveness of agricultural production;

D the creation of very substantial direct income support, in the form of "direct payments"; these now represent the major part of expenditure on Agriculture;

E the abolition, or phasing out, of regular, or recurrent, intervention in the market place – albeit with permission given to the Commission to take appropriate action when market prices in a sector are disturbed - has enabled the substantial transfer of budgetary resources away from market support to both direct payments and to rural development;

F more flexible criteria for "national aids" to be authorized by the Commission to deal with difficult situations;

G there is increasing recognition of the positive role for Producer Organizations which should also be able to alleviate the competitive disadvantage of producers who are price takers from a decreasing pool of purchasers;

H there is growing attention to the mechanisms of the whole food chain and improving fair competition.

The **existing market management system** in the Single CMO can be summarized as follows:

A **Internal Market:**

- Intervention measures: Public intervention and private storage; Special intervention measures; Production limitation systems; Aid schemes (specific).

> *Market stability can be promoted using a combination of instruments: Cooperation, contracts, market transparency, use of tools as "hedging", insurance systems, use of modern technologies to stabilize yields.*

The above have all been abolished or, are in the process of being phased out, with the exception of the reserve responsibilities of the Commission to deal with market disturbances. However, as confirmed by recent experience, exceptional intervention actions by the Commission are likely to be needed in the future.

They will continue to contribute to market stability. However, they are no longer expected to be capable of fulfilling the role that they had prior to the reforms of the last twenty years.

- Provisions concerning marketing and production: Marketing standards and production conditions; Producer organizations (POs) and inter-branch organizations.

B **Competition rules** - essential in a Single Market -continue to be clarified on an on-going basis:

- Rules applying to undertakings (agriculture)
- State aid rules

C **Trade with third countries**, are currently constrained by our Uruguay Round obligations. The completion of the Doha Round, taking into account as basis the results of the last meaningful round of negotiations would for:

- Import quotas and tariffs – reduce import protection both at home and abroad, while maintaining some import protection.
- Export refunds (and their equivalent) – disappearance both at home and abroad.

Further application of these disciplines to new WTO members (e.g. Russia) would bring substantial benefits to European exporters.

Instruments to influence the **demand in agricultural products** are also included in the current CAP. These cover a wide range of measures like: support for the use of milk products in industrial activity; distribution of milk, fruits and vegetables in schools; aid for the most deprived people; processing aid; etc. However, some criticism was heard about the budget intensity of such measures and also their limited effect. A redesign of such policies or replacement with more efficient instruments might be needed.

Supply stability

In the current CAP, **supply** has been influenced by the use of public intervention and private storage. Production limitation mechanisms also played a role through quotas (the major ones, still in force are related to milk and sugar production and vineyard planting rights) and mandatory set-aside (abolished through the Health Check decisions).

Due to the budgetary constraints and the general shift in the CAP towards market orientation, the relative importance of such instruments is in continuous decline, their application being phased out.

> *Promoting technology uptake and innovation; insurance for production losses due to weather, pests or diseases will all contribute to stabilizing supply on the market.*

We should address the issue of **production risk from losses due to weather damage, crop pest infestation, or animal disease outbreaks.** The CAP Health Check in November 2008 allowed Member States to redistribute some of the financial resources for direct support granted under the first pillar of the CAP to the development of risk management measures. Member States can now make a financial contribution to crop, animal and plant insurance premiums against economic losses caused by adverse climatic events and animal or plant diseases or pest infestation and by way of mutual funds for animal and plant diseases and environmental incidents.

The **role of technology is paramount in managing the risks associated with the production** process. The application of the available instruments can guarantee a higher yield and better quality for the final product. Only the use of pesticides can increase the yield by 20-30% by managing the risks associated with various pests. The use of appropriate cultivars, certified seeds and good practice in production technology application are also factors which contribute to the reduction of the risks related to the output of the agricultural activity.

According to FAO estimates, during the 21st century global crop production will have to increase by 70 % to meet growing food and feed demand driven by human population growth and likely increases in income in developing countries. Moreover, because of limits on the availability of resources, a significant increase in production must come through an acceleration of the rate of technological change to stimulate the sustainable intensification of crop and livestock production systems.

Effective technologies for pest and disease management can help **reduce yield volatility** and therefore poverty and hunger. The added threat of global climate change clearly makes even more imperative the need for the uptake in production technologies and proper crop management to address future threats to agricultural production.

From a long term perspective, developments in markets have always been influenced by **innovation**. Today, the post-industrial economy is driven more than ever by research and technology and by their uptake; this is also true for agriculture. Therefore, it is important that the **potential of innovation is taken into account when considering the requirements for supply stability.**

Out of the three phases usually identified: invention (research), innovation (transformation of invention into marketable products) and diffusion (uptake at farm level), the last one has most impact on the competitive position of, in this case, European agriculture.

EU policy has the chance to address four major problems faced by the agricultural research and development activities in Europe, to promote:

- horizontal coordination of research priorities across the EU and vertical coordination with the needs of agricultural production;
- financial support to a level comparable with the resources employed in agricultural R&D by other competitors on the world market;
- creation of a business environment to promote public and private research and public-private partnerships, along with information campaigns to change public perception to the results of technological development;
- deliver mechanisms at farm level to increase and accelerate the uptake of the results.

Research and development in productivity means providing farmers in the future with the tools to better meet the challenges of the world market as well as facilitating the delivery of public goods such as combating climate change and providing for water and soil protection.

Strengthening the market element through access to innovative services and production tools would also contribute to the aim of increasing the competitiveness of European agriculture.

Even where sufficient knowledge seems to be available, knowledge distribution to farmers, again, is the missing part; policy objectives and the reality on the ground do not match up.

The interaction between public policy and regulation and the innovation strategies of the input industries can lead not only to a more sustainable agriculture, the key objectives of the last decade, but also to more competitive European agricultural production, the key objective for the coming decade. The interaction between the objectives of Agenda 2020 and the reform of CAP must be taken into account.

If these lead to a stabilization of supply, they will implicitly lead also to stabilization of markets and of farmers' income. For this to be achieved, **better horizontal policy integration is required, as well as an intensification of public-private sector cooperation.**

Reducing price and income volatility

Price and income volatility has to be addressed in the CAP with two mechanisms. The first component, "Price and income safety net" should address directly the issue of the excessive volatility of agricultural commodity prices. Such an approach should have the objective of avoiding that temporary, non-recurrent exceptional market circumstances significantly affect the capacity of competitive farmers to stay in business and/or avoid that significant changes in structures take place.

The second component, "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 hence to allow him to adapt while at the same time to assure some income stability.

A Price and income safety net

The mix of instruments to be used in the price safety net should be built on the existing instruments, adapted to better respond to extraordinary market situations. Concretely, the public or private storage and special intervention instruments when deployed should be modified to be made available in a timely manner. The decisions on the use of such instruments need to be taken swiftly as to allow maximum effect in the markets. Market management structures at EU level should be given a broad mandate to act in such circumstances.

Intervention purchasing and withdrawals: Public intervention should operate more as a safety net. This instrument should be used in similar conditions to those described by art 44, 45, 47 and 186 of the Single CMO regulation (R 1234/2007), where both the significant rise and fall in prices are taken into account for all products.

Intervention purchases should be applied only as a last resort, in exceptional circumstances. The use of automatic triggering mechanisms and fixed prices for intervention should be avoided. The instrument should be flexible and easy to use by the Commission when required.

The decided quantities for intervention should be subject to the approval of the Single CMO committee.

Similar principles should apply to the wine and fruit and vegetables sector where, under certain conditions producer organizations may apply market withdrawal measures. These measures should have exceptional character and be subject to supervision by the Single CMO Committee.

We should avoid that recourse to fixed price purchases retreat from the market orientation of EU farming. A new system for market stability should provide for a framework where the market signals are properly transmitted to farm level and farmers are able to take the appropriate decision in their productive activities.

A key element is to provide them with the necessary information infrastructure systems at national and European level that delivers meaningful, high quality and timely market insights.

Aid for private storage (APS): Depending on the state of the market, the Community authorities should have the option of encouraging additional private storage, through targeted aid. Such schemes could be used in combination with the alternative: public intervention.

The advantage of such schemes, where they are applicable, is the relative lower costs of implementation, hence the capacity of such mechanisms to mobilize a critical mass of products with a calming effect on the market.

As before, the application of such a mechanism should follow strict rules, under the control of the Single CMO Committee. Again, as for the intervention measures, an effective transparent information system on market developments and the prospects for the prices would have a positive effect on farmer's marketing decisions and would reduce the need to use such mechanisms.

Subsidies designed to promote internal consumption: While processing aid for butter has been eliminated, two categories of processing aid (skimmed milk powder for animal feed and skimmed milk made into casein or caseinate) are maintained. The EU should have the possibility to use this type of measure in other sectors, for the promotion of consumption of certain products as a counter cyclical measure.

As a general principle it should be avoided that these measures lead to the re emergence of intervention as a regular market outlet. The justification for this discipline is to prevent the EU pursuing a domestic policy objective of increased price stabilization at the expense of destabilizing world prices as well as avoiding back tracking on the progress towards the market orientation of European agriculture.

In the current system Direct payments are intended to provide income stability and as such are a vital component of the support for farmers' incomes. If these payments were to be significantly curtailed then the difficulties of survival in periods of crisis encountered by some producers would be made significantly worse.

State aids: The current Commission guidelines for state aids in the agricultural sector permit aids under the risk and crisis management heading only for A damage caused by natural disasters or exceptional occurrences; B losses caused by adverse weather conditions; C to combat animal and plant diseases, and D insurance premia to address these risks.

The rules were recently amended to introduce a de minimis threshold below which state aids do not have to be notified to the Commission. These provisions should remain virtually unchanged.

The primary role of this instrument is to stabilize the income of the farmers in exceptional economically difficult situations. This mechanism should be used to avoid that temporary negative circumstances have a permanent effect on agricultural structures and the overall competitiveness of the farming sector (e.g. excessive drought over a long period can drive farmers out of business).

Income safety net: An instrument should be made accessible, under the rural development instrument, so that Member States may provide farmers with financial compensation for significant reduction of their income. The instrument should be compatible with WTO rules. Under this option farmers would be compensated for a serious fall in income, defined as a decrease of more than 30%. To remain within WTO rules, the amount of such payments should not exceed 70% of the producer's income loss in the year, defined as the difference between the current year income and the average for the three previous years.

This measure requires an agreement on a precise definition of income. Other administrative issues related to data collection, controls, and rules on calculating the compensation should be taken into account when using such instrument. It should be avoided that this leads to the creation of significant disparities between member states.

The use of this instrument may cover losses caused by significant market disturbances and where other mechanisms have not been successful in producing the desired results.

Various options such as the creation of mutual funds need to play a greater role in the CAP. Although there are indications that production risks in Europe are also growing (greater likelihood and frequency of extreme weather events, greater likelihood of non-traditional pest or disease outbreaks also as a consequence of globalization), the greater interest in risk and crisis management policies is largely driven by the experience and fear of increased price volatility.

B Risk reduction- Market based risk management instruments

Market driven instruments are in place to help farmers to reduce their exposure to risks associated to production and the risks for their income. Already many member states operate schemes to subsidize the premium for insurance against climatic and pest related exceptional situations. In other member states the practice of contracting in advance is very well developed. In addition new instruments should be promoted to reduce farmer exposure to risks related to the volatility of their production and income.

> *Risk reduction should address the production and income related risks so as to reduce the exposure of the farmer to the variations.*

Forward contracting has always played a role in helping individual producers to manage price risk. 'Contractualisation' is used to suggest the use of collective agreements between suppliers and processors to manage prices equitably.

Strengthened contractual relations between private parties can be proposed as an alternative way of ensuring minimum and maximum prices. Long term contracts that specify a delivery and purchase commitment have been widespread. However, these arrangements have come under increasing pressure as long term relationships have been eroded and producers have sought shorter contract periods. Faced with greater market price volatility, longer term contracts with appropriate risk sharing arrangements may become more popular again.

Promoting long term contracts as a measure to reduce volatility, will also have a positive impact on the competitiveness of the whole food chain. Such schemes could further develop the necessary framework for a cluster based development approach in some particular sectors and regions in the EU.

The CAP needs to develop a system of incentives, including financial ones; to promote vertical integration and the new framework for Rural Development can be the place to do it.

Market based risk transfer instruments such as over the counter (OTC) contracts, futures and other derivatives offer a useful way for farmers to cope with high price volatility and market uncertainty.

Futures markets play an important role in price discovery as well as allowing producers and processors to hedge their price risk. The use of futures markets in Europe has traditionally been lower than elsewhere, in part because of the effectiveness of historic public risk management interventions.

However, there is now considerable evidence of innovation in this area. Contracts offered by European Exchanges provide a fairly effective method for agricultural price risk management, and European producers can make use of risk protection as American farmers can, using their "more established" US instruments.

The main agricultural contracts traded are on Euronext in London and Paris. There are also futures markets in Germany and in Spain. Moreover, lately there have been considerable efforts to develop new agricultural futures and options markets.

Recently a number of parties have expressed interest in launching dairy futures in the EU. While many of the new European agricultural futures and options markets are not actively traded, the pace of innovation in this area is such that a range of hedging possibilities is now opening up for European farmers.

Futures markets have a number of drawbacks which may limit participation:

- Basic risks and trading costs;
- Markets may not be available for all commodities;
- The quantities specified in the contracts may be large relative to the scale of many producers;
- They are more useful in addressing within year volatility rather than cyclical price fluctuations.
- lack of understanding due to inadequate information and training.

A series of actions need to be taken in public policy to overcome these difficulties. The different instruments of the CAP could promote cooperation to increase the volumes, could create a clear environment for the development of new products in some markets; provide better information on the markets and the options of instruments for risk management.

The EU can promote their development by ensuring an appropriate and effective regulatory and supervision environment; by ensuring the availability of high quality, timely and reliable market information; and by encouraging and supporting training and education in the use of these risk management tools.

Revenue or income insurance: Governments have investigated alternative instruments to address income instability, including insurance. Much of the interest in insurance schemes in recent years, both in the United States and in Europe, is arguably due to the inclusion of two measures in the WTO Green Box, government financial participation in income insurance programs or income safety nets, and payments for relief from natural disaster.

The Health Check of the CAP only provides for production risk insurance. However, interest in revenue and income insurance has been growing, in part stimulated by the lessons from the US and Canada which from the early 1990s began to develop different mechanisms of revenue insurance policies.

All observers agree that a revenue insurance scheme would not be possible without a significant level of public subsidy. While doubts were expressed on the low transfer efficiency of such instruments in terms of income support as compared to direct payments, insurance subsidies may be more effective in reducing income variability.

However, in Europe total farmers' welfare is found to benefit more from direct payments than from insurance subsidies. Hence, from the perspective of maintaining farmer income at a reasonable level compared to other sectors, direct payments should be maintained in the CAP.

Mutual funds are mechanisms with a long tradition and wide scope in some member states, while in others this tool does not exist. The policy should take a pro-active attitude in supporting the development of such mechanisms wherever they are appropriate and feasible. The risk management package of measures could include this as an objective.

The pro-active management of the capital under mutual funds would also help to overcome some financial limitations on the use of other risk management instruments.

It should be avoided that such instruments remain dependent on public support indefinitely, creating a new form of permanent subsidy.

Market transparency

The food supply chain has mainly functioned very well, allowing every segment of the chain to contribute to high-quality products at affordable prices. Both innovative products and traditional production methods are traceable, having ensured wide consumption including outside the EU. In spite of this, the whole food chain has suffered in terms of competitiveness and economic growth, having difficulties to balance price shocks.

> *Significant disparities in **marketing and food safety standards** imposed by food chain actors can significantly affect the proper functioning of the internal market.*

Retaining transparency in the food supply chain, while upholding high safety and quality standards, has become a crucial factor to remain competitive and fair.

Increasingly, farmers complain of **unjustified practices in the food chain**, imposing unnecessary production conditions above and beyond those mandatory in food safety legislation or environment protection legislation. Requirements imposed only to support marketing campaigns based on the lack of information or emotional attitude at consumer level, interfere with the production technology, affect productivity and increase costs while they do not necessarily provide supplementary benefits to the consumer or society. Moreover, these affect the proper functioning of trade flows in the internal market potentially increasing price levels and volatility for consumers.

On the internal market, we often observe that market instability has its roots in **local, regional or national imbalances** in supply and demand. This is relevant particularly in certain regions with insufficiently developed transport infrastructure. In other cases, the **proper functioning of trade flows to regulate supply and demand is hindered by significant disparities in marketing and food safety standards.**

One solution would be to promote **guidelines of good commercial practices** which would prevent that the margins of profits are unevenly distributed in the food chain and would make a positive contribution to **increasing the fluidity along the chain.**

Price monitoring at different stages could be one of the major tools to better understand markets so that we can improve transparency. Then, transparency will contribute to market stability and subsequently farmers could be able to stay competitive in a rapidly changing environment.

For a better functioning of the European agricultural markets it is crucial to develop an efficient system to collect information on agricultural and food prices and trade. It is essential to collect systematically information on the price structure for food products so as to understand the different cost elements in food production and to identify the bottle necks in price transmission between farmer and consumer.

As indicated before, good quality and timely information on prices delivered in the public domain for the use of the farmers allows them to take the necessary business management decisions to adapt to market developments.

European farmers and other actors need to be provided with such data as to be able to compete on the internal market but also to take into account the international developments so as to be able to compete at global level.

The most suitable solution is to provide public support for the setting up and development of **independent price monitoring structures**, in parallel with the official collection of relevant information and statistical data. The model of coordinated price observatories seems suitable for this purpose.

Trade patterns in Europe need identification so as to clarify which are the **barriers which hinder the proper functioning of the internal market.**

According to Commission evaluations, in the food chain, **the structure of the cost** of final products delivered to consumers, , includes only 20-30% on average for the agricultural raw materials. Hence the variations of commodity prices are scarcely translated into the final product. Other factors like energy costs have a significant impact on the final retail price.

Continuous monitoring and assessing farmer's behaviour and activity becomes one of the most crucial tools for the future of the CAP. Information directly from farmers, throughout the EU, will offer a powerful tool in framing policy and will support proper market functioning.

Provisions should be made in the CAP for the further **development of the Farm Data Accountancy Networks (FADN)** to replicate national or regional conditions of production and to be used as a powerful analytical tool. Similar models should to be developed for the evaluation of consumption patterns.

The Commission system for market information needs to be expanded and made more transparent and accessible.

The future CAP needs to actively promote more frequent **systematic projections on food prices** which are transparent to the public and farmers. Such projections should take into account different spatial scales as well as different vertical levels in the food chain. Such an instrument is an essential tool to help farmers to address the price risk and to increase the effectiveness of market mechanisms in regulating imbalances.

Competition law, of course, plays a central role in regulating the market in the sense of discouraging anti-competitive practices. It has become evident that more usable guidelines over competition policy are needed to clarify these aspects and also to act as a catalyst for associates to enter into forms of cooperation that have been deemed unattractive in the past.

> *"CAP needs to develop pro-active mechanisms to promote cooperation and integration in the food chain as well as communication between farmer and consumer."*

Regular exhaustive analysis should carried out on the functioning of the agro-food chain and of the mechanisms of price formation, in order to evaluate if there are any forms of abuse of dominant position.

Cooperation and structural issues

Cooperation on a variety of layers has shown to be an effective tool to boost the negotiation power of the agricultural sector with the rest of the food chain. Producer Organizations or Cooperatives are one possibility for farmers to cooperate among one another (horizontally) or with the other segments along the supply chain through the integration of production (vertically). In whatever shape, cooperation remains at the core to improve farmers bargaining power and simplify the supply chain.

Cooperation might be the solution to farmers' weak negotiating powers, however cooperatives are not the sole key to a stronger position – there are many ways of cooperating to reap the benefits.

The CAP needs to develop pro-active mechanisms to promote cooperation and integration on the food chain. This is one possible solution to empower farmers to be able to respond to a rapidly changing market.

There is still very **little dialogue between farmers, traders, processors and supermarkets.** Most of the products on our shelves are processed which makes it difficult to ensure that agricultural producers are aware how to deal with their purchasers.

The consumer who buys food at the supermarket often finds it difficult to conceptualize the value added throughout the chain and the farming activity loses its value. The result is rigid attitude towards the sector and a negative view on the policies to support it. Price transparency is often mentioned as a prerequisite

to ensure that consumers are aware exactly what they are paying for when buying a product. Transmitting such information to final consumers would generate also a positive impact on society's image of the agricultural sector.

Improving the producer-processor-consumer relationship is a must for the future policy. The transfer of information along the whole food chain helps farmers and processors to better respond to consumer demands while consumers are able to conceptualize the roles in food production and assign a value to agricultural products.

THE GLOBAL DIMENSION

EU trade policy

EU trade policies underwent significant changes, in part as a result of domestic policy changes, in part as a result of external influence. The conclusion of the Uruguay Round brought the elimination of variable levies, which had insulated domestic markets from international price fluctuations, and imposed limits on export subsidies; both policy instruments had the effect of reducing the volatility of domestic prices at the expenses of international prices.

Over the years the EU has successfully negotiated many new bilateral and regional trade agreements (such as those with South Africa, South Korea, Central America, Colombia and Peru), as well as unilateral trade concessions (e.g. the Everything But Arms initiative), and expanded the depth (trade concessions) and the width (product coverage) of preferential trade schemes already in place (e.g. the Mediterranean Partnership, the improved GSP schemes and the Economic Partnership Agreements with ACP countries). The future entry into force of the EPAs, with their emphasis on regional markets, notably in Africa, the Pacific and the Caribean, is likely to have a stimulating effect on these countries agricultural trade, which over time may provide an impetus for agricultural production and innovation.

> *"EU trade policies underwent significant changes, as a result of domestic policy changes and of external interests. This made domestic prices more integrated with international prices."*

While the future of the Doha round, and the liberalization strength of the agreement eventually reached, if any, remain difficult to predict, it is fair to assume that within the next few years the EU will successfully conclude many of the potentially far reaching trade agreements it is currently negotiating (e.g. those aiming at the creation of free trade areas in the Mediterranean, and those with Mercosur, Russia, India, Canada, Vietnam and Indonesia). The trade liberalization these agreements will bring, although on a preferential basis, will increase further the integration of EU domestic markets with international markets bringing further increases in the volatility of domestic prices.

Finally, it is important to recognize that if an agreement is reached concluding the Doha round, this may include a revision of the "green box", i.e. of the set of domestic policies in agriculture which are exempt from support reduction commitments; such a revision may constrain on the price and income stabilization schemes which countries are allowed to use today.

In the wake of its **accession to the WTO, Russia** is expected to begin in the near future a period of liberalization of agricultural tariffs, but is not yet clear how liberal the Russian agricultural trade and support policies would become.

During the last EU-Russia Summit in December 2010, the Russian Federation and the European Commission concluded the bilateral talks on key issues in the accession of the Russian Federation to the WTO. However, this did not include bilateral issues regarding agricultural trade and technical regulations, including sanitary and phytosanitary rules, which still need to be resolved in the overall process of accession of Russia to the WTO. Agricultural trade issues will feature high on the agenda of the remaining multilateral negotiations at WTO level in the first half of 2011.

Policy options for global food security

The volatility of commodity markets are a major threat to food security in developing countries, as the rise in prices impact more heavily on the poor, who see their spending on food increased.

For farmers in such countries, volatility will create income fluctuations and their capacity to react by taking production decisions is limited as the delay between production decisions and actual production does not allow an immediate response to market signals. The social pressure is higher in these cases since there are limited means to buffer such variations in their income.

In the long run, countries can lower their vulnerability by raising agricultural productivity for a diverse set of crops that prove both competitive and sustainable. The EU should play an important role in this process by coordinating further its agricultural policy with the external aid and development policy to help delivery of the required tools for competitive and sustainable production.

Proposals have been made at international level lately to establish **global mechanism of food stocks** to be used in fighting food insecurity and in regulating the global food market in times of crisis. However, there are some important limitations in implementing such a mechanism. The quantities which would need to be mobilized to cover shortages are important. The financial resources for mobilizing such stocks are substantial while it's not clear which can be the source. Experience has shown that in the past such initiatives have failed.

Others consider that the commercial stocks are enough to overcome any such crisis and that the **global market should function as freely as possible** to allow market mechanisms to play their role in the global economy.

However, it is clear that the EU could support improving transparency of global markets by supporting international processes to further develop a global information system on export availabilities and import demands, inspired by the on-going work of such bodies as the International Grains Council and the International Sugar Organization. This would allow better preparation and better response from countries to avoid price volatility. Such measures would also help stabilize the global market and the positive spilloverspill over effect for the European markets is obvious.

Existing WTO commitments focus on import restrictions, such as high border protection, domestic support, and also export subsidies. Meanwhile, there are no disciplines on differential export taxes and other restrictions on exports.

This asymmetry of treatment contributes to greater global price volatility (by increasing the likelihood of high world food prices) as was demonstrated by the recent behaviour of exporters. **The EU should work for more stable world markets through seeking stronger disciplines on export restrictions and differentiated export taxes.**

Recently, Von Braun et al. (2009) have proposed an internationally coordinated strategic reserve system for food grains. They propose that there should be an agreement under the auspices of the United Nations that each participating member country would hold a certain amount of public grain reserve in addition to the pipeline stock that the private sector holds for commercial operations. The exact amount of public reserve that each country holds would be subject to further study, it would not be too large as a percentage of its annual domestic grain demand. These reserves would be drawn upon by a high level technical commission when needed for intervention in the spot market.

There are still many elements where solutions would need to be found before implementing such a system, such as the price ceiling to be defended and the mechanisms to be used, but attempts to establish decentralized but internationally coordinated stocks rather than centrally managed buffer stocks may help to improve the prospects for success.

Food grains play a fundamental role in global food security and there might be a common interest to act at global level. However, we might see regional variations of such an instrument on more specific products of particular interest.

CONCLUSIONS AND RECOMMENDATIONS

In the current system, "**Direct payments**" are intended to provide income stability and as such are a vital component of the support for farmers' incomes. If these payments were to be significantly curtailed or re-distributed, then the difficulties of survival in periods of crisis encountered by some producers would be made significantly worse unless strong former market management tools were to be re-deployed.

I Price volatility in agricultural markets, as for any other markets, is normal in a free market. It has the role of sending a signal to consumers and farmers on the balance between supply and demand. These signals constitute the basis for appropriate management decisions in the production and marketing of agricultural products. It is the responsibility of farmers to adjust their businesses to market conditions.

II However, extreme volatility can create major difficulties not only for individual businesses but also for an entire sector, region or state. There is scope for public policy, the CAP, to put in place instruments to protect farmers from such situations. It should be avoided that occasional extreme market conditions drive farmers out of business, or significantly affect the structure of an entire sector, which would be competitive under normal circumstance. However, public policy should not try to solve all the issues and in doing so leave no incentive for farmers to adapt.

III EU agricultural markets are now more linked to world markets than in the past. EU market policies should not "export volatility" from the internal market to the rest of the world. Excessive EU use of intervention instruments would inevitably have a spill over effect and would have a negative influence on other regional or even global markets - including developing countries, where appropriate mechanisms or resources to react are not available.

IV To work towards a stable environment for farming businesses, market policy should be complemented by structural reforms, particularly Rural Development measures, to provide the tools and the economic framework to increase competitiveness and stabilize agricultural incomes.

V One solution for addressing extreme price volatility is to use safety net mechanisms to protect against exceptionally low prices. The safety net to protect against extremely low prices can start from some of the existing CAP market instruments, completed by an instrument to deal with market disturbance, similar to the one already included in the Single CMO Regulation but having a wider scope. However such mechanisms need to be kept within pre-established limits; non-automatic and exclude pre-fixed price purchases. Due to the extraordinary nature of peaks of high prices supply cannot be adjusted in a short period of time. However, stimulating increases in productivity and the uptake of technology as a continuous process can create the premises to build the necessary productive capacity to reduce the time needed to adjust production to demand. As a result, high prices will be structurally reduced in a shorter time span.

VI Stimulating innovation plays a key role in responding to volatility. For example, innovation in product diversification and quality; innovation to provide environmental benefits or innovation in more productive techniques or technologies, all contribute to a stabilizing effect on farm output or revenue and a better fit between consumer demands and supply.

VII The EU should therefore invest more in generating sustainable new technologies and stimulating their rapid uptake in agricultural production. The tools provided by technology can help to protect farmers from the variability of yields due to elements like climate change, pests and diseases.

VIII Pro-actively stimulating cooperation, both vertically and horizontally, in the food chain has a positive effect in reducing price and income volatility for farmers.

IX In normal market conditions, when a certain degree of volatility is to be expected, farmers should be encouraged to use existing and developing market-based risk management instruments in order to reduce the volatility of their incomes. An additional effort needs to be made in educating farmers on the characteristics and benefits of such instruments and providing training in their use.

X Provision should be made in the CAP Rural Development pillar to permit, those Member States who wish to do so, to provide income insurance and safety net schemes, in line with WTO norms, as a complementary tool to help maintain farm incomes during periods of extremely adverse market conditions.

XI A key tool to reduce volatility and to improve a farmer's capacity to adapt to changing market conditions is market transparency. An improved system is needed to expand and enhance the quality and accuracy of the data collected and made publicly available on market prices at all levels of the food chain in the member states. Equally important is the production of regular and timely forecasts on the agricultural prices. An improved common data collection framework is required for such information and forecast systems to be effective as well as provisions for the data to be publicly available.

XII At global level the EU should avoid that the reduction in domestic price volatility translates into increased volatility of international prices. It should actively participate in developing effective solutions, on a multilateral basis, to reduce the volatility of the international agricultural markets and address food security issues.

ANNEX I

Prospects for agricultural prices

The **OECD-FAO Agricultural Outlook 2010-19** sees average dairy, vegetable oils, wheat and coarse grain prices 15-40 % higher over the next 10 years than their average levels during the 1997-2006 period.

Higher food costs will undermine global food security, which in turn will have negative effects on some country's political and social stability and may lead to uncontrollable migration streams. About one billion people are now estimated to be undernourished. The Outlook argues that agricultural production and productivity will need to be stepped up everywhere.

A recent DG AGRI report[1] notes "For all the products, November 2010 price levels were above the levels observed one year before (soft wheat (+66%), durum wheat (+22%), maize (+53%), barley (+66%), skimmed milk powder (+5%), butter (+23%), cheese (Edam) (+21%), beef (+6%), pork (+3%) and poultry meat (+14%)".

Von Witzke et al. (2009) expect the world market prices of agricultural commodities to increase 50 to 100 % between 2003/05 and 2015/17. In their projections, central driving force of prices is the price of energy.

The study requested by the Commission on the "Prospects for the agricultural markets and income 2008-2015" concludes that: "While the agricultural sector is generally more resilient to economic crises than other sectors, it is expected to face great challenges, especially in demand growth and farm income, which may continue to exert strong pressure on agricultural prices and trigger significant structural adjustment."

During the public consultation process conducted by the Commission[2] services in 2010, there was a huge interest in this issue. In the conference organized in July 2010 the subject of market stability was recognized as important and included among the priorities for the next policy. Similar opinions were expressed by the Council and the European Parliament.

1 • ****European Commission, Directorate General for Agriculture and Rural Development, D (2011) 98085 – 100525, 31.01.2011 NOTE TO THE FILE: JANUARY 2011 update on recent agricultural commodity and food price developments in the EU (based on the November 2010 prices)*

2 • *http://ec.europa.eu/agriculture/cap-post-2013/conference/index_en.htm*

In the Commission Communication on Tackling the challenges in commodity markets and on raw materials, issued on the 2nd of February 2011, it is stated that for the future "three conclusions are clear for agricultural commodities:

- agricultural commodity prices are expected to stay higher than their historical averages, reversing their long term downward trend at least for the foreseeable future.
- Price volatility is also expected to remain high, although uncertainties in respect to its causes and duration persist.
- The level of input prices in agriculture is also likely to remain higher than its historical trends."

With a proper functioning of the markets, higher prices should have a positive effect on farmers stimulating them to invest in their businesses and improve their competitive position.

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