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Centre for Agricultural Strategy

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WITHDRAWN

The British interest and the green pound

A Swinbank

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CAS Paper 6

The British interest and the green pound

A SWINBANK

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Preface

The Centre for Agricultural Strategy was established to consider the long-term objectives of UK agriculture and the options for their attainment.

Though the green pound may be regarded as a short-term tactic, some short-term tactics turn into long-term measures which affect the eventual objectives and the options available to policy makers. The green pound is an example of a short-term 'European' tactic which is likely to affect considerably the long-term objectives of UK agriculture.

The green conversion rate system shows little sign of disappearing in the near future and is likely to become more necessary with the entry of new member states to the European Community. Retention of green currencies may preclude attainment and necessitate reconsideration of some of the objectives of the Common Agricultural Policy. The 'green' pound may have lasting and important effects on the long-term development of UK agriculture.

It is clear that the issues relating to the 'green' pound are complex and it is therefore difficult to judge the most appropriate action for the UK. Even within the UK, the short-term conflict of interest between the consumer and the producer of food tends to obscure the issues. Indeed, the short-term conflict makes it extremely difficult to explain to the general public the long-term opportunities and alternatives which will be affected by present decisions on the 'green' pound.

As part of its aim of stimulating an informed debate on major agricultural issues in the UK, the Centre sought the views of Dr Alan Swinbank of the Department of Agricultural Economics and Management, University of Reading who, until recently, worked for the European Communities in Brussels. This paper on the 'British interest and the green pound' is complementary to Centre Paper No 1 entitled 'UK agricultural policy within the European Community'

by Professor Marsh.

A draft of this paper was discussed at a Centre workshop held at the University of Reading in February 1978; those participating are listed in Appendix II. The Centre is extremely grateful to Dr Swinbank and to all those attending the workshop. The views expressed in this paper are those of the author; the Centre staff, members of its Local and Advisory Committees and the participants of the workshop do not necessarily concur with them.

John C Bowman
Director

Contents

Preface	4
Abbreviations	8
Summary	9
1	Introduction 12
2	Background 13
3	CAP pricing
3.1	The price decisions of the mid-1960's 15
3.2	1969 18
3.3	CAP pricing today 19
3.4	The impact of the German mark on CAP pricing 21
3.5	The annual farm price review 24
3.6	A digression: The Danish krone 25
4	The basket unit of account and the CAP 26
5	The green pound and the British economy
5.1	Farmers 29
5.2	Traders 31
5.3	Consumers 33
5.4	Income distribution and inflation 34
5.5	Devaluation, the balance of payments and the terms of trade 36

6	CAP prices: common or national?	
6.1	The benefits of common prices	41
6.2	The disadvantages of common prices	41
6.3	National prices?	42
6.4	Chapter summary	44

References 53

Appendices

I	Technical terms	46
II	Participants at workshop	48

ABBREVIATIONS

CAP	Common Agricultural Policy
EC	European Communities
*EUA	European unit of account
IMF	International Monetary Fund
*MCA	Monetary compensatory amount
UK	United Kingdom

NOTES

* For explanation of these and other technical terms, see Appendix I.

Throughout this paper the use of 'Germany' and the 'mark' is with reference to the Bundes Republik Deutschland and its currency.

Summary

CAP pricing

The price decisions of the 1960's resulted in Common Agricultural Policy (CAP) support prices at levels above the then prevailing world market prices. CAP prices reflected a political compromise between Member States and were not based on economic criteria.

Exchange rate changes

The exchange rate changes that followed, particularly after 1971, have allowed Member States to regain some control over their own national price levels. CAP prices continue to be expressed in units of account, and conversion to national currencies is effected by means of green conversion rates.

Seven price zones

Seven regional price zones now exist, with only the Danish price level corresponding to the so-called 'common' level. The border taxes and subsidies that are needed between Member States are known as monetary compensatory amounts (MCA's).

The unit of account

The unit of account that is used in the agricultural sector is linked to the European currency snake. Thus it has appreciated on world currency markets. As the unit of account appreciates so the variable import levy, and the MCA's of the non-snake currencies, have increased. This 'optical' effect may well have important implications for policy if, for example, it leads people to believe that Germany—with an MCA of 7.5%—is in some sense more communautaire than the UK.

Advantages for the UK

The current system of green currencies and MCA's has some distinct advantages for the UK. All MCA's paid and levied come from, or are paid into, the EC's budget. Although the British public must ultimately bear its share of EC budget expenditure, the green pound in effect means that British policy makers determine not only internal CAP prices but also the cost of imports. Thus, within the constraints imposed by our partners, the more 'over-valued' the green pound on a continuing basis, the cheaper our imports and the greater the benefit to the economy—at the cost of the farm sector.

Costs for the other Member States?

The costs imposed on our partners are not as high as is sometimes maintained. Provided the British price level is not less than the world price level, it is better for the other eight member states to have Britain 'in' rather than 'out'.

Benefits of common pricing

It is doubtful whether the present policy is in keeping with commitments to our EC partners. A common price could confer economic benefits on the EC economy because of the specialisation of production that could result. In addition such a policy would be more communautaire.

Disadvantages of common pricing

However, the benefits outlined above will not result if the common price level is set too high. This would result in losses to the EC economy in general and the UK economy in particular. Consumers would have to pay higher prices than necessary and taxpayers would have to finance the disposal of produce that could not be sold at prevailing prices.

Level of price harmonisation

CAP prices in Germany are considerably higher than those in the UK. Price harmonisation at the German level would be unacceptable to the UK. Equally, the other Member States would find the British level unacceptable. British policy should be directed to obtaining price harmonisation towards the lower end of the price range.

Policy measures

To this end, policy should be directed to influencing three variables. The value of the green pound is of major concern, and its value should be kept as high as possible. Of equal concern is the level of unit of account prices, for a price rise in terms of units of account can negate any advantage gained with the green pound.

However, the green conversion rates of the other Member States are also of importance. For example, the Danish policy of devaluing the green krone over the past months has increased the price gap between Denmark and the UK.

Primacy of UK interests

In the final analysis, the UK Government must protect the interests of all UK citizens. If this interest indicates CAP price support levels below those sought by our partners then the concept of common farm prices must be jettisoned.

1 Introduction

The United Kingdom (UK) became a member of the European Communities (EC) on 1 January 1973 and, one month later, began to apply the Common Agricultural Policy (CAP). In a previous paper from the Centre for Agricultural Strategy, John Marsh explored the policy options open to the UK given the constraints imposed by the CAP and other EC policies (Marsh 1977). In the present paper the discussion is narrowed down to the one issue of the value of the conversion rates used in the CAP — the so-called green conversion rates. These rates are necessary to pass from 'common' prices (expressed in units of account) into real moneys (pounds sterling, French francs, German marks, etc). Thus, the central theme to be discussed relates to the impact British policy could and should have on the level of UK and EC food and farm prices — both now and into the foreseeable future.

The study in large measure complements a recent report prepared for the Trade Policy Research Centre by Theodor Heidhues, Tim Josling, Christopher Ritson and Stefan Tangermann (Heidhues *et al* 1978). Both studies tackle the topic of CAP pricing and the use of green conversion rates in much the same fashion, and come to similar conclusions. However, points of emphasis do differ, and the present text takes a distinctive view of the British interest, whilst keeping in mind the overall needs and aspirations of the EC and of the world economy.

From time to time the green conversion rates are changed; for convenience, these changes are referred to as revaluations or devaluations of the green rate. If a green rate is revalued then a reduced domestic price will be associated with the CAP price, in much the same way as the domestic price of traded goods is reduced when a currency is revalued. Similarly, a devaluation of a green conversion rate will result in an increase in domestic CAP prices in much the same way as the domestic price of imports would rise if a currency were devalued.

2 Background

It has been said of the CAP that its mere existence precluded exchange rate changes between Member States. Thus the CAP could be viewed as a first step in a natural progression towards monetary union. In 1969 the EC countries discovered that intra-EC exchange rate changes were possible despite the common pricing of the CAP. Today, over eight years later, the so-called 'common policy' consists of seven different price zones separated by a confusing array of monetary compensatory amounts (MCA's).

National governments are able to influence their own food and farm price levels because they have retained some control over the green conversion rates—or representative rates in EC terminology—that are used within the CAP pricing mechanism. The Council of Ministers, on the basis of proposals from the Commission of the European Communities, fixes green conversion rates. But in practice—and within certain limits—each Member State can itself (by making its own preferred rate known) determine its green rate. If necessary, a Member State will veto a Commission proposal inconsistent with national objectives; by convention, Member States generally refrain from frustrating the national price objectives of other Member States.

In early 1978 this doctrine began to appear less certain. In January, the British House of Commons instructed the Minister of Agriculture to seek a 7.5% devaluation of the green pound. The Council of Ministers appeared very reluctant to accede to this request and it was only after an acrimonious debate that a 5% devaluation for beef and pigmeat was sanctioned, together with the decision that, in the context of the annual farm price review, the percentage in all sectors would be increased to 7.5. At the time of writing the price review is not complete, nor are the motives of the farm ministers entirely clear, for in the recent past Britain has been chastised for failing to devalue. Three strands of thought may perhaps help explain this apparent contradiction. It may be that

the Council resented the assumption on the part of the House of Commons that green conversion rates are fixed by national decision. Alternatively, Ministers may have been convinced by previously stated arguments that the UK price level was already high enough. More probably, the Ministers feared the domestic repercussions of British farmers securing significant price increases before a price review likely to result in very low increases in other Member States. The 7.5% devaluation would secure an institutional price rise of 8.1% for British farmers; over and above the 2% rise in 'common' prices proposed by the Commission.

It might be thought that the UK Minister in the Council of Ministers had one task—that of safeguarding the interests of British farmers and consumers. However, this is not the limit of the Minister's responsibility because the value of the green pound is also of concern to our partners. It will help to determine, for example, the size of UK agriculture within EC agriculture. It will also be instrumental in determining the British consumers' demand for farm products from third countries and the other Member States.

For better or for worse, the UK is a member of the European Communities, and so should also look to the European interest. The UK should have clear views on the desirable level of food and farm prices in the other Member States and in the EC as a whole. By discussion, the UK can influence CAP prices and help balance the interests of EC producers, consumers and taxpayers. Equally, the UK should be willing to give proper consideration to the views of her partners.

Three sets of policy discussions are currently taking place in Brussels. The first concerns the EC policy towards green currencies, MCA's and CAP pricing in general. The UK view on these issues should be clearly formulated and expressed. It will be apparent that it is not just expedients for solving today's problems that are being discussed, but farm prices that will determine the expectations of a generation of farmers and thus price trends for the next 15 or 20 years.

Secondly, three Mediterranean States—Greece, Portugal and Spain—have applied to join the EC. Accession of these three states would have implications for CAP pricing, and thus the problems posed by accession are melanged with other price questions.

Finally, there are renewed calls for monetary union. If monetary union were to come about, many of the CAP's day-to-day pricing problems would be resolved. Monetary union would only arrest the divergence of domestic farm price movements; it would not in itself restore common pricing though it might herald the arrival of more uniform economic conditions throughout the EC which, in turn, could lead to the restoration of common pricing. However, the UK and Ireland have long had monetary union and experienced similar rates of economic growth, unemployment and inflation; and yet the CAP price levels applied in the two countries are significantly different.

3 CAP pricing

3.1 THE PRICE DECISIONS OF THE MID-1960's

To obtain the stability of markets and an increase in 'the individual earnings of persons engaged in agriculture', as urged in Article 39 of the Treaty of Rome, an element of price support was built into the common organisation of the farm produce markets. The archetypal model of CAP market organisation—that for cereals—consisted of:

- (i) An intervention price at which the authorities would act as the buyer of last resort and so provide a floor to the market;
- (ii) A threshold price below which imports would not be permitted; the difference between the lowest offered world market price and the threshold price being covered by a variable import levy (tax);
- (iii) Export refunds (subsidies) to permit EC traders the same return on the world market as would be received internally;
- (iv) Various production and denaturing subsidies to meet the price gap, on the internal market, between the intervention price and the value of the product in alternative uses.

The system was designed to provide stability, in that the import levy would insulate the EC market from price fluctuations on the world market, and in that the intervention system would hold surplus produce from periods of abundant supply to be released in periods of inadequate supply. It has also been possible to tax the export of EC produce and so insulate the internal price from high world market prices. In the case of sugar, in the winter of 1974, import subsidies were given so that the EC market could be supplied at the EC price.

It is the element of income support, built into the CAP pricing mechanism, which has evoked much of the criticism directed at the policy and at the EC

itself. CAP prices are supported in an attempt to maintain farm income above what it otherwise would be and to retain more people on the land than would otherwise choose to farm. Economic theory is consistent with the supposition that high farm produce prices stimulate the use of more land and labour in agriculture, but high prices will also encourage a greater use of machinery and other manufactured inputs. Equally, high prices will tend to increase the price of land (the supply of which is limited) but the impact upon the wage rate for those engaged in farming will probably be slight if, as is believed by many agricultural economists, the effective supply of labour to the farm sector is relatively elastic. It is certain that output will be greater than it would otherwise be. This means that a food deficit area will import less and that a food surplus area must export more (with the aid of export subsidies) or place in store those products that cannot be sold.

In December 1964, after an intense discussion, the prices for cereals were set; they came into force at the beginning of the 1967-68 marketing year. This was the most crucial price fixing exercise the EC has ever undertaken. On the one hand it set the price hierarchy throughout the farm sector, on the other hand it determined farmers' expectations of future price trends. It is always possible to increase the price of farm products should they prove too low, but it is very difficult to reduce them if they have been set too high.

Over a quarter of the agricultural area of the EC is devoted to cereal production. Thus the price of cereals is an important factor in determining the price of alternative arable crops such as potatoes, sugar beet, fodder.

Similarly, the allocation of labour, machinery and managerial skill will depend upon the relative returns from alternative farm outputs. In addition, cereals are an important input for other farm enterprises. The production of pigmeat, eggs and poultry is critically dependent upon the price of grains; they are also used, though to a lesser extent, in the production of beef and milk. Thus the prices fixed for cereals do have important ramifications throughout the entire farm sector and largely determine the overall level of farm prices.

In general, price harmonisation involved price falls in Germany and price rises in France. For example, on 1 July 1967 the target price for common wheat fell by about 10% in Germany, whereas in France it rose by over 10%. France stood to gain from an expansion of market outlets at the expense of farm production in other Member States — particularly in Germany. Germany was reluctant to accept the price reductions advocated by France and the Commission, as such reductions implied greater dependence on imported foodstuffs and major adjustments in German agriculture. In compensation for harmonisation, German cereal farms received degressive payments (financed by the EC) over the three year period, 1967-1970.

Just 18 months after the common cereal prices came into force, Sicco Mansholt presented his famous plan for the reform of agriculture in the EC. In that document the Commission of the European Communities admitted that 'in the case of most agricultural products, these (common) prices do not seem to have been fixed primarily with reference to economic criteria and the requirements of the specialisation that should exist in the common market. More often than not the price fixed was the result of political compromises acceptable to all Member States' (Commission of the European Communities, 1968, p 30).

Despite continued inflation in all Member States, the EC is still struggling to impose common prices fixed with reference to economic criteria—and not the result of political compromises. As shown in section 3.2, the struggle has been made more difficult by the exchange rate changes that have occurred since 1969.

Farmers, quite naturally, have been reluctant to accept real price reductions and have pressed for price increases to compensate for any increase in production costs. New entrants into the industry have, in all probability, based their education and careers on prevailing prices. Land has been bought, buildings erected, and machinery obtained—all in the expectation that future prices will reflect today's prices.

As well as trying to correct unfortunate price decisions taken in the 1960's, the EC has also had to contend with two further factors. First, in all modern societies, farm output tends to increase faster than the appetite of consumers. Thus a shift from employment in the farm sector to employment in other sectors of the economy is to be expected. Because of their increasing productivity, a smaller and smaller group of farm workers can supply the food and fibre requirements of the rest of society. If this shift is thwarted because of government support for farm prices, unsaleable stocks will result. Second, the enlargement of the EC in 1973 — and its proposed enlargement to include the agricultures of Greece, Portugal and Spain — fundamentally changed the balance between the supply of and demand for farm products. With enlargement, competitive market forces all attempt to relocate farm outputs into those areas that are best suited to producing particular products. If a price policy supports the incomes of the less efficient then this relocation of production cannot occur; the benefits of enlargement will be lost and more and more costly surpluses will result. There is little evidence to suggest that the EC recognises that a milk price suitable for a Community of six Member States is unsuitable for a Community that includes the UK and Ireland, or that CAP prices for Mediterranean products must be amended if three Mediterranean States join.

The conclusion is that British Governments, acting in the interest of both the UK and the EC should adopt a policy of caution as regards any farm price increases for any Member State. The average of European farm prices has to fall

for a number of reasons:

- (i) Prices were set too high in the Community of six (but have since been eroded);
- (ii) It is probable that the farm prices suitable for a Community of six will not be suitable for a Community of 9 or 12 with its more diverse agriculture;
- (iii) Increased productivity ensures that, over time, the farm sector must contract.

The social and political consequences of such price changes are far from negligible, and alternative forms of income support will have to be found.

3.2 1969

The amounts referred to in the preceding section are all fixed in units of account and then converted into the currencies of the Member States. Prices could just as easily have been expressed in German marks, or United States dollars. The unit of account was, however, a neutral European accounting unit. It will be shown later how the unit of account lost its neutrality and became more and more closely linked with the German mark.

Any policy which attempts to maintain common prices in two or more currency areas faces two problems. On the one hand, the conversion rates used by the policy must correspond to the exchange rates in the international money markets, otherwise commodity:currency arbitrage will result and the pricing mechanism will be circumvented. On the other hand, in a period of fluctuating exchange rates, if the conversion rates used by the policy are allowed to reflect market rates then domestic price stability will be forfeit. The CAP faced both these problems in 1969.

At the time, both France and Germany—together with most other countries—had fixed exchange rates within the International Monetary Fund system (IMF par values). Within certain margins, there were fixed relationships between European currencies, the US dollar and gold. The unit of account slotted into this framework with a value equivalent to the dollar.

By the end of 1968 there was considerable pressure in the international money markets for a re-alignment of the exchange rates of the mark and the French franc. A revaluation of the mark, or a devaluation of the French franc, or both, was expected. If realised, then one mark would buy more francs or, expressed in another fashion, one franc would buy fewer marks. This was reflected on the forward market, by the franc becoming cheaper in terms of marks, in expectation of the inevitable exchange rate change. Thus traders were able to buy francs cheaply on the forward market; with these francs they bought wheat in France to be sold into German intervention stores for payment in marks. The profit lay in the fact that the conversion rates used to determine intervention

prices differed significantly from the exchange rates actually experienced by traders.

When the franc devaluation and mark revaluation did come, national governments realised that domestic price stability was more important than the maintenance of common prices. The latter implies an upward domestic price shift in a devaluing country—in much the same way as the price of imports rises. In a revaluing country a domestic price fall is to be expected, as with the price of imported products.

France was slowly emerging from a period of social unrest and, barely two years previously, had reluctantly accepted significant price increases for many farm products. France was unwilling to accept a further price increase because of the impact that would have on consumers and might have on the rate of inflation. A compromise was reached whereby for the 1969/70 marketing year franc prices would be unchanged. For 1970/71 they would rise by 5.6%—half the extent of the devaluation; in 1971/72 common prices would again prevail. In the meantime the French price would be kept below the common EC price with the aid of import subsidies and export taxes — the forerunner of today's MCA's.

The mark was floated in early October, and revalued on 24 October 1969. For a few weeks domestic support prices were maintained and then, on 1 January 1970, they fell by 8.5% to the common level. It was estimated that the annual loss in revenue to German farmers was 1 700 million marks. This sum was reimbursed to the farmers over a four-year period partly through direct area payments and partly through adjustments to value added tax. The Organisation for Economic Co-operation and Development has reported that 823 000 farmers each received on average 8 100 DM (£922) over the four-year period. In effect the price fall was delayed until 1 January 1974.

It will be seen, from the arrangements made, that common prices were to be reintroduced into European agriculture—in the case of France over a two-year period and for Germany, effectively, over a four-year period. Following subsequent exchange rate changes, governments have been unwilling to accept similar time limitations on the maintenance of preferred national farm prices.

3.3 CAP PRICING TODAY

Common prices for farm products were never re-established in the EC because in 1971 the international currency markets were again in a state of flux. On 10 May 1971 the German mark and Dutch guilder were both allowed to 'float'. That is to say the national authorities no longer intervened to maintain the IMF par values but allowed each currency to find its own value on international currency markets. Consequently, both the mark and guilder appreciated in value

with respect to other currencies. Again Member States were reluctant to accept the price changes implied. Thus on 12 May 1971 the Council of Ministers enacted the famous regulation (Regulation 974/71) whereby MCA's were introduced for a temporary period. That regulation is still valid today.

An account of the events that followed would amount to a many paged history of the international currency markets. Suffice it to say that the world moved from a system of fixed exchange rates to one of floating rates. Throughout this time the Member States endeavoured—with some success—to maintain domestic food and farm prices whilst paying lip-service to the idea of common EC prices. Irving & Fearn (1975) have supplied a detailed history showing how the CAP reacted to every new blow to its structure. This paper simply examines the CAP pricing mechanism as it operates in 1978.

Individual governments have been so successful in maintaining their own national food and farm price preferences that there are now seven price zones in place of the theoretical common price. Ranked in descending order of price they are Germany, the Benelux countries, closely followed by Denmark, then Ireland. Italy has recently moved ahead of France, the latter being left to jockey with the UK for sixth place. The price level in Germany is about 35% higher than in the UK as shown in Table 1. The price gaps between countries are bridged by MCA's. The 'German' MCA is calculated at 7.5% of the German price level; Denmark has no MCA; and the 'British' MCA is in excess of 20%.

Table 1
MCA percentages and relative CAP prices, February 1978¹

	MCA percentages	Index of CAP prices
Germany	+7.5	135.4
Benelux	+1.4	127.0
Denmark	—	125.2
Ireland	-3.0	119.8
Italy	-16.5	106.1
France	-21.5	101.8
UK	-23.7	100

¹ Week beginning 20 February 1978.

Notes: The MCA percentages for the non-snake currencies are 1.5 percentage points less than the calculated depreciation.

The UK and Ireland have different green pounds even though their currency is common. The table takes into consideration green conversion rate changes implemented in February 1978, but not the decision to devalue the green pound by 7.5%. In Italy and the UK not all sectors were affected by the latest devaluations.

The existence of such a wide price range demonstrates the lack of a consensus on the desirable common level of prices. In the following pages certain guidelines will be laid down to help policy makers answer two critical questions: is it desirable that common CAP prices once again be imposed and, if so, at what level should they be set?

3.4 THE IMPACT OF THE GERMAN MARK ON CAP PRICING

For all practical purposes there are seven currencies within the EC. The Belgian franc and the Luxembourg franc have long been linked and considered the same. Equally, the pound sterling and the Irish pound still maintain a one-to-one relationship despite suggestions from Dublin that the currency union should be broken. Four of the currencies are linked together in the European currency snake or joint float. The snake is made up of the German mark, the currencies of the Benelux countries and—somewhat unhappily—the Danish krone. The Norwegian krone is also a member as was, until recently the Swedish krone. Three of the EC currencies—the pound, the French franc and the Italian lira—float independently.

The members of the currency snake are committed to maintaining, within certain margins, the values of their currencies with respect to one another, but there is no obligation to maintain their values with respect to third country currencies. The snake is dominated by the German mark, as it rises on international currency markets it tends to pull the other snake currencies with it. Corden, an acknowledged expert on international trade theory, commented in a recent report:

'Essentially the snake has become a German currency area. The various smaller countries in the snake have found it convenient to tie their currencies to a neighbour which is their principal trading partner and which has managed in recent years to maintain the real value of its currency more than any other major capitalist country' (Corden 1976, p3).

The unit of account, in which the CAP 'common' prices are fixed, is in fact linked to the snake—as explained in Appendix I. In practice, this means that if the snake appreciates on world currency markets the 'common' price level expressed in terms of foreign currencies—in particular the dollar—increases. That is to say the degree of protection against overseas suppliers, implied by the 'common' price level, increases and must be matched by increases in the variable import levies and export refunds. Since the spring of 1971 the value of the unit of account used for expressing CAP prices has appreciated against the US dollar by about 54%. It required 54% more dollars to 'buy' one unit of account.

Figure 1 shows a hypothetical situation in which no changes in unit of account prices have taken place. In April 1971 the EC price of 100 units of account was

equal to 100 US dollars and no import levy or MCA's were payable. In mid-February 1978, with the EC price unchanged, the Community 'price' had risen to 154 US dollars and had to be protected by an import levy. In addition, to enter Germany, a further payment—monetary compensatory amount—of about 12 dollars was due. In the case of the UK however, the levy is partially offset by a monetary compensatory amount that is paid to the importer.

A number of conclusions can be drawn from Figure 1. First, it should be noted that the CAP price line set at 154\$ is completely arbitrary. What matters are the real prices—the world market price and the prices in each of the Member States. A CAP price line could be drawn anywhere within the diagram and real prices would not change; it is where it is simply because of the way in which the unit of account has been defined. Suppose, for example, that the unit of account had retained its equality to the US dollar; the CAP price line would then be set at 100\$, equal to the world market price.

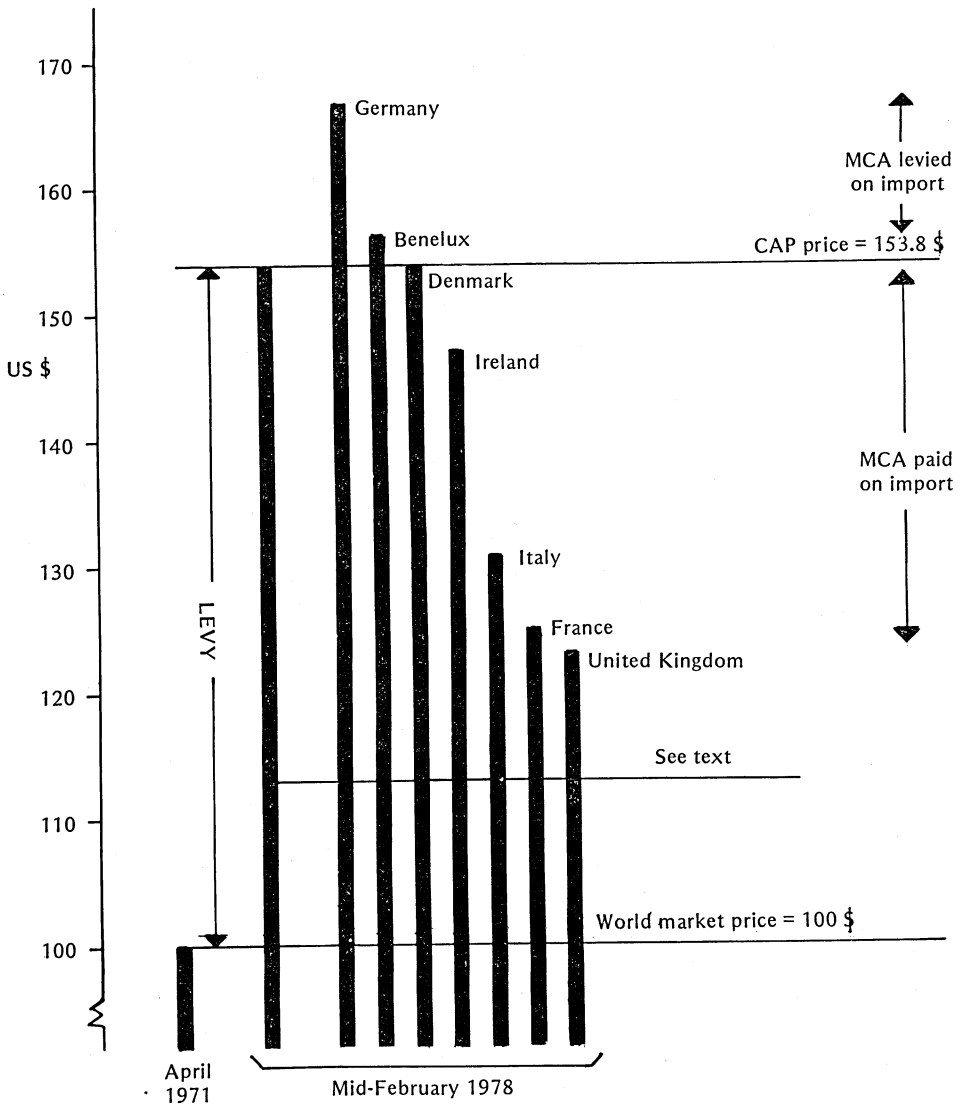
Second, although the CAP price line is completely arbitrary and does not change the degree of protection in any of the Member States, it does determine the terminology used. Thus by setting the CAP price level at 154\$ and labelling the excess over the world market price an import levy, the system has disguised the fact that appreciation of the snake currencies on international currency markets has increased the degree of protection to European agriculture. Linguistics can give no clue as to why the major part of the additional protection is called a levy, and the minor part a monetary compensatory amount.

Third, the figure demonstrates the futility of labelling one part of the subsidy, when produce moves from Germany to Britain, as a 'German' MCA and the larger part as a 'British' MCA. The relative size of these two parts depends entirely on the level of the CAP price line.

Figure 1 shows only price changes consequent upon real exchange rate, and green conversion rate revaluations and devaluations; there are no institutional price changes involved. Revaluations of the green mark have in fact occurred, with the result that mark prices are now 6.8% below what they would otherwise be. Similarly there have been devaluations of Britain's green pound, on the most recent occasion (2 February 1978) by 5% with the consequence that CAP prices expressed in sterling have risen by 33.7%.

The Morgan Guaranty Trust Company of New York regularly calculate, for various currencies, a trade-weighted appreciation or depreciation. Details of the calculation are given in the August 1976 edition of their periodical *World Financial Markets* (Morgan Guaranty Trust Company of New York, 1976). Such calculations show that between April 1971 and mid-February 1978 the trade weighted depreciation of the US dollar amounted to 11.4% expressed in terms of a basket of foreign currencies. Conversely, it required 12.9% more dollars to buy

Figure 1
A foreign view of CAP pricing



The Figure takes into account green conversion rate changes implemented in February 1978, but not the decision to devalue the green pound by 7.5%.

the original basket of foreign currencies. If we were to posit that the world market price in Figure 1 had increased to compensate for this devaluation, then we could draw a new world market price line at about 113\$. This would then be the standard by which to compare CAP prices, showing the additional degree of protection that has accrued through currency changes.

There is no logical justification for the CAP price line being set at 154\$; nor is there a consensus among the Member States that it should be set there. The only reason it is there is that the unit of account is linked to the European currency snake and consequently rises on the coat-tails of the mark.

3.5 THE ANNUAL FARM PRICE REVIEW

Every year, between December and March, the EC's farm ministers meet in Council to decide farm prices for the following marketing year. By a judicious mix of revaluations and devaluations of the green conversion rates, and by alterations to the 'common' CAP prices expressed in units of account, the farm prices in each of the seven price zones are determined. One result of this procedure is that money prices might rise even though real prices fall. Real prices will fall if the increase in the money price fails to keep pace with the rate of inflation.

Attempts to reduce real prices are resisted, and suggestions that money prices should be reduced attract outright hostility. At the 1976/77 price review the Council of Ministers got their sums wrong, for the arithmetical result of the revaluation of the green mark, and the increase in the intervention price, should have resulted in a price fall in Germany of 1.1% for skim milk powder. Consequently measures were taken to ensure that this theoretical price fall was not allowed to take place.

To the extent that national governments view the annual farm price review as an exercise in national price fixing then the value of the unit of account, and the unit of account prices, are largely irrelevant. It is simply a question of choosing the green conversion rate that gives the national price preference. However, the situation is probably more complex.

In the first place, green conversion rates are only changed in one direction— that is to say nearer to the valuation given to the unit of account. Thus the green mark can only be revalued, and the green pound devalued.

Second, the CAP price level is still thought of as the desirable goal to which all national farm sectors should be aligned. Moral and political pressure will be brought on any Minister who fails to make some adjustments towards the 'common' price level from time to time.

Thus the level at which the 'common' price is set is important, because the institutional framework and farmers' expectations all converge on the 'common' price level.

It has been suggested that if the definition of the unit of account were changed, then the situation would be eased. This, however, is not necessarily so. Suppose—in terms of Figure 1—the unit of account were defined as one US dollar and, to compensate, the price were increased to 154 units of account; nothing would be changed.

Whilst one Member State continues to insist that any revaluation of her green currency must be matched by increases in unit of account prices, then EC price harmonisation can only take place at that higher price level. If such an event were to occur then the EC would have abrogated its responsibility to its consumers, taxpayers and—ultimately—its farmers and to the citizens of the world.

Somewhere between the German price level and the UK price level is the common price which would be a suitable compromise for Europe's farmers and consumers. It is the farm Ministers' task to attempt to find that level.

3.6 A DIGRESSION: THE DANISH KRONE

It sometimes happens that between the annual price fixings there are requests to change the green conversion rates of particular countries. For example, in August 1977, the Swedish krone was forced to leave the European currency snake, and the Danish and Norwegian kroner were devalued in the snake. Prior to this event the green Danish krone had been equivalent to the market rate between the Danish krone and the unit of account, and consequently there had been no MCA's.

The Danes immediately requested a devaluation of the green krone; after some hesitation, the Council of Ministers agreed. Thus Danish food and farm prices rose by the full extent of the devaluation and 'Danish' MCA's were again eliminated. The myth—that Denmark is the only country respecting the CAP's 'common' prices—was perpetuated. And the European currency snake, with the Danish krone at a new lower level, was again free to appreciate on world currency markets and so further inflate the CAP's 'common' price level.

4 The basket unit of account and the CAP

In section 3.4 it was shown that the way in which the unit of account is defined has a perceived—if not real—impact on CAP price levels. By linking the unit of account to the snake currencies the 'common' level of CAP prices tends to rise through time as the snake appreciates on world currency markets; the gaps between real national prices and the 'common' CAP price are met by MCA's. These MCA's are fixed for snake currencies, and variable for non-snake currencies.

Throughout 1977 there was much discussion on the desirability of using the basket unit of account, or European unit of account (EUA), in the agricultural sector; a discussion which may well continue throughout 1978. Other points raised, relating to the financing of the EC budget, go beyond the scope of the present paper. However, some issues are of direct relevance and, though probably of temporary interest, might well be considered here.

In October 1977, the Commission published its long-awaited *Report on the use of the European Unit of Account in the Common Agricultural Policy* (Commission of the European Communities 1977a) and a few days later submitted to the Council a proposal for the gradual dismantling of MCA's (Commission of the European Communities 1977b).

The EUA is made up of a weighted 'basket' of EC currencies, and thus its value evolves to reflect the changing values of its constituent parts. During the period 1 January 1976 to 19 September 1977 the German mark appreciated by 13% with respect to the EUA, whereas it appreciated by only 2% with respect to the joint-float unit of account (see Table 2). Similarly, the pound sterling depreciated by only 14% against the EUA as opposed to 28% against the joint-float unit of account.

Table 2
Evolution of EC currencies with respect to the EUA and the joint-float unit of account (1.1.76–19.9.77)

Currency	vis-a-vis EUA	vis-a-vis joint-float unit of account
German mark	+13%	+2%
Belgian/Luxembourg franc	+11%	0
Dutch guilder	+10%	0
Danish krone	+ 3%	-13%
French franc	- 7%	-20%
Pound sterling/Irish pound	-14%	-28%
Italian lira	-26%	-43%

Source: Commission of the European Communities 1977a, p10.

At the end of the period in question, if MCA's had been zero at the beginning of the period and no green currency changes had taken place, then the MCA percentages would have depended on those displayed in the Table. However, the level of national food and farm prices is not affected by the choice of unit of account used. The question arises as to whether the perceived impact will affect the decisions of the Council of Agriculture Ministers at the annual farm price review.

If Ministers are perfectly informed, and base their decisions accordingly, then the method of expressing MCA's is irrelevant. However, it is possible that Ministers do not have access to perfect information and, even if they do, may be swayed by subjective factors. Thus, if Ministers saw that the 'German' MCA had grown by 13% over the reference period, they might be more inclined to limit real CAP price increases than if the growth in the 'German' MCA had been only 2%. Such an action might be more acceptable to public opinion.

The Commission is committed to a re-establishment of common prices, and a large part of its report was devoted to trying to establish what that level of common prices should be. Five options were outlined and two immediately rejected. Those were that CAP prices be harmonised at either the current German or current British level. A solution in between was suggested as more feasible.

If the EUA were to replace the joint-float unit of account without any coefficients being applied then the 'common' level of CAP prices would—on 1 June 1977—have been 16% lower. Consequently, the 'German' MCA percentage would have risen from 7.5 to 22, and the 'British' MCA percentage would have fallen from -34.1 to -12.1.

However, if the 'common' level of prices were to be maintained at its existing

level it would have been necessary to multiply all CAP prices by the coefficient 1.192 (and the green conversion rates similarly amended).

The third of the feasible alternatives suggested was more complex. It calculated the weighted average EC price level on the basis of existing national prices, posited that a movement to common prices would take place, and determined the conversion into EUA such that the average price level would remain unchanged. This necessitated that CAP prices be multiplied by the coefficient 1.086 and resulted in a fall of 8.9% in the 'common' price level.

Thus, three possibilities were considered: that the 'common' price level should fall by 16% (1 EUA = 1 joint-float unit of account); that the 'common' price level should remain unchanged (1.192 EUA = 1 joint-float unit of account); or that the 'common' price level should fall by 8.9% (1.086 EUA = 1 joint-float unit of account). Whether or not these three possibilities represent three real choices as to the eventual level of common prices, if ever achieved, would depend on the price decisions taken by the Council of Ministers. A decision to replace 1 joint-float unit of account by 1 EUA, and then to raise unit of account prices by 19.2%, would be equivalent to replacing 1 joint-float unit of account by 1.192 EUA. If however the EUA were introduced on a one to one basis, *and this did not generate an increase in unit of account prices*, then a significant step would have been taken. Given this scenario only the high price countries could make price adjustments. The low price countries would not be able to make large devaluations of their green conversion rates because the gap between the green rate and the market rate would quickly be closed.

The Commission favoured 'in principle the introduction of the EUA to the common agricultural policy' (p2) for a number of reasons not least of which was that the EUA reflects 'correctly the average economic and monetary reality in the Community' (p2). However, several options for converting the joint-float unit of account 'to the EUA are open, each implying different common price levels. Choice between these options would be a matter for political decision' (p13). Consequently, the Commission felt unable to submit a proposal, feeling that a further examination of the question was necessary. A few days later — as if its EUA report had never been — it submitted the proposal that existing MCA's be eliminated over a seven-year period such that prices be harmonised on the unchanged joint-float 'common' level (Commission of the European Communities 1977b).

5 The green pound and the British economy

5.1 FARMERS

The value of the green pound determines the sterling equivalent of CAP prices expressed in units of account. If the green pound were to be devalued then one unit of account would be equivalent to a greater number of pounds when converted with the aid of the green pound. Thus CAP prices in the UK would rise and the MCA between the UK and the other Member States would fall by a corresponding amount.

Clearly the overall impact of such a change would be a rise in farm revenue, an increase in resource use, and an increase in farm output. However, each of the foregoing statements must be qualified.

In the first place, the value of the green pound is only one element in the equation determining the real price incentive to UK agriculture. The sterling equivalent of the intervention price is, for example, dependent upon the value of the green pound and upon the unit of account price. Consequently, it can be increased by a devaluation of the green pound, or by an increase in the unit of account price. As was pointed out in Chapter 3, German farmers are well aware of this relationship and consistently demand increases in the unit of account price to compensate for revaluations of the green mark. This ensures that at the annual farm price review British farmers can normally expect a price increase made up of two elements: a devaluation of the green pound and an increase in unit of account prices to compensate for a revaluation of the green mark. Over the past five years during the accession period they have also benefited from annual moves to align with CAP prices.

It should, incidentally, be noted that CAP prices can and do differ from farm gate prices. Thus the intervention price for grains applies to grains delivered at the store. The 'intervention' equivalent at the farm gate is somewhat less.

However, the market price may well be above the intervention level, which means that small changes in the intervention price will not necessarily have any impact on the market price.

Second, the rate of change of CAP prices must be judged in relation to price increases for farm inputs, and the rate of productivity growth within agriculture. Output does, of course, vary from year to year and thus farm incomes tend to be somewhat unstable, representing the gap between fixed costs and variable output. But over time, the tendency is that a greater physical output can be obtained from a smaller input. The farm sector naturally expects to retain some of the benefits of productivity growth in the form of higher incomes. But some must be passed on to consumers in the form of lower real prices, otherwise output will expand at a faster rate than consumption. Consequently, one would not always expect CAP price increases to match the rate of increase of farm input prices.

It has become the practice that new green conversion rates come into force only at the beginning of the marketing year. As marketing years begin on different dates throughout the year, more than one green conversion rate for a given country can be in operation at any one time. Indeed, British milk producers in 1977/78 had to wait a year before the full impact of the 1977/78 green pound devaluation was felt in their sector. None-the-less the normal rule is that green currencies apply uniformly to all CAP products. Although the level of prices throughout the EC is not common, the price ratios between CAP products are.

Consequently, a devaluation of the green pound will have the same percentage impact on the support price of feed grains as it will on the support price of pigmeat. A pigmeat producer, worried about feed costs, is unlikely to find a complete panacea in the form of a green pound devaluation. He would much prefer to see the price ratios changed: either a reduction in the price of cereals or an increase in the price of pigmeat. Similarly, a change in the green conversion rate is unlikely to affect the farmers' decision as to planting barley or wheat, whereas a changed price ratio between barley and wheat would.

However, that is not to say that the value of the green pound will have no impact on the relative size of enterprises within the farm sector. The value of the green pound will have no impact as such on the price of manufactured inputs, or on the price of animal feeds imported from third countries without levy.

A number of animal feeds are imported into the EC at zero, or very low, tariffs. These include feed proteins such as fishmeal and soya bean meal; and carbohydrate fillers such as manioc. Thus, if there is a green pound devaluation these products will become cheaper in relation to grains, and their use as animal feed will tend to increase. This implies that farming systems such as those producing pigmeat, eggs and poultry, will have a more than proportionate gain from a green pound devaluation in comparison to such products as beef; but the

overall result will depend upon the movement in market prices.

In the case of milk, where the cost of producing an additional litre is critically dependent upon the cost of concentrates, a substantial increase in farm income, and output expansion, would result from a green pound devaluation. This is because the milk price increases whereas the price of concentrates, other things being equal, is relatively stable. However, the result will largely depend on current market conditions. Thus if the UK Government refused to allow the price of milk for the liquid market to rise in like manner, the potential gain for milk producers would be negated. Such action, however, would run the risk of eroding the price margin for liquid milk and destroying the main argument for the retention of the Milk Marketing Boards.

5.2 TRADERS

As a theoretical exercise, the MCA system appears to be one of great simplicity. One merely compensates for the difference in price levels between Member States. However, the real world is more complex and in practice many traders view MCA's as an arbitrary and blunt method for correcting price discrepancies. A whole new cadre of personnel, expert in predicting MCA changes and the profitability of trade, has been engaged by the larger trading organisations, and smaller firms have been discouraged from trade.

It is important to remember that in 1971, when MCA's were first formally introduced, the problem was thought to be of a temporary nature. MCA's were not designed to be finely tuned instruments of agricultural trade. As national price levels grew further and further apart, the importance to traders of the arbitrary methods of calculation has grown. Some have profited by the system and some have lost; one consequence is that any amelioration proposed by the Commission now acts against the interests of at least one group of traders in the Community.

The particular problems that arise can be classified in two groups. On the one hand, the MCA percentage applicable may not correspond to the exchange rates actually experienced—or predicted—by the trader; on the other hand, the method of determining the MCA for any particular commodity may not suit the interests of one or more traders. Examples of both cases have been cited (Josling & Harris 1976).

The reasons why the MCA percentage may not exactly compensate for the exchange rates actually experienced are three fold. First the MCA for a 'snake' currency is fixed regardless of the currency's actual position within the snake. Second, the MCA percentage for a 'non-snake' currency is reduced by 1.5 points. Third the MCA percentage for a 'non-snake' currency is calculated as an unweighted average against the 'snake' currencies from a Wednesday to the

following Tuesday, and then applied the following Monday. This factor can often work in favour of a trader who is capable of predicting MCA changes and arranging his trade accordingly.

The reasons why the MCA percentage may not correspond to the exchange rates predicted by traders are more complex. Trade is not an instantaneous activity. It is often planned and contracted well in advance. Traders have, of course, long faced the risks of exchange rate change and one expects them to cover themselves accordingly on the forward market. However, banking rules in Member States are not uniform, and the forward market deals only in currencies and not MCA percentages. Consequently, there has been a long debate in Brussels as to whether or not the possibility for prefixing MCA percentages should be introduced. Essentially, the idea is that any trader with a contract to be executed sometime in the future, with his currency transactions already settled in the futures market, should also be able to fix the MCA percentage that will be applicable on the day of trade.

The problems relating to the MCA for a particular product are essentially of three kinds. The first, of considerable practical significance, is easy enough to understand. Clearly the shorter the list of MCA's the easier it will be for customs officials to classify products and to administer the system. But the corollary of this is that some products—particularly cheeses and processed products—will have MCA's not exactly suited to their composition.

Consequently two forces will be at work: there will be a tendency for individuals to request further subdivisions of the MCA list so as to reflect more faithfully their traded products; there will also be a tendency for products to be produced and traded to take advantage of the classification in existence.

There are also problems that relate to the price level to be used as the basis for the MCA calculations. For intervention products, this is supposed to be the support or intervention price in the country concerned. Thus the MCA will exactly compensate for the difference in intervention prices between countries. If the actual price is below the intervention price, the MCA will over-compensate; when the actual price is above the intervention price the MCA will under-compensate. Although an over simplification, one could view the UK complaints on beef shipments from the Irish Republic, and pigmeat from Denmark and the Netherlands, in this light. In the case of imports from third countries—which must respect a threshold price—the MCA will under-compensate.

Of a more fundamental nature, are questions concerning the scope of the MCA system. The MCA must perform two functions: to give the farmer the national price level determined by government, and to stop commodity: currency arbitrage between countries. These two objectives are not wholly compatible. For example, to support the price of milk, intervention prices are

fixed for butter and skim milk powder; but the whole of the intervention price, not just the farm gate value, is converted into national currencies with the aid of green conversion rates. Consequently, some people view an MCA based on the intervention price as an over-compensation for farmers based in countries whose green conversion rate is 'undervalued' (Germany for example), and as an under-compensation for farmers based in countries whose green conversion rate is 'over-valued'. Theological debates on this question have racked Brussels for some time without a consensus emerging.

If the EC comes to the view that MCA's—or something similar—are desirable as a permanent feature of the CAP, then serious thought will have to be given to improving the mechanics of the system. This will not be easy; if one party is disadvantaged by the existing scheme a trading partner will invariably be similarly advantaged. Nor is it reasonable to expect that all the disadvantages of the existing system could be removed. The complexities and uncertainties of maintaining a regional pricing system will always involve costs in the form of extra administration, or trade foregone.

5.3 CONSUMERS

Throughout the 1970's consumers in the UK have, on average, spent just under 25% of their total expenditure on food. For some—notably the poorer members of society—the percentage is much greater, for others, much less. Another point to be noted is that in modern societies agricultural products undergo some degree of processing and incur distribution costs before being bought by consumers.

Table 3 shows that in Denmark, in 1976, 35% of consumers' expenditure on foodstuffs was paid to the farmer. For some commodities, such as butter, there is a much closer relationship between the prices paid by the consumer and received by the farmer, than for other products such as bread. On average, 53% of consumers' expenditure paid for processing and distribution, and a further 11.5% was the net result of a value added tax on food and consumer subsidies. Over time, as consumers' expenditure on foodstuffs has increased, a smaller share of consumers' expenditure on foodstuffs has been paid to the farmer.

In each of the Member States of the EC similar situations exist. In some Member States the costs of processing and distribution will be greater than in others; the incidence of taxation differs. In the UK, for example, there is no value added tax on food (other than on restaurant meals). One consequence is that even if farm prices are equalised throughout the EC there is no reason to suppose that food prices will also be equal.

Table 3
The Danish farmers' share of consumer expenditure

Commodity	1963	1976
Drinking milk	62%	46%
Butter	80%	72%
Cheese	47%	35%
Eggs	73%	52%
White bread	23%	12%
Rye bread	40%	20%
All commodities	50%	35%
—of which farmers' net income		7%
Distribution and processing		53%
Net: VAT and subsidies		11.5%

Source: Federation of Danish Farmers' Unions 1977, p44.

If the green pound is devalued such that the sterling equivalent of CAP prices rise by 10% then food prices will rise by a much smaller percentage, say by about 3%. Not only are processing and distribution costs to be taken into account—as illustrated in Table 3 for Denmark—but not all foods will be affected by the green pound devaluation and for some the change in the market price will not exactly reflect the change in the CAP price. The cost of living might be expected to increase by between 0.5 and 1%.

Such aggregates are somewhat innocuous—they do, of course, camouflage more extreme price changes for certain products and income groups. The lower income groups will find that the price rises have far more impact upon their weekly budgets than will the higher income groups, simply because expenditure on food pre-empts a larger proportion of the lower income group's budget. Individuals who have a higher consumption of butter, meats and other animal products will also find their expenditure adversely affected. In contrast to butter, one does not expect the price of margarine to rise because, on the one hand, a larger portion of the retail price is made up of processing and distribution costs and, on the other hand, the raw materials are not covered by CAP pricing. To summarise: a green pound devaluation will have very different effects on the various individuals who make up the British society.

5.4 INCOME DISTRIBUTION AND INFLATION

As the preceding section has attempted to demonstrate, the UK Government's

view on the value of the green pound—and by implication CAP pricing—cannot simply be judged as a trade-off between farmers and consumers. A devaluation of the green pound transfers from consumers to farmers, and may well result in the poor becoming poorer and the rich richer. Rich farmers tend to produce more farm products than do poor farmers. Therefore, a price change, whilst having the same percentage impact on both, will result in a greater absolute increase in revenue to the large farm. Rich consumers tend to eat more than do poor consumers and therefore a general price rise will result in a greater absolute increase in expenditure for the rich consumers. But the proportionate impact on the poor man's pocket will be greater. Thus the government's attitude to the green pound cannot depend solely on its overall farm policy, but must be subsumed under the broader objectives of social and economic policy.

As yet the economics of inflation are imperfectly understood. Among the different theories—some conflicting and some complementary—is the belief that wage rates will reflect price rises and in time produce further price rises. In recent years successive UK governments have attempted to moderate the rate of price and wage increases; thus control over the green conversion rate is a useful policy tool for governments. To the extent that governments believe that they can affect the rate of inflation by controlling CAP prices, then farm groups will find their interests less well cared for in policy decisions.

The rise in food prices does have a number of interesting implications, not all of which have yet been thoroughly explored. As the price of food rises it will affect the cost of living index which, other prices constant, will rise. It may be that a rise in the cost of living index or in the price of foodstuffs will lead to inflationary tendencies in the economy, as outlined in the preceding paragraph. The second effect is that, with other prices constant, resources will be transferred from consumers to farmers and the pattern of income distribution correspondingly changed. This may lead to inflationary or deflationary tendencies in the economy depending on the pattern of expenditure of the different groups. The third effect, because our food imports cost more, is that spending power will be withdrawn from the British economy for the benefit of other Member States. This would be deflationary. The real impact of such forces, and their effect on rates of inflation and the level of unemployment, have yet to be quantified.

It is interesting to note that France faces slightly different problems. The French government is also concerned about the impact of food prices on the cost of living and thus on the rate of inflation but, under normal conditions, France is a net food exporter. Thus, with foreign consumers paying higher prices for French farm output, there would be an increase in spending power. This might lead to a reduction in unemployment, but could also be reflected in a

higher rate of inflation.

5.5 DEVALUATION, THE BALANCE OF PAYMENTS AND THE TERMS OF TRADE

Calculations made by the Ministry of Agriculture, Fisheries and Food and published in the *Annual review of agriculture 1977* show that the UK imports a significant proportion of foodstuffs. In recent years, slightly more than 45% by value of food for manufacture or distribution has been imported. Some 70 to 75% of these net imports were of product types produced in the UK. The terms under which this trade is effected have significant implications for the UK economy.

Just as with the economics of inflation, there is some disagreement amongst economists as to the effects of a currency devaluation. The most widely accepted view can be summarised as follows. If people are unwilling to hold a particular currency and offer for sale greater quantities of the currency than others are willing to buy, then some adjustments to its exchange rate will be necessary.

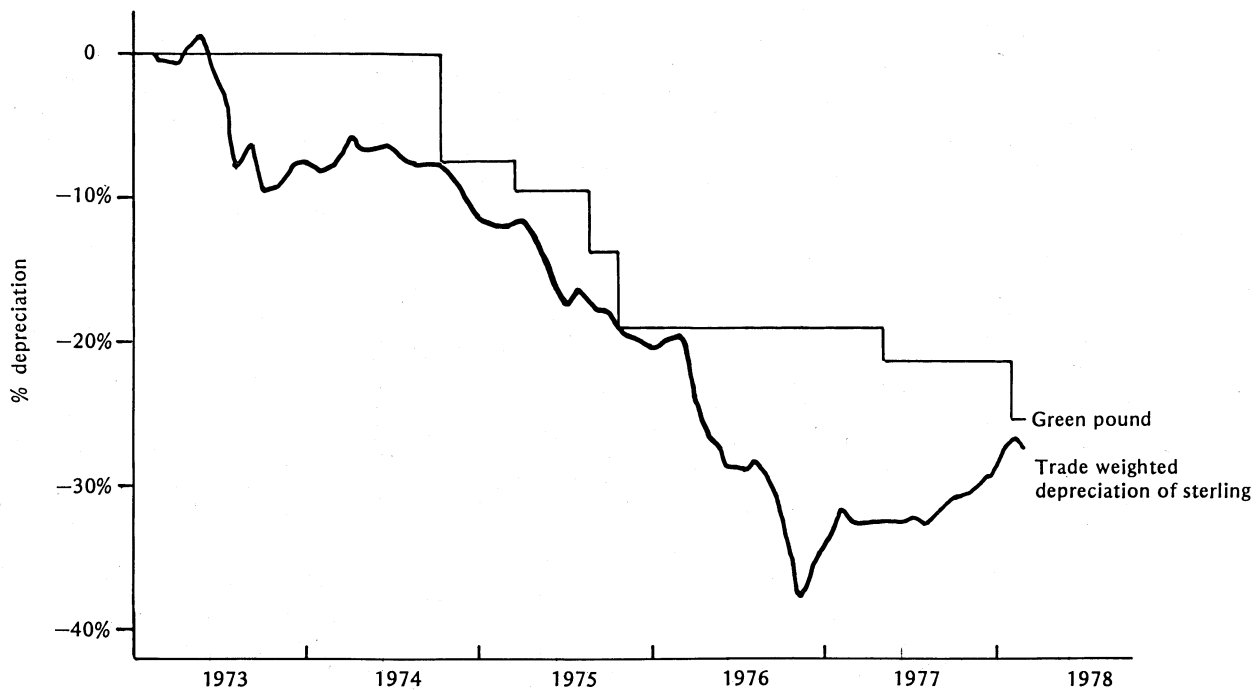
A devaluation of the exchange rate, or a depreciation of a floating currency, will raise the domestic price of traded goods. Consumers will buy less of the higher priced imported products, and the volume of goods exported will increase. Provided the volume effects outweigh the price effects, then the balance between export receipts and payments for imports (the balance of payments) will improve and confidence in the currency will recover. However, this is conditional on there being sufficient slack within the economy to expand export production (and production of import replacers) and that inflation does not negate the price effects of devaluation.

Since UK accession to the EC in 1973 the pound has depreciated on international currency markets, reaching an all-time low in October 1976. It has been argued (for instance by Marsh 1977) that by holding the value of the green conversion rate excessively high the burden of balance of payments adjustment has been borne by manufacturing industry. This point should be examined.

In mid-February 1978 the effective exchange rate of the pound was 27.25% below its value on 15 February 1973 (Source: Morgan Guaranty). Over the same period the green pound conversion rate was changed by 25.18%; Figure 2 illustrates the development over the period. It will be seen that until the spring of 1976 devaluations of the green pound did, in fact, match the depreciation of sterling – although with some time-lag.

In 1976 sterling fell sharply on international currency markets, with a particular trough in October. However, sterling appreciated throughout 1977 so that by the end of the year the gap between the green pound and sterling was much less than many observers had recognised. The 5% devaluation of the green

Figure 2 Depreciation of Sterling and of the Green Pound, 1973-78.



Source: Trade weighted depreciation: Morgan Guaranty

pound agreed in January 1978 virtually closed the gap and the further step to 7.5%—when implemented—would eliminate the gap altogether.

Over the period under review the green pound has determined CAP support prices expressed in sterling, although farmers' costs and realised sale prices have not necessarily been affected in like manner. At the same time, that portion of the UK economy that engages in world trade has received various price signals from the depreciation of sterling—a depreciation that has been marked against various strong currencies (the German mark for example) but less marked against weaker currencies. It would appear from Figure 2 that, *after a certain interval*, the CAP price signals given to British farmers consequent upon green pound devaluations have been very similar to the price signals given to British importers and exporters through the depreciation of sterling.

In accordance with Article 7 of Council Regulation (EEC) No 974/71 the EC's budget has, since 1 July 1972 for extra-Community trade and 1 January 1973 for intra-Community trade, met all the financial consequences of applying the system of monetary compensatory amounts. These rules have important consequences for the terms of trade and the balance of payments. Thus, the price at which the UK effectively trades is not the world market price, nor the EC's 'common' price, but the UK's own CAP price levels. If the pound sterling depreciates, and the green pound is *not* devalued, then the cost of food imports—as measured in foreign currencies—actually falls. Similarly, if the green pound is devalued in a period during which the pound sterling maintains its value on international currency markets, then the costs of food imports in terms of *all* currencies will rise. As green currencies have evolved, so governments have gained an additional policy tool.

Suppose a sharp depreciation of the pound sterling were required to restore balance to the UK's payments. Amongst the range of possibilities open to the UK government would be:

- (i) To maintain the green pound unchanged;
- (ii) To devalue the green pound by the same amount as sterling's trade weighted depreciation;
- (iii) To devalue the green pound by the extent of sterling's depreciation against the snake currencies.

If the first alternative were adopted, the foreign exchange cost of food imports would fall. Internally, the price of most traded goods would rise, whilst that of farm products would not change. Thus, farm production would tend to fall and food consumption increase; a greater import volume would be sucked into the country. However it might be, at least in the short-run, that the volume effect would be small in relation to the price effect. Under such conditions the balance of payments would be helped by maintaining the value of the green pound—a

situation which would occur because the EC's budget would allow the foreign price of imports to fall.

Under the second alternative the price effect on food and farm produce would be equivalent to the average price effect on all other traded goods. Farm production would tend to expand and food consumption contract, resulting in a reduced import demand. Provided the volume effects outweighed the price effects—the 'normal' case—then the devaluation would be beneficial to the balance of payments. As already shown, there is evidence to suggest that this is the policy that has been followed by the UK over the past five years, or at least until the spring of 1976.

Under the third alternative food and farm prices would rise by more than the average price rise for traded commodities, thus shifting the burden of adjustment from the rest of the economy to the farm sector. If it were thought that the responsiveness of farm output and food consumption were greater than the responsiveness in other sectors—that is to say that the import demand were more elastic—then such a policy would restore the balance of payments with a smaller sterling depreciation than would be necessary under option two. It is quite probable that in the medium-to long-run, the response of farmers to price incentives will exceed that of other sectors of the economy; however it is likely that consumers will try to maintain the level of consumption despite price rises. Although the farming community would canvass support for such a policy option, its efficacy is as yet unproven. In addition, the government would have to consider the impact on the distribution of incomes and on inflation; questions considered in the previous section.

Despite UK preoccupation with the balance of payments, this is, in a sense, only a part of a wider question concerning trade policy. An individual will be concerned to balance his income and expenditure, but will also be concerned to know the quantity of goods he can buy with a given income. Similarly, a country is concerned with its terms of trade. Other things being equal, the lower the cost of food to a food importer, then the better off that country will be. This, of course, was one of the major points in the discussion on UK entry into the EC: was it wise for the UK to commit itself to paying a higher price for food imports? To the extent that the UK can influence the value of the green pound, it can influence its terms of trade. Thus, under policy option one above, it is difficult to see why the UK should pay a higher price than necessary for food imports, provided its partners are willing to acquiesce to such a policy. As far as the UK economy is concerned the proper price incentive to British farmers and consumers corresponds to the price at which imports can be obtained *on a continuing basis*.

It should be noted that the foregoing discussion depends on the continued

payments of MCA's from the EC budget, and collection by the budget of all MCA's levied. In the next chapter these assumptions will be relaxed. One further caveat should also be entered with respect to Chapters 5 and 6. Until 1 January 1980 the *gross* contribution of the UK to the EC budget will, in practice, be limited because of transitional arrangements agreed at the time of accession. Until 1980 a change in levy revenue on UK trade with third countries will be reflected in a change in UK exchequer receipts and not in the EC budget.

6 CAP prices: common or national?

6.1 THE BENEFITS OF COMMON PRICES

The main advantage that common prices can bring to the EC is those economic benefits that would derive from the specialisation of production throughout the Community. A particular region might for example, be more suitable for the production of cereals, wine or milk than other regions in the Community.

If price is allowed its allocative function and production allowed to relocate, the EC will be supplied at the lowest possible cost. The benefits that accrue to consumers, taxpayers and the farmers whose output has expanded should be large enough to allow compensation to those producers whose output and incomes have fallen.

A second reason for favouring common prices is that the costs of operating the MCA system (detailed in Chapter 5.2) could be eliminated. The costs involved are of three kinds: the personnel employed by the EC, by governments and by the trade to operate the system; economic benefits foregone because of restrictions to trade caused by the uncertainties of the system; manipulations and fraudulent practices. It should be noted, however, that these three categories are inter-related. For example, the more that is spent on government personnel to implement the system, the less the chance of fraud.

The third advantage, probably the most important to the Commission, is that common prices would emphasise the communautaire nature of the CAP. This is a very important aspect of the whole problem, closely enmeshed in people's minds with that of specialisation, and not to be underrated.

6.2 THE DISADVANTAGES OF COMMON PRICES

The advantages of specialisation can only be reaped if the necessary employment adjustments are allowed to take place. However, the Member States have been

very reluctant to allow price its allocative functions and have tended to set the CAP support prices too high. Thus, the most efficient producers have been encouraged to expand production and the least efficient have been insulated from the forces which would lead them to contract. High protective levies have been necessary to protect the CAP support system and, for products for which the EC is nearly or wholly self-sufficient, surpluses have developed to be stored or exported.

A common price, in itself, is not an advantage from an economic point of view; it must be the competitively determined common price. The only true measure of that level is that given by the market over time. Ideally, one would seek to relate the CAP price to a competitively determined world market price, but a lesser objective would be an EC price that did not produce unsaleable surpluses.

However, it might be that governments—responding to the wishes of their electorates—would wish to give some protection to their farm sectors. A variety of valid reasons might be listed and a consensus quickly reached on the items to be included. The problems arise in trying to put some sort of valuation on the different items. An additional factor to be taken into consideration is that common CAP prices also determine the trading price between EC states and thus the transfers from importing to exporting states.

Germany, which has high industrial wages, a fragmented agriculture, and is largely land-locked, has come to a different decision than the UK. There is little evidence to suggest that common prices would be politically acceptable. Not only would national aspirations have to be compatible, but national electorates would have to accept the intra-EC income transfers implied.

6.3 NATIONAL PRICES?

It may be useful to classify three possible arrangements for the CAP:

- (i) Common support and trading prices between partners;
- (ii) National support prices and nationally determined trading prices;
- (iii) National support prices, but common trading prices.

The first of these possibilities is the policy to which the EC is, in theory, committed. The second corresponds to the current system of MCA's and green conversion rates, as described in Chapter 5. The third of the possibilities, a hybrid between the other two, corresponds to the scheme put forward by Marsh (1977).

The major problem to be settled, given a system of national pricing within a CAP framework, would be to determine the level of trading prices. The current system—using green conversion rates—allows Member States not only to influence their own national price levels, but also the prices at which they trade. The

system has survived because the EC budget has, in effect, met the financial consequences. EC citizens must, ultimately, bear the burden of budget expenditure but for the purposes of the present analysis it suffices to note that financing and expenditure are two separate activities.

It is sometimes said that UK policy imposes an unnecessary financial drain on the Community—but this is not necessarily so. Provided the UK price level is not less than the world market price, it will be cheaper for the EC to allow the UK to retain its preferred price level than to encourage secession. This is because the other eight Member States, taken together, have surplus supplies which must be exported; some of these would be destined for the British market whether or not the UK were a Member of the Community. Suppose that the UK, outside the Community, maintained domestic price levels with the aid of variable import levies, then produce moving from the eight to the UK would attract export subsidies at least as costly as the current MCA payments. In addition, the net levy receipts from third country imports into the UK would be lost to the EC budget.

Marsh put forward his hybrid proposal as an attempt to maintain preferred national price levels and yet retain some degree of Community pricing, and to reduce the budget costs of MCA's. The idea is that Member States would agree a common trading price for intra-Community trade and, at that level, imports from third countries could enter the EC trade area. All budgetary consequences of maintaining national prices above or below the agreed trading price would fall on the national exchequers. In effect, green conversion rates would continue to be used but MCA's would no longer be financed by the EC budget.

Apart from noting the difficulty, if not impossibility, of ever agreeing a common trading price, we should recognise that the system would be far less attractive to the UK. The advantage with the present system is that with one policy variable—the green pound—domestic food and farm prices and the trading price are determined. As a net food importer, this allows the UK to keep its cost of imports low, and yet, because the internal price equals the external price, does not intrinsically involve resource misallocation.

However, with a common trading price, the UK would have far less influence over the price of imports. Indeed, the food exporters in the EC would consistently press for high trading prices, and the importers for low trading prices. At the same time, if the UK chose a green conversion rate resulting in domestic food and farm prices below the agreed trading price then—in the absence of extenuating circumstances—resource misallocation would occur. This is because consumers would be eating more foodstuffs than justified by the UK position in the world economy, and because farmers would be producing less than they should.

6.4 CHAPTER SUMMARY

The arguments in this chapter may be summarised as follows. The main advantage to be gained from common CAP prices is that resources in the EC farm sector could be most profitably utilised. Thus, the primary objective of government policy should be to align EC food and farm prices. However, all Member States and indeed, most countries in the world, wish to give varying degrees of protection to their farm sectors for one reason or another. This has two consequences for the concept of common prices. First, more resources will be devoted to the farm sector than would otherwise be used. The loss to the EC in economic efficiency—measured in terms of the extra unit cost of imports and import replacers and in stocks of unsaleable surpluses—represents the costs of achieving the EC's objectives in the farm sector. Second, there is little evidence to suggest that the different national units within the EC can or could agree on a suitable common price level. Under such circumstances there seems little alternative but to continue with a system of national pricing.

The UK interest will then lie in a continuation of the present green currency/MCA system. This is because harmony will exist between UK internal food and farm prices, and trading prices. Although MCA's involve considerable EC budget expenditure, there is no evidence to suggest that this runs counter to the EC interest. The realistic measure is to compare the existing situation with one in which the UK were no longer a member of the EC. Provided UK CAP prices were equal to, or above, world market prices then no loss would result for the EC; in fact, a benefit might accrue. This is because the UK is a net food importer and net (or zero) levies would be paid on third country imports. Produce exported from the other Member States to the UK receives an MCA payment, but this amount is less than would be paid in export subsidies if the UK were not a member of the Community.

A system of national prices and common trading prices would be disadvantageous to the UK because of higher import costs. In addition, it is difficult to see that such a policy would be in the EC's interest because of the endless discussions and recriminations that would ensue in trying to agree on the level of the common trading price.

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Appendices

I Technical terms

This Appendix is designed to enable the reader to understand those items of CAP pricing necessary to follow the text. Irving & Fearn (1975) have provided an exhaustive record of events and legislation for those wishing to delve deeper into the technicalities of the subject.

UNIT OF ACCOUNT

In the implementation of its common policies the EC has fixed certain prices. In so doing it could have denominated the prices in terms of one or more national currencies as it has done, for example, in fixing the salaries of eurocrats in terms of Belgian francs. However, a European accounting unit unconnected with national currencies was thought to be necessary, and so the unit of account was born. Unfortunately, there soon developed a variety of different units of account, four of which concern agriculture. The first three outlined below all derive from the same base, whilst the fourth — the European unit of account — is entirely different.

Until 1971 the only unit of account was the *gold parity unit of account*. It has a value fixed in terms of gold and it was equal, at the then prevailing exchange rates, to one US dollar.

In August 1971, President Nixon suspended the convertibility of the dollar into gold and the dollar began to float on the world currency markets; thus—*de facto*—a new unit of account emerged which will be termed the *dollar-value unit of account*. This derived from the gold parity unit of account and its value followed the fortunes of the dollar in the international currency markets, having taken into account the formal devaluations of the dollar. Thus, its value depended upon the central values notified to the International Monetary Fund (IMF).

The joint-float of the 'snake' currencies in March 1973 meant that the dollar-value unit of account had to be reformulated. In effect it joined the joint-float—becoming the *joint-float unit of account*—and so its value now followed the fortunes of the joint float, appreciating against the dollar. This corresponds to the unit of account which is now used in EUROSTAT statistics and is known as the *EUR*.

The European unit of account (EUA) is quite different and is not related in any way to the units of account that have gone before. Its value does not depend upon gold, the dollar, or the collective strength of the snake. Instead, this unit of account is made up of a bundle of currencies: 0.828 marks plus 1.15 French francs plus 0.0885 pounds sterling, etc. Thus, its value depends upon the weighted average value of community currencies. This is different in two respects from the joint-float unit of account:

- (i) Revaluations and devaluations in the snake, as opposed to a general appreciation or depreciation of the snake, have no effect on the value of the joint-float unit of account, but do affect the value of the EUA;
- (ii) The values of all Community currencies help to determine the value of the EUA, but only the snake currencies that of the joint-float unit of account.

CONVERSION RATES USED IN THE CAP (GREEN RATES)

Prior to May 1971 agricultural prices were fixed in gold parity units of account and the conversion was effected with the dollar parities of the respective Community countries. The same conversion rates continued to be used even after the exchange rate changes of that year. This meant that the conversion rates used in the CAP no longer corresponded to the exchange rates between Community currencies and so border taxes and subsidies were introduced.

More specifically in countries which had revalued and whose farm prices now exceeded those of their neighbours, import taxes and export subsidies were imposed. The opposite was true in countries that had devalued and in which the conversion rates used in the CAP were now over-valued in relation to the exchange rate. Over time, limited adjustments to the conversion rates became politically feasible. Thus, in countries whose currencies had depreciated, a limited 'devaluation' of the conversion rate used for agriculture became possible, with a consequent increase of CAP prices in that country. The conversion rates are now known as *representative rates* or *green rates*, with CAP prices fixed in joint-float units of account.

MONETARY COMPENSATORY AMOUNTS (MCA)

Green rates are now used in all Member States; however, only Denmark has maintained a close liaison between the krone green rate and value of the joint-

float unit of account. The consequence is that farm prices are not uniform throughout the Community; the border taxes and subsidies that are necessary to maintain this diversity of prices are known as *monetary compensatory amounts*.

The system that has emerged and is operated is incredibly complex and cumbersome but the principle is quite simple. For every country, and for each eligible commodity, an MCA is calculated. For each currency the calculation is based on the percentage difference between the value of the joint-float unit of account and the green rate. This percentage is then applied to the product's CAP price expressed in national currency. Thus, the intervention price for product X in Germany (with an 'appreciated' currency in relation to its green rate), minus the German MCA, will be equal to the intervention price in 'devalued' Britain, plus its MCA, when conversion is made at the market exchange rate.

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