

## **Of Snakes in the Tunnel, Green ECU's and the EMU**

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### **1. A brief history**

Following the need for a monetary denominator to carry out financial flows between member states, the establishment of the European Community (EC) also involved the creation of a *unit of account*. Originally, this unit of account was called "the gold parity unit of account" (Harris, Swinbank, Wilkinson, 1983, p.187), defined as the amount of gold equal to the value of the U.S. dollar and also used since 1962 for the purpose of fixing CAP support prices. This link with the U.S. dollar made it possible that converted CAP support prices were internally consistent, differing only on account of transport costs and adjustment lags. Hence, during this period of relative currency stability (resulting from the Bretton Woods agreement of 1944<sup>1</sup>), one of the major objectives of the CAP was satisfied: the attainment of a common level of farm support prices throughout the Community (Swinbank, 1991, p.3). However, during the early 1970's, the objective of common prices was again undermined when individual currencies floated against the U.S. dollar and the Gold Standard was effectively broken down.

Exchange rates for the purpose of agricultural policy were introduced that differed from market exchange rates. This resulted from the reluctance of the French and German government to allow their farm prices to adjust to the realities of changes in market exchange rates. These conversion rates that were used to fix support prices in national currencies became known as the 'green rates of exchange' or 'green conversion rates'.

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For a devaluing [revaluing] country, the effect of converting CAP support prices into national currencies at the old, i.e. 'green' rate, meant that domestic market prices were

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<sup>1</sup> which established fixed, though in principle adjustable exchange rates throughout Western Europe (Fearne, 1991, p.48)

<sup>2</sup> "inaccurately known as green 'money' " Harris *et al.*, 1983, p.188

lower [higher] than implied by market rates of exchange. In order to prevent trade adjustments following these price differentials, in 1969, the EC introduced '*monetary compensatory accounts*' (MCA's), financed by FEOGA.<sup>3</sup> They covered CAP products which dominated intra-community trade and for which an intervention buying mechanism is important in determining market prices. <sup>4</sup>

On *intra*-community trade, these were taxes on exports and subsidies on imports of weak-currency countries, and subsidies on exports and taxes on imports of strong-currency countries (Josling & Gardiner, 1991, p.8). Thus, in the latter [former] case, the country is said to have a *positive* [*negative*] MCA, since its CAP support prices expressed in national currency were above [below] the "so-called 'common' level" (Swinbank, 1991, p.5). On *extra*-community trade, MCA's were used to reduce net import tax (or export subsidy) towards low-price countries and to raise them for high-price countries.

However, although MCA's were designed as a temporary measure to reduce the effect of currency fluctuations on the farm and food sector<sup>5</sup>, the demise of the Bretton Woods system of fixed exchange rates and the resulting greater instability in currency markets lead to a further build up of MCA's. Following the removal of the gold standard and the Commission's decision to keep up the unit of account-dollar link, the Community adopted its own measures in the hope of restoring stability in foreign exchange markets. The agreement on the "snake in the tunnel" (Fearne, 1991, p.49) involved a maximum margin of fluctuation of 2.25 per cent between those market rates of member states' currencies showing the greatest appreciation and greatest depreciation. Furthermore, the establishment of the *European Monetary System* (EMS) in 1979 "introduced an

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<sup>3</sup> "It is paradoxical that MCAs which are meant to remove trade distortions by compensation for differing price levels between Member States actually lead to a significant level of trade distortion themselves." (Harris *et al.*, 1983, p.210)

<sup>4</sup> e.g. fruit, vegetables, rice and oilseeds were excluded from the MCA system. (Ibid., p.203; Swinbank, 1991, p.7)

<sup>5</sup> "... no really convincing economic argument has as yet been advanced why MCAs should be generally necessary. The only slightly rational argument why agriculture may need some protection against exchange rate changes, while the rest of the economy is exposed to them, is that prices of homogeneous bulk commodities like agricultural products react more strongly to exchange rate variations, in particular if these prices are controlled by the government. However, if some compensation for abrupt price changes appears necessary in agriculture, the more economic approach would be to grant or levy that compensation in the form of direct payments or taxes, rather than in the form of price interventions." (Tangermann, 1991, p.76)

important stabilising factor into European currency markets and member states' exchange rates." (Fearne, 1991, p.58). The 'snake' system was extended when a weighted currency 'basket' unit, the *European Currency Unit* (ECU), replaced the unit of account. The introduction of the ECU was a direct consequence of the establishment of the *Exchange Rate Mechanism* (ERM), wherein currency exchange rates fluctuate within specified bands of their central rates against the ECU and where a parity grid is maintained by fixed bilateral exchange rates. Currencies within the narrow band (+/- 2.25 percent) of the ERM used the ECU central rate as market rate and observed *fixed* MCA's in the sense that MCA's only change when green rates or central rates with respect to the ECU change. For non-ERM currencies and those countries that observed the wider band (+/- 6 percent), the percentage difference between the market exchange rate and the green rate, the so-called *real monetary gap* (RMG), was calculated frequently (weekly), resulting in MCA's that were therefore known as *variable* MCA's.<sup>6</sup>Budgetary concerns during the 1984/85 price fixing not only lead to the introduction of quotas on milk production, but also involved the emergence of the *switchover mechanism* with the goal of eliminating all fixed positive MCA's before 1987/88. To prevent the creation or increase in fixed positive MCA's and still allow ECU prices to remain stable when a currency realignment occurs, a *correcting factor* was applied to the ECU central rates. This solved the undesirable outcome arising when a country with positive MCA's revalued its currency in the narrow exchange rate band of the ERM, since the gap between its central and green rates widened, with the MCA increasing in direct proportion.<sup>7</sup> The *correcting factor* therefore revalued the central rate for CAP purposes by the amount necessary to maintain the MCA unchanged, i.e. the central ECU rate was increased by the amount of the correcting factor and created a new central rate, the '*green ECU*'. The switch-over effect involved a reduction in the positive RMG of the strong-currency country corresponding to the increase in the

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<sup>6</sup> Thus, the  $RMG = ((Market\ rate/Green\ rate) - 1) \cdot 100$  determined the MCA percentage, assigned to each member state. The initial MCA was therefore equal to  $Intervention\ price \cdot Green\ rate \cdot MCA\ percentage$ . (Swinbank, 1991, p.5)

<sup>7</sup> However, if a currency is revalued without a corresponding change in the green conversion rate, the increased positive MCA being created for that country may be reduced via feedback from international currency markets. Depending on the weight in the currency basket, the rise in international value of the ECU following the revaluation of a basket currency acts to reduce the positive MCA for that country. (Swinbank, 1991, p.12)

negative RMG of other countries, without affecting support prices to farmers since the green rate remained unchanged. Since the corrective factor is increased in line with the revaluation of the strongest currency, the value of the green ECU is tied not to the real or market ECU but to the strongest currency within the EMS (Fearne & Perry, 1989, p.526).

The 1991/92 price review may be seen in line with the European Council's agreement on the proposals of the Delors Report <sup>8</sup> (June 1989), which envisaged a three-stage progression towards *Economic and Monetary Union* (EMU). This price review accelerated the rate of dismantling the RMG gaps, and involved that all countries within the narrow exchange rate band of the ERM eliminated their RMG's. However, since the goal was to achieve the " '1992' single market ideal" (Swinbank, 1992, p.10) by 31 December 1992, several aspects of the Agrimonetary arrangements were seen in the way of this ideal. "First, that MCA's as applied at the border are impossible in a Community without internal borders; and second, that the use of green conversion rates, resulting in different levels of price support from one Member State to another, in itself shatters the concept of a single market." (Ibid., p.10).

*"The logic of '1992' is that new MCAs should be eliminated immediately, for in a Europe without internal frontiers MCAs could not be tolerated even for a day." (Swinbank, 1991, p.38)*

Following the total elimination of MCA's by spring 1992 for eight countries participating the narrow ERM band of EMS, an opportunity for a change may have existed:

*"There is a window of opportunity which should not be missed: the 1991/92 CAP price review swept away all RMGs for these eight countries, and a switch to payment in ECU could readily be made without causing too much disruption to farmers and food traders. If the opportunity is not taken, the danger is that a future EMS*

*realignment could recreate RMGs and MCAs, and make their elimination more difficult."*

(Swinbank, 1992, p.13) <sup>9</sup>

However, Commission Regulations from January 1, 1993 established a new Agrimonetary regime, extending the existing "complicated and inflationary system." (Swinbank, 1991, p.20). Critics seem to suggest that not only a window of opportunity has been missed, but rather a "new panoply of agri-monetary legislation" (Agra-Europe, 8.1.93, P/2) has been established whose complexity "is verging on the absurd" (Agra-Europe, 5.2.93, E/8).

Some aspects of the *general provisions* include:

- the retention of the switch-over mechanism " 'for a period not exceeding two years' ", following the Council Regulation ... (Agra-Europe, 8.1.93, E/3), i.e. "at least until December 31, 1994. ... When the switchover is increased following an EMS realignment, ECU prices are to be cut by 25% of the percentage of the change in the correcting factor at the beginning of the next marketing years." (Agra-Europe, 8.1.93, E/1)

- changes of green rates for narrow-band ERM currencies will be determined by EMS realignments (Agra-Europe, 8.1.93, E/1)

- green rates of floating currencies<sup>10</sup> are subject to adjustment when monetary gaps reach certain individual and bilateral threshold levels (Agra-Europe, 8.1.93, E/2)

- several forms of *compensation*, which "were proposed in order to obtain agreement for the abolition of the switchover. In the event, however, the Council not only agreed to

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<sup>8</sup> "The ultimate goal of the Delors Plan was the establishment of a *single* currency." (Swinbank, 1991, p.42)

<sup>9</sup> However, to move over to direct payment in ECU "would not be problem free" (Swinbank, 1992, p.16). Beyond necessary ECU bank accounts for recipients of CAP support payments, increase in exchange rate risk, problems linked with increased CAP prices due to the switchover mechanism, and other impacts, "A significant drawback is that it might be seen as an endorsement of the concept of a two-speed Europe." (Swinbank, 1991, p.43)

<sup>10</sup> i.e. currencies outside the ERM 'narrow band'.

maintain the switchover, it also refused to allow the extra compensation to be withdrawn once the switchover abolition ... had failed." (Agra-Europe, 8.1.93, E/3)

- "Floating currency countries may ... grant farmers compensatory aid for three years 'when the average agricultural conversion rate over the previous 12 months is lower than the average agricultural conversion rate over the 12 months preceding that period.' ... Community financing of the aid is to be 75% for less-favoured ... areas and 50% for other regions." (Agra-Europe, 8.1.93, E/3)

- countries where national currency prices are reduced as a result of the neutralisation of the first 25% of a future increase in the switchover coefficient following an EMS realignment can apply for a " 'national compensation aid' " (Agra-Europe, 8.1.93, E/3)

- compensatory aid set in ECUs for crops and livestock payable under the MacSharry reforms will be increased in national currency terms if the national currency revalues and the green currency has to be revalued, thus reducing compensation subsidies in national currency. (Agra-Europe, 8.1.93, P/2)

Thus, beyond the provision of several types of compensation, the new agreements require that the " 'green' conversion rates should be kept closely in line with currency market values." (Agra-Europe, 22.1.93, P/4)

## ***2. Some political and economic effects caused by the agrimonetary agreements***

### ***2.1. Effects of the switchover mechanism***

- the "introduction of the green ECU ... considerably weakened the Community's control over CAP price fixing." (Swinbank, 1991, p.20)
- "During the crises in the money markets last year and so far in 1993, the switchover had already cost 1 550 million ECU to the Community farm budget."(Agra-Europe,5.2.93,E/1)

- Compared to the compensatory aids, "retention of the switchover will be by far the most expensive for the Community." (Agra-Europe, 8.1.93, E/3); "the additional cost of this measure is likely to amount to at least 1 billion ECU a year or even more." (Ibid., P/2)
- retention of the switchover <sup>11</sup> "will continue to protect strong currency countries from the obligation to revalue green rates and cut national currency prices, while continuing to allow inflationary green rate devaluations by weak currency countries." (Ibid., E/3)
- it therefore creates a "divide among Community countries" since devaluing countries "have obtained substantial national currency price increases (around 22% since last September in the cases of Italy and the UK). In the arable crop sector, there is less pressure in these countries for farmers to diversify into an unregulated field crop such as potatoes. But in the core ERM countries ... the squeeze on the CAP arable sectors remains intense and it will be that much more difficult to reduce the present level of excessive potato plantings." (Agra-Europe, 5.2.93, E/7)

## **2.2. The GATT and some aspects of the agrimonetary regime**

- The green ECU defines a higher level of border protection against imports from third countries (Swinbank, 1991, p.20)
- "Outside observers could have been misled about the CAP's real protective effect if they had failed to realise that the green ECU is worth 14.5% more than the real ECU." (Swinbank, 1992, p.6)<sup>12</sup>. However, the abolition of the switchover coefficient would involve a declining support price, but "An equal increase in ECU price could compensate this price decrease. ... To raise ECU prices by 14 percent would raise many international eyebrows." (Josling *et al.*, 1991, p.14)
- critics seem to question the Commission's will to increase transparency via tariffication in the sense of converting protective measures into tariff equivalents: real money was used in determining a total Aggregate Measure of Support and in determining 'tariff equivalents' for the offer on tariffication. (Swinbank, 1992, p.6,7)

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<sup>11</sup> which was a ministers' decision against the will of the Commission (Agra-Europe, 5.2.93, E/1)

<sup>12</sup> currently the 'switchover mechanism' inflates the value of the 'green' ECU in comparison with the real ECU by 20.5% (Agra-Europe, 5.3.1993, E/5)

### **2.3. Further effects and distortions**

- *increased administration and budgetary expenditure*: about 12% of FEOGA expenditure went on MCA's in 1977 (European Commission, 1989, p.24)
- "*intercountry price distortions*" where relative prices, such as livestock-to-feed ratios, were retained (prior to 1977), since one green rate prevailed for each member country (Josling *et al.*, 1991, p.12)
- *variation of raw material prices from one member state to another*: the emergence of separate green rates for individual agricultural commodities lead to advantages for producers of certain livestock products in one country over another "because of more favorable feed-livestock price ratios." (Josling *et al.*, 1991, p.12)
- *reducing national control over pricing*: "the use of MCAs returned some sovereignty over agricultural policy to member state governments" (Fearne, 1991, p.57)
- the link of the Community's price level to the value of the strongest currency meant that the objective of restoring *common pricing* was "to be achieved by harmonising at the level of the highest price." (Swinbank, 1991, p.20)
- *effects on resource allocation*: "Differential pricing is inefficient from a resource allocation viewpoint"<sup>13</sup>: "By supporting prices at higher levels in some countries, more resources are employed in agriculture than otherwise would occur." (Josling *et al.*, 1991, p.12). More specifically, MCA's were "encouraging production in those areas with higher relative prices and inhibiting specialisation of production." (Saunders, 1991, p.170)

*"Persisting differences between the official parities and the green rates tend to distort competition, hamper structural adjustment of agriculture and jeopardise the optimum allocation of available resources in the Community."*

(European Commission, 1989, p.24)

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<sup>13</sup> Bureau of Agricultural Economics 1985, p.42

- *effects on trade patterns and reduction in economic welfare:*

- *effects on trade patterns due to higher support prices*

"The distortions caused by the CAP and MCAs on the specialisation of production imply that the effects of the EC membership on trade could be due more to the impact of the CAP rather than to the original objective of the EC - that of free trade between member countries. ... As a result [of CAP and MCAs] member countries may not necessarily specialise in those commodities in which they have a cost advantage, but in those commodities receiving a relatively higher degree of support." (Saunders, 1991, p.171).<sup>14</sup> Therefore, trade will be distorted and "production will not be concentrated in the low cost regions, and a potential source of gain in economic efficiency will be lost to the European Community." (Harris *et al.*, 1983, p.206).<sup>15</sup> -

- *effects on trade patterns due to different price levels:*

"The system of green rates and MCA's prevents the realization of common prices among countries and , therefore, affects resource allocation, production, consumption, and trade patterns." (Josling *et al.*, 1991, p.12)

- *effects on economic welfare:*

"To the extent that this elaborate [green conversion rate/MCA] system is successful in affecting *market* prices then the volumes of production and consumption, trade flows, and resource use; and ultimately the state of the 'balance of payments' and the level of national income will all be affected." (Harris *et al.*, 1983, p.206)

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<sup>14</sup> "The result of their [Loseby & Venzi (1978)] analyses on the impact of MCAs on a country's competitiveness and comparative advantage were inconclusive but seemed to support their hypothesis that MCAs affect both the competitiveness and comparative advantage of member states." (Saunders, 1991, p.171)

<sup>15</sup> Trade will be distorted in the sense that "the levels of price support influence supply and demand and hence import and export requirements." (Harris *et al.*, 1983, p.210)

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