

I

(Information)

COURT OF AUDITORS

SPECIAL REPORT No 1/89

on

The agrimonetary system accompanied by the replies of the Commission

(89/C 128/01)

(Observations pursuant to Article 206 (a) paragraph 4 of the EEC Treaty)

TABLE OF CONTENTS

	Paragraph reference
1. Introduction	1.1 — 1.9
Common market organizations and common prices	1.2 — 1.5
Objectives of the Court's enquiry	1.6 — 1.7
Summary of results	1.8 — 1.9
2. Conceptual framework of the agrimonetary system	2.1 — 2.11
Regulatory Framework	2.1
Green rates and monetary gaps	2.2 — 2.5
Monetary compensatory amounts	2.6
Applications of MCA's	2.7
The green ECU and the switchover mechanism	2.8
Automatic dismantling of MCA's	2.9 — 2.11
3. The impact of green rates on the system of common prices	3.1 — 3.16
Variations in common price levels	3.1 — 3.4
Green rates and Member States pricing policy	3.5 — 3.13
Impact on resource allocation	3.14 — 3.16
4. The switchover mechanism	4.1 — 4.8
Rationale for 'switchover'	4.1
Artificial exchange values	4.2 — 4.3
Impact of correcting factor of common price level	4.4 — 4.8
5. The calculation and applications of MCA's	5.1 — 5.36
Introduction	5.1
Basis of calculation of MCA's	5.2 — 5.22
MCA's in the pigmeat sector	5.7 — 5.11
Neutral margins	5.12 — 5.20
Processed Products	5.21 — 5.22
Absence of MCA's in certain sectors	5.23 — 5.27
Rice	5.24 — 5.25
Sheepmeat	5.26 — 5.27

Complexity of the MCA system	5.28 — 5.32
Frauds and irregularities	5.33 — 5.36
6. The budgetary impact of green rates and MCA's	6.1 — 6.26
Introduction	6.1
Direct budgetary impact, MCA's	6.2 — 6.9
Amounts recorded in the annual accounts	6.6 — 6.7
MCA's deducted from export refunds	6.8
MCA's added to and deducted from import levies	6.9
Indirect budgetary impact of the agrimonetary system	6.10 — 6.18
Dual rate coefficient	6.11 — 6.13
Impact of the switchover on the dual rate coefficient	6.14 — 6.16
Budgetary impact, 1987	6.17 — 6.18
Budgetary impact of artificial trade flows	6.19 — 6.20
Estimated total budgetary impact of the agrimonetary system, 1987	6.21 — 6.22
Clarity of accounting information	6.23
Budgetary impact of the switchover mechanism	6.24 — 6.26
7. Principal conclusions and Recommendations	7.1 — 7.18
The switchover mechanism	7.2 — 7.3
Budgetary impact	7.4 — 7.5
National Pricing Policies	7.6 — 7.8
Calculation and application of MCA's	7.9 — 7.13
Pigmeat	7.10
Uncovered Monetary Gaps and Triangular Trade	7.11 — 7.12
Complexity	7.13
Prospects for complete abolition of the agrimonetary system	7.14 — 7.18
	Pages
Annex I: Regulatory Framework, Agrimonetary System	30
Annex II: The ECU, The European Monetary System and the Common Agricultural Policy	31
Annex III: Monetary gaps and Monetary Compensatory Accounts (MCA's)	31
Annex IV: The switchover mechanism and the automatic dismantling of artificial and natural monetary gaps	33
Annex V: Cost to the budget of expenditure in different Member States: May 1988	34
Annex VI: Export of cereals, to third countries, June 1988	35
Annex VII: Glossary of terms	37
Replies of the Commission	40

1. INTRODUCTION

1.1. This report records the results of an examination by the Court of Auditors of the agrimonetary system. It places particular emphasis on the consequences for the general budget of the system, and the extent to which it interferes with the sound management of the common agricultural markets, which provide the basis for the functioning of the common agricultural policy ⁽¹⁾. To aid the reader, a glossary is included in *Annex VII*.

Common market organizations and common prices

1.2. In order to ensure freedom of trade it was originally envisaged by the Council ⁽²⁾ that the level of prices in each currency would remain the same in ECU terms. This meant that the common prices set by the Council in ECU would be converted into national currencies by the application of agricultural conversion rates (known as green rates) which would normally be the same as the market rates of exchange. Any adjustment in market rates of exchange would be accompanied by equivalent changes to the green rates, to keep them in line with the market rates.

1.3. However, on the occasion of the first changes in currency parities after the introduction of common prices into the CAP, the principle of the unity of prices was breached. In 1969 when the FF was devalued and the DM was revalued, the Council allowed green rates and market rates to diverge. Monetary Compensatory Amounts (MCA's) were introduced to fill the gaps, in order to try to preserve the effects of the pre-existing common price system in the operation of the intervention arrangements and in enabling trade to continue at a common price level.

1.4. The objectives of monetary compensation, as set out in the current regulations, emphasize the need to preserve

the functioning of the common agricultural markets, including freedom of trade. The regulations state:

- (a) in order to avoid jeopardizing the proper functioning of the market organizations in general and the intervention system in particular, and to avoid difficulties caused by abnormal changes in prices and artificial movements in trade flows, a system of monetary compensatory amounts should be applied in trade bridging the gap between the market rate and the agricultural conversion rate; this is further qualified by;
- (b) monetary compensatory amounts must be paid or charged only where their absence would engender distortions in the intervention system and/or in trade;
- (c) monetary compensatory amounts must be kept down to the levels strictly needed to offset the impact of the gap between the agricultural conversion rate and the market rate on the price of basic products for which intervention measures have been laid down ⁽³⁾.

1.5. The agrimonetary system has undergone a number of modifications, most notably in 1984 with the introduction of the green ECU and the switchover mechanism (see below paragraph 2.8) and most recently in 1987 when Council decided to retain the switchover mechanism and to introduce, by means of regulations, arrangements for automatically dismantling new MCA's created in the future (see paragraph 2.9). This is intended to be a step towards the gradual elimination of the system by 1992, when, in line with the current programme, the single market is to become effective.

Objectives of the Court's enquiry

1.6. The purpose of the Court's enquiry was:

- (a) to evaluate the extent to which the agrimonetary system — both before and after the introduction of the switchover — interferes with the sound management of the common market organizations, in particular by its impact on common prices;

⁽¹⁾ Articles 39 and 40 of the Treaty establishing the European Economic Community set out the objectives for the common agricultural policy and the basic rules for achieving them. They provide for the common organization of agricultural markets, excluding any discrimination between consumers or producers in the Community. Accordingly, the functioning of the common agricultural policy's common market organizations is based on:

- (a) common systems of agricultural market support, with a common price level denominated in ECU applying throughout the Community; and
- (b) freedom of trade between Member States.

⁽²⁾ Council Regulation No 129 of 23 October 1962, OJ No 2553, 30. 10. 1962/62. Council Regulation No 653/68 of 30 May 1968, OJ No L 123, 31. 5. 1968.

⁽³⁾ Recitals, Council Regulation (EEC) No 1677/85 of 11 June 1985, OJ No L 164, 24. 6. 1985.

- (b) to evaluate the budgetary impact of the agrimonetary system, and the way in which that impact is presented in the budget and the revenue and expenditure accounts of the Community.

1.7. The Court's examination, which included missions to France, the United Kingdom and the FR of Germany, did not include a detailed audit of Member State management and control systems. These systems are operated by the customs authorities and paying agencies in the Member States, and to a considerable extent are the same systems as those used for the collection of agricultural levies and the payment of export refunds. As such, these systems are the subject of other detailed audits carried out by the Court ⁽¹⁾.

Summary of results

1.8. The results of the Court's examination can be summarized as follows:

- (a) the annual decisions of the Council fixing the level of agricultural prices in ECU do not reflect real developments in institutional prices: following each EMS realignment the application of the switchover mechanism to avoid the creation of positive MCA's in effect raises the common price level in line with the strongest currency in the EMS, the DM. These increases in the common price level, however, are essentially hidden (paragraphs 4.1 — 4.8). The impact of these hidden price increases feeds through as increased budgetary expenditure in a manner that is obscure (paragraphs 6.11 — 6.18). The switchover, therefore, has not improved the management of expenditure in the agricultural markets. It has, also, resulted in the exchange rates used for agricultural purposes becoming further removed from real exchange rates (paragraphs 4.2 — 4.3);
- (b) the budget and accounts give only an incomplete picture of the impact of the agrimonetary system on the budget: for example, instead of the 636,9 Mio ECU recorded in chapter 28 of the EAGGF budget for 1987, the Court has assessed the full impact on the combined revenue and expenditure budget at at least 1 578,2 Mio ECU (10-month basis) and 1 824,6 Mio ECU on a full 12-month basis. This is equivalent to 7 % of EAGGF expenditure (paragraphs 6.2 — 6.22). By far the largest element of this results from the hidden increases in the common price level caused by the switchover mechanism. Interpretation of the data in the accounts is made

very difficult by the fact that the impact of the agrimonetary arrangements, including the switchover, are not adequately identified.

The situation described above means that without detailed knowledge of the impact of the agrimonetary system, it is not possible either to understand fully the real meaning of the annual agricultural price fixing decisions, or to interpret the accounting information presented by the Commission.

1.9. The existence of green rates that diverge from market rates and the resultant monetary compensation arrangements are an impediment to the creation of a genuine common agricultural market in the Community. As the Commission has stated ⁽²⁾, the agrimonetary system is inconsistent with the concept of the single European market which is to be achieved by 1992. Failure to abolish the agrimonetary system will mean that Community agriculture will continue to be protected from the laws of supply and demand, as measured by real exchange rates, which determine levels of economic activity in other sectors of the economy and which provide the basis for the single European market. However, abolition of the system presupposes agreement on a genuine common price level, a closer degree of monetary convergence between the Member States and a weakening of the role of agricultural support prices in determining market prices. Without this, it is unlikely that the target of a genuine common agricultural market will be achieved.

2. CONCEPTUAL FRAMEWORK OF THE AGRIMONETARY SYSTEM

Regulatory framework

2.1. As the agrimonetary system has developed, it has been necessary to develop a framework of regulations to govern its application. These regulations have been subject to frequent amendment. In 1985, following the introduction of the switchover mechanism, the latest set of regulations was issued. These are listed in *Annex 1*.

⁽¹⁾ See, for example, the audit of export refunds, points 4.20 — 4.59 of the Court of Auditors Annual Report concerning the financial year 1987, OJ No C 316, 12. 12. 1988.

⁽²⁾ Doc. COM(87) 64 final of 27 September 1987, p. 3.

Green rates and monetary gaps

2.2. The European Monetary System (EMS), with the ECU as its currency unit, provides the monetary background to the system of green rates and MCA's. This is explained further in *Annex II*.

2.3. To maintain a genuine common price system between Member States, with prices in each Member State's currency having the same equivalent value in ECU, it would be necessary for green rates to follow fluctuations in central and market rates of exchange. However, ever since the first modification to currency parities after the introduction of common prices, Member States have not been prepared to accept the consequences of this for institutional prices and aids in national currency. In the case of a Member State whose currency had been revalued, these prices and aids, though unchanged in ECU, would fall, at the new rate, thus bringing about a fall in agricultural revenues. In the case of a Member State whose currency had been devalued, the ECU amounts in national currency would rise, increasing agricultural incomes, but also putting inflationary pressure on prices to consumers.

2.4. Member States have, therefore, sought to cushion the impact of currency movements on agriculture by delaying the adjustment of the green rates to the new real parities, maintaining the value of institutional prices in national currencies at their former levels. As a result, monetary gaps have opened between green and market rates of exchange. *Annex III* describes how these gaps are calculated. The objective has been to realign progressively the green rates with the real rates as the economic impact of the currency realignment works through to the agricultural sector. It has not, however, always been possible to complete this adjustment process before new realignments have opened new monetary gaps between the green rates and real rates.

2.5. If nothing were done to cover the monetary gaps, there would be immediate consequences for the operation of the intervention mechanisms and for trade flows. For example, an operator in a Member State whose prices in national currency were below the common price level (e.g. France, with a depreciated currency) would obtain higher prices by selling into intervention in other Member States whose prices were above the common price level (e.g. FR of Germany, with an appreciated currency) and converting the foreign currency obtained into their own currency at the market rate. Similarly, imports into the Community would be channelled through Member States where agricultural levies were expressed in national currency at prices below

the common price level, and exports to third countries would be channelled through those Member States where the refunds were expressed in national currency at prices above the common price level.

Monetary compensatory amounts

2.6. Thus, in order to minimize the impact on the intervention system and trade flows, and to preserve some of the appearances of a common price system, the agrimonetary regulations provide that, where green and market rates of exchange are different, MCA's broadly covering the gap shall be applied. For Member States where the green rates are below the market rates (i.e. whose prices in national currency are above the common price level) the MCA is applied as a levy on imports and a subsidy on exports, and is called a positive MCA. For Member States where the green rates are above the market rates (i.e. whose prices in national currency are below the common price level) the MCA is applied as a subsidy on imports and a levy on exports and is known as a negative MCA.

Application of MCA's

2.7. Although the system of green rates applies through all the market sectors, the existence of a monetary gap does not necessarily lead to compensation. The principle underlying the application of MCA's is that they should only be paid or charged 'where their absence would engender distortions in the intervention system and/or in trade' ⁽¹⁾. Where intervention arrangements do not exist, or where there is no perceived risk of trade disturbance despite the existence of a monetary gap, MCA's are not applied. *Table 1* lists the markets where MCA's are applied.

⁽¹⁾ 13th recital, Council Regulation (EEC) No 1677/85 of 11 June 1985, OJ No L 164, 24. 6. 1985.

Table 1: Sectors where MCA's applied,
at beginning of 1988

Sector	Basis used for MCA calculation
Milk and milk Products	95 % of intervention price for butter and SMP. For other products, the basis of calculation is the two intervention prices less a flat rate amount for processing costs
Cereals	92,5 % of intervention price, without reference to monthly increases (for starch and maize groats for brewing, MCA calculated on basis of price used for calculation of product concerned minus production refund)
Pigmeat	35 % of the basic price (reflects pigmeat as derived product of cereals)
Eggs and Poultry	Derived from MCA's for cereals according to content of various cereals in the feed ration Coefficients of derivation as for import levies
Beefmeat	80 % of intervention price
Sugar and isoglucose	Intervention price plus storage levy. For raw sugar the storage levy is multiplied by yield factor of 0.92
Wine (France, Italy, Germany, Greece and Spain only)	MCA's limited to certain wines only. Basis is guaranteed minimum price
Olive oil (from 7.9.1987)	Intervention price. Where packed in packs of less than 5 litres, consumption aid deducted
Processed fruits and vegetables (jams and marmelades with more than 50 % sugar)	50 % of MCA for white sugar (do not apply if less than 3 ECU/100 kg)
No Annex II products	Derived from MCA's of basic ingredients (cereals, milk, sugar) less 10 % (do not apply if less than 3 ECU/100 kg)

In addition monetary differential amounts are applied to the aids for colza, rape, and sunflower seeds and peas, field beans and lupins.

currencies because of the reduction in prices in national currency that this entails. The 'Gentlemen's Agreement' approved by a majority of the Council Members in March 1979, which provided that any reduction in MCA's should not lead to a reduction in prices in national currencies, combined with an increasingly restrictive pricing policy adopted as the problem of surplus production became more serious, in effect institutionalised what was already reality. In 1984, therefore, a device was introduced which aimed to circumvent the problem by 'switching' positive MCA's into negative ones, and avoiding the creation of new positive MCA's in the future for the fixed rate currencies. How this device works is shown in *Figure 1* and described in *Annex IV*. The key element in the arrangements is the application of a correcting factor to the central rates of those Member States' currencies which are in the Exchange Rate Mechanism of the EMS and to the notional central rates used for the floating rate currencies.

Automatic dismantling of MCA's

2.9. As part of the 1987/88 prices package, adopted in June 1987, Council agreed on automatic arrangements for dismantling new MCA's created at future currency realignments. These arrangements do not apply to MCA's already existing at the time of the decision. The detailed provisions ⁽¹⁾ are set out in *Annex IV*.

2.10. The decisions of June 1987 concerning new MCA's were supplemented by decisions taken in June 1988 by the Council as part of the 1988/89 price fixing to dismantle the remaining negative MCA's of the narrow-band EMS Member States (Belgium, Denmark, France, Ireland, Luxembourg) in four stages leading up to 1992, starting with a dismantling of about 25 % on 1 January 1989. A commitment was also made to dismantle the monetary gaps for Italy and the remaining four Member States with variable MCA's (Greece, Spain, Portugal, United Kingdom), but no details were fixed.

2.11. The objective of these two sets of decisions is to achieve the full dismantling of all the real monetary gaps by 1992. This could be achieved if the decisions are fully applied, the commitment in respect of the variable MCA countries and Italy is followed through, and there are no monetary disturbances in the years leading up to 1992. Any realignment after the beginning of the 1990/91 campaign

The green ECU and the switchover mechanism

2.8. Experience since the introduction of MCA's in 1969 shows that it is extremely difficult to dismantle the positive monetary gaps for Member States with appreciated

⁽¹⁾ Council Regulation (EEC) No 1889/87 of 2 July 1987, OJ No L 182, 3. 7. 1987.

Figure 1: The Agrimonetary System

Situation 1 Point of Departure		Situation 2 Realignment: Reevaluation of DM Devaluation of FF Introduction of green rates		Situation 3 Introduction of switchover Correcting factor: 1,033651		Situation 4 Dismantlement Marketing year 1984/85		Situation 5 At 1. 1. 88 Correcting factor: 1,137282	
Central rate		Green rate		Green rate		Green rate		Green rate	
		2,51457 DM		2,51457 DM		2,38516 DM		2,38516 DM	MCA + 1,9 %
		MCA + 10,8 %		MCA + 7,8 %		MCA + 2,8 %		1 ECU (g) =	2,34113 DM 7,85183 FF
		1 ECU (g) = 2,31728 DM = 7,10190 FF		1 ECU (g) = 2,31728 DM = 7,10190 FF		MCA - 3,5 %		MCA - 5,0 %	
1 ECU = 2,51457 DM = 6,49211 FF		1 ECU = 2,24184 DM = 6,87456 FF		1,033651		Green rate		1,137782 Green rate 7,45826 FF	
		MCA - 5,9 %		MCA - 9,5 %		6,86866 FF		ECU = 2,05853 DM = 6,90403 FF	
		Green rate		Green rate					
		6,49211 FF		6,49211 FF					

year will mean that monetary gaps will be carried through into 1993.

3. THE IMPACT OF GREEN RATES ON THE SYSTEM OF COMMON PRICES

Variations in common price levels

3.1. When green rates diverge from market rates, the value of the common ECU farm prices when converted into national currencies varies from one Member State to another. The common price level, therefore, differs from one Member State to another, and is, therefore, no longer truly common. The extent of the variation in common prices, which is measured by the real monetary gap between the green and real rates, has varied considerably during the life of the agrimonetary system, and between Member States. At certain times the gaps have been small for most Member States whereas at others the gaps have been wide. In 1978, for example, the combined real monetary gap between French and German green rates was over 25 % for much of the year: thus the level of institutional agricultural prices in national currency in the FR of Germany was 25 % higher than in France. At the time of the introduction of the switchover in 1984 the difference was about 17 %.

3.2. Following the agrimonetary decisions which formed part of the 1987/88 and 1988/89 price fixing agreements, the monetary gaps have been considerably narrowed in most Member States, and with it the differences in price levels between the Member States have been reduced. As is shown in paragraphs 4.5 — 4.6, the convergence is on the price level in the FR of Germany.

3.3. In addition to the variations in common prices between Member States, since 1984 there has been an increase in the number of different green rates for different market sectors within Member States. This differentiation of green rates, however, is not the same in each Member State. Thus, in March 1988, for example, the FR of Germany had three different green rates in operation (milk, cereals, all other products). France had six green rates (milk; pigmeat, beefmeat/sheepmeat, other animal products, wine and other vegetable products), the United Kingdom five green rates (pigmeat, beefmeat, sheepmeat, other animal products, all vegetable products), and Italy three different rates (pigmeat, cereals/oil seeds, all other products).

3.4. The variations in the common price level between Member States and between markets within Member States have a number of implications:

- (a) they raise the question of the extent to which Member States are able to use the system to pursue national pricing policy objectives which may not be consistent with Community objectives for the functioning of common market organizations;
- (b) differing price levels would be expected to affect the allocation of resources in agriculture;
- (c) there are direct budgetary consequences.

The direct budgetary consequences are examined in detail in chapter 6 of this report. The other two implications are considered in the following paragraphs.

Green rates and Member States pricing policy

3.5. Formally, green rate changes are decided by Council on the basis of a proposal by the Commission. Normally green rate changes are decided once a year as part of the price fixing decisions ⁽¹⁾. This means that individual Member States, by negotiation, are able to exert considerable influence over the level of their green rates and thus to keep an important degree of national control over the internal level of their prices.

3.6. At certain times the interest of the Member States has been to resist pressure to dismantle monetary gaps. In the case of positive gaps this is because the national priority has been to avoid reductions in the incomes of its producers (e.g. FR of Germany, United Kingdom between 1980 and 1985), in the case of negative gaps it has been because the Member State's priority was to avoid increasing food prices

⁽¹⁾ This is to try to ensure that institutional prices in national currency remain stable during specified periods, e.g. a market campaign year. However, changes at other times do occur. Since the 1987/88 price decision concerning automatic dismantling of MCA's after a realignment, and the specific provisions for pigmeat MCA's (see paragraph 5.10), provision for changing green rates at times other than the annual price fixing has been institutionalised.

(e.g. United Kingdom in the 1970's and 1986 to 1987, France in the early years of the agrimonetary system).

3.7. In other cases, Member States with negative monetary gaps have sought special treatment for particular groups of producers by selective devaluation of the green rates. This has been particularly so when Member States have sought to alleviate the effects of a restrictive ECU prices policy, securing price increases in national currency by means of green currency adjustments. For example, in 1986 and at the beginning of 1987 monetary gaps were reduced more for animal products than for cereals products because farmers' net returns were considered to be under greater pressure in the animal products sector, while similar price increases for cereals producers could not be justified.

3.8. In the 1988/89 price fixing the Commission's initial proposals for limited dismantling of Greek monetary gaps only were not accepted by a number of Member States with negative gaps. They sought, and eventually obtained, a much greater degree of dismantlement of their own gaps. One specified objective was to achieve progress towards the goal of full dismantlement by 1992, but it was also clearly stated in the arguments of the Member States concerned that they were seeking higher prices in national currencies for their producers at a time when common prices in ECU were being frozen for a further year.

3.9. *Table 2* and *Figure 2* show that since 1984 Member States have been able to obtain price increases in national currency by means of green rate changes while common price increases in ECU have been restrained. For EUR 10 common prices in ECU have fallen marginally after the increase in 1983/84, but, following green rate adjustments, they have continued to rise significantly in national currency in nominal terms in each year. For some Member States the nominal price increases in national currency have been considerable: leaving to one side the special case of Greece, which is affected by the adjustments in price levels made following accession, France, Ireland, and Italy have obtained over the period nominal price increases in their own currencies in excess of 4 % per annum.

3.10. On the one hand it can be argued that with the limited economic and monetary co-operation between the Member States that has existed since 1969 the flexibility in the common price system that results from the use of green rates has been essential to the continued functioning of the common market organizations: if this flexibility had not

been provided by the agrimonetary system, it would have had to have been provided in some other way, as otherwise the strains on the common market organizations would have been too great.

3.11. It can also be argued that differentiating green rates by market does not introduce new principles in the agrimonetary system, but is rather a refinement of the basic principle of allowing the agricultural conversion rates to deviate from market rates.

3.12. On the other hand, it is an unsatisfactory situation where Member States are able to use the green rate system to pursue national pricing policy objectives which conflict with the Community common price interest. For several years a central element in Community agriculture policy has been to restrain institutional prices in order to try to contain surplus production, and thus budgetary cost. The effect of freezing prices in ECU is undermined if Member States can obtain price increases by means of green rate devaluations. For example, after the restricted dismantling of cereals negative gaps in 1986 and early 1987 referred to in paragraph 3.7 France and the United Kingdom obtained reductions in their monetary gaps of 5,5 percentage points in the 1987/88 prices package, and a further 1,5 points (France) and 3,2 points (United Kingdom) in the 1988/89 prices package, at a time when the entire thrust of the Commission's policy on cereals was to restrain the growth in production.

3.13. Also, as far as different green rates for different markets are concerned, the argument in paragraph 3.11 can be countered by considering that differentiating the rates means that the agrimonetary system is no longer a neutral instrument of market management, with all markets affected equally.

Impact on resource allocation

3.14. With different price levels in Member States, and with the isolation of agriculture from the rest of the economy implied by the green rate system and MCA's, normal operation of the price mechanism could be expected to produce various distortions in resource allocation, for example:

- (a) in appreciating currency countries, green rates below the market rate keep farm prices above the real

Index of Increases in Intervention Prices in ECU and in National Currency
for the Marketing years 1982/83 to 1988/89: All Agricultural Products
(1982/83 = 100)

Member State	1982/83		1983/84		1984/85		1985/86		1986/87		1987/88		1988/89	
	ECU ⁽¹⁾ Index	N.C. ⁽²⁾ Index	ECU ⁽¹⁾ Index	N.C. ⁽²⁾ Index	ECU ⁽¹⁾ Index	N.C. ⁽²⁾ Index	ECU ⁽¹⁾ Index	N.C. ⁽²⁾ Index	ECU ⁽¹⁾ Index	N.C. ⁽²⁾ Index	ECU ⁽¹⁾ Index	N.C. ⁽²⁾ Index	ECU ⁽¹⁾ Index	N.C. ⁽²⁾ Index
Belgium	100,0	100,0	104,4	107,7	103,8	110,6	104,0	110,4	103,9	112,3	103,9	114,2	103,9	114,6
Denmark	100,0	100,0	104,0	104,7	103,3	106,3	103,4	106,4	102,7	107,8	102,6	110,6	102,6	111,4
FR of Germany	100,0	100,0	104,1	102,0	103,5	101,4	103,8	101,7	103,6	101,5	103,6	101,5	103,6	101,5
France	100,0	100,0	104,0	109,4	103,4	114,9	103,3	116,8	103,0	119,2	102,8	124,0	102,8	125,4
Greece ⁽³⁾	100,0	100,0	105,6	125,8	106,0	147,9	106,4	168,1	105,9	190,7	105,5	216,1	104,8	246,8
Ireland	100,0	100,0	104,2	109,0	103,6	111,9	104,0	112,4	103,7	115,2	103,7	125,0	103,7	127,6
Italy	100,0	100,0	104,5	108,7	104,1	115,7	103,9	119,5	103,3	124,5	102,8	126,5	102,5	128,9
Luxembourg	100,0	100,0	103,9	107,2	103,4	110,2	104,0	110,9	103,9	112,7	103,9	114,5	103,9	114,9
Netherlands	100,0	100,0	104,0	102,6	103,5	102,1	104,0	102,6	104,0	102,6	104,0	102,6	104,0	102,4
United Kingdom	100,0	100,0	104,2	104,4	103,6	103,8	103,8	104,0	103,3	105,0	103,2	112,6	103,2	115,3
EUR 10	100,0	100,0	104,2	106,9	103,6	110,3	103,7	112,3	103,4	114,8	103,2	118,6	103,1	120,5

Sources: 'Newsflashes' Green Europe.

⁽¹⁾ Common prices in ECU (intervention or equivalent) weighted by agricultural production.

⁽²⁾ Common prices in ECU converted into national currencies (n.c.) at green rates resulting from the annual price decisions, taking into account the incidence on prices expressed in national currencies of adjustments in green rates since the previous price decisions.

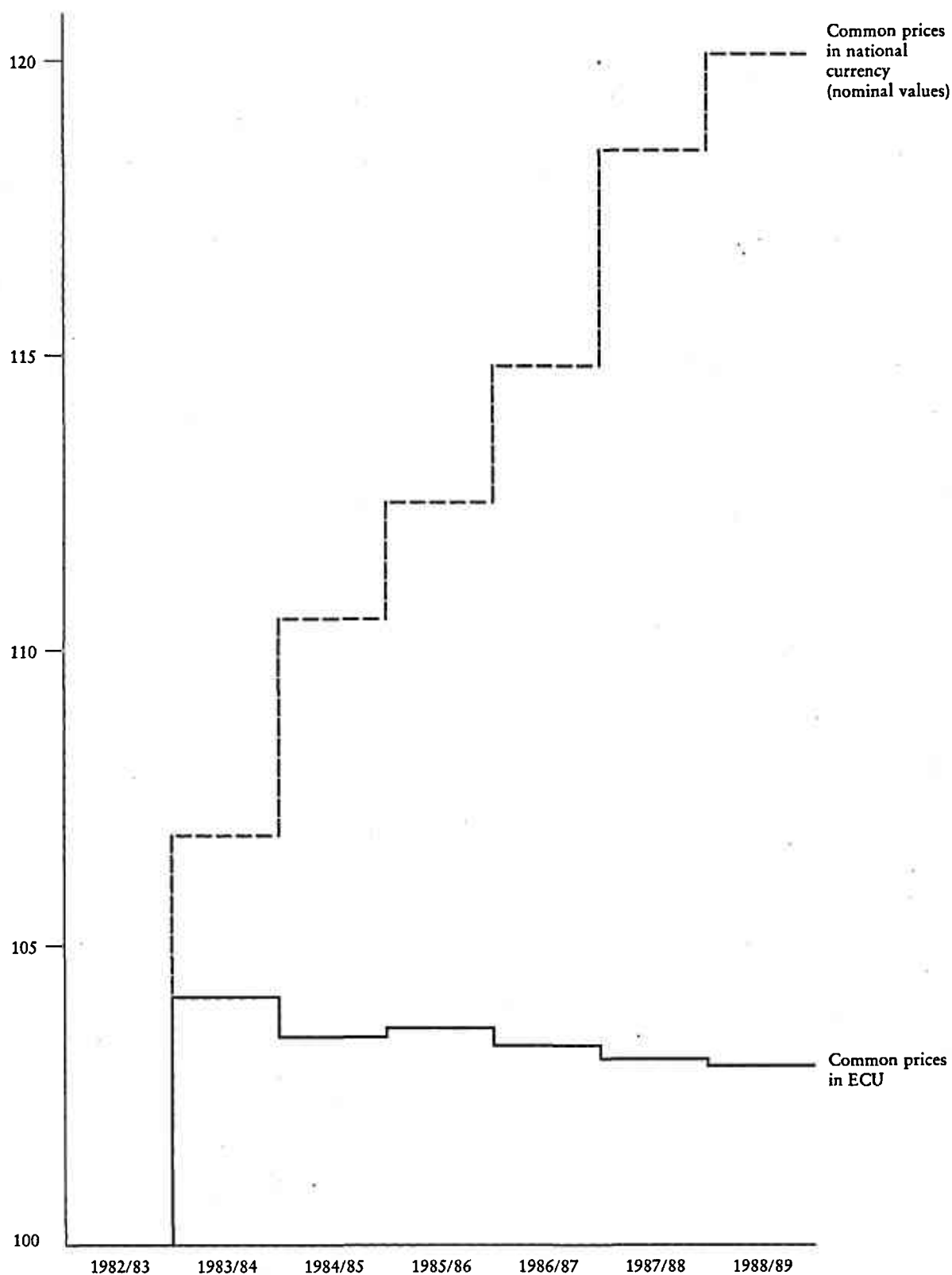
⁽³⁾ Including incidence of the adjustment of national prices on common prices following measures connected with adhesion.

Figure 2: Index of changes in intervention prices in ECU and in national currency for the marketing years 1982/83-1988/89

All agricultural products, EUR 10

Source: Table 2

(1982/83 = 100)



common price, increasing farm income: this would normally lead to greater investment and output in agriculture than would have been the case at market rates. The converse is true for countries with depreciating currencies if green rates are kept below the market rate. If, as a result, production is stimulated in higher cost parts of the Community, and depressed in lower cost areas, regional disparities are exacerbated and the Community pays an unnecessarily high price for its food production;

- (b) the system of MCA's permits unequal treatment of agricultural sectors in different Member States because it only applies to some agricultural inputs. Devaluation causes production costs to rise as non-agricultural import prices rise and labour costs tend to increase as part of the wage/price spiral, while, conversely revaluation tends to lead to lower production costs: thus, if green rates remain unchanged, returns to agriculture increase in appreciating currency countries and fall in depreciating currency ones, again tending to encourage agricultural resources towards appreciating currency countries with higher price levels;

- (c) if green rates are held constant, agricultural investment and output are favoured vis-à-vis their industrial counterparts in Member States with an appreciating currency, and vice-versa in Member States with a depreciating currency.

3.15. On the other hand, arguments based on the working of a free market economy are of uncertain relevance in the context of the CAP where prices are centrally determined and the intervention system gives all producers equal assurance of outlets irrespective of the level of prices in national currency terms and of the supply/demand situation in the Community. The Court has reviewed the Commission and academic literature which is available in order to try to assess the impact of the agrimonetary system on the structure of agricultural production in the Community. Apparently little has been done to evaluate the impact of such a fundamental element in the functioning of the market organizations. Although the Commission has issued four reports, in 1978, 1979, 1984 and 1987 ⁽¹⁾, on the economic effects of the

agrimonetary system, these comprise no more than series of official statistics on each market, with analytical commentary. In the 1978 and 1979 reports the Commission interpreted the statistics as showing that Member States with positive MCA's were attracting resources into agriculture and increasing their share of final agricultural production at the expense of Member States with negative monetary gaps. These findings, however, have been disputed ⁽²⁾, and the more recent reports have been less emphatic.

3.16. The explanation for this state of affairs obtained from officials in the Member States visited was that the agrimonetary system is only one of many factors affecting developments in Community agriculture, and it is very difficult if not impossible, to isolate the agrimonetary impacts from all other factors. The Court recognizes this, but, nonetheless, considers that greater efforts should have been made by the Commission to gather evidence which would either support or reject the theoretical hypotheses regarding the economic impact on the common market organizations.

4. THE SWITCHOVER MECHANISM

Rationale for switchover

4.1. The switchover mechanism was introduced in 1984 as a means of overcoming the difficulty of dismantling positive MCA's during a period when price increases in ECU were severely restrained. Certainly, the mechanism has prevented the creation of new positive MCA's for the fixed rate currencies, and the preexisting positive MCA's of FR of Germany and the Netherlands have been dismantled. This achievement, however, has been at the price of:

- (a) additional conceptual complexity, with the creation in the green ECU of an artificial set of exchange values;
- (b) hidden increases in the common level of prices.

Artificial exchange values

4.2. The creation of the green ECU, by multiplying the central rates of each currency against the ECU by the

⁽¹⁾ Doc. COM(78) 20 final of 10 February 1978, doc. COM(79) 11 final of 14 March 1979, doc. COM(84) 95 final of 26 April 1984, and doc. COM(87) 168 final of 14 August 1987.

⁽²⁾ See, for example 'The Economic Effects of Monetary Compensatory Amounts' by R. Strauss, Journal of Common Market Studies, Vol. XXI No 3, March 1983.

correcting factor means that a wholly notional set of exchange values is created in addition to the preferential green rates used to convert the common ECU farm prices into national currencies.

4.3. Under the pre-switchover system the objective of dismantling monetary gaps was synonymous with bringing green rates into line with market rates. With the introduction of the correcting factor, the short term objective has been shifted to dismantling the monetary gaps between the green rates and the artificial green central rates. For example, in situation 5 of *Figure 1*, dismantling the monetary gaps would mean $2,34113 \text{ DM} = 7,85183 \text{ FF} = 1 \text{ ECU (green)}$ rather than $2,05853 \text{ DM} = 6,90403 \text{ FF} = 1 \text{ ECU}$, which are the EMS central rates. Thus, if at some time in the future all the gaps have been removed, the green rates will still not be aligned with real exchange rates. A further conversion will be needed to achieve this, involving a decision by the Council to remove the correcting factor. To do this, all the green rates will have to be revalued by the correcting factor. Unless, however, the Community is willing to accept a reduction in the amounts received by beneficiaries in national currencies, i.e. to abandon the 'Gentlemen's Agreement' of 1979, it will be necessary to increase the common prices in ECU. At this point, the increase in the common price level caused by the switchover mechanism, and largely hidden at the present time, will become apparent. In the following paragraphs the impact of the correcting factor on the common price level is analysed.

Impact of correcting factor on common price level

4.4. The revaluation of the ECU for agricultural purposes, i.e. the green ECU, which results from multiplying the ECU by the correcting factor means that the level of common agricultural prices is effectively increased. The green ECU does not affect intervention prices in national currency, which continue to be expressed in terms of unchanged green rates against the real ECU. However, the differences in the common price level in national currencies are measured by the positive and negative monetary gaps either side of the common price level in ECU. If the dividing line is raised, as it is by the application of the correcting factor, then the common price level is raised. This can be seen from *Figure 1*. Taking the position at situation 3, if the positive MCA of 7,8 points and the negative MCA of 9,5 points are dismantled, the common price level between the FF and the DM will be at 1 ECU (green) = $2,31728 \text{ DM} = 7,10590 \text{ FF}$, which is 3,37 % higher than the central rate relationship (1 ECU = $2,24184 \text{ DM} = 6,87456 \text{ FF}$). Thus, after a realignment involving an increase in the correcting

factor and thereby a raising of the common price level, the effects of the higher price level feed through as green rates are progressively devalued afterwards.

4.5. As it is the DM which has remained the strongest currency, and which has been revalued the most within the EMS, in practice the new method of calculation means that the evolution of the green ECU central rate is tied to the evolution of the central rate of the DM against the ECU. At each revaluation of the DM, the level of common agricultural prices has been increased. At the beginning of 1988 the cumulative effect of these revaluations was that the level of common prices had been raised in this way by 13,7 % since April 1984. Thus, the green ECU is 13,7 % higher than the real ECU, and at each realignment the ECU for agricultural purposes diverges more and more from the real ECU.

4.6. Raising the common level of prices in this way has the following consequences:

- (a) the correcting factor provides for automatic increases in the common price level each time there is a realignment involving a revaluation of the DM against the real ECU; increases in the price level are tied to the appreciation of DM, which reflects the strength of the industrial economy of the FR of Germany rather than the requirements of Community agriculture;
- (b) these automatic increases in the common price level are divorced from the normal annual price fixing procedures for the agricultural markets;
- (c) increasing the common price level in this way rather than by overt political agreement to raise prices in ECU means that the increases are largely hidden: the ECU prices agreed in the annual price fixing no longer reflect the real level of common prices.

4.7. The switchover mechanism is a technical device which has enabled positive MCA's to be dismantled while at the same time maintaining the appearance of a restrictive common price policy. In reality, however, it has not enabled positive MCA's to be dismantled without any increases in common prices, indeed its operation is entirely consistent with the 1979 Gentlemen's Agreement: the majority of the reductions in positive MCA's have been compensated for by increases in the common price level ⁽¹⁾. As shown in paragraphs 4.2 — 4.3, this will become fully apparent when all the monetary gaps have been removed and it becomes necessary to realign green rates with market

⁽¹⁾ Some of the reductions in positive MCA's have been compensated for by other forms of compensatory aid, to avoid adverse effects on agricultural incomes.

rates, and raise ECU prices to preserve the values in national currencies of those ECU prices. The Court considers, therefore, that a major consequence of the switchover has been that real developments in common agricultural prices have been obscured.

4.8. In chapter 6 of this report, the budgetary impact of the increase in the common price level caused by the correcting factor is assessed (paragraphs 6.14 — 6.20).

5. THE CALCULATION AND APPLICATION OF MCA'S

Introduction

5.1. In order to assess whether the MCA's themselves are neutral in their impact on the sound management of the common market organizations, it is necessary to examine whether the manner in which MCA's are calculated and applied correspond to the objectives of monetary compensation, as set out in paragraph 1.4 above. In summary, the MCA's as applied should enable the market organizations, and their intervention systems in particular, to function without distortion or discrimination and should not impede trading flows.

Basis of calculation of MCA's

5.2. The principle underlying the application of MCA's is that all trade into or out of a Member State should take place at a common price level. The level chosen is the one at which the intervention system supports the market. The starting point for the calculation of MCA's, therefore, is the intervention price. In the case of the beefmeat market, market prices have been below the intervention price over a long period, so in 1984 it was decided to use 85 % of the intervention price for calculating MCA's. Since 1987 there have been changes to the intervention arrangements in the beefmeat, milk and cereals markets resulting in price levels below the intervention prices being supported. Accordingly, there has been a downward adjustment of the intervention price base used for the calculation of MCA's in these markets.

5.3. *Table 1* sets out the bases of calculation used, as at the beginning of 1988. Various other adjustments are applied in some sectors (e.g. the processing costs allowances included in skimmed milk powder and butter

intervention prices are excluded when calculating MCA's for other milk products).

5.4. For products derived from the base products, standardized technical yield coefficients are applied. These are in many cases the same as the coefficients used for import levy purposes, but in the case of certain cereals (maize and products derived therefrom) special coefficients have been developed following rulings by the Court of Justice that the import levy coefficients resulted in overcompensation, and threatened trade distortion.

5.5. The system for the calculation of MCA's is necessarily a flat rate one. In most cases, where the level of market prices is directly related to the price level supported by the intervention system, basing the MCA calculation on the intervention price, adjusted to reflect the actual price support level, works reasonably well and does not in general terms lead to market distortions. Further, it seems that, at least at present, the technical coefficients used in respect of derived products are not causing difficulties. This does not necessarily mean that the coefficients are correct in every case, but operators recognize the need for a standardized system and are reluctant to contest the coefficients applied by the Commission unless serious anomalies are perceived.

5.6. However, problems have arisen where the influence of the intervention system on market prices is limited, and where market developments are affected by factors other than the system of market support. One of the most problematic sectors in this regard has been the pigmeat sector.

MCA's in the pigmeat sector

5.7. The basis for the calculation of pigmeat MCA's has changed several times, coming down from 92 % of the basic price in 1971 to 35 % of the basic price in 1987. In addition, it was decided in June 1987 that there should be no further increases in pigmeat MCA's, and to achieve this the Commission was authorized to adapt the green rates as necessary. To avoid distortions of trade this only applies so long as the difference between the cereals and pigmeat monetary gaps is 8 % or less. Following the price decisions for 1988/89, as a result of this policy, pigmeat MCA's were zero in all Member States except Greece, Ireland, Italy and the United Kingdom.

5.8. The argument that has prevailed is that pressed most vigorously by the French authorities as they sought to reduce, indeed eliminate MCA's in this sector. This is that pigmeat should not be treated as a base product, but as a product derived from cereals. MCA's therefore, should compensate only for the cereals component in pigmeat production. The origins of the problems in this sector are, however, structural. Pigmeat production in the Netherlands, Northern Germany and Flanders is intensive, with low unit costs of production based on a high use of cheap cereal substitutes (soya, tapioca) imported through Rotterdam and Hamburg, and which do not attract MCA's. French pigmeat production is concentrated in the North West (Brittany), which is further from the main French markets than are the main Dutch and Belgian production areas, and uses a higher proportion of cereals in the pig ration. The comparative advantage of the Dutch, German and Belgian producers was seen to be strengthened further by the agrimonetary system as both the Netherlands and the FR of Germany had positive MCA's (granted on export) and Belgian negative MCA's were lower than French ones. Although the evidence was not conclusive that the level of MCA's generated by treating pigmeat as a base product was the cause of the French pigmeat industry's difficulties in the 1980's, it was agreed to reduce MCA's by basing the calculation on a standardized cereals component. The 35 % of the basic price currently used reflects this.

5.9. This solution, however, cannot be said to result in a neutral level of MCA's because of the wide variation in the proportion of cereals used in pigfeedingsuffs from Member State to Member State. It has been estimated (1) that in 1983 cereals accounted for 37,2 % of the cost of production of pigmeat in Denmark, 28,3 % in France, 11,7 % in the FR of Germany, and 8,4 % in the Netherlands. Commission data (2) shows that the use of cereals in the production of compound feedingsuffs (for all animals) in 1985 was 46,8 % in France, 24,6 % in FR of Germany, and 15,2 % in the Netherlands.

5.10. The decisions of the Council of June 1987 to avoid any new pigmeat MCA's by adapting pigmeat green rates so long as the difference between cereals and pigmeat monetary gaps is 8 % or less is another attempt to maintain the competitive position of the pigmeat producers using a higher level of cereals in their feed.

5.11. The example of the pigmeat sector illustrates the difficulty of applying satisfactorily the MCA system where the market is not determined by a strong intervention system. Neither the solution of treating pigmeat as a base product, nor that of treating it as a product derived from cereals provides a suitable formula, given the structural developments in the industry. The de facto policy pursued in recent years, in line with the interests of pigmeat producers with depreciating currencies, has been the complete elimination of MCA's on pigmeat.

Neutral Margins

5.12. The MCA's that are calculated are reduced by a flat rate amount known as the neutral margin. This means that the monetary gap between Member States is not fully covered. Between two Member States, one with positive and the other with negative MCA's, the neutral margins are cumulative. The purpose of the neutral margins is to avoid any overcompensation in the calculation of MCA's, although their flat rate nature makes this a rather approximate way of achieving this. The Commission in 1987 sought a more flexible approach, with wider neutral margins in those sectors where the impact of the intervention system on the market was reduced. It saw this as a step towards further gradual dismantling of the system. However, although the Council agreed to wider neutral margins in certain specific sectors where it was considered artificial trade flows would not result (e.g. olive oil), Member States were not ready to devolve the general power of Council to decide the level of neutral margins to the Commission.

5.13. The Court has examined a number of situations to see whether the existence of neutral margins (and thus of uncovered monetary gaps) has encouraged artificial trade flows. While there seems to be no real evidence that the neutral margins result systematically in such flows, there are particular cases which illustrate the extent of the problem. A recent example concerns the marked increase in expenditure on export refunds in the Netherlands. *Table 3* shows that in the cereals, sugar and milk and milk product sectors there was a very large increase in export refunds paid by the Dutch paying agencies during the first six months of 1988 compared with the first six months of 1987. At the same time export refunds paid by France for cereals and milk products, and by Belgium for cereals and sugar, fell significantly. Although there has always been a tendency for exports to be directed through strong currency Member States, the 1988 increases were exceptional. The Dutch authorities observed a considerable increase in the export refunds paid to firms established outside the

(1) Quoted in 'Distorsions de Concurrence dues à la PAC', J. Courgeon et L.P. Mahé, *Economie Rurale* No 173, 1986.

(2) Table 4.13.7.5, *The Agricultural Situation in the Community*, Report 1987.

Table 3: Average Monthly Expenditure ⁽¹⁾ on Export Refunds for first 6 months of 1986, 1987 and 1988: Cereals, Sugar and Milk Products

Member State	January-June (incl.)	Cereals ⁽²⁾		Sugar ⁽³⁾		Milk + Milk Products ⁽⁴⁾	
		n.c. (Mio)	% change	n.c. (Mio)	% change	n.c. (Mio)	% change
Netherlands	1986	12,1	—	9,3	—	133,8	—
n.c. = HFL	1987	41,1	+ 239,7	41,5	+ 346,2	239,2	+ 78,8
	1988	106,6	+ 159,4	122,7	+ 195,7	342,4	+ 43,1
France	1986	545,8	—	227,6	—	177,6	—
n.c. = FF	1987	1 272,0	+ 133	232,9	+ 2,3	230,2	+ 29,6
	1988	905,2	- 29	267,4	+ 14,8	191,7	- 16,7
Belgium	1986	571,0	—	1 359,9	—	96,2	—
n.c. = BFR	1987	712,2	+ 24,7	638,6	- 53,1	134,2	+ 39,5
	1988	558,4	- 21,6	477,9	- 25,2	154,2	+ 14,9

⁽¹⁾ Source: Member States' Monthly Declarations of Expenditure to EAGGF.

⁽²⁾ Budget Items 1000, 1001, 1002, 1003.

⁽³⁾ Budget Item 1100.

⁽⁴⁾ Budget Items 2000, 2001, 2002, 2003.

Netherlands and without subsidiaries in the Netherlands: for the period January to April 1988 60 % of export refunds in the sugar sector paid by Dutch intervention agencies were to such firms, whereas in 1987 the percentage was only 7 %.

5.14. A particular traffic that has been observed involves loading goods at Antwerp in Belgium, sailing them along the Scheldt to Vlissingen, where they are declared and cleared for export, thus obtaining the export refunds in HFL. Another involves ships loading at Dunkirk in France and sailing to Vlissingen for export clearance. Among the reasons for this are that:

- (a) both French and Belgian firms could obtain an increase of 3 %-3,5 % in export refunds in national currency by exporting through the Netherlands. This is shown in *Annex VI* in respect of cereals exports for June 1988. The advantage was slightly greater in respect of milk products, and slightly less in respect of sugar;
- (b) Dutch paying agencies pay export refunds more quickly than paying agencies in other Member States, which means that exporters face lower financing costs exporting through the Netherlands.

5.15. Traders who export to third countries through the Netherlands in this way are taking advantage of an uncovered monetary gap made up of the following:

- (a) the neutral margin for the two countries in question, added together: in the case of cereals, 0,9 points of the 1,0 point neutral margin for Netherlands remaining uncovered plus 1,5 points for France (total 2,4 points), and plus 0,5 of the 1,5 points for Belgium (total 1,4 points);
- (b) additional parts of the monetary gap not covered by MCA's because of rounding and application of the non-cumulation rule (see Annex III): in the case of cereals there is no more than the 0,029 points of rounding in respect of France: for milk products, however, an additional 0,385 points were uncovered in the Netherlands by virtue of the non-cumulation rule;
- (c) additional parts of the monetary gap caused by the extent of the actual divergence of market rates of exchange as compared with the central rates: in this case 0,9 points between the Netherlands and France, and 1,7 points between the Netherlands and Belgium: this is a consequence of the EMS, rather than the agrimonetary system.

5.16. The Court considers that it is unsatisfactory that the rates applied in the agrimonetary system should in any

way encourage triangular traffic of this kind. Further, the Court has some doubts about the legality of the procedures adopted by traders to obtain export refunds in this way, and is examining this aspect further in its audit of export refunds. It is, therefore, important that action is taken when such situations are identified to modify the rates and remove the opportunity. An important step towards this would be the revaluation of the Dutch green rates for the products in question to remove the uncovered monetary gaps. Although the 1988/89 prices package included a 1,0 point revaluation of the dairy products green rate from 25 July 1988, no other decisions were taken which would affect the uncovered monetary gaps.

5.17. An important consequence of this is that the export refunds paid in the Netherlands cost the Community budget more than if they were paid in France or Belgium. This is explained in chapter 6, paragraphs 6.19 — 6.20.

5.18. The Court has also examined whether similar factors explain the very large flow of skimmed milk powder into German intervention stores from other Member States particularly in 1986. However, it appears that other factors ⁽¹⁾ provide the main explanation of this, particularly the fact that the cost of prefinancing products put into intervention were lower in the FR of Germany.

5.19. The Court concludes, therefore, that the absence of systematic distortion indicates that the departure from the principles of monetary compensation that the neutral margins constitute can be justified. However, the fact that specific cases of artificial trade flows do occur as a result means that the Commission and Member States need to act promptly when they are identified.

5.20. The case referred to in paragraphs 5.13 — 5.17 highlights a specific problem with the neutral margins which becomes more significant with the tendency to increase them for certain products, namely that it becomes possible to dismantle the MCA's but still be left with a gap between the green and market or central rates. It is necessary, therefore, to ensure that the dismantling process deals with the real monetary gap, and not just the applied gap.

⁽¹⁾ These include monetary (rather than agrimonetary) factors. In addition, Dutch operators could sell fresh SMP into intervention in FR of Germany, and buy a return load of old intervention SMP being disposed of at a very low price for compounding into pig feed under Commission Regulations (EEC) No 368/77 and 443/77.

Processed Products

5.21. MCA's are applied on a range of processed goods containing combinations of milk and milk products, sugar and cereals (known as the Non-Annex II products as they are not specified in Annex II of the EEC Treaty). These products include such items as biscuits, confectionary. The MCA's are calculated on the basis of the MCA's applicable for the base products incorporated in the final products, less 10 %. Flat rate quantities of the base products are used for this.

5.22. A large number of products are covered by this regulation, with varying proportions of the value of the final product accounted for by the base products. In accordance with the principle that MCA's should only be applied if they have an economic impact, various attempts have been made to fix thresholds below which MCA's are not applied. Since June 1987 MCA's of a value not exceeding 3 ECU/100 kg are not applied. While this provision is an improvement on previous arrangements, which were excessively complex and arbitrary in their effects, it can be questioned whether the threshold is high enough. The competitive market situation facing highly processed products with substantial value added is not affected significantly by the agrimonetary situation of the base products incorporated in them. MCA's should only be applied where it can be shown that their absence would lead to trade distortion. The administrative arrangements in respect of MCA's for processed products are particularly burdensome, and should be avoided whenever possible.

Absence of MCA's in certain sectors

5.23. As noted in paragraph 2.7 above, MCA's are not applied in all sectors despite the existence of green rates. According to the principles underlying the system, this should be because there are no dangers of disruption either to the market support arrangements or to trade. This is considered below in respect of two sectors, rice and sheepmeat.

Rice

5.24. In its 1978, 1980 and 1985 annual reports ⁽²⁾ the Court drew attention to the problem of triangular trade in rice occurring as a result of the absence of MCA's in the rice

⁽²⁾ Point 2.36, Annual Report concerning the financial year 1978, OJ No C 326, 31. 12. 1979; points 3.18 — 3.22, Annual Report concerning the financial year 1980, OJ No C 344, 31. 12. 1981; point 3.35 — 3.39, Annual Report concerning the financial year 1985, OJ No C 321, 15. 12. 1986.

sector. The Court identified shipments of rice from third countries entering the Community in Member States where the import levy was low because of an overvalued green rate, and then reexported immediately to the real destination in other Member States. As a result, own resources were lost (estimated at 1,5 Mio ECU in 1984 and 2,0 Mio ECU in 1985).

5.25. Despite the clear evidence of this traffic — it was sufficiently striking to appear clearly in the official statistics of the Community — the Commission and Member States resisted taking action until 1986. Then the depreciation of the UKL and the opening up of a wide negative monetary gap meant that large quantities of rice for the FR of Germany and the Netherlands flowed through the United Kingdom. Imports of long grain husked rice from the United Kingdom increased from 77 tonnes in 1985 to 27 262 tonnes in 1986 in respect of the FR of Germany, and from 20 tonnes to 30 636 tonnes in respect of the Netherlands. The Court estimates the loss of own resources involved at 3,7 Mio ECU. When action finally was taken, interestingly, it did not take the form of the introduction of MCA's. Instead, a special conversion rate virtually equivalent to the market rate has been introduced for the purposes of calculating the rice levies. This means that there is no longer a monetary gap left uncovered.

Sheepmeat

5.26. Sheepmeat is covered by intervention arrangements ⁽¹⁾, and in principle MCA's may be applied. In practice, however, whatever the inconveniences caused by currency fluctuations and particularly by the United Kingdom's shift from a positive monetary gap to a negative one, they have not been sufficiently persuasive to bring about the application of MCA's in this sector.

5.27. Sheepmeat production is concentrated in France, Ireland and the United Kingdom, with the main intra-Community trade flows from Ireland and the United Kingdom to France. While the United Kingdom had a positive monetary gap the absence of MCA's reduced the competitive position of exports to France, but the opening

up of a substantial negative gap since 1986 resulted in United Kingdom exports putting pressure on the French market. This has been dealt with by other measures, especially the 'clawback' arrangements on exports of certain types of British sheepmeat, rather than by the introduction of MCA's.

Complexity of the MCA system

5.28. The Commission has itself acknowledged ⁽²⁾ that the system has become exceptionnally complex, and that changes have 'increasingly robbed it of all transparency'. The question of complexity can be considered at a number of levels, i.e. conceptual complexity, complexity in the rules for calculating MCA's, complexity in the day-to-day application of the system with its large number of individual rates and tariff headings, procedural and control requirements.

5.29. Conceptually, the system as it has developed has become more complex, and the introduction of the switchover with the correcting coefficient and the green ECU means that very few people other than the specialists in the Commission, the Member States' administrations and in commerce understand what the system now involves. As paragraphs 4.4 — 4.7 show, the lack of transparency in respect of the system of the common level of prices is a major criticism in this regard.

5.30. Also, the detailed rules for calculation the MCA's and for dealing with dismantling MCA's under the June 1987 agreement are complex, and it requires a degree of expertise and application to master them. The importance of doing this, however, is shown by the number of organizations — government departments, trade bodies, trading concerns — which operate their own computer models to 'shadow' the official calculations of the Commission, notably of the weekly changes in variable MCA rates. The problem of complexity at this level should not be overemphasized: few people need to know the fine details of how calculations are carried out, for most people affected by the system it is sufficient to know how to apply the results.

⁽¹⁾ Article 7 of Council Regulation (EEC) No 1837/80 of 27 June 1980, OJ No L 183, 16. 7. 1980.

⁽²⁾ Page 25 'Report on the Agrimonetary System', doc. COM(87) 64 final of 27 February 1987, p. 25.

5.31. At the level of complexity in day-to-day application, it is true that there are thousands of rates, and for the smaller, occasional trader it is difficult to apply the system. It is not, however, clear that the system is more complex than other EC agricultural measures, and, as the system is ideally suited to computerization in some respects it is straightforward to apply. The control requirements are no more severe than the usual physical and administrative controls on agricultural trade, of which they form a part.

5.32. In overall terms, however, it must be recognized that the agrimonetary system is obscure, complex, and difficult to understand. This is inevitable, once the decision to have monetary compensation is taken, but it is unsatisfactory that Community arrangements for the management of the common market organizations should involve this degree of complexity. Also, the greater the complexity, the more likely it is that errors will be made and that attempts will be made to manipulate the arrangements, with consequent financial loss to the Community (see for example the case of rice imports considered in paragraphs 5.18 — 5.19).

Frauds and irregularities

5.33. Frauds and irregularities involving MCA's can occur both in intra-Community and third country trade. In the case of third country trade, however, it is normally the export refund or import levy which is the prime reason for the fraud or irregularity, the MCA element being merely incidental. This section, therefore, is concerned with frauds and irregularities in intra-Community trade only.

5.34. *Table 4* sets out the number of cases of frauds or irregularities involving MCA's in intra-Community trade reported by Member States under Council Regulation (EEC) No 283/72 ⁽¹⁾. These 142 cases involve an estimated 11,5 Mio ECU. At the beginning of September 1988, 95 of these cases were considered as closed, and 1,5 Mio ECU (13 % of the total amount involved) had been recovered.

5.35. The table shows that 58 of the 142 cases reported concern the United Kingdom. Nearly all of these cases concern problems on the border between Northern Ireland and Ireland. In 1980 and 1981 when the United Kingdom

had high positive MCA's, pigs and cattle were smuggled across the border to Northern Ireland to avoid the MCA payable on import, and then legally exported back to Ireland, thus qualifying for the MCA payment. In some cases the animals repeated the journey several times. This 'carousel' arrangement was stopped when improved controls were introduced, but also because the smuggling became no longer worthwhile as the monetary gaps between the United Kingdom and Ireland diminished. Subsequently, in 1986, the pound sterling depreciated substantially, leading to a large negative gap, with significant disparities in MCA's between the two countries. Cattle reared in Northern Ireland were smuggled across the border to avoid paying the MCA on import, were slaughtered in Ireland and the meat then exported legally to the United Kingdom mainland where it attracted a large MCA payment. This illegal trade was estimated ⁽²⁾ to have netted in excess of UKL 100 (150-160 ECU) per head of cattle, paid from the Community budget. In order to stop this trade, special task forces were established in November 1986 by the United Kingdom and Ireland customs authorities to police the border in an attempt to prevent the smuggling. Although there has been a reduction in the cases reported, it is unlikely that this traffic has completely stopped, given the difficult security problems on the border and the continuing existence of monetary gaps between the two countries. The Court's investigations, however, indicate that the Irish and British authorities are taking all reasonable steps to prevent irregular traffic.

5.36. The above problem is the most extreme example of the type of fraud that is encouraged by the existence of large agrimonetary disparities on either side of a border across which there is a great deal of commerce, and close economic integration. As long as such disparities exist, it is inevitable that there will be a degree of fraud, probably only the most blatant of which will be detected.

6. THE BUDGETARY IMPACT OF GREEN RATES AND MCA'S

Introduction

6.1. For an instrument of policy which occupies such a central place in the functioning of the common agricultural policy it is important that the budget and accounts present

⁽²⁾ P. 12 'External Trade Measures for Agricultural Produce'. Report by the Comptroller and Auditor General, UK National Audit Office, 22 January 1988.

⁽¹⁾ OJ No L 36, 10. 2. 1972.

Table 4: Frauds and Irregularities reported by Member States,
1980-1987
Intra-EEC trade MCA's

Member States	Number of cases								Total
	1980	1981	1982	1983	1984	1985	1986	1987	
Belgium	2	0	1	1	0	2	1	0	7
Denmark	3	0	1	0	0	0	2	1	7
FR of Germany	10	4	3	3	3	10	2	0	35
France	3	5	4	0	3	1	3	0	19
Greece	0	0	0	0	0	0	0	0	0
Ireland	0	0	0	1	0	0	0	0	1
Italy	0	0	0	0	0	0	0	0	0
Luxembourg	0	0	0	0	0	0	0	0	0
Netherlands	8	1	0	1	2	2	0	1	15
United Kingdom	17	12	8	3	8	9	1	0	58
Total EUR 10	43	22	17	9	16	24	9	2	142

Source: Commission of the European Communities.

a clear and comprehensive picture of the budgetary impact of the agrimonetary system as a whole. Also, the meaning of data in the accounts should be clear and unambiguous so that they can be interpreted readily without misunderstanding. This is not, however, the case at present:

- (a) the amounts recorded in chapter 28 of the general budget, which is the only part of the budget where the effect of MCA's is specifically identified, cover only part of the direct budgetary cost: in particular, the impact of MCA's on import levies and export refunds is not specifically identified in any budget lines;
- (b) the budgetary impact resulting from the use of the green rates when payments are made from the budget (or agricultural revenue is received), and the use of market rates when amounts are recorded in the budget is hidden: in addition to the lack of transparency that this involves, it makes the interpretation of accounting data difficult.

In the following sections the Court presents the results of an evaluation of the full budgetary impact, direct and indirect, of the agrimonetary system. The budgetary cost of the switchover mechanism is also analysed.

Direct budgetary impact, MCA's

6.2. *Table 5* sets out a classification of the direct budgetary impact of MCA's, identifies where the amounts concerned are recorded in the budget, and indicates whether they can be identified separately from the accounts. This shows that the only data on the direct budgetary costs of MCA's that are separately identified are those presented in chapter 28 of the general budget, and that these present a partial picture only. MCA's on intracommunity trade are shown in full, but those on trade with third countries are almost entirely hidden.

6.3. Following the publication of the Court's opinion of July 1980 ⁽¹⁾ concerning MCA's, a change in budgetary nomenclature was made by the Commission to try to show more clearly the full budgetary impact of MCA's, but this did not go far enough, and failed to take into account some of the key parts of the Court's opinion. Thus, as *Table 5* shows, all MCA's which affect import levies are recorded as part of those levies in chapter 10 of the revenue budget. This covers positive MCA's which are added to the levy, as

⁽¹⁾ Opinion of the Court of Auditors on a proposal for a Council regulation concerning MCA's, OJ No C 165, 5. 7. 1980.

Table 5: Direct Budgetary Impact of MCA's shown in the Accounts

	Impact	Recorded in Accounts	Gross Amounts Identified
A. Intra Community Trade			
1. Member States with appreciated currency (positive MCA's)			
1.1. MCA's paid on exports	expenditure	items 2803	yes
1.2. MCA's levied on imports	revenue (negative expenditure)	items 2802	yes
2. Member States with depreciated currency (negative MCA's)			
2.1. MCA's paid on imports	expenditure	item 2800 item 2801	yes yes
2.2. MCA's levied on exports	revenue	item 2804	yes
B. Extra Community Trade			
1. Member States with appreciated currency (positive MCA's)			
1.1. MCA paid on exports	expenditure	item 2811	yes
1.2. MCA levied on imports	revenue	Article 100, Agricultural levies	no
2. Member States with depreciated currency (negative MCA's)			
2.1. MCA's paid on imports: MCA less than import levy	expenditure	reduced levy recorded in Article 100	no
2.2. MCA's paid on imports: MCA greater than import levy	expenditure	levy amount cancelled, nothing entered in Article 100. Excess of MCA over levy recorded under item 2810	no
2.3. MCA's levied on exports: MCA less than export refund	revenue	reduced refund recorded on refund budget line	no
2.4. MCA's levied on exports: MCA greater than export refund	revenue	export refund cancelled, nothing recorded on refund budget line. Excess of MCA over refund recorded in Article 100, agricultural levies	no

in the case of the FR of Germany, for example, and negative MCA's which reduce the amount of levy, as in the case of Greece, for example. The only exception to this is where the negative MCA deducted from the import levy is greater than the levy itself, so that a net grant of MCA is made to the importer. This item of net expenditure is recorded in budget item 2810, and nothing is recorded under import levies. Accounting for MCA's and import levies in this way is unsatisfactory, as it means that a substantial part of the impact of MCA's is not known, and, further, that the data available on import levies does not show the gross revenue from them.

6.4. Secondly, negative MCA's charged on exports from Member States with depreciated currencies, and which reduce the export refund, are also not accounted for separately: the net export refund, less the MCA charged, is recorded for each market sector in the appropriate chapter

of the EAGGF budget. If the MCA is greater than the refund, nothing is recorded as a refund, and the net excess is entered in chapter 10 as an agricultural levy. This is not consistent with the practice whereby positive MCA's added to export refunds in respect of Member States with appreciated currencies are declared separately from the refunds, in item 2811. Thus not only is another important part of the budgetary impact of MCA's not identified in the budget, but also the full cost of export refunds is not shown.

6.5. The Court has tried to estimate the full direct budgetary cost of MCA's including:

- (a) those amounts recorded in the annual accounts under chapter 28;

(b) MCA's deducted from export refunds;

MCA's deducted from export refunds

(c) MCA's added to and deducted from import levies.

Amounts recorded in the annual accounts

6.6. Table 6 shows the amounts recorded in the annual accounts under chapter 28 for the period 1983 to 1987. This table shows that in 1987 gross expenditure was 1300,9 Mio ECU, offset by 'negative expenditure' — i.e. revenue — from MCA receipts of 664,0 Mio ECU, leaving a balance of 636,9 Mio ECU. Taking MCA's in intra-community trade only, which is the only complete part of the budgetary cost of MCA's shown, gross expenditure was 1073,9 Mio ECU, offset by revenue of 664,0 Mio ECU, leaving a balance of 409,9 Mio ECU net expenditure.

6.7. The table shows that individual budget items and the net totals fluctuate considerably from year to year, depending on the size of the monetary gaps. For example, the fall in net expenditure in 1984 and 1985 reflects the degree of success in dismantling MCA's after the introduction of the switchover, but in 1986 and 1987 there was a period of relative monetary instability resulting in wider negative monetary gaps, which is reflected in the amounts recorded in the accounts.

6.8. As far as the budgetary impact of MCA's deducted from export refunds is concerned, no data is available at Commission level on the actual amounts involved, because the current accounting instruction from the Commission requires Member States to declare refunds net of MCA's. During its mission to the United Kingdom and France the Court established that the intervention agencies have gross data, i.e. the full export refund separate from the MCA amount, more or less readily available in their internal accounting systems, and that it would be possible without any great administrative difficulty to declare the gross data. For the Court's examination, however, it was not feasible to assemble all the gross data from each Member State, so an alternative estimate has been made, based on the Commission's budgetary preparation work. For each market in which MCA's are applied, the Commission estimates an amount by which the forecasts of export refunds should be reduced. This is done using historical data on actual trade flows, combined with the latest agrimonetary and monetary parameters. In the last estimate for the 1987 budget, prepared by the Commission's services at the end of August 1987 ⁽¹⁾, the estimated amount by which export refunds should be reduced was 216 Mio ECU. For the 1988 budget, the estimated amount was 111 Mio ECU ⁽²⁾.

⁽¹⁾ Commission internal working document of 31 August 1987.

⁽²⁾ Commission working document VI/302/87 of 22 December 1987.

Table 6: MCA's Recorded in the Accounts, 1983 to 1987

Budget item	(Mio ECU)				
	1983	1984	1985	1986	1987
280 MCA's on Intra Community Trade					
2800 MCA's on Imports paid by Importing Member State (Depreciating Currency)	174,8	84,5	67,7	269,3	368,7
2801 MCA's on Imports paid by Exporting Member State for Importing Member State (Depreciating Currency)	72,4	25,0	66,3	326,4	551,0
2802 MCA's on Imports levied by Importing Member State (Appreciating Currency)	- 635,3	- 583,2	- 213,9	- 179,7	- 121,8
2803 MCA's on Exports paid by Exporting Member State (Appreciating Currency)	750,9	590,8	213,4	185,9	154,2
2804 MCA's on Exports charged by Exporting Member State (Depreciating Currency)	- 213,8	- 157,7	- 72,3	- 296,0	- 542,2
Subtotal 280	149,0	- 39,6	61,2	305,9	409,9
281 MCA's on Extra Community Trade					
2810 Portion of MCA's granted on Imports (into Member State with Depreciating Currency) Exceeding Import levy	0,5	0,1	4,1	69,4	116,1
2811 MCA's on Exports paid by Exporting Member State (Appreciating Currency)	338,7	415,5	124,3	100,6	110,9
Subtotal 281	339,2	415,5	128,4	170,0	227,0
Total Chapter 28	488,2	375,9	189,8	475,9	636,9

MCA's added to and deducted from import levies

6.9. Again, no data are available in the Commission on the actual amounts of MCA's added to and deducted from import levies by the Member States. The Commission makes an estimate as part of its preliminary draft budget, based on import forecasts, forecasts of average levy rates, and MCA rates that accord with the Commission's proposals for dismantling MCA's. For the 1987 budget the net effect of MCA's added to and subtracted from import levies was forecast at a 36 Mio ECU reduction in levies ⁽¹⁾, for 1988 it was a 57,5 Mio ECU reduction ⁽²⁾.

Indirect budgetary impact of the agrimonetary system

6.10. In addition to the direct budgetary impact of MCA's, there is a cost to the budget resulting from the use of green rates, which give different values to the common prices fixed in ECU when they are converted to national currencies. This is the budgetary impact of having different common price levels in different Member States.

Dual rate coefficient

6.11. This budgetary impact results from the procedure whereby, when an institutional common price amount denoted in ECU is paid from the budget to a beneficiary it is converted into national currency using the green rate, but when it is recorded in the accounts it is reconverted into ECU using a market rate of exchange ⁽³⁾. Thus, for example, in May 1988, in applying the prevailing green rates to 100 ECU of aid for skimmed milk powder for incorporation into animal feed, a beneficiary in FR of Germany received DMs to the equivalent of 115,15 ECU when recorded in the accounts, one in France received FFs to the equivalent of 106,26 ECU, and one in the United

Kingdom received UKL to the equivalent of 99,22 ECU. This is shown in *Annex V*. Thus, in this example, the cost to the budget of the aid paid in FR of Germany is 16 % higher than that paid in the United Kingdom. By the same token, an item of agricultural revenue, such as sugar levies, received in the FR of Germany is worth 16 % more to the budget than the same item in the United Kingdom.

6.12. The budgetary impact of having different price levels in each Member State can be represented by the 'dual rate coefficient', which is defined as follows:

$$\text{Dual rate coefficient} = \frac{1 \text{ ECU, converted into national currency, at the green rate}}{1 \text{ ECU, converted into national currency, at a specified market rate}}$$

A dual rate coefficient exists, therefore, for each Member State and for each market where there is a separate green rate.

6.13. Under the agrimonetary system which existed prior to 1984 and the introduction of the switchover, those Member States with positive MCA's and a price level in national currency above the common price level had a dual rate coefficient greater than one: i.e., the effect of the coefficient was to increase budgetary expenditure. On the other hand, those Member States with negative MCA's and a price level in national currency below the common price level had a dual rate coefficient less than one, so that its effect was to reduce the level of budgetary expenditure in ECU. In terms of budgetary impact, therefore, the increased cost to the budget of the higher price level in the strong currency Member States was offset by the reduced cost of the weaker currency Member States. The larger the gaps between the green and central, or market rates, the greater the impact on the budget of the dual rates.

Impact of the switchover on the dual rate coefficient

6.14. The introduction of the switchover, however, by enabling the Community to reconcile the FR of Germany's interest in preserving the level of domestic prices with the Community's interest in avoiding the creating of new positive MCA's, has had a significant effect on the relationship between green and market rates, and thus on the dual rate coefficients. For FR of Germany and the Netherlands, which had coefficients greater than 1 before

⁽¹⁾ Page B/420, volume 7/2, preliminary draft general budget, 1987, doc. COM(86) 200 of 13 June 1986.

⁽²⁾ Page 366, volume 0/3, preliminary draft general budget 1988, doc. COM(87) 150 of 15 June 1987.

⁽³⁾ Neither the central nor the green central rate are involved in the calculation.

the introduction of the switchover, at each realignment where the DM and the HFL have been revalued, the double rate coefficients have increased. They have only been reduced when the positive gaps that were in existence in April 1984 have been dismantled by revaluation of their green rates. For the Member States with negative gaps, the dual rate coefficients have increased as those gaps, both 'natural' and 'artificial' have been dismantled ⁽¹⁾. The green rates for these Member States are devalued towards the green central rate (the central rate adjusted for the correcting factor) which means that once the green rate has been devalued past the central rate the dual rate coefficients for these Member States can also exceed unity.

As situation 5 of *Figure 1* shows, a result of the switchover mechanism, therefore, is that at each realignment and subsequent green rate devaluations, the green rates for both Member States with negative and positive monetary gaps diverge further and further from real exchange rates, increasing the dual rate coefficient.

6.15. *Table 7* shows the dual rate coefficients for cereals and milk and milk products for all Member States as at May 1988. This shows that only those for the United Kingdom and Greece are less than one.

6.16. The increased impact of the dual rate under the switchover mechanism, therefore, reflects the impact on budgetary expenditure of the effective increase in the common price level caused by the correcting factor. Under the pre-April 1984 arrangements an increase in common prices in ECU agreed by the Council resulted directly in higher budgetary expenditure without influencing the dual rate. Under the current arrangements with switchover, the increase in common prices caused by an increase in the correcting factor at the time of a realignment leaves ECU prices unaffected, but increases expenditure via the dual rate effect, immediately for FR of Germany and the Netherlands, and as green rates are devalued for the Member States with negative gaps. Thus, a devaluation of a green rate without any change in market rates has the following effects:

- (a) it increases the level of common prices in national currency for the beneficiaries in the Member State concerned;
- (b) it reduces the negative monetary gap, resulting in a positive budgetary impact in respect of exports and a negative one in respect of imports;

⁽¹⁾ The dual rate coefficients have been reduced in the short term when a currency has been devalued more quickly than the green rates for the Member State concerned (e.g. United Kingdom 1986, Greece 1985 and 1986).

Table 7: Double Rate Coefficient ⁽¹⁾, May 1988 ⁽²⁾
Cereals and Milk + Milk Products

Member State	Cereals	Milk and milk Products
Belgium	1,1094	1,1172
Denmark	1,1025	1,1025
FR of Germany	1,1455	1,1515
Spain	1,1095	1,1208
France	1,0625	1,0626
Greece	0,8089	0,7526
Ireland	1,0723	1,0733
Italy	1,0413	1,0520
Luxembourg	1,1094	1,1172
Netherlands	1,1373	1,1493
Portugal	—	—
United Kingdom	0,9781	0,9921

⁽¹⁾ Double rate coefficient
1 ECU, converted to national currency at green rate

— 1 ECU, converted to national currency at market rate

⁽²⁾ The market rates used to record expenditure declared in May 1988 in the EAGGF accounts in ECU is the rate of 18.3.1988, see OJ No C 73, 19. 3. 1988.

- (c) it increases the dual rate coefficient, which means a direct increase in budgetary expenditure.

This last point is an important consideration in relation to requests from Member States for devaluations of their green rates and the need to dismantle the negative monetary gaps in order to achieve the same common price level throughout the Community. The Commission has estimated in the context of the 1988/89 price fixing that a dismantling of 1 percentage point of the monetary gaps for the Member States with negative MCA's would have a net impact on the budget of 220 Mio ECU additional expenditure. The dual rate effect itself would increase expenditure by 210 Mio ECU. With the current budgetary discipline limiting agricultural expenditure, this is an additional constraint.

Budgetary impact, 1987

6.17. The dual rate coefficients affect every line in the EAGGF expenditure budget, and chapter 10, agricultural levies, in the revenue budget. However, this effect is not separately identified. In its annual report on the 1978

financial year ⁽¹⁾ the Court criticized the fact that the published budget and the accounts do not permit the effect of dual rates to be assessed. In its reply, the Commission argued that the dual rate effect was weakening as monetary gaps were reduced. This may have been so under the pre-April 1984 system, but under the switchover arrangements the effect is becoming more significant and should be clearly identifiable.

6.18. The Court has calculated the effect on the 1987 EAGGF expenditure accounts ⁽²⁾. For the 10 months expenditure given in the official accounts, it amounts to 1137,5 Mio ECU. If expenditure for the full 12 months of 1987 is taken, the impact of the dual rate increases to 1365,1 Mio ECU. In both cases these amounts are 5,0 % of total expenditure.

For agricultural levies in chapter 10 of the revenue budget there is insufficient disaggregated data at the level of each market to permit a detailed calculation of the impact. Once again, it is necessary to fall back on budget forecast data. For 1987, the Commission forecast the double rate effect at 50 Mio ECU increase in budget revenue, for 1988 the forecast is 100 Mio ECU.

For the sugar levies in Chapter 11 of the revenue budget, the double rate coefficient effect calculated from the accounts is 108,5 Mio ECU for the full 12 months of 1987.

Budgetary impact of artificial trade flows

6.19. Paragraphs 5.13 — 5.17 describe how the existence of uncovered monetary gaps caused partly by the structure of the agrimonetary system has encouraged the export to third countries of sugar, cereals and dairy products from other Member States, for example France and Belgium, through the Netherlands, in order to obtain the export refund paid in HFL. This situation leads directly to increased Community budget expenditure, because of the

higher price level in the Netherlands compared to Belgium or France reflected in the dual rate coefficient.

The data given in Annex VI (Section 3, Budgetary Impact) show that in respect of the export of cereals from France in June 1988, an export refund less the MCA payable on export, of 100 ECU at the common price level, would have been charged to the accounts at 101,47 ECU if the export had been direct from France. If, however, the cereals had first been exported to the Netherlands and then exported to third countries, so that the export refund was paid in HFL, the amount charged to the accounts would have been 106,06 ECU, which is 4,5 % higher. The corresponding figures for cereals exported from Belgium would have been 110,64 ECU if exported directly, and 114,27 ECU if exported via the Netherlands, a difference of 3,2 %.

6.20. To assess the budgetary impact of this over a period, for cereals, sugar and milk products requires assumptions about what would be normal levels of exports from the countries involved. From *Table 3*, it can be hypothesized that at least the additional monthly expenditure during the first six months of 1988 on export refunds in the Netherlands for cereals (+ 65 Mio HFL), sugar (+ 80 Mio HFL), and milk products (+ 100 Mio HFL) was all above 'normal'. If it is assumed that normally this expenditure should have been paid in Member States such as France or Belgium, then the Court has estimated that EAGGF expenditure for the first six months of 1988 was increased by at least 25 Mio ECU by the refunds being paid in HFL.

Estimated total budgetary impact of the agrimonetary system, 1987

6.21. *Table 8* summarizes the total estimated direct and indirect budgetary impact on the revenue and expenditure account of the agrimonetary system in 1987 at 1 578,2 Mio ECU for 10 months, and 1 824,6 Mio ECU for the full year. This is equivalent to 7 % of total expenditure, in each case. Although this estimate contains a mixture of amounts actually declared as expenditure, budget estimates, and calculations made on amounts declared, it gives the order of magnitude of the full impact which should be shown clearly in the budget and in the accounts. By far the largest single amount is the impact of the double rate coefficient.

⁽¹⁾ Point 2.31, Annual Report concerning the financial year 1978, OJ No C 326, 31. 12. 1979.

⁽²⁾ The expenditure charged to the official accounts presented by the Commission for 1987 were for the 10 months January to October 1987. For more detailed consideration of this, see points 1.2 — 1.3 of the Court of Auditors' Annual Report concerning the financial year 1987, OJ No C 316, 12. 12. 1988.

Table 8: Estimated Total Budgetary Impact of the Agrimonetary System, 1987

		Mio ECU	
		10 months (January-October)	12 months (January-December)
1. Direct Budgetary Cost			
(a) MCA's in Intra Community trade:			
— Article 280 Expenditure ⁽¹⁾	1073,9		1212,6
— Revenue (negative Expenditure) ⁽¹⁾	(664,0)		(764,8)
Subtotal MCA's in Intra Community Trade		409,9	447,8
(b) MCA's in Extra Community Trade:			
— Article 281 Expenditure ⁽¹⁾	227,0		247,2
— MCA's deducted from export refunds ⁽²⁾	(94,3)		(113,2)
— MCA's adjusting import levies ⁽²⁾	30,0		36,0
Subtotal MCA's in Extra Community Trade		162,7	170,0
Subtotal Direct Budgetary Cost		572,6	617,8
2. Indirect Budgetary Cost: Double Rate Coefficient:			
— EAGGF expenditure ⁽³⁾	1137,5		1365,1
— agricultural levies ⁽²⁾	(41,5)		(49,8)
— sugar levies ⁽⁴⁾	(90,4)		(108,5)
Subtotal Indirect Budgetary Cost		1005,6	1206,8
Total Budgetary Cost (1 + 2)		1578,2	1824,6

⁽¹⁾ From EAGGF Accounts.

⁽²⁾ Budget estimates. For the 10 months January-October, the 12-month data have been reduced proportionately.

⁽³⁾ Calculated by Court from actual expenditure data in EAGGF accounts.

⁽⁴⁾ Calculated by Court from actual data in the revenue accounts. The 12-month data have been reduced proportionately to give the 10 months January-October data.

6.22. The Court considers that, so long as the agrimonetary system continues the Commission should ensure that the accounts show clearly the impact of the régime, in particular:

- (a) in third country trade, MCA's and export refunds should be shown separately, in gross terms;
- (b) similarly MCA's and import levies should be shown separately, in gross terms;
- (c) the actual impact of the double rate coefficient should be shown clearly by way of a note to the revenue and expenditure accounts.

Clarity of accounting information

6.23. By not separately identifying the dual rate effect, comparative analysis of budgetary expenditure between Member States is misleading. Paragraph 6.11 above shows how in May 1988 an item of expenditure in FR of Germany

cost 16 % more to the budget than the same transaction in the United Kingdom. It is not possible, therefore, to compare expenditure on a budget line between Member States and identify relative activity levels, for example. This seriously limits the value of the accounts as a source of information.

Budgetary impact of the switchover mechanism

6.24. A key issue in the consideration of the budgetary impact of the agrimonetary system is the effect on budgetary expenditure of the switchover mechanism. An evaluation of this is complex, and depends on the assumptions made. The comparison to be made is with what would have happened if the switchover had not been introduced, and the pre-April 1984 system had remained in operation. The elements to be taken into account are the following for each system:

- (a) the system with switchover:
 - (i) the direct costs of the MCA's actually applied;

(ii) the costs of the dual rate effect, incorporating the increase in budgetary expenditure resulting from the impact on this effect of the correcting factor;

(iii) the impact on the level of export refunds and import levies resulting from the increase in the gap between the level of world prices and the level of Community prices caused by the correcting factor;

(b) the pre-April 1984 'system':

(i) the costs of the increase in ECU common prices that would have been agreed by Council in the absence of the effect of the correcting factor on the common price level in national currencies;

(ii) the MCA's and green rates that would have been applied if the existing positive MCA's had been reduced and no new ones created by means of revaluations of the green DM rates, resulting in reductions in institutional prices in DM;

(iii) the costs of the double rate effect, taking into account the green rates that would have been applied (see (ii) above).

6.25. The central assumption that determines the outcome of the assessment is that concerning the increases in ECU prices that would have been agreed by Council. It can be argued that, under the terms of the Gentlemen's Agreement, increases in ECU prices would have been necessary to the extent that prices in DM remained unchanged. This would imply increases of over 3 % at the beginning of 1984/85, over 5 % at the beginning of 1985 ⁽¹⁾, over 8 % in 1986/87 and over 1 % in 1987/88. If this assumption is made, detailed calculations show that the budgetary impact of the two systems is approximately equal.

6.26. The alternative hypothesis is that ECU price increases would have been smaller because of the pressures for a restrictive prices policy. This would imply prices in DM lower than they currently are, perhaps compensated for partly by means of income aids. In these circumstances it is likely that EAGGF expenditure would have increased

at a lower rate. Under this hypothesis, the automatic price-increasing effect of the correcting factor has increased budgetary expenditure.

7. PRINCIPAL CONCLUSIONS AND RECOMMENDATIONS

7.1. This report highlights serious shortcomings in the current agrimonetary arrangements. These are summarised in the following paragraphs, together with the Court's recommendations.

The switchover mechanism

7.2. The switchover, or green ECU, system has undermined the Community's efforts to impose stricter budgetary discipline on agricultural expenditure by the largely hidden way in which it has raised the effective level of prices by 13,7 % since 1984. As a result, the level of common prices is no longer effectively fixed by the Council during the annual agricultural price fixing. Instead, the common price level is now tied to the appreciation of the DM, reflecting the strength of the industrial economy of the FR of Germany rather than the requirements of Community agriculture. Dismantling monetary gaps in this context aligns agricultural prices in all Member States on the level determined in the FR of Germany (Chapter 4).

7.3. The Court considers that the Commission should present, at the earliest opportunity proposals for the abolition of the switchover mechanism and the green ECU. Ending the switchover should not await full dismantling of the monetary gaps: in the interests of clarity the effective increase in the common price level that has built up since 1984 by the workings of the switchover should be made apparent without delay.

Budgetary impact

7.4. It is not possible to identify from the budget or accounts in their current form what is the true budgetary impact of the agrimonetary system. The absence of clarity

⁽¹⁾ This relates to the dismantling of 5,0 points of FR of Germany's MCA's from 1 Januari 1985, as part of the 1984/85 price fixing decisions. This was compensated for by a concession to farmers on the VAT rate they paid. As this was partly financed by EAGGF, adjustment for this has to be made in the calculation.

in this regard effectively prevents meaningful interpretation of accounting data. Not only is the direct impact of MCA's not identified fully in the budget, but also the impact of the effective increase in agricultural prices resulting from the application of the switchover mechanism is not shown (Chapter 6).

7.5. The Court recommends that the accounts should show clearly the impact of the agrimonetary system, while it continues to be applied, in particular:

- (a) in third country trade, MCA's and export refunds should be shown separately, in gross terms;
- (b) similarly, MCA's and import levies should be shown separately in gross terms;
- (c) the actual impact of the double rate coefficient should be shown clearly in a note to the revenue and expenditure accounts, so that comparative analysis of accounting information can be carried out without being confused by the different exchange rates used when payments are made and when they are charged to the budget.

National pricing policies

7.6. By retaining considerable influence over the level of their green rates, and thus keeping an important degree of national control over the internal level of their prices, Member States have been able to pursue national pricing policy objectives which have not always been consistent with Community objectives (paragraph 3.12).

7.7. The existence of different green rates for different markets, means that the agrimonetary system is not a neutral instrument of market management which affects all markets equally (paragraph 3.13).

7.8. The Court considers that the process of dismantling the monetary gaps as part of the process of abolishing the agrimonetary system should be carried out in accordance with Community priorities for the return to a genuine common price system. Further, it considers that the objectives for dismantlement should, whenever possible, include the ending of multiple green rates at the earliest opportunity.

Calculation and application of MCA's

7.9. At the detailed level of the calculation and application of MCA's there are a number of areas where it has proved difficult to maintain the agrimonetary system as a neutral tool of market management.

Pigmeat

7.10. This sector is an example of one where market developments are affected by factors other than the system of market support. In such cases the application of MCA's has proved problematical (paragraphs 5.7 — 5.11).

Uncovered Monetary Gaps and Triangular Trade

7.11. There have been various instances where uncovered monetary gaps, for example because of the absence of MCA's (rice sector) or because of the existence of the neutral margins, have contributed to encouraging triangular trade. A recent example of this is the marked increase in 1988 of exports to third countries being channelled from other Member States through the Netherlands, at extra budgetary cost (paragraphs 5.12 — 5.17 and 6.19 — 6.20) (see also paragraphs 5.24 — 5.25 for budgetary loss in respect of rice levies).

7.12. The Court recommends that the Commission and Council should act promptly to stop such anomalies when they are identified. In the case of rice, despite repeated evidence from the Court in its 1978, 1980 and 1985 annual reports that the Community was suffering loss of own resources, it was only in 1986 that action finally was taken.

Complexity

7.13. The agrimonetary arrangements, particularly since the introduction of the switchover and the automatic dismantling arrangements, are extremely complex and difficult to understand. Apart from this being intrinsically undesirable, it also facilitates attempts at manipulation, with financial loss to the Community (paragraphs 5.28 — 5.32).

Prospects for complete abolition of the agrimonetary system

7.14. The current objective of the Council and the Commission is to abolish the agrimonetary system by 1992 so that a true common price system can function as originally intended. The decisions of June 1987 and 1988, on dismantling monetary gaps form a key, if as yet incomplete, element in this. The Court supports this objective, but recognizes that there are considerable difficulties to be overcome.

7.15. For 20 years the common agricultural market organizations have been disturbed by the agrimonetary system. Yet the system itself is a consequence of the inherent incompatibility between a policy of agricultural support based on common institutional prices exerting considerable influence over market prices, and divergent trends in member States' economies.

7.16. The implications of the decision to dismantle the agrimonetary system in the context of the single market objectives are significant. It is clear that the existence of green rates that diverge from market rates, and MCA's, are incompatible with a genuine single market. At a practical level, for example, a system of MCA's cannot work without border controls to check the reality of movement of goods for which the MCA's are charged or paid. Yet abolition of MCA's would require Member States to accept the immediate consequences for agricultural prices of changes to currency values following a monetary realignment. Prices that farmers receive/consumers pay would increase in national currencies in those Member States whose currency depreciates in value, which would tend to lead to an increase in agricultural production. They would

decrease in those Member States whose currency appreciates in value, with an inverse influence on agricultural production. If on balance following a realignment agricultural production is increased, this may lead to an increase in budgetary expenditure, which in turn might put at risk budgetary discipline targets.

7.17. Three factors will determine whether such arrangements will be acceptable to Member States:

- (a) progress towards economic and monetary convergence would reduce the frequency and intensity of currency movements: if movements are few and relatively small, Member States may be able to absorb their impact more easily;
- (b) agreement on a genuine common price level for Community agriculture that reconciles the requirements of efficient agricultural markets and of producer incomes;
- (c) a reduction in the role of agricultural support prices in determining agricultural market prices. If this link is weakened, as it has been to some extent in several markets under the pressure of budgetary discipline (e.g. beef, milk products, cereals), then the adjustment of agricultural prices in the market following a currency realignment will be more gradual.

7.18. If these elements are not achieved, the objective of complete and lasting abolition of the agrimonetary system will be difficult to achieve, and the necessity for green rates that diverge from market rates will continue, together with the requirement for some form of compensation.

The present report was adopted by the Court of Auditors at Luxembourg at its meeting of 30 March 1989.

For the Court of Auditors

Marcel MART

President

ANNEX I

REGULATORY FRAMEWORK, AGRIMONETARY SYSTEM

Institution	No.	Date	OJ Ref.	Title	Comment
Council	1676/85	11 June 1985	L 164 of 24. 6. 85	On the value of the unit of account and the conversion rates to be applied for the purposes of the common agricultural policy	Concerns the fixing of 'green' rates
Council	1677/85	11 June 1985	L 164 of 24. 6. 85	On monetary compensatory amounts in agriculture	Defines the rules for the introduction of MCAs for the calculation of real and applied monetary gaps. Provides for the 'correcting' factor ('switchover'), and automatic dismantlement. Includes general rules on accounting for MCAs
Council	1678/85	11 June 1985	L 164 of 24. 6. 85	Fixing the conversion rates to be applied in the agricultural sector	Sets out the actual green rates to be applied. Amended each time a green rate is changed
Commission	3152/85	11 November 1985	L 310 of 21. 11. 85	Laying down detailed rules for the application of Regulation (EEC) No. 1676/85 on the value of the unit of account and the conversion rates to be applied for the purposes of the common agricultural policy	Self-explanatory
Commission	3153/85	11 November 1985	L 310 of 21. 11. 85	Fixing the methods for the calculation of monetary compensatory amounts	Detailed calculation rules based on principles set out in Regulation 1677/85
Commission	3154/85	11 November 1985	L 310 of 21. 11. 85	Laying down detailed rules for the administrative application of monetary compensatory amounts	Detailed rules for administrative application of MCAs when goods imported and exported between Member States, and with 3rd countries.
Commission	3155/85	11 November 1985	L 310 of 21. 11. 85	Providing for the advance fixing of monetary compensatory amounts	Self-explanatory
Commission	3156/85	11 November 1985	L 310 of 21. 11. 85	On transitional measures concerning the application of monetary compensatory amounts	Measures to prevent speculation at the time of changes to monetary gaps
Commission	3578/88	17 November 1988	L 312 of 18. 11. 88	Laying down detailed rules for the application of the system for the automatic dismantlement of negative monetary compensatory amounts	Rules for putting into effect the decisions on dismantlement agreed in June 1987 and 1988

ANNEX II

THE ECU, THE EUROPEAN MONETARY SYSTEM AND THE COMMON AGRICULTURAL POLICY

1. The European Monetary System (EMS), which was introduced in March 1979, is the exchange rate stabilizing system of the European Community. The basis of the EMS is the ECU, which is a 'basket' unit whose value is equal to the sum of defined amounts of each Member State's currency, including the drachma and sterling (but not yet the peseta and escudo).

2. Monetary stability within the EMS is achieved using the Exchange Rate Mechanism, participation in which is not compulsory. Each participating Member State has a central rate against the ECU, which is a target rate for the national currency, fixed by the Finance Ministers acting in concert at a realignment conference. Under the Exchange Rate Mechanism, the participating Member States undertake to maintain market rates for their currencies within an agreed range on either side of their bilateral central rates. Belgium, Denmark, FR of Germany, France, Ireland, Luxembourg and the Netherlands observe narrow fluctuations of $\pm 2,25\%$ from their bilateral central rates, while Italy observes a $\pm 6\%$ margin. Greece and the United Kingdom, although including their currencies in the ECU basket, do not participate in the Exchange Rate Mechanism.

The ECU and the common agricultural policy (CAP)

3. Since April 1979 ⁽¹⁾ the ECU has been used as the common unit in which amounts within the CAP are expressed (i.e. intervention prices, agricultural levies, export refunds, production and consumption aids, etc.). Payments to and receipts from operators in the Member States are converted from their ECU amounts into national currencies using the representative rates known as 'green' rates. These green rates are fixed by Council, normally as part of the annual price fixing for a full campaign year.

ANNEX III

MONETARY GAPS AND MONETARY COMPENSATORY AMOUNTS (MCAS)

1. Under the classical system, which operated until 1984, when green rates diverge from central or market rates, gaps are created between the level of common prices fixed in ECU (converted notionally into national currencies at the central or market rates) and the level of institutional prices actually applied in the Member States using the green rates (see *Figure 1*). A real monetary gap is identified for each Member State, and, if differentiated, for each market. The real monetary gap is the percentage difference between the green rate and the market rate. There are two ways of calculating the real monetary gaps for the Member States' currencies, depending on their situation within the EMS. For those Member States observing the narrow fluctuation band within the EMS, the ECU central rate is used as a proxy for the market rate, to which the Exchange Rate

⁽¹⁾ The first common unit of account used in agriculture for fixing support prices was the European Payments Union unit of account (u.a.), adopted for agricultural purposes in 1962.

Mechanism ensures that it approximates. These real monetary gaps are fixed, because they alter only if the green or central rates are changed, which happens relatively infrequently.

2. For Greece, Spain, Italy, Portugal and the United Kingdom, the real monetary gaps calculated are variable. They are based in principle on real monetary gaps calculated from the percentage difference between their green rates and their market rates against the ECU over a five-day reference period. For practical reasons, however, a proxy is devised which involves using the rates against the narrow-band currencies within the Exchange Rate Mechanism. The mathematical calculation of this, which is carried out each week, is straightforward, if involved.

3. The purpose of MCAs is that they should broadly fill the monetary gap. In practice there are a number of rules in the system which reduce the MCA so that it does not completely do this. In particular, since 1973 a flat-rate deduction, known as the 'neutral margin', has been made. Currently, the neutral margin is 1,5 percentage points for most products and all Member States except for the Netherlands, where it is 1,0 points. For wine and eggs and poultrymeat the neutral margin is 5,0 points and for olive oil, where MCAs have only been applied since September 1987 the neutral margin is 10,0 points. The real monetary gap minus the neutral margin is called the 'Applied Monetary Gap'.

The other rules affecting the size of the MCAs are:

(a) non-cumulation rule [Article 5 (3) of Council Regulation (EEC) No 1677/85]

This is designed to avoid the application of very small MCAs. It states that if the RMG less the neutral margin is 0,50 or less, an MCA percentage of zero is applied. If the RMG less the neutral margin is 1,0 or less but more than 0,50, an MCA percentage of 1,0 is applied. As soon as the RMG less neutral margin becomes 1,1 or more, it is applied directly as the MCA percentage;

(b) 'de minimis' rule [Article 9 (2) of Council Regulation (EEC) No 1677/85]

For countries with variable MCAs, this rule stipulates that the applied monetary gap is changed only if the difference between the new gap and the present gap is not less than 1,0 point. There are three exceptions:

(i) the non-cumulation rule takes precedence over the 'de minimis' rule;

(ii) if the RMG is smaller than, or equal to, the neutral margin, then no MCA will be applied irrespective of the 'de minimis' rule;

(iii) if the change in the MCA results from the introduction of a new green rate or a new central rate, the MCAs may be 'actualized', i.e. based directly on the new RMG;

(c) the lower limit rule [Article 8 of Council Regulation (EEC) No 1677/85]

No MCA shall be applied if it is negligible in relation to the average value of the product. Thus, on processed foods (Non Annex II of the Treaty) and jams, MCAs are not applied if worth less than 3 ECU/100 kg.

ANNEX IV

THE SWITCHOVER MECHANISM AND THE AUTOMATIC DISMANTLING
OF ARTIFICIAL AND NATURAL MONETARY GAPS*Rationale for 'switchover'*

1. The switchover mechanism was introduced in 1984 as a means of overcoming the difficulty of dismantling positive MCAs during a period when price increases in ECU were severely restrained. It was seen, therefore, as a step forward towards the restoration of market unity. Council Regulation (EEC) No. 1677/85 of 11 June 1985 ⁽¹⁾ provided that the switchover arrangements should be tried on a provisional basis until the beginning of the 1987/88 milk marketing year: if by this time the Council had not decided either to extend the system in force or to introduce a new one, then the pre-existing arrangements would come back into effect. In the event, it was decided to extend the mechanism.

2. How this device works is shown in *Figure 1* to the report. As the diagram shows, the effect of the 'correcting factor' is to 'switch' some positive MCAs below the line, converting them into negative MCAs. If green rates are unchanged, the total monetary gap between the green rates of any two Member States is unchanged; it is the dividing line between positive and negative MCAs that changes. Since 1984, at each realignment of Member State's currencies, in order to avoid the creation of new positive MCAs, the correcting factor has been increased, revaluing the green ECU upwards in line with the strongest currency — in practice this has been the DM. Between April 1984 and the beginning of 1988 the difference between the real ECU and the green ECU, as measured by the correcting factor increased from 1,033651 to 1,137282: that is, the green ECU was 13,7 % higher than the real ECU at the beginning of 1988.

3. Under the 'switchover' system, therefore, the monetary gap is calculated as the percentage difference between the green rate and the green ECU central rate. The operation of the 'switchover' has led to further development of the agrimonetary jargon: the part of a Member State's negative MCA which results from the operation of the switchover is called an 'artificial' negative MCA, that part which results from changes in the exchange rate of the Member State's currency is described as a 'natural' MCA.

Automatic dismantling of natural and artificial monetary gaps

4. the detailed rules agreed by Council in June 1987 ⁽²⁾ provide for dismantling as follows:

- (a) up to 30 % of the new natural real monetary gap immediately after the realignment;
- (b) 50 % of the balance of the new 'natural' real monetary gap, plus 25 % of the new 'artificial' real monetary gap, at the beginning of the marketing year following the realignment;
- (c) the balance of the new 'natural' real monetary gap, plus 37,5 % of the new 'artificial' real monetary gap, at the beginning of the second marketing year following the realignment;
- (d) the balance (i.e. 37,5 %) of the new 'artificial' real monetary gap at the beginning of the third marketing year following the realignment.

⁽¹⁾ Eleventh recital, OJ No L 164, 24. 6. 1985.

⁽²⁾ Council Regulation (EEC) No 1889/87 of 2 July 1987, OJ No L 182, 3. 7. 1987.

The first dismantling of the artificial MCAs (by 25 % at the beginning of the first marketing year following the realignment) must be accompanied by a reduction in agricultural prices in ECU, to offset partially the increase in prices in national currencies following the adjustments to the green rates. This reduction in ECU prices can be compensated for, however, by national social aids not linked to production, if the ECU price reduction leads to a reduction of prices in national currency.

ANNEX V

COST TO THE BUDGET OF EXPENDITURE IN DIFFERENT MEMBER STATES: MAY 1988

Assume 100 ECU of aid for skimmed milk powder for incorporation into animal feed, to be paid in FR of Germany, France, and the United Kingdom.

(1) FR of Germany

Green rate, milk and milk products:	1 ECU =	2,38591 DM
budgetary rate, May 1988:	1 ECU =	2,07200 DM
Amount paid to beneficiary and declared as expenditure in May 1988 =	100 ECU × 2,38591 =	238,59 DM
Amount charged to EAGGF accounts =	238,59 DM/2,07200 =	115,15 ECU

(2) France

Green rate, milk and milk products:	1 ECU =	7,47587 FF
budgetary rate, May 1988:	1 ECU =	7,03562 FF
Amount paid to beneficiary and declared as expenditure in May 1988 =	100 ECU × 7,47587 =	747,59 FF
Amount charged to EAGGF accounts =	747,59 FF/7,03562 =	106,26 ECU

(3) United Kingdom

Green rate, milk and milk products:	1 ECU =	0,665557 UKL
budgetary rate, May 1988:	1 ECU =	0,670808 UKL
Amount paid to beneficiary and declared as expenditure in May 1988 =	100 ECU × 0,665557 =	66,56 UKL
Amount charged to EAGGF accounts =	66,56 UKL/0,670808 =	99,22 ECU

ANNEX VI

EXPORT OF CEREALS, TO THIRD COUNTRIES, JUNE 1988

1. Basic data

	Netherlands	France	Belgium
Green Rate (GR)	1 ECU = 2,66089 HFL	1 ECU = 7,47587 FF	1 ECU = 48,0658 BFR
EMS Central Rate (CR)	1 ECU = = 2,31943 HFL	1 ECU = 6,90403 FF	1 ECU = 42,4582 BFR
Green Central Rate (GCR) (CR × 1,137252 correcting factor)	1 ECU (green) = 2,63785 HFL	1 ECU (green) = 7,85183 FF	1 ECU (green) = 48,2869 BFR
Real Market Rate (RMR) (average June 1988)	1 ECU = 2,33513 HFL	1 ECU = 7,00860 FF	1 ECU = 43,4527 BFR
Real Monetary Gap (RMG)	+ 0,866	- 5,027	- 0,460
Neutral Margin (NM)	1,0	1,5	1,5
Applied Monetary Gap (AMG) (RMG - NM)	0,0	- 3,5	0,0
Observed Monetary Gap (OMG) = (1 - (RMG × 1,137252) / (GR)) × 100	+ 0,198	- 6,620	- 2,813
Cumulative Differences:			
RMG (% points)			
(a) Netherlands — France (0,866 + 5,027) = 5,895			
(b) Netherlands — Belgium (0,866 + 0,460) = 1,326			
OMG (% points)			
(a) Netherlands — France (0,198 + 6,620) = 6,818			
(b) Netherlands — Belgium (0,198 + 2,813) = 3,011			
Monetary Coefficient (MC)	1,000	1,035	1,000
MCA, common wheat	0,0	43,43 FF/tonne	0,0
Export Refund (ER) common wheat (CN = 1001 90 91) = 75 ECU/tonne			
Export Refund of 100 ECU = 1,333 tonnes			

2. Advantage to traders in France and Belgium exporting via the Netherlands

Assume 1,333 tonnes of common wheat exported, refund = 100 ECU

2.1. Export of cereals by French trader

(a) Export directly from France:

Export refund in FF, adjusted for monetary coeff = ER × MC × green rate

= FF 100 × 1,035 × 7,47587 FF =

773,75 FF

Less MCA = 43,43 FF × 1,333 t =

57,89 FF

Net export refund received =

715,86 FF

(b) Export from France, via Netherlands:

(a) Import to Netherlands

MCA paid

57,89 FF

- (b) Export refund in HFL: $100 \times 1,000 \times 2,66089 = 266,09$ HFL
 No MCA received
 Refund converted to FF at market rate = $266,09 \times \frac{7,0086}{2,33513} =$

798,64 FF

Net export refund received, in FF
 Thus French trader obtains $740,75/715,86 =$
 by exporting via the Netherlands

740,75 FF

3,5 % more

2.2. Export of cereals by Belgian trader

- (a) Export directly from Belgium:
 Export refund: $100 \times 1,000 \times 48,0658$ BFR = 4 806,58 BFR
- (b) Export from Belgium, via Netherlands:
 No MCA payable on import to Netherlands nor received on export from Netherlands
 Refund in HFL, converted to BFR at market rate =
 $266,09 \times \frac{43,4527}{2,33513} =$ 4 951,47 BFR
- Thus Belgian trader obtains $4951,47/4806,58 =$ 3,0 % more
 by exporting via the Netherlands

3. Budgetary impact

Budget rates for June 1988 expenditure:
 Netherlands = 1 ECU = 2,32864 HFL
 France = 1 ECU = 7,05492 FF
 Belgium = 1 ECU = 43,4425 BFR

3.1. Export by French traders

- (a) Export directly from France:
 Export refund (net of MCA) = $\frac{715,86}{7,05492} =$ 101,47 ECU
- (b) Export via the Netherlands:
 MCA received when cereals exported from France to the Netherlands
 MCA = $\frac{57,89}{7,05492}$ FF = 8,21 ECU
- Export refund from the Netherlands
 ER = $\frac{266,09}{2,32864}$ HFL = 114,27 ECU
- Net budgetary impact 06,06 ECU
 Export via the Netherlands costs the budget $106,06/101,47 =$ 4,5 % more

3.2. Export by Belgium traders

- (a) Export directly from Belgium:
 Export refund = $\frac{4806,58}{43,4425}$ BFR = 110,64 ECU
- (b) Export via the Netherlands:
 Export refund = $\frac{266,09}{2,32864}$ HFL = 114,27 ECU
- Export via the Netherlands costs the budget $114,27/110,64 =$ 3,2 % more

ANNEX VII

GLOSSARY OF TERMS

The terms in this glossary are arranged in alphabetical order. The number preceding each term indicates the first paragraph in the report in which the item is used.

1.2	Agricultural conversion rate ('green' rate):	the conversion rate fixed by Council used to convert institutional prices (intervention prices, production and consumption aids, export refunds, import levies) expressed in ECU into national currency in a Member State. It is called 'green' because it relates only to agricultural products.
Annex III	Applied Monetary Gap (AMG):	Real Monetary Gap less neutral margin. It is the percentage actually applied when calculating the Monetary Compensatory Accounts (MCAs).
2.8 Annex II	Central rate:	for each Member State participating in the Exchange Rate Mechanism of the European Monetary System (see below) the conversion rate fixed by agreement between Finance Ministers for its national currency against the ECU. Central rates are fairly stable.
2.8	Correcting factor:	a factor, in effect determined by the appreciation in the value of the strongest currency (i.e. the DM normally) which is used to multiply the central rates in order to 'switch' positive MCAs into negative MCAs.
4.4(a) Annex II	Currency realignment:	within the EMS, a change in the central rates of exchange of those Member States participating in the Exchange Rate Mechanism, as a result of which the bilateral market and central rates are altered.
6.12	Dual rate coefficient:	the coefficient that results from the fact that when payments are made from the budget, the ECU amounts are converted into national currency using the green rate, but when they are recorded in the accounts of the Community, they are reconverted into ECU using market exchange rates. The dual rate coefficient is defined as: the equivalence of 1 ECU in national currency, converted at the green rate
		the equivalence of 1 ECU in national currency, converted at the market rate.
2.2	European Monetary System (EMS):	the exchange rate stabilization system of the European Community, established in 1979. The ECU forms the basis of the system.
Annex II	Exchange Rate Mechanism:	the mechanism within the EMS by which monetary stability is achieved. Participating Member States agree to maintain the market rates for their currencies within an agreed range on either side of their bilateral central rates.
Annex III	Fixed MCAs:	MCAs calculated for the Member States respecting the narrow fluctuation margin ($\pm 2,25\%$) within the EMS: these MCAs only change if the green or central rates change, which happens infrequently.
1.5, 4.1 Annex IV	Green central rate (green ECU):	the central rate multiplied by the correcting factor, for the purposes of the switchover mechanism. The equivalence of green central rates against the ECU is often referred to as the green ECU.

1.8	Institutional prices:	agricultural support prices (intervention prices, export refunds, import levies, production and consumption aids) decided by the Council or Commission as part of the operation of the common agricultural market organizations.
1.2	Market rate:	the actual rates of exchange of one national currency against another, as fixed in the currency markets.
Annex VI	Monetary coefficient:	the monetary coefficient is applied to levies and refunds in trade with third countries. Its purpose is to adjust levies and refunds, which have been converted from their ECU amount into national currency using the green rate, so that they are all worth about the same at market rates. The MCA is then added/subtracted from the adjusted levy/refund. The monetary coefficient is calculated as: $MC = 1 - \frac{(MCA \%)}{(100)}$
1.3	Monetary Compensatory Amount (MCA):	an amount applied in trade between Member States, or between Member States and third countries, to cover the AMG. The objective is for the MCA to fill the gap created by having green rates that vary from the rates of exchange in the market.
2.6	Negative MCA's:	MCAs applied by Member States with weak currencies (e.g. France, Italy, Greece), i.e. their agricultural prices in national currency are <i>below</i> the common price level. Negative MCAs are applied as a subsidy on imports and a levy on exports, in principle restoring the final price to the common price level.
2.6	Positive MCAs:	MCAs applied by Member States with strong currencies (e.g. FR of Germany, Netherlands) i.e. their agricultural prices in national currency are <i>above</i> the common price level. Positive MCAs are applied as a levy on imports and a subsidy on exports, in principle restoring the final price to the common price level.
5.12 Annex III	Neutral margin:	a flat rate reduction made to the Real Monetary Gap to give the Applied Monetary Gap.
2.11 Annex III	Real Monetary Gap (RMG):	the percentage difference between the 'green' rate and the central rate, according to the formula $RMG = \frac{(1 - \text{central rate})}{(\text{green rate})} \times 100$ Since the introduction of the switchover and the correcting factor, the central rate has been multiplied by the correcting factor, so that: $RMG = \frac{(1 - \text{green centr. rate})}{(\text{green rate})} \times 100$ Within the context of the switchover arrangements, the RMG for Member States with weak currencies (i.e. the RMG is negative) divides into two parts, the 'artificial' RMG and the 'natural' RMG.
Annex IV	Real Monetary Gap-artificial:	an artificial RMG is that part of a positive RMG that would have resulted from a change in the central rate of the strongest currency, transferred into a negative RMG by the use of the correcting factor.
Annex IV	Real Monetary Gap-natural:	within the context of the switchover system, the part of the negative RMG resulting from a change in the central rate of the Member States currency.

1.5	Switchover:	the arrangements whereby, since 1984 existing positive MCAs have been dismantled and the creation of new ones avoided. This is done by multiplying each central rate by a correcting factor. The RMG between the green rate and the green central rate is reduced for strong currency countries (with a corresponding reduction in positive MCAs) and increased for weak currency countries (with a corresponding increase in negative MCAs).
Annex III	Variable MCAs:	MCAs calculated for the Member States which do not participate in the ERM of the EMS, and for Italy, which observes the wide $\pm 6\%$ margin of fluctuation. These MCAs are reviewed weekly.

COMMISSION REPLY

General comment

The Commission has always taken the view that the application of MCAs is a barrier to trade in agricultural products and must be abolished as quickly as possible. With that in mind, it has put forward several times, initially in 1976, arrangements for systematically dismantling MCAs. It was only in 1987, however, that these proposals resulted in a Council decision.

The 'switchover' mechanism, introduced in 1984, represented an important step in this direction. The Commission believes that the mechanism has led not only to the speedier dismantling of positive MCAs but paved the way also for the adoption in 1987 of a mechanism for the automatic dismantling of monetary gaps which the Court itself regards (7.14) as a key element in the abolition of the agrimonetary system.

Furthermore, on the political level, the switchover mechanism has made the fixing of agricultural prices easier.

The Commission is aware, however, of the complexity of the agrimonetary system and of the drawbacks of the switchover mechanism, in particular its effects on prices. For that reason it is seeking to reduce those drawbacks and is examining the consequences of abolishing the mechanism as suggested by the Court (7.3).

It is also true that the complexity of the agrimonetary system makes it difficult to obtain an accurate picture of price movements. It must not be inferred from this, however, that the final level of common prices is no longer effectively fixed by the Council during the annual agricultural price fixing operation (7.2). One factor which cannot be controlled by those responsible for making agricultural policy decisions is the forecasting of currency realignments and their impact on agricultural prices. Once a currency realignment occurs, however, its effects on prices are analysed in detail (and the correcting factor referred to in point 2.8 is adjusted); they are taken into consideration and can be corrected when the common prices are fixed and when decisions are taken to dismantle the monetary gaps. The effect on the budget is also known.

1. INTRODUCTION

Regarding the conclusions of the Court of Auditors set out in the introduction to the Report, the Commission here refers to its answers to point 7 entitled 'Principal conclusions and recommendations'.

The description of the system of MCAs given by the Court in a significant section of its report is, generally speaking, correct.

3. THE IMPACT OF GREEN RATES ON THE SYSTEM OF COMMON PRICES

Variations in common price levels

3.4(a) The regular adjustments of green rates are made by Council decision. It is out of the question therefore that a Member State alone can use the system to pursue national objectives.

Green rates and Member States' pricing policy

3.7. The reason for the smaller reduction of the monetary gaps in 1986/1987 for cereals than for animal products was not the extent of the pressure on farmers' returns. It was possible to dismantle the monetary gaps for animal products by a greater amount either because there were already production stabilizers in the product area (milk) or because the intervention arrangements had a generally lower impact on price levels. Therefore the risk of production being stimulated as a result of a rise in prices in national currency was less.

3.12. The inconsistency referred to by the Court illustrates the dilemma facing the Commission, which is

confronted, on the one hand, with production policy objectives which entail a price freeze and, on the other hand, with the need to dismantle monetary compensatory amounts with a view to a return to an economic situation where there are no barriers to intra-Community trade.

Impact on resource allocation

3.14(a) The reasoning was correct before the introduction of the switchover mechanism. In all cases (with the exception of Greece at the moment) the green rates are higher than the market rates. The size of the gaps continues to vary from one Member State to another, however, and consequently they have different relative effects.

3.15. Like the Court, the Commission would like to know more about the economic effects of the agrimonetary system on the market organizations. It has come up against the same problems as the Court, however, when preparing its four reports.

4. THE SWITCHOVER MECHANISM

Impact of correcting factor on common price level

4.7. After each decision on prices — in green ECUs — was adopted by the Council, the true price in national currency was known immediately by those concerned.

5. THE CALCULATION AND APPLICATION OF MCAS

MCAs in the pigmeat sector

5.7. To avoid distortions of competition between pigmeat produced in some Member States with low cereals prices and pigmeat produced elsewhere, the fixing of MCAs for pigmeat was made subject to a minimum difference of eight points between the monetary gaps for

cereals and for pigmeat. The reason for this eight point rule was the use of substitute products (not subject to MCAs) in certain Member States.

It should be pointed out also that on 30 January 1989, following the price fixing operation for 1988/1989, pigmeat MCAs no longer existed except in Greece.

5.8. The problems in this area are mainly structural ones. The agrimonetary mechanisms have gone some way towards remedying them.

5.11. The policy pursued has been to limit the application of MCAs to the portion representing the raw material entering into the production costs for pigmeat. The MCA is calculated therefore on 35 % of the basic price for pigmeat.

Neutral margins

5.13–5.16. The agrimonetary system is only one of many factors responsible for changes in trade flows. Among these can be mentioned the currency fluctuations within the band of 2.25 %, in the context of the EMS, the speed of administrative services and the infrastructure of ports.

Processed products

5.22. For products known as non-Annex II products, the absence of MCAs could give rise not only to distortions of trade but also to disturbances on the market as a result of artificial changes in the composition of products. Care must be taken therefore when considering the level of the threshold below which MCAs would not be applied.

Complexity of the MCA system

5.32. The Commission has instructed its staff to simplify rules where necessary. This applies also to MCA rules.

Frauds and irregularities

5.35 – 5.36. On the problem of cattle smuggling across the Irish border the Commission has carried out on-the-spot inspection visits from February 1986 onwards. Close examination of the control system governing the movement of cattle from North to South and vice versa was made and certain weaknesses observed. During a follow-up visit in March 1988 the documentary control was noted as 'good' and the weaknesses earlier identified seemed to have been remedied. At the same time it was observed that the incentive for live cattle smuggling did not currently exist as the MCA gap was narrow. However, as a wide MCA gap existed for cereals a specific investigation was considered necessary for this commodity. A joint operation relating to cross-border grain smuggling has been carried out by the Customs Services of the United Kingdom and Ireland. An interim report on the results is expected by the Commission's staff shortly.

6. THE BUDGETARY IMPACT OF GREEN RATES AND MCAS

Direct budgetary impact of MCAs (points 6.1 — 6.4)

As regards the charging of MCAs to the budget, Chapter 28 of the budget contains seven lines on the financial effects of MCAs which are broken not only into intra-Community trade and trade with non-member countries, but also into import and export operations.

It is true that for trade with non-member countries the budget shows only net expenditure relating to the MCA mechanism. Where the effect of applying an MCA is to vary the charging of an import levy or to reduce the grant of an export refund, the net amounts only of the levies and refunds are recorded in the budget and accounts, and the impact of these reductions is now shown as revenue (Chapter 10), or as expenditure (Chapter 28).

Even though this form of presentation is unsatisfactory from the point of view of strict budgetary transparency, it was adopted because it was the only one acceptable to all the Member States. Indeed, when it was introduced some Member States did not indicate that they were able to keep detailed accounts of two amounts for a single commercial transaction.

The method of entering MCAs in the accounts applied in particular by the customs authorities of certain Member States is to enter the net balance of a transaction where it gives rise to two payments, one in favour of and the other payable by a single trader.

The Commission will study the question of whether a detailed accounting system can be introduced in all Member States but notes that there would not appear to be economic reasons favouring a change in the existing accounting arrangements.

Indirect budgetary impact of the agrimonetary system dual rate effect (points 6.10 — 6.23)

To avoid any misunderstanding, the Commission is anxious to emphasize that what it has been agreed to call the 'dual rate effect' does not constitute an expense generated by the agrimonetary system and concealed in the budget and management accounts as presented at present.

The budget, and the management accounts, are drawn up in budgetary ECUs, i.e. in ECUs whose parities are established on exchange markets. The conversion rate for agricultural products (green rate) must be regarded as a special unit of account used in the agricultural sector to take account of the concern to ensure a certain level of prices in national currency. While the use of the green rate is mandatory for the application of agricultural regulations, only the ECU can be used for implementing the budget.

The dual rate coefficient expresses the relationship between the conversion rate for agricultural products and the actual rate of the currency concerned. It does not represent intervention in itself or an autonomous type of expenditure. Separate accounts for this are therefore not possible. Its impact is very relative, moreover. A revaluation of the central green rates and of the green rates *vis-à-vis* the ECU with a simultaneous increase in Community prices in ECUs would produce a reduction in the effect of the dual rate without any impact on budget appropriations since the prices in national currency would remain unchanged.

The Commission does not therefore interpret the Court's conclusions as meaning that in future agricultural expenditure should be managed, in terms of both forecasts (budget) and implementation (accounts), in a unit of account other than that provided for in Article 10 of the Financial Regulation.

If, on the other hand, it is a matter of providing for information purposes an overall estimate of the dual rate effect, the Commission is prepared to look into the possibility of including remarks in its preliminary draft budget and in the management accounts.

6.19 – 6.20. See answer to 5.13 to 5.16.

Budgetary impact of the switchover mechanism
(point 6.26)

In view of the positions which have always been held within the Council, the hypothesis that price increases expressed in ECUs would have been smaller because of pressures in favour of a restrictive prices policy would appear to be ruled out. The change in the agrimonetary system brought about by the introduction of the switchover mechanism was necessary precisely because this hypothesis had no chance of success.

7. PRINCIPAL CONCLUSIONS AND RECOMMENDATIONS

The Commission is anxious to reiterate certain views expressed already in the general comments. It believes that the switchover mechanism (7.2 and 7.3) has helped on the political level to facilitate the annual agricultural price fixing operation and the adoption of automatic arrangements for the dismantling of monetary gaps which the Court itself regards as a key element in the abolition of the agrimonetary system (7.14).

While it is true that the complexity of the agrimonetary system can conceal price movements, it would not be correct to infer from this that the final level of common prices is no longer effectively fixed by the Council during the annual agricultural price fixing operation (7.2 and 7.6).

A factor which cannot be controlled by those responsible for agricultural policy decisions is the forecasting of currency realignments with their consequences for farm prices. However, when such a currency realignment is about to take place, its effects on prices are analysed in detail. They are taken into account and can be corrected when the common prices are fixed and when decisions are

taken to dismantle the monetary gaps. In addition, the impact on the budget is also known.

Regarding triangular trade (7.12), the Commission wishes to state that it reacted very promptly once these practices had been detected.

The Commission is aware that the agrimonetary system is complex (7.13). It is endeavouring to mitigate its drawbacks and is examining ways of abolishing it and the consequences that will ensue.

Market organizations have, admittedly, been disturbed (7.15) by the agrimonetary system but it is a necessary evil and the question can be put as to what would have happened to market organizations without those 'disturbances'. This view was also taken by the Court of Justice in the case of REWE-Zentrale v HZA Kehl as far back as 1973 ⁽¹⁾.

The Commission reaffirms that with a view to the attainment of the large European market in 1992 it hopes to be able to return to a situation of agricultural price unity. This, however, will demand progress in other areas (e.g. in economic and monetary integration).

Annex IV

Rationale for 'switchover'

1. The switchover mechanism was introduced in 1984 in response to the fact that it is more difficult generally to dismantle positive MCAs, with or without a reduction in prices in national currency, than to dismantle negative MCAs.

⁽¹⁾ Judgment of the Court of Justice of 25 October 1973 in Case 10/73.