# AgriMatters

AIB supporting the Irish Agricultural Industry

August 2011

## 20th Anniversary of the Tullamore Show

## Competitiveness of the Dairy Sector / CAP Reform

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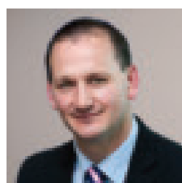


LIAM PHELAN
AIB ENNISCORTHY

# Welcome to the August Edition of Agri Matters

## Michael Dowling, Editor, Agri Matters

Welcome to this special edition of *Agri Matters*, which we are publishing to mark the completion of research undertaken by Teagasc, and sponsored by AIB, on the competitiveness of the Irish dairy sector at farm level.

The dairy industry is looking towards a more open and exciting future. Milk quotas will end in 2015 and the straitjacket that has limited production for three decades will be removed. It is an appropriate time to look at how internationally competitive our industry is.

The results are encouraging but not uniformly so. In cash terms, Irish producers are among the most competitive in the world but, when measured in total economic terms, we are considerably less competitive, especially on smaller scale farms.

The ending of quotas will inevitably result in a major scaling up of production, which will see a significant rise in overall competitiveness. Thus, on the basis of the research results we are entitled to look forward to a major expansion in the industry here with consequential benefits to producers and to the economy generally.

Trevor Donnellan and colleagues' article outlines the research outcome in some considerable detail. We have also included articles on the recently published preliminary results of the 2010 National Farm Survey; on the beginning of the negotiations of the post 2013 CAP reform; on the desirability of building a strategic farm reserve in 'good' years (written by Patrick O'Meara, one of our agri advisers), as well as our usual market and economic commentaries.

The publication of this edition of *Agri Matters* coincides with the Tullamore Show and we congratulate all involved on the 20th anniversary of the Show. The next edition of *Agri Matters* will be published to coincide with the Ploughing Championships.

Michael Dowling
Editor

# Recent Appointment

## Liam Phelan, Enniscorthy

AIB has recently expanded its Agri Adviser service with the appointment of Liam Phelan to the team. Liam has worked as a Financial Adviser with AIB since 2007. Prior to joining AIB, Liam had 10 years' commercial experience in the agri sector. Liam comes from a tillage background and has a Degree in Agricultural Science and an MBA from UCD. Based in Enniscorthy, Liam will cover the South East Region. Commenting on his new role Liam said: "I am joining the AIB Agri Adviser team at an exciting time for the industry. The Food Harvest 2020 report has highlighted the potential of the agri-food industry and has set specific targets for each of the farm sectors. I am looking forward to working with our farming customers in helping to support the future growth and development of this very important sector."

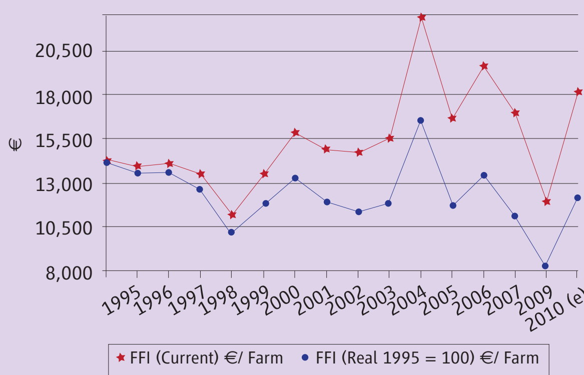
# National Farm Survey

### Family Farm Income

Teagasc has recently published estimates based on the 2010 National Farm Survey, which show that family farm income rose by 48% last year. This is consistent with the CSO figures for aggregate farm income in 2010 which puts the growth in entrepreneurial farm income at 45%. Both are evidence of an impressive performance but they need to be put in perspective.

The comparison is with 2009, a year in which farm incomes collapsed to their lowest levels in more than a decade and a half. Even with the sharp increase, last year's incomes were still more than 8% behind the peak year of 2007 (this ignores 2005, in which farm incomes were artificially high due to the partial double payment of direct subsidies on the introduction of the single farm payment system). In real terms, family farm income in 2010, while ahead of most years in the last decade, was below the levels of the mid 1990s. The graph below traces the development of family farm income in current and real terms in the period 1995 to 2010.

Figure 1: Family Farm Income (FFI) per farm 1995 - 2010




Nevertheless, the increase was very welcome and looks like being sustained into this year. All the main sectors shared in the good performance with the income increases being most pronounced in dairying, mixed livestock (dairying being the biggest element in the mix) and tillage, the sectors which had suffered most in 2009. With the exception of the sheep sector, incomes were still below 2007 levels but, as is clear from the table below, well ahead of the three year average 2007 – 2009.

**Table 1: Family Farm Income**

| € | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Dairying | Mixed Livestock | Cattle Rearing | Cattle Other | Sheep | Tillage | All |
| 2007-2009 Average | 40128 | 24027 | 7351 | 10400 | 9996 | 25008 | 16216 |
| 2010 | 47171 | 34404 | 7013 | 9781 | 11586 | 33381 | 18022 |

### Direct Payments

Direct payments remained the single most important (but somewhat declining) element in farm income in all sectors other than dairying, where they accounted for only 15% of gross farm output and 42% of farm income. In the average of all sectors these payments were 31% of gross output (down from 37% in 2009) and they represented 94% of family farm income (down from 140% in 2009). The importance of direct payments in the individual sectors in 2010 is outlined in the following table.

**Table 2: Direct Payments as a % of:**

| | Gross Output | Family Farm Income |
|---|---|---|
| Dairying | 15 | 42 |
| Mixed Livestock | 25 | 71 |
| Cattle Rearing | 50 | 191 |
| Cattle Other | 45 | 150 |
| Sheep | 45 | 129 |
| Tillage | 27 | 74 |
| All Systems | 31 | 94 |

### On-farm investment

The level of net new farm investment (i.e. investment less grants and subsidies) peaked in 2007 and 2008 under the stimulus of the Farm Waste Management Scheme, fell to low (negligible in some sectors) levels in 2009 but recovered significantly last year.

**Table 3: Net New Investment per farm**

| (€) | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Dairying | Mixed Livestock | Cattle Rearing | Cattle Other | Sheep | Tillage | All |
| 2007/2008 Average | 32250 | 19557 | 6885 | 7474 | 7453 | 18458 | 12722 |
| 2009 | 964 | - | 55 | 2425 | 872 | 6986 | 1502 |
| 2010 | 12143 | 10250 | 2463 | 2921 | 2450 | 7830 | 4850 |

### Off-farm employment

The effect of the recession on off-farm employment is clearly illustrated in developments as measured in the last four national farm surveys. On 58% of farms, the farmer or spouse had an off-farm job in 2007. This figure fell to 56% in 2008, to 53% the following year and to 49% in 2010. Given current economic circumstances, it is likely that the survey for this year will record a further decline in that figure.

*Pictured receiving their prize of an €8,000 product development fund are the overall winners of the Green Dragon Innovation Challenge 2010/11 Barry Holland, Declan Moore and David Ryan from Clonakilty Community College with Bernard Donohue, Chairman Agri Aware, John Farrell, AIB and Hylda Adams, Bord Bia.*

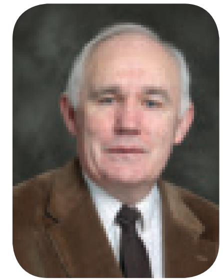
*Pictured at the launch of the AIB Macra na Feirme Club of the Year Competition (L to R) were Anne Finnegan, Agri Strategy, AIB; 2010 Queen of the Land winner Celine Smyth, Athboy Macra; and Alan Jagoe, Macra na Feirme National President.*

# Keeping an Eye on the Competition

**How competitive is the Irish dairy sector? How do farms in Ireland compare with farms in other countries, in terms of milk price, costs of production and profit margin? With the end of the milk quota system just around the corner, and with ambitious plans set out for dairying in the Food Harvest 2020 report produced for the Government by farming and industry representatives, these are important questions.**

**Dr Fiona Thorne, Teagasc**

**Dr Trevor Donnellan, Teagasc**



**Dr Michael Keane, Economic Consultant**

Ireland's current economic difficulties have focused attention on the importance of maintaining and improving the competitiveness of all areas of our economy. The dairy sector has entered a phase of considerable change. Traditional EU policy supports are now less prevalent due to CAP reform and the most significant policy change in the dairy sector, the milk quota removal, is to occur in 2015. Given that it is highly export focused, the international competitiveness of the Irish dairy sector at farm level is quite important.

Several studies over the last 30 years have compared the performance of the dairy sector at farm level in Ireland with the dairy sector in other countries. A new report sponsored by AIB on the financial health of the Irish dairy sector has now been produced by economists from the Agricultural Economics Department at Teagasc and the economic consultant Dr Michael Keane.

### The FADN and IFCN

In Ireland we are fortunate to have very detailed financial information on farms, which is collected by the Teagasc National Farm Survey (NFS). Comparing the economic performance of dairy farms in Ireland with dairy farms in other countries might sound like a relatively straightforward task.

However, in reality it is quite complicated because one needs to take account of specific factors that exist in each country, e.g. differences in types of feed used, milk constituents, calf values, labour costs, land rental, etc. These factors affect how milk output and costs are measured.

To get around these difficulties the EU Farm Accountancy Data Network (FADN) produces information across the EU using a common accounting standard. The Teagasc NFS is part of the FADN.

The FADN is confined to countries in the EU, so if we want to compare Ireland with countries further afield we need to use another common accounting system called the International Farm Comparison Network (IFCN).

If every country produced milk with the same constituents and received the same selling price for that milk then a competitiveness study could focus on the cost of production alone. However, the sales value of milk varies considerably around the world, so normally costs are compared relative to the value of milk output.

### Different types of cost measures

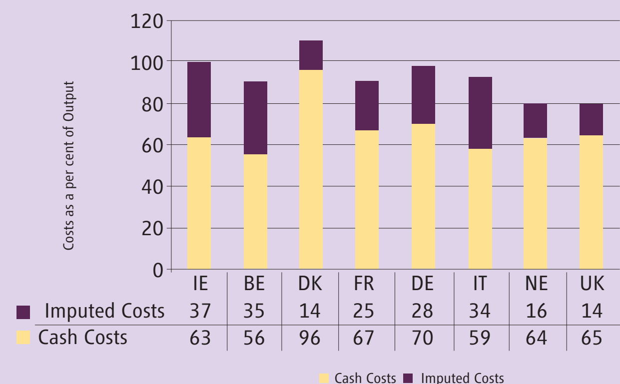
The simplest forms of production costs to collect from farms are the very visible cash costs. These include purchases of feed, fertiliser, fuel, rented land, hired labour and services such as vet fees. However, there is another category of costs that are not as easily determined. These costs are harder to measure and are referred to as imputed costs, which are the costs of the farmer's own labour, the cost of the owned land and the cost of borrowings. Economists add together cash costs and imputed costs to calculate what they refer to as full economic costs. To make a true profit over the long term a farm needs to cover its full economic costs.

**Figure 2: Breakdown of costs**

### How does the Irish dairy sector measure up at EU level?

For the purposes of this part of the study Ireland was compared with a number of key competitor countries in the EU15, namely Belgium, Denmark, France, Germany, Italy, the Netherlands and the United Kingdom. FADN data was used in making this comparison. Comparing the average dairy farm in these countries on a cash cost basis alone, Ireland is in quite a good position. Ireland had amongst the lowest cash costs as a percentage of output value in the EU15, as illustrated in Figure 3.

**Figure 3: Estimates of Economic and Cash Costs for specialist Milk Producers in EU (2008-10)**



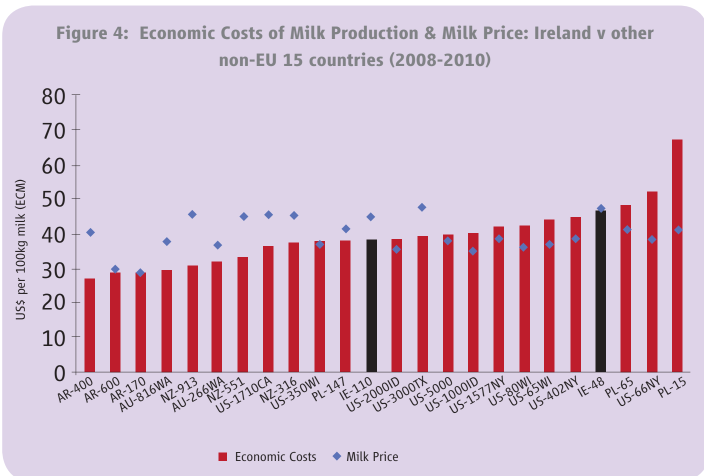

**Note: IE – Ireland, BE – Belgium, DK – Denmark, FR – France, DE – Germany, IT – Italy, NE - Netherlands, UK - United Kingdom**

However, when imputed costs are added to these cash costs, the situation changed. Imputed costs on Irish farms tend to be quite high compared to our EU competitors due to higher Irish labour and land costs. This means

that on a full economic cost basis the average Irish dairy farm (with 55 cows) would be considered to be a high cost, rather than a low cost producer in the EU15, as illustrated in Figure 3.

It is also possible to make a comparison among farms of a similar size across the EU15. This approach makes allowance for the fact that the average dairy farm size differs between countries across the EU15. Looking at cash costs and economic costs across the EU15 for the sub category of farms of 50 to 99 cows, Irish farms perform better than in the comparison of average sized farms.

**Figure 4: Economic Costs of Milk Production & Milk Price: Ireland v other non-EU 15 countries (2008-2010)**




Source: IFCN Data (2008) and Authors' Own Estimates (2009 & 2010)
Note: AR – Argentina, AU – Australia, IE – Ireland, NZ – New Zealand, PL- Poland, WI – Wisconsin, CA – California, ID – Idaho, TX – Texas, NY – New York, WA – Western Australia
The numbers represent the herd size in the selected countries.

## How does the Irish dairy sector measure up at a global level?

In this second part of the study Ireland was compared with a number of competitor countries around the world, namely Argentina, Australia, Poland, New Zealand and the USA. IFCN data and the authors' own estimates are used in making this comparison. Comparing the average dairy farm in these countries on a cash cost basis alone, Ireland is in quite a good position. Ireland has amongst the lowest cash costs internationally. However, in common with the analysis for the EU15, when imputed costs are added into the analysis, the ranking of the average Irish farm deteriorated and tended to be amongst the higher cost countries across the countries examined, as illustrated in Figure 4.

Again the analysis was repeated, looking instead at larger farms. In the Irish case, a 110-cow farm was used for comparison with larger dairy farms around the world. In this comparison the larger Irish dairy farm performed quite well, which indicates that the small scale of the average Irish dairy farm (by the standards of global competitors) is a key factor in determining the competitive position of these farms.

## Volatile Milk Prices and Production Costs

Over the last five years milk prices and certain input prices have begun to fluctuate considerably from one year to the next. The degree of movements in input prices such as feed, fertiliser and energy have been relatively common internationally, since trade in these commodities takes place in a relatively free market environment with minimal Government involvement in market management.

In terms of farm milk price volatility across the world, the story is a little different. Issues such as the seasonality of production, differing degrees of export dependence and the extent of Government intervention mean that milk prices have varied more widely in some countries compared to others.

To examine these issues, and their potential to impact on the future competitiveness of the Irish dairy sector, a number of future possible input price and milk price scenarios were examined in this study. The results indicated that the Irish dairy sector is relatively insulated from movements in feed and fertiliser prices, but is vulnerable to the effects of low milk prices in periods when international dairy commodity prices fall.

## Conclusions

Overall, the results of the study highlight the high level of imputed costs on Irish farms, as a significant handicap in competitiveness terms. However, the results of the study also demonstrate that larger Irish dairy farms have a more internationally competitive cost structure. Ultimately, this suggests that average sized Irish farms can become more internationally competitive by increasing in size. Over the last 25 years, access to milk quota has been an impediment to farm expansion in Ireland. The elimination of milk quotas in 2015 may make it easier for mid sized Irish dairy farms to increase towards the 100-cow mark, which should make Irish dairy farms much more competitive in international terms.

*A full copy of this report entitled the 'Study of the International Competitiveness of the Irish Dairy Sector at Farm Level' is available to download on the Teagasc website.*

*Launching the results of the 'Study of the International Competitiveness of the Irish Dairy Sector at Farm Level' were Minister for Agriculture, Food and the Marine, Simon Coveney TD; Dr Gerry Boyle, Director, Teagasc; Denis O'Callaghan, Head of Branch Channels, AIB; and the authors of the report Dr Fiona Thorne, Dr Trevor Donnellan and Dr Michael Keane.*

# Review & Outlook

## Market generally good but superlevy problem looming

As is clear from the results of the National Farm Survey (see separate article in this edition), 2010 was an extremely good year for farm incomes. The income position was underpinned by strong agricultural markets and generally favourable weather conditions. The market position remains strong and, indeed, in most sectors has improved compared to last year, so farm revenues will again be fairly buoyant this year. Input costs have, however, risen sharply and are proving to be a drag on farm incomes. Nevertheless, an income increase of over 5%, or roughly double the rate of inflation, can be expected.

Looking at the individual sectors, cattle prices in the first half of the year have been about 15% above the same period last year. Throughput has been down about 5%. The strong prices and the decline in slaughterings and live exports are expected to continue through the year. Sheep and pig prices are likely to be 10% up. Pig slaughterings are running 10% ahead of last year and sheep throughput is about 5% ahead and thus, 2011 may see a slight reversal of the trend of output decline which has been a feature of that sector for much of the past fifteen years. High feed costs have, however, been hitting pig producers very hard and most incurred losses throughout the first six months. Efficient producers are just moving back into profit and the sector as a whole should be profitable in the second half of the year.

Grain prices rose dramatically last harvest and have remained strong since. There has been some weakening in the past few weeks, which would indicate that prices may not be as good this year. Nevertheless, prices should be higher than in any year in the past decade other than 2007. In fact, if that estimate is correct, three of the four years from 2007 will have seen the highest prices in the past two decades and 2009, the fourth of those years, will have seen the lowest. High input costs have, of course, also hit grain growers but, nonetheless, aggregate income growth in the sector should be positive. While grain production in the EU is estimated to be marginally down, production in Ireland, at an estimated 2 to 2.1 million tonnes, may be up 20% to 30%.

This is turning out to be a very good year for milk producers. Prices at 33c to 34c per litre are up 10% and will, on average, be at least equal to the bumper year of 2007. Production is likely to be some 7.5% higher and butterfats are also higher. Some market weakening was evident in recent weeks but the outlook remains positive. Despite cost increases we can expect a significant improvement in milk supplier incomes.

The cloud on the horizon is the superlevy situation. Milk supply in the April to June quarter, the first three months of the quota year was up 10%. Even if, as is likely, the monthly production increase in the remaining 9 months falls back to less than 5%, without corrective action we are facing a substantial superlevy fine. This is serious for a great many producers but could be disastrous for a minority. These are mainly people who - in the belief arising from the very poor position in 2009 that a quota excess was unlikely in the future and in anticipation of the ending of quotas in 2015 - have expanded production to levels well above their quotas. People in that situation need to take action urgently but most producers need to exercise caution.

In our last edition we published an article by Laurence Shalloo and Brendan Horan of Teagasc on quota management in the period 2011 to 2015. In this they outlined possible strategies for producers at risk of superlevy, while stressing that no one plan will fit all situations. They outlined a number of mitigation strategies that can be put in place on farms at risk:

- Reducing supplementary feed;
- Feeding more milk to calves;
- Purchasing milk quota;
- Reducing the milking frequency for part or all of the year;
- Reducing lactation length; and,
- Reducing mature cow or heifer numbers.

They underlined that farmers at risk of a relatively small over-run may need to do no more than adopt the first two strategies but that those facing a more severe problem would probably need to adopt some or all of the other strategies as well. In their view, farmers facing very big quota over-runs (say, more than 50%) will probably have little option but to reduce numbers.

All milk suppliers who face any risk of superlevy should stay in very close contact with their co-op or other purchaser. Those who, nevertheless, incur a significant superlevy charge and/or significant income loss from the purchaser suspending milk payments for part of the year are encouraged to contact their bank as early as possible to see how any cashflow problems can be most effectively dealt with.

# Economic Outlook

Irish national accounts data for Q1 2011, as published recently by the Central Statistics Office (CSO), show that while the economy remains generally weak, there were some signs that a turning point is at hand. Revised annual data showed that the economy contracted by 0.4% in 2010 on a GDP basis. This was an improvement on the previous estimate of a fall of 1% last year. It also shows a considerable easing in the rate of contraction as seen in the previous two years, when GDP declined by 7.0% and 3.0% respectively. Real GNP (which deducts net factor income from the rest of the world), actually rose by 0.3% in 2010. In terms of the performance so far in 2011, the data shows that GDP rose by 1.3% on a seasonally adjusted basis in the first quarter of this year after the fall of 0.4% in 2010. There has been an erratic trend to quarterly GDP data since the start of 2010, but the underlying view is that the economy has bottomed out.

The economy remained in recession in 2010 because of the weakness of domestic demand, which fell by a further 5% in real terms relative to 2009. This brought the cumulative fall in domestic demand to over 20% over the past three years. The biggest contributor to this decline was, of course, the collapse in real fixed investment, which fell by 52% over the period. Within fixed investment, residential construction has declined by 66% since 2007 and indications are that we are approaching the bottom of the fall in housing output.

Some of the decline in domestic activity was cushioned by the strength of exports, which rose by 6.3% in 2010 after two years of decline. This upturn in the export sector is reflected in manufacturing production, which rose by 7.8% last year. This contributed to a 2010 balance of payments surplus, the first one recorded since 1999. This strong performance by the traded

sector continued into the first quarter of this year, with exports up 3.8% on a seasonally adjusted basis over the period.

While the correction in the housing sector continues to work its way through, a critical feature of the adjustment that is now underway in the domestic economy is how consumer spending will behave in the face of so many obstacles. The outlook for consumer spending, which accounts for almost 53% of GDP, is however difficult to call. It fell by a cumulative 8.6% over the past three years but the decline in 2010 itself was relatively small at 0.8%.

The outlook for consumer spending will have a significant bearing on major tax revenues and our ability to reduce our fiscal deficit to more manageable levels. Preliminary data for the first quarter of 2011 show that real GDP rose by 1.3% on a quarter-on-quarter basis and was only down 0.1% in year-on-year terms. However, the trend in consumer spending was far less favourable. In real terms, consumer spending fell by 2.9% in the first quarter compared with the same period of 2010 and was down 1.9% on a quarter-on-quarter basis.

As a result of this weakness in the first quarter, we now expect that this key category of spending will fall by about 2.5% on average in 2011. Spending looks set to decline again in 2012 but the extent of any fall will depend on the outlook for employment and on the degree to which fiscal policy reduces real personal disposable income in the next budget.

On foot of the publication of the real GDP data for the first quarter, and in particular the performance of the export sector, which accounts for almost 100% of GDP, we remain of the view that the economy can return to growth in 2011. We are retaining our forecast that real GDP will increase by 0.5% this year. However, real GNP could fall by about 0.5%. Growth remains firmly dependent on the trend in exports with real domestic demand likely to fall by another 3.5% this year. Exports are forecast to grow by 5% in 2011.

**Table 4: Economic Forecast – Ireland**

Annual % Change Unless Otherwise Stated

| | 2009 | 2010 (e) | 2011(f) | 2012(f) |
|---|---|---|---|---|
| Real GDP | -7.0 | -0.4 | 0.5 | 2.0 |
| Real GNP | -9.8 | 0.3 | -0.5 | 1.2 |
| Consumer Spending | -6.9 | -0.8 | -2.5 | -0.5 |
| Government Spending | -4.5 | -3.8 | -3.0 | -2.0 |
| Fixed Investment | -28.7 | -24.9 | -13.5 | -3.0 |
| Exports | -4.2 | 6.3 | 5.0 | 5.0 |
| Imports | -9.3 | 2.7 | 2.0 | 3.0 |
| CPI (%) | -4.5 | -1.0 | 2.7 | 2.2 |
| HICP (%) | -1.7 | -1.6 | 1.4 | 1.2 |
| Unemployment (%) | 11.8 | 13.6 | 14.2 | 14.1 |
| General Govt. Deficit (as % of GDP) | 14.3 | 32.4* | 10.0 | 8.6 |

Source: AIB Economic Research Unit

** Includes full upfront support to parts of the banking sector*

A broadly similar pattern is forecast for 2012 with real GDP expected to grow by 2%. Within this, domestic demand could contract by another 1% with overall growth supported by a projected expansion in exports of about 5%. The expected slowdown in Irish export growth in 2011 and 2012 relative to 2010's performance reflects the forecast deceleration in the growth in world trade. However, as has often been the case in the past, Irish exports could outperform these forecasts, thus providing some overall comfort should the recovery in the domestic side prove more difficult than envisaged.

# CAP Reform

In our Spring edition, we discussed the distribution of direct payments among Member States, as this is clearly going to be a key element in the negotiations that are about to begin on the post 2013 CAP. We return to this important topic here, and examine the European Commission's outline proposals published in June.

The first definite step in the negotiations took place on June 29 with the publication by the European Commission of its proposals for the multi annual financial framework for the 2014-2020 period (essentially the EU budget for that period). From an agricultural point of view there are a number of key elements in the proposals:

- Expenditure on the CAP would be frozen at 2013 levels;
- Certain expenditure, normally taken from the CAP budget, would be charged to other headings which, together with reduced expenditure on market support, would give scope in the agriculture headings to cover the final phasing-in of direct payments to the new Member States;
- Direct payments would be targeted at active farmers and would be subject to an upper limit on individual farms;
- About 30% of direct support would be for greening measures beyond current cross compliance requirements; and,
- There would be a gradual convergence between the rates of aid paid in individual Member States, with the long-term aim of all Member States receiving at least about 90% of the Community average and the medium-term aim of reducing the gap between current levels and the 90% figure by about one-third by 2020.

The freezing of overall CAP expenditure at 2013 levels would, of course, represent a drop in real terms, with the result that CAP expenditure would fall from 39% to 36% of the overall EU budget. Nevertheless, given the pressure from some Member States to reduce the agriculture budget, maintaining the proposal as it stands would not be a bad outcome especially as direct payments are not, in any event, currently inflation proofed.

Concentrating future payments on active farmers is likely to be generally welcome in Ireland and, while the greening proposal has yet to be sketched out, the nature of agricultural activity in Ireland is such that compliance may not be too onerous.

Distribution of aid between Member States and within Member States are critical elements. Ireland's rate of aid is at roughly the Community average, so it is possible to have a rough idea of the implications for us of the first element. But we will have to await the publication of the detailed agriculture proposals in the first half of October to begin assessing the implications of the second element.

It must be emphasised that these are only proposals, the negotiations on which are only beginning and are unlikely to be finalised before the first half of 2013. Much may change between now and then. We will come back to this topic in future editions as the negotiations progress.

# Saving for a rainy day

**Patrick O'Meara, Agri Adviser AIB, discusses the option of building a strategic farm reserve in 'good' years.**

Agriculture is one of the best performing sectors of the Irish economy at the moment. With the positive outlook for the global food sector and agricultural commodities in general, Ireland is well placed to meet future demand. Confidence is high in the sector and the future looks bright. It is refreshing to see the high demand for agricultural college places, which will result in an influx of new blood into the sector. There is also a renewed focus on best farm practices driven, in part, by initiatives such as the Better farm beef programme and Dairy Efficiency programmes but, more importantly, by a desire from a great number of individual farmers to improve the efficiencies of their farms.

Working with many of our farming customers, I know that they are still very conscious of 2009, where farm income was affected by low prices, high costs and adverse weather conditions. Much of that year was extremely difficult for Irish farmers, with a significant number concerned about their viability. Many of these farmers are now concerned about exposure to such events in the future and are examining their own plans to deal with periods of low / negative returns in the hope that their business can rebound quickly and without the burden of additional debt. During periods of strong commodity prices, decent weather conditions and reasonable levels of direct payments, I believe that farmers can do something to plan for the rainy day. It is worth considering options which could act as a buffer to help deal with the financial hardship that another downturn could bring.

### The rationale for building a buffer

The increased volatility in commodity markets is the biggest issue concerning many farmers. There is difficulty in determining output and input budget prices. The expectation is that commodity prices will, on average, continue to improve over time but that volatility will be a greater feature of the market in the future than in the past. This volatility experienced by Irish producers is driven by both supply and demand factors. Population and income increases have and will continue to increase the demand for food, while tight stocks of commodities, policy responses by individual countries to commodity prices and more unstable weather patterns all impact on supply. With this greater volatility and the trend towards reducing the influence of market management instruments, Irish farmers may need to cope with more frequent income shocks.

### Who is most exposed to income shocks?

Farmers need to consider both their business and personal circumstances and how they are likely to change in the short, medium and long-term to assess their vulnerability to income shocks. For example: are there dependent children who are in / going to college? Will an inheritor soon have to build a house? Will the farm be required to support two households? Will the farm need further capital development in the near future – investment in machinery / buildings / stock? In reality most income pressure will occur when a number of factors coincide with one another.

Another scenario where income pressure can occur is when individuals or companies complete significant expansion. They may have used up their savings, may have higher bank repayments and may have underestimated certain costs associated with expansion that they planned to cover from cashflow. It is important to remember that a significant portion of the hardship in 2009 related to the unprecedented level of capital investment carried out by Irish farmers in the previous two years.

### What can be considered a buffer?

Automatically, one thinks of a savings account, which can be built up by regular, seasonal, or once-off contributions. In the current environment there are attractive interest rates available on these accounts. Most savings accounts can provide great control over finances as they allow access to a pool of funds at relatively short notice if, and when, required.

There are many other options for providing a buffer available to farmers. While it is often nice to have access to cash, particularly in the current economic environment, some of the following options can also help better position a farm business to withstand periodic downturns and to cope with an income shock. Detailed below are some practical steps that farmers already consider in good years, which can reduce the financial pressures in periods of low / negative returns.

- Reduce creditors – This may enable farmers to increase their level of credit in a difficult period while also obtaining a better cash price for inputs. It could also enable them to more readily obtain bank facilities in a down period as banks generally are cautious of unexplained high levels of creditors;
- Forward purchase inputs (feed, fertiliser, etc.) – This may enable farmers to purchase inputs possibly at a lower cost, giving some price certainty over a period and allowing them to reduce cash payments in a period when money is tight. It may also have an effect on the amount of tax to be paid;
- Reduce working capital facility – This is similar to reducing creditors. While it is important to maintain the same working capital facility level, reducing the level of debt or bringing the facility into credit can improve track record and credit grading; and,
- Ongoing maintenance and upgrading – Don't defer maintenance or upgrading of machinery and facilities in good years. If it should be deferred at all, it would be best to do so in a difficult year and thus ease cashflow pressure.

Proper financial planning should now involve planning for unexpected periods of income pressure. Farmers should take the opportunity to discuss income volatility and appropriate mitigation options with their accountant, farm adviser and bank relationship manager. This may be a new concept for some but recent experience has shown that it is necessary.

Overall, I have looked at some of the short-term options that could be considered to build a buffer and better position a farm business to cope with a downturn period. There are also a range of other investment options for the medium and longer term that may be worth considering including pensions and medium term investments. It is prudent to seek independent investment, legal and tax advice when considering any investment opportunity.

While volatility is likely to be a feature of the market in the future, prices are likely to be on average higher than in the past. AIB has a positive medium-to-long term view of the Agri-food sector in Ireland and we are committed to supporting the industry into the future. It remains our strategy to work with farmers through the inevitable market cycles that will arise.

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