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Concept and Unintended Consequences of Weather Index Insurance: The Case of Mexico

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Abstract:

Recently, Weather Index Insurance (WII) has received considerable attention as a tool to insure farmers against weather related risks, particularly in developing countries. Donor organizations, local governments, insurance companies, development economists as well as agricultural economists are discussing the costs and benefits of WII. While the literature on WII has mainly focused on many cases in Africa and Asia, in this article we analyze the WII program in Mexico, which is one of the largest WII programs worldwide. In this context we discuss potentially important spill-over effects on related markets which so far have not been considered in the academic literature. First, we argue that WII creates disincentives to invest in other non-insured crops leading to potential overspecialization and monoculture. Secondly, WII generates disincentives to invest in irrigation systems because farmers are insured only as long as production takes place on non-irrigated land. Third, in case of catastrophic events food prices can potentially inflate with indemnity payments at the expense of the uninsured poor. We also suggest that in Mexico the thresholds of the weather index be (continuously) re-calibrated in order to adjust for the development of drought resistant seeds. Finally, the index could relatively easily be extended to account for precipitation variances. We argue that these factors and spillover effects should be accounted for in cost benefit analysis of WII.

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