Special Article

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Ag Trade Environment With an Enlarged European Union

The prospective enlargement of the European Union into Central and Eastern Europe could add as many as 100 million new consumers to the EU market and double the number of farmers, having potentially profound effects on global and U.S. agricultural trade. Initial USDA analysis indicates that accession to the EU and subsequent implementation of EU agricultural policies will increase agricultural output in Central and Eastern Europe (CEE), particularly in the livestock sector, creating increased demand for feedstuffs, and opportunities for additional U.S. corn and oilseed exports. On the other hand, CEE preferential trade agreements with the EU, in addition to geographic ties, could limit U.S. trade potential in this growing market.

Ten CEE countries, including the Baltic states, have applied for membership in the European Union and have signed Association Agreements (Europe Agreements) with the EU. These countries are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. Negotiations between the EU and the applicant countries are not expected to begin before 1998. European enlargement is likely to occur in a number of stages, with the Czech Republic, Poland, and Hungary—the most market-oriented and reformed countries of the proposed group—favored to join first. The Europe Agreements provide a framework for preparing the CEE countries for eventual membership, allowing them time to continue their economic and political reforms.

CEE countries will benefit from EU membership through unrestricted access to EU markets and higher producer prices for their farmers. However, membership will not be without cost. Higher expenditures by the EU will be required to support CEE agriculture at current EU producer prices, completely open borders will increase competition with Western Europe's agro-food sector, and consumer expenditures on food, already a large proportion of CEE incomes, will rise, having an inflationary impact.

A potential risk is that, with completely open borders between EU and CEE countries, the CEE agro-food sector will find it difficult to compete with Western European firms. This is particularly true of the food processing industry. Some CEE food processors have modernized sufficiently to meet EU product standards, but for most of the CEE food industry, considerable investment is still needed. Among raw agricultural products, CEE livestock will have difficulty competing in the EU market, as most CEE meat and dairy products do not meet EU quality standards.

While CEE countries have made significant progress toward recovery from the recession of the early transition period, considerable restructuring of their agricultural sectors will be needed for successful integration into the EU. The remaining challenges include improvement of farm productivity, completion of privatization of state farms and agro-industry, simplification of government purchasing and market management practices, training in agribusiness and quality control, and programs to encourage rural development and structural adjustment.

Agencies created in many of these countries to administer minimum prices, export subsidies, or other measures often operate in a nontransparent way, leading to questions of compliance with World Trade Organization (WTO) regulations on state trading. State policies in Bulgaria and Romania, for example, cause significant distortions in domestic markets. Procurement of bulk commodities in these countries is still mainly in the hands of state-owned companies that use their market power to hold down prices. In addition, these governments continue to exert some control over retail prices through limits on processing margins.

The EU has taken a multi-pronged approach in its preparations for enlargement. It has funded an extensive program of technical assistance for the CEE region, designing projects to improve agricultural structures and market mechanisms, food production, processing and distribution, and infrastructure. In addition, the 1996/97 EU Intergovernmental Conference is addressing institutional preparations for enlargement.

Enlargement Could Trigger EU Ag Reforms

The EU is a global player in agricultural trade, and EU enlargement will inevitably have implications for European agriculture. The EU, one of the world's largest and most competitive agricultural exporters, is a major force in multilateral trade negotiations. The prospect of adding 100 million consumers and doubling the number of EU farmers is a matter of keen interest to U.S. agriculture because it is likely to be an impetus for major changes.

Europe Agreements Pave Way to EU Membership

The Europe Agreements form the basis for gradual integration of CEE countries with the EU. The agreements cover five main areas: political dialogue, economic cooperation, financial assistance, adoption of EU legislation, and trade liberalization. The first agreements were signed with Poland, Hungary, and Czechoslovakia in 1991, with mutual trade provisions taking effect the following year and the entire agreements taking effect in 1994. The objective of all the agreements is membership of the CEE countries in the EU. All 10 CEE countries—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia—have formally applied for EU membership.

Scheduled CEE "Europe Agreements" and EU Membership Applications

	Europe Agreements		EU membership
	Signed	Effective	application
Hungary	Dec. 1991	Feb. 1994	Mar, 31, 1994
Poland	Dec. 1991	Feb. 1994	Apr. 5, 1994
Romania	Feb. 1993	Feb. 1995	June 22, 1995
Bulgaria	Mar. 1993	Feb. 1995	Dec. 16, 1995
Czech Rep.	Mar. 1993	Feb. 1995	Jan. 23, 1996
Slovakia	Oct. 1993	Feb. 1995	June 27, 1995
Estonia	June 1995	N/A	Nov. 28, 1995
Latvia	June 1995	N/A	Oct. 27, 1995
Lithuania	June 1995	N/A	Dec. 8, 1995
Slovenia	June 1996	N/A	June 10, 1996

N/A = not yet in effect.

Economic Research Service, USDA

The bilateral trade and cooperation provisions of the Europe Agreements call for most-favored nation (MFN) treatment and gradual elimination of selective quantitative restrictions over a 10-year period, beginning when the agreements go into effect. Separate protocols cover "sensitive sectors," including agricultural products, clothing, textiles, coal, and steel. For agricultural products, most concessions are phased in within 5 years and involve tariff reductions and quota increases. For example, beef, pork, mutton, poultry, and dairy products are subject to a 20-percent tariff reduction over 3 years, while import quotas will increase 10 percent per year for 5 years. However, trade in some commodity groups, such as grains, has not been liberalized.

The two-way preferences were structured to accelerate liberalization for CEE exports to the EU. Despite this, EU exports to the CEE have far outstripped trade in the opposite direction. In the first years of the agreements, lack of information and familiarity with EU procedures prevented the CEE countries from fully utilizing their allotted quotas. The EU's quarterly administration of preferential quotas, which hinders full utilization of annual quotas where seasonal commodities are concerned, also limited CEE exports. Finally, the method of administering tariff-rate quotas places CEE countries at a disadvantage—the quotas were allocated to EU importers rather than CEE exporters. Recently, the EU and the associated countries began renegotiating their agricultural protocols to expand preferences in order to accommodate the final WTO Agreement on Agriculture.

The CEE countries have huge agricultural sectors which, despite the advances of recent years, are generally less developed than those of the EU. The application of current Common Agricultural Policy (CAP) mechanisms to CEE would be very costly to the EU. Extending the generous benefits provided to EU producers would significantly increase EU agricultural spending. It is increasingly likely, therefore, that the enlargement will precipitate a sweeping reform, further reducing price support to farmers and expanding upon the limited reforms undertaken in 1992. The U.S. views this prospect as an opportunity for the EU to further liberalize its agricultural policies and build on the accomplishments of the Uruguay Round agreements.

The European Commission has examined different enlargement scenarios to measure the economic implications, including implications for the CEE and EU farm sectors. One approach would continue the CAP reform efforts begun in 1992, which reduced producer support prices and compensated producers with payments, and would extend these reforms to cover other sectors such as dairy, in an effort to improve EU agricultural competitiveness. Such an approach implies greater use of direct compensatory payments to help maintain farm revenues.

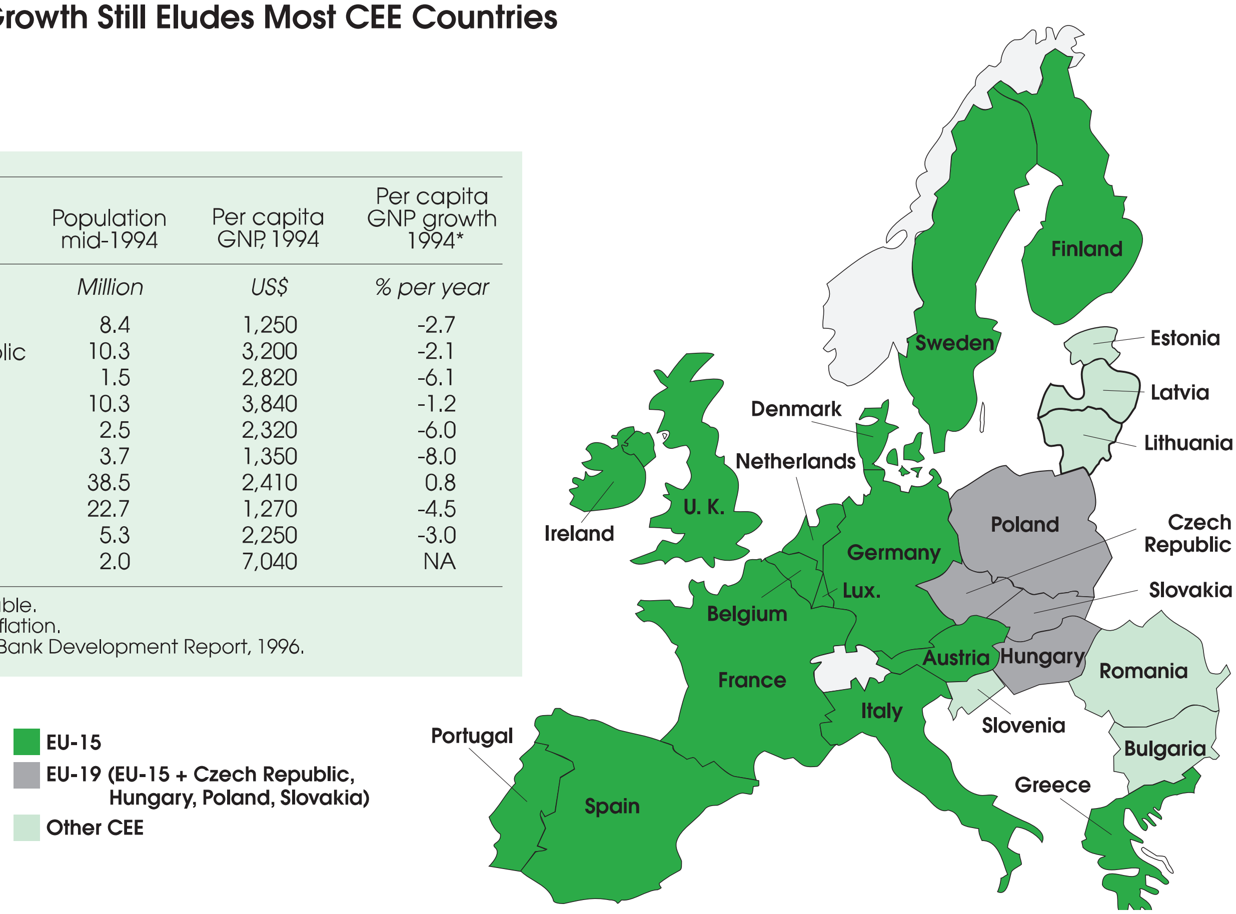
USDA also conducted preliminary analysis on the impact of CEE accession to the EU, under two extreme scenarios: in one, the current CAP applies to CEE, and in the second, farmers in an enlarged EU-19 (including the Czech Republic, Hungary, Poland, and Slovakia) face world prices. The results in both cases reveal that the agricultural economies of the current EU-15, and CEE, are likely to experience major adjustments.

Agricultural commodity prices in the EU are typically above world prices, while most CEE prices are currently below world prices. The CEE countries will be required to adopt EU prices after accession, which will likely stimulate CEE agricultural output and hinder consumption. If the EU-19 adopted world prices, CEE production gains would be smaller (than under EU-15 prices), while EU-15 output would decrease and EU-15 consumption would increase. The effect would be greatest for commodities with the largest current world-to-CEE price differentials.

Economic Growth Still Eludes Most CEE Countries

	Population mid-1994	Per capita GNP, 1994	Per capita GNP growth 1994*
	Million	*US$*	*% per year*
Bulgaria	8.4	1,250	-2.7
Czech Republic	10.3	3,200	-2.1
Estonia	1.5	2,820	-6.1
Hungary	10.3	3,840	-1.2
Latvia	2.5	2,320	-6.0
Lithuania	3.7	1,350	-8.0
Poland	38.5	2,410	0.8
Romania	22.7	1,270	-4.5
Slovakia	5.3	2,250	-3.0
Slovenia	2.0	7,040	NA

NA = not available.
*Adjusted for inflation.
Source: World Bank Development Report, 1996.



Under both scenarios, CEE meat prices would increase significantly, spurring production and discouraging consumption. Meat production would shift somewhat from the EU-15 to CEE, increasing the share of CEE production. The EU-19 would continue to have some exportable surpluses of pork and poultry. CEE grain production would also increase under both scenarios, as CEE producers respond to higher prices. However, due to the EU's mandatory set-aside program, the increase in CEE grain production would be very small under the current CAP and would be dwarfed by the increase in consumption due to rising feed use by the livestock sector.

If the EU-19 adopted world prices and abolished the set-aside, the region would become an even larger wheat exporter than the EU-15, while potentially importing more corn. It is likely that large increases in EU-19 agricultural production would lead to lower world prices, dampening future production gains slightly.

Growing Market for U.S. Farm Exports

The U.S. has had a keen interest in the CEE countries from the beginning of the region's transition process in 1989. Many CEE countries have made significant progress in their transition to market economies, and trade with the West has boomed. U.S. agricultural exports to the region were roughly $400 million in fiscal 1996, making the region one of the fastest growing markets for U.S. farm products.

The CEE countries represent a potentially large export market, with strong growth potential. Prospects are uncertain for U.S. trade, however, as EU competition in the region presents a major obstacle to increased exports. The EU is the most important CEE trading partner and the source of about half of all CEE agricultural imports. The EU has benefited from natural advantages conveyed by geographic proximity, lower transport costs, longstanding cultural ties, ease of marketing servicing, and the opportunity for frequent direct contact with customers.

In 1996, U.S. agricultural exports to CEE countries represented only 5 to 10 percent of the CEE market and were not highly diversified, consisting primarily of wheat, feed grains, and poultry meats. Traditional U.S. exports of bulk commodities, particularly grains, have declined since 1990 and fluctuate considerably from year to year, depending on domestic CEE grain production.

On the other hand, the high-value-product (HVP) share of U.S. exports to CEE has been rising. Poultry claims the largest share of HVP exports, although it has slumped in the last 2 years as CEE countries take increasingly protectionist measures. Exports of hides and skins and variety meats such as fresh or frozen offal are beginning to recover, and U.S. companies are finding markets for new products not traditionally imported by CEE, including popcorn, other processed grain products (such as ready-to-eat cereals), and horticultural products, especially nuts.

While the U.S. supports EU enlargement, it is also committed to furthering the development of free trade in the global economy. Therefore, the U.S. will work to ensure that EU terms of accession are consistent with the Uruguay Round agreement.

Prospects for U.S. agricultural exports to the region as it becomes more integrated with the EU are favorable in the near term, particularly for high-value products. Rising income growth resulting from EU membership should increase overall demand for agricultural products, and U.S. exports could rise as total exports to the region expand. U.S. exports of oilseeds, oilseed products, and some feeds may benefit as the livestock sector expands. An expanding and modernizing farm sector may also raise demand for U.S. agricultural inputs.

Opportunities for increased U.S-CEE trade will likely be limited, however, by CEE government intervention, increased protection, and stiff EU competition. As CEE countries come under the EU's import regime, shipments to these countries will encounter the principle of community preference, whereby the EU (like all customs unions) discriminates against third-country imports in favor of products from member countries.

As EU members, CEE countries will adopt EU veterinary, sanitary, and phytosanitary standards. Restrictions on trade between the current EU-15 and its trading partners will then also apply to imports into the new member countries. This could present problems for U.S. access to CEE-10 countries. After enlargement, longstanding U.S.-EU disputes over hormone-treated meat, meat inspection standards, and more recently, genetically modified organisms, will have greater impact, affecting nearly all of Europe.

As increased protection and competition from the EU in the market for agricultural goods render trade prospects uncertain, U.S. businesses may find that investing in this region will allow them to take advantage of expanding demand. While the climate for investment by agricultural industry varies by country, economic developments in the region overall are generally favorable for investment. The region's advantages include a highly educated, low-cost workforce, rapidly growing economies with rising per capita incomes, and close proximity to major markets in the EU and the newly independent states of the former Soviet Union. The recovering agricultural GDP will enhance investment and joint-venture opportunities in the areas of farm inputs such as fertilizers, feed, and agricultural machinery, as well as marketing and food processing.

Some obstacles to investment remain, however. Political and economic instability continue in the region. During the transition process, agricultural output has declined, fueling pressure for protectionism.

Risk is an important consideration for potential investors in the region. Despite strong growth, per capita incomes are still low relative to developed market economies, and unemployment is high. Markets for land are not well developed, which increases risks and transaction costs. Some countries' legal structures may not yet be developed for private business operations. Privatization is not complete, especially in the agro-industrial sector. The lagging reform of the processing and distribution sectors remains a major bottleneck. Infrastructure is frequently inadequate, particularly in rural areas.

On the positive side, opportunities for profitable investment in agriculture are linked to increased mechanization of the farm sector, demand for high-tech inputs, and land consolidation. Rising incomes offer opportunities in high-value and processed products, and in oilseeds and other inputs for the expanding livestock sector.

Moreover, EU enlargement will expand the size of the market, with output of most agricultural products expected to expand. EU assistance to CEE countries through structural funds will address some of the obstacles to investment that are aggravated by an outdated agricultural infrastructure. At the same time, EU membership may address some of the problems attendant to economic and political instability and lack of transparent economic and legal systems, reducing risk to investors.

The overall benefits to exporters and investors in an enlarged EU are not without costs. CEE agricultural sectors are rife with distortions resulting from many years of a command-structured economy. The EU's CAP, even if "reformed," may simply replace one set of market distortions with another. Despite short-term improvement in the trade outlook, EU membership may limit opportunities for U.S. agricultural exports to CEE countries. The best opportunities in the CEE region will remain in exports of HVP's, targeted bulk commodities, and investment in certain sectors. Higher agricultural prices following CEE membership could reduce global competitiveness of businesses based in CEE countries. Despite such reservations, CEE will continue to be an important region for U.S. agriculture, as it is an expanding market for U.S. farm exports and a strong magnet for U.S. investment.

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