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EU Enlargement, Agriculture and the WTO

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Abstract

The planned reform of the CAP will be insufficient for the EU to meet its existing WTO commitments on the volume of subsidised exports, unless there is a substantial upward movement in world prices. The problem that the EU faces arises from the partial nature of the reform process, partial cuts in the difference between the intervention and the world price and partially decoupled direct payments have not reigned in EU output of key products such as cereals. This reflects the desensitisation of farmers to changes in prices under the CAP and the stimulus to intensification of land use under the direct payments scheme. Farmers in Central and Eastern Europe, on the other hand, will face greater market stability in the EU as well as higher prices in a range of products. The combination will create incentives to increase production. This will only exacerbate the problems of the EU in meeting current limits and handicap the scope for genuine concessions by the EU in the next round of WTO negotiations on agriculture.

Key words: Agriculture, WTO commitments, CEECs, EU Enlargement

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Paul Brenton and Jorge Núñez Ferrer

Introduction

The 1994 Uruguay Round Agreement on Agriculture commits the contracting parties to further negotiations to continue the process of 'progressive reductions in support and protection' in agriculture (Article 20). The Agreement states that fundamental reform of agricultural protection and support is an 'ongoing process'. These negotiations should commence one year before the end of the six year implementation period (that is by 31 December 1999) during which the developed countries agreed to reduce or limit external protection against agricultural products and made commitments on levels of domestic support and on export subsidies.

The first decade of the next century will see substantial changes to agricultural policies and markets in Europe. The EU has recently agreed to further reform of the Common Agricultural Policy following the reforms introduced in the early 1990s and the Uruguay Round commitments. In addition, the EU will expand during the decade to include 10 countries in Central and Eastern Europe (CEECs). Accession of all ten of the CEECs would increase the area of cultivated land in the EU by 50 per cent and would lead to a doubling of the number of farmers.

The timing of accession has not been specified and will be determined by the negotiations on accession, which are conducted individually with each of the applicant countries. Thus, at present it remains unclear exactly when the next wave of enlargement will occur and the number of countries that will be involved. However, what is significant is that the EU will be participating in multilateral trade negotiations *at the same time* as it is preparing for an enlargement. It is for this reason that discussion of the implications of enlargement for the WTO negotiations on agriculture is a rather complex issue.

Although the Uruguay Round Agreement provides a date by which the next set of negotiations should commence, no timetable or completion date is specified. A key issue here is whether the negotiations on agriculture will take place under the umbrella of a comprehensive new round of multilateral trade negotiations or whether a stand-alone agreement will be sought. If the next WTO round is comprehensive then an overall agreement will be dictated by the pace of talks on the most difficult issues. If the Uruguay Round experience is anything to go by then an enlargement to at least a subset of the CEECs will probably occur before an agreement on multilateral liberalisation of agricultural trade is finalised. Currently it would appear that a date of January 2003 is the earliest possibility for enlargement. In this case the new members from Central and Eastern Europe will party to any vote in the European Council on a deal in agriculture.

On the other hand, if the next talks are confined to those areas where a decision has already been made to negotiate then an agreement on agriculture may arise at an earlier date. Croome (1998) suggests that the end of the time-limited peace clause agreed to under the Uruguay Round, which constrains countries from taking countervailing actions against certain agricultural support measures and subsidies, at the end of 2002 may encourage a conclusion to the new negotiations on agriculture by this date. In this case enlargement is unlikely to have been undertaken and the CEECs will not be able to directly influence the final decision on any new trade deal. However, Croome also presents the commonly held view that if negotiations on agriculture are held in isolation they are unlikely to proceed very far since there will be little opportunity for the balancing of interests across issues which characterised the Uruguay Round negotiations.

It is apparent that there are conflicting views as to whether the next round of multilateral negotiations on agriculture will be short (less than three years) or long. There is also little consensus concerning the date of the next enlargement of the EU.   This makes an assessment of the implications of the next enlargement for the WTO talks rather difficult. Nevertheless, it is clear that negotiations on agriculture will take place before enlargement, even if a final agreement is not achieved. So the EU will have to keep the enlargement issue in mind, and cooperate closely with the CEECs to ensure that commitments are not made that will subsequently be difficult to adhere to once the CEECs become EU members.

A rather complicated situation could arise whereby the Council of Ministers of the EU votes on a package which is designed in the light of the next enlargement and which will be of fundamental importance to the CEECs, but where the CEECs themselves are unable to vote. Another way of looking at the problem is that the CEECs will be negotiating their entry to the EU on the basis of a set of rules in agriculture which may change during the accession process. All of the CEECs, with the exception of Lithuania are now members of the WTO and will thus be able to influence, albeit in a much more limited way than if they were EU members, the outcome of the negotiations on agriculture from this perspective.

This paper seeks to assess the implications of the enlargement of the EU for the next round of multilateral negotiations of agricultural policy at the WTO. The answer to this issue is very much framed by an assessment of the extent to which the EU and the CEECs are able to satisfy their existing WTO commitments in agriculture and the extent to which these commitments will be further threatened by the eastwards extension of the CAP. Consistent with other studies we suggest that the EU will have difficulty in meeting its volume commitments on subsidised exports. However, we home in on a key reason for this, the apparent insensitivity of farmers in the EU to reductions in intervention prices. This has been the main vehicle of CAP reform with accompanying compensating direct payments in a supposed production-limiting scheme.

A further problem that the EU will face when trying to define a position for the next agricultural negotiations is uncertainty concerning the impact of transition and accession (and the prospect of accession) on agricultural output in the CEECs. In general farmers in the CEECs will be integrated into a market in which producer prices are in many cases higher and more stable than those that they currently face. An important issue affecting the ability of the enlarged EU to meet existing obligations and commit to new reductions in agricultural support and border restrictions will be the degree to which farmers in the CEECs respond to these higher prices by raising their output. Previous experience shows that it is dangerous to underestimate the extent to which farmers can respond to incentives.

Thus the EU faces the problem of relative insensitivity to price reductions in the EU but the possibility of rapidly rising output in the face of increasing internal prices in the CEECs. We start by briefly restating the commitments entered into under the Uruguay Round and then review the extent to which the EU and the CEECs are able to satisfy these requirements. The next section discusses the implications of enlargement for the ability of the EU to adhere to current commitments. The paper then proceeds to consider how this might affect the negotiating position of the EU and the next round of negotiations on agriculture.

The Uruguay Round Commitments, The EU and Enlargement

The Uruguay Round was the first set of multilateral trade talks to cover agricultural policies in a comprehensive manner. The key outcomes of the negotiations were:

- agreement to limit export subsidies. Specifically, countries agreed to reduce the value of export subsidies by 36 per cent from the average in the base period of 1986 to 1990 in six equal annual instalments. Commitments were also made to reduce the volume of subsidised exports by 21 per cent from the same base period, with similar instalments. Reductions were generally to be applied to specific products at the 4 digit level of the harmonised system, although in some sectors such as coarse grains and fruit and vegetables commitments could cover a broader range of goods allowing some flexibility to shift subsidies between sub-groups of products. For developing countries the respective cuts were 24 and 14 per cent to be implemented over 10 years.

- Commitments were made to reduce domestic subsidies by 20 per cent from the base period of 1986-88, again over a six-year period. The commitments related to overall subsidies (as captured by the aggregate measure of support (AMS)) and so allowed for flexibility in levels of support provided to individual sectors. Certain types of subsidy programmes could be excluded from the calculation of the AMS and hence were not subject to the reduction commitment. Such programmes included direct payments to farmers decoupled from production (so-called ‘green box’ payments) and schemes involving payments to farmers involving production limiting schemes (‘blue box’ payments) as implemented in the CAP reform of 1992 and enhanced and extended under the recent reform package (Agenda 2000).[1]

- Market access commitments were also given.
  - Countries were required to convert all non-tariff barriers into tariff equivalents, an important step to improve the transparency of trade policies in agriculture. Countries then agreed to bind tariffs at the combined rate of existing rates and the tariff equivalents of the NTBs and to cut these rates by an unweighted average of 36 per cent in equal instalments over a 6 year period. Each tariff had to be reduced by at least 15 per cent over the 6-year period. For developing countries the average cut was 24 per cent implemented over 10 years.
  - Countries also agreed to implement minimum access quotas for products or product groups which have faced prohibitive trade barriers, such as meat and dairy products. In general these were to take the form of tariff-rate quotas with the rate for imports within the quota generally no greater than 32 per cent of the bound tariff.
  - As part of these market access commitments countries were permitted, under strict conditions, to implement special safeguard measures, in the form of temporary duties. These safeguard measures could only be triggered by a sudden surge in the volume of imports or by an abrupt fall in prices. This contingent protection being available for ‘the duration of the reform process’ and so covers the 6 year period of tariff and subsidy reductions as well as further periods of liberalisation agreed to under future trade negotiations.

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[1] Such payments are excluded from the commitments to reduce domestic support entered into in the Uruguay Round if the payments are made in respect of fixed areas, yields or livestock numbers. Payments can also be included in the ‘blue box’ if made on 85 per cent or less of production in a specific base period. So, production is required to receive such payments but the actual amount received is not directly linked to current levels of production. It is for this reason that such payments are referred to as being partially decoupled.

We now briefly review the extent to which the EU and the CEECs have managed to implement the WTO commitments on agriculture and highlight areas where implementation may be difficult under current domestic policies and how enlargement might affect these current commitments.

AMS commitments

For the EU, the calculated base AMS level leaves a huge amount of slack. The ceiling was calculated using a period prior to the MacSharry reforms, which reduced price support in exchange for direct payments. The direct payments are in the blue box and are excluded from the calculation of the AMS. In fact, the level of the AMS in 1997 was 51 billion Euro well under the maximum ceiling of 73.8 billion Euro and considerably below the final commitment of 67 billion Euro for the year 2000. With the additional reforms of the Agenda 2000, the AMS level is bound to fall further. Thus, the EU will have no difficulty meeting current commitments on the level of domestic subsidies and there will be enough slack in its commitments to accommodate the acceding countries in Central and Eastern Europe. There would also appear to be scope for the EU to make further significant commitments on the AMS during the next round of agricultural negotiations unless the exclusion of blue box payments from the calculation of the AMS is successfully challenged.

Export subsidy value and volume commitments

It is in the subsidised export commitments that the EU may well face the strongest constraints. The EU has agreed to limits on export subsidy values and volumes. A number of studies suggest, usually on the basis of simulation models, that the EU will have difficulty meeting its commitments on export subsidies, particularly for grains (see, for example, Josling et al (1998)). Export volumes for the year 1997 are shown in the following tables together with the volume commitments for the year 2000. For the EU the figures represent actual exports (source DGVI Web site, statistical data) and the volume of subsidised exports notified to WTO. For the CEECs we use the difference between domestic supply and consumption (source: Göttingen University database).

Table 1 Export volume commitments and exports or exportable surpluses, 1997

A)Wheat	Max. sub. Export ('1000t), year 2000	1997 Exports (1000t)	Quantity over limit	% over limit
EU-15 WTO notified[5]	13437	17109[2] 14410	3672 973	27.3 7.2
Czech Republic	65.5[1]	0	-65.5[1]	-100
Hungary	1141	1954	813	71.2
Poland[3]	0	0		n/a
Slovak Republic	109[1]	134	25[1]	22.9[1]
Total	14752.5	19197	4444.5	30.1

B)Coarse Grains	Max. sub. Export ('1000t), year 2000	1997 Exports (1000t)	Quantity over limit	% over limit
EU-15 WTO notified[5]	9973,4	16414[2] 11844.5	6440.6 1871.5	64.6 15.8
Czech Republic		0		n/a
Hungary	n/a	n/a	n/a	n/a
Poland[3]	0	257	257	n/a
Slovak Republic		127	127	n/a
Total	9973.4	16798	6824.6	68.4

C) Beef	Max. sub. Export ('1000t), year 2000	1997 Exports (1000t)	Quantity over limit	% over limit
EU-15 WTO notified[5]	817	971 1177.4	154 360	18.8 30.6
Czech Republic	49.8	11	-39	-78.3
Hungary	83	173	90	108.4
Poland[3]	40.9	10	-31	-78.8
Slovak Republic	28.4	4	-24	-84.5
Total	1019	1169	150	14.7

D) SMP	Max. sub. Export ('1000t), year 2000	1997 Exports (1000t)	Quantity over limit	% over limit
EU-15 WTO notified[5]	243	275 269.5	32 26.5	13.1 9.8
Czech Republic	66.9	24	-43	-68.7
Hungary[4]	0	14	14	n/a
Poland[3]	37	131	94	254.1
Slovak Republic	15	4	-11	-73.3
Total	362	397	35	9.6

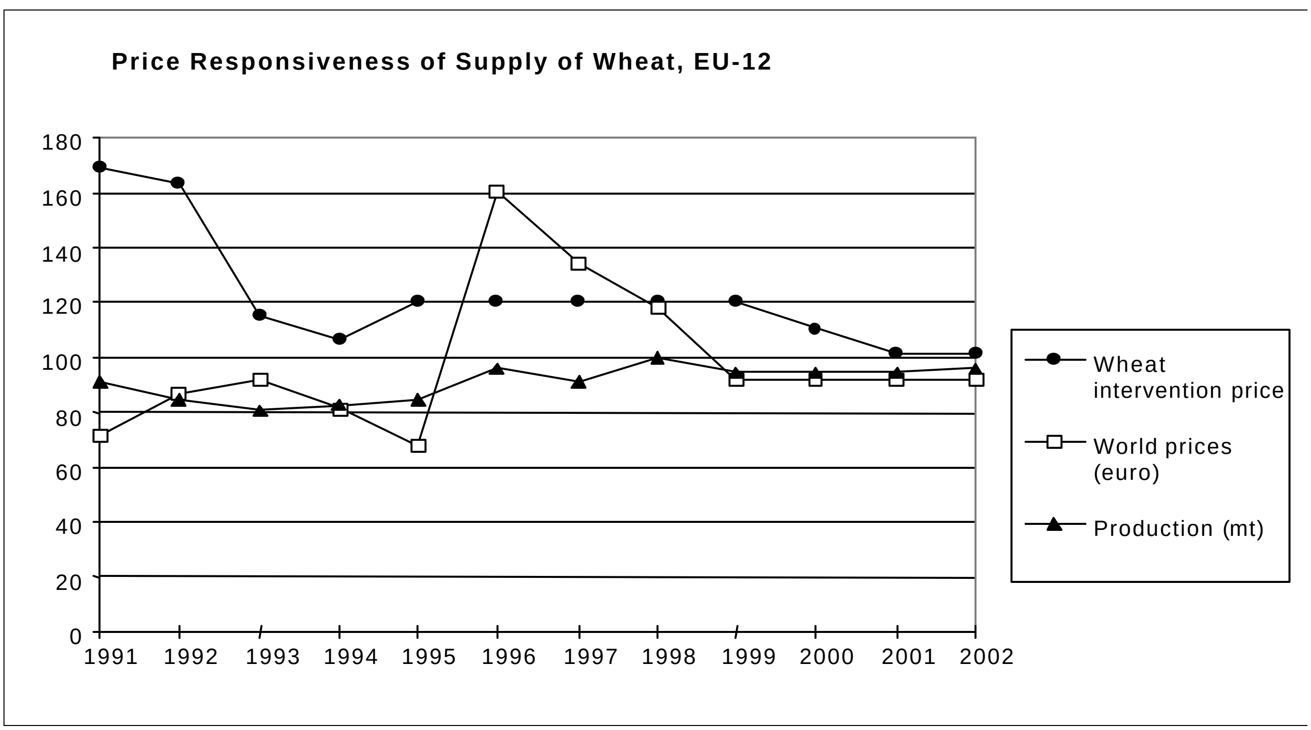
E) Sugar	Max. sub. Export ('1000t), year 2000	1997 Exports (1000t)	Quantity over limit	% over limit
EU-15 WTO notified[5]	1151	3835[2] 1200.3	2684 49.3	233.2 4.1
Czech Republic	4.9	217	212	4328.6
Hungary	32	199	167	521.9
Poland[3]	104.4	395	291	278.3
Slovak Republic	3.9	8	4	105.1
Total	1296	4654	3358	259.0

[1]Total Cereals (quantities and % over limit for wheat + coarse grains), [2] Marketing year 1996/97, [3] 1998
[4] average exports 1995-98, [5] Subsidised exports notified to WTO: Marketing year 1996/97

Notes: The world prices of some grains exceeded intervention prices in this year so that exports occurred without being subsidised. It is worth noting that stocks of wheat are reported to be rising.

In most of the key agricultural products the current levels of exports or exportable surplus exceed the subsidised export volume commitments for the year 2000. It is worth noting that for beef the notified level exceeds the commitments for the marketing year 1996-97. A number of other products have reached the limit, notably cheese and other milk products, a problem due to the unreformed dairy regime. The ability to meet these commitments will depend upon developments in world market prices and changes in domestic demand and supply in response to the reform of the CAP.

We now proceed to a more detailed analysis of the problems facing the EU in the cereals sector, and particularly wheat. The principal mode of reform in the EU has been to reduce the intervention price, but not to fully liberalise to the world price level, with compensatory payments linked to initial production levels with a requirement for a certain portion of cultivated land to be set-aside. However, a very crude and simple analysis of the price sensitivity of wheat output in the EU, as shown in the following figure which covers the period of the first reform of the CAP, suggests a high degree of inelasticity. Production in the EU during the 1990s appears to have been unresponsive to price falls. Indeed production has continued to rise despite a fall in the intervention price.



Thus, despite the MacSharry reforms and the set-aside area obligations, production in the EU has increased steadily, with little apparent reaction to changes in the intervention price or the world price. The following table summarises the extent of variability in world prices and in production during the 1990s in the EU, the USA and in Australia, a country with relatively little policy intervention.

Table 2
Summary Measures of Production and Price Variability of Wheat in the 1990s

	Standard deviation	Mean	Coefficient of variation (std dev/mean)
World price	30.84 euro	100.51 euro	30.7
Production:			
EU-12	6.52 mt	89.38 mt	7.2
USA	4.73 mt	63.39 mt	7.5
Australia	4.88 mt	16.94 mt	28.9

Data Sources: World Prices - Eurostat c.i.f. Rotterdam 91-93, 93-99 FAO Commodity review (1999)
Production - Web site of FAO statistical office

This again indicates inelastic responses to the variability in world prices in both the EU and US, which reflects the isolation of farmers in these countries from world market movements. The comparison with Australia is informative where variability in output has been substantially greater than that in the other regions. So, this all crudely suggests that the price elasticity of supply is very low and that supply change is most strongly affected by technical growth and farm restructuring. During the period since the recent CAP reforms there has been a rise of the average size of farms as well as an increase in area of land under agricultural production.

To precisely estimate the supply price elasticity in the EU for many agricultural products is nigh on impossible due the high degree of interference in the market and the difficulty of accurately capturing the impact of the raft of policies which affect output decisions. In addition, the price elasticity has probably been changing (becoming more inelastic) as a result of policy intervention which has de-sensitised farmers to changes in world market conditions, and expectations concerning future intervention. This suggests some difficulty for simulation models which predict the long-run impact of policy changes with fixed elasticity values. In addition, the observed movements in agricultural supply may reflect a form of hysteresis whereby large upward movements in prices lead to significant adjustments in production, whilst price falls have a smaller impact upon output decisions.

The profile of supply over time also reflects the nature of the reform in the EU. The direct payments made as compensation for the fall in the intervention price are linked to production. To qualify for the payments farmers have simultaneously to set-aside a certain amount of land, but are not allowed to exceed the specified level of set-aside. As a result farmers will have an incentive to intensify production in the area remaining under cultivation.

We have made a very simple prediction, as shown in the figure, of future output of wheat in the EU to assess the implications for WTO commitments. We have projected production and domestic consumption forward from the average of the years 1997-1999[2] with assumptions on exogenous growth and price elasticities. Two variables are crucial to the ability to meet existing commitments on the volume of export subsidies. One is the world price level, of course. The other is domestic consumption. Feed demand has increase at an annual rate above 4% since the MacSharry reforms, considerably reducing the level of exportable surplus of the EU.

We assume here that yields and land area increase contributing to an exogenous growth rate of supply of 2 per cent per year. The price elasticity of wheat supply is taken to be small and inelastic, at 0.25 and the change in intervention price is taken to be that agreed at the Berlin summit. Under these assumptions the EU will violate its existing export subsidy volume commitments. The table below shows that the extent of this violation will depend upon changes in domestic demand.

An alternative way of presenting this issue is the calculation that under existing policies the world price will have to increase by 18 Euros from the level of today if the EU is to avoid exceeding the limits on the volume of subsidised exports in the year 2000. For the year 2003, by which the further price reforms agreed to at the Berlin Summit will have been implemented,

[2] Data by the FAO database. 1999 production levels are FAO estimates.

we calculate that the world price will have to be higher than today's value by around 10 Euros. In terms of value commitments there are unlikely to be any problems for wheat. At the world price of today, the value of subsidised exports by the EU in 2000 would be 80 per cent below the commitment.

Table 3: Predicted Exports of Wheat by the EU in 2000

	Scenario 1: Domestic Demand grows at 2% per annum 1998-2000	Scenario 2 : Domestic Demand grows at 4% per annum 1998-2000
Production (1000t)	98038	98038
Domestic demand (1000t)	73382	80117
Difference (1000t)	24656	17921
% over limit	84	33

To conclude, the nature of the reform of the CAP, in terms of partial price reduction towards the world price and the provision of compensating payments which encourage intensification of production, combined with the insensitivity of output to changes in price, entail that the EU will find it difficult to meet existing commitments for wheat. The only solution within the current approach would be to increase the area under set-aside. As export subsidy commitments are expected to get much tighter, this is a very sub-optimal and controversial solution. This does question the rationale behind the use of partially decoupled direct payments to farmers in the EU and the maintenance of the intervention price above the world price level. We will consider other products in the discussion of the next round of agricultural negotiations, which follows later.

Market Access Commitments

There has been no difficulty in the EU in implementing the market access commitments of the Uruguay Round. Non-tariff barriers have been tariffied and the resulting overall tariff has been reduced in line with the commitments under the agreement. Between 1995 and 1997 the simple average tariff for agricultural products declined by 25 per cent to reach a figure of almost 21 per cent in 1997.[3] However, these commitments appear to have done little to improve overall access to the EU market. Between 1995 and 1998 the volume of EU agricultural imports (HS 0-21) from non-member countries fell by over 6 per cent and the share of the volume of extra-EU imports in total EU imports (extra + intra) declined from 38.6 to 35.1 per cent (see Table A1 in the annex). Within this total there was a large degree of variability between products in movements in import volumes, with imports of wheat, meat and milk products rising but those of barley, maize and other cereals falling sharply.

Over this period the value of extra-EU imports of agricultural products increased by over 12 per cent with the share of the value of extra-EU imports in total EU imports remaining roughly constant at 33 per cent. This then reflects that the overall price (as proxied by unit value) of extra-EU imports of agricultural products increased between 1995 and 1998 by about 20 per cent showing the importance of movements in world prices in this period. Again a different picture emerges amongst the various types of agricultural product, with the import price of other cereals rising substantially whilst that of wheat fell slightly. This price is of course the price measured at the border. The internal price in the EU may have been affected by the reduction in tariff rates agreed to under the Uruguay Round.

The EU tariff schedule for agricultural products is still dominated by tariff peaks for products such as meats, cereals and milk products. For example, in 1997 the simple average tariff (taking account of the ad valorem equivalents of specific duties) for fresh meat of bovine animals was 107.5 per cent with a narrow range from 94 to 125 per cent. For wheat the simple average tariff in 1997 was almost 77 per cent whilst for milk and cream the simple average was 59 per cent with a maximum tariff of 134 per cent (WTO (1997)). The Uruguay Agreement on Agriculture has made transparent these very high levels of border protection for certain agricultural products. Progress in further reductions of these tariff rates is likely to be an important aspect of the next round of multilateral negotiations on agricultural trade.

Agenda 2000 and the Reform of the CAP

The European Commission set the guidelines for the medium-term future evolution of the CAP through the Agenda 2000 proposals. In these proposals the European Commission (1998a) recommended significant cuts in intervention prices granted in the grain, beef, and dairy

[3] WTO(1997)

sectors, together with greater reliance on the system of direct payments to compensate farmers for falling prices, which could be partly implemented through national programmes. According to the Commission, the main challenges facing this reform were internal in nature: if the levels of price support were not corrected, surpluses would appear again, and stocks would build up, since subsidised exports are limited by the Uruguay Round commitments. This would create intolerable budget costs over ever tighter supply controls.

Taking the Commission proposals as a basis for negotiation, the Council of ministers reached an agreement on reform of the CAP on the 11 March 1999, just a few weeks before the decisive EU summit in Berlin. This agreement weakened the proposals of the original Agenda 2000 by reducing the magnitude of price cuts and introducing phasing out periods, thereby temporarily reducing the costs of reform by lowering direct payments.

An even less ambitious reform of the CAP emerged from the Berlin Summit. Price cuts for cereals were reduced[4] and the mechanism to cut direct payments annually was abandoned. Milk reforms were postponed until 2005, whilst milk quotas were increased for various member states. Therefore, the reforms in agriculture are less expensive than those originally proposed in Agenda 2000. However, the apparent achievement in limiting expenditure that was announced was a consequence of slowing down or postponing various items of the agricultural reforms.[5]

This reform was supposed to pave the way for a smooth enlargement to the east. However, it is clear that a number of issues have been inadequately addressed or totally avoided. A number of authors have argued that the price reductions, particularly those for cereals will be insufficient to enable an enlarged EU to meet its international commitments. However, as we have shown above, much will depend upon the evolution of world prices. In addition the issue of direct payments to farmers in the CEECs has not been solved in these negotiations. Also problematic are the postponement of milk reform and the disregard of sugar. The lack of

[4] For example, price cuts in cereals were reduced from 20 per cent to 15 per cent and from 30 per cent to 20 per cent for beef.
[5] For further discussion see Moehler *et al* (1999)

reform in these sectors will make enlargement more difficult and will effectively handcuff negotiations on these products in the next WTO round.

Enlargement and the Incorporation of the CEECs into the CAP

Levels of market support in the CEECs are still generally lower than, and often substantially below, that in the EU. In aggregate, agricultural protection in 1997 was only one quarter of that in the EU in the Czech Republic, 38% in Hungary and 50% in Poland (Banse, 1999). Only Slovenia has a level of support comparable to the EU. Although it is very difficult to predict what could be the medium term evolution of these protection gaps, an immediate extension of the CAP would substantially raise levels of market support, encouraging increases in production and inducing major changes in the agricultural sectors of the CEECs. In addition, accession to the EU will also encourage agricultural growth by providing free access to the large EU market.

The stimulus to increase production will occur particularly in the beef and milk sectors. The prices of cereals are currently similar in the EU and in the CEECs. Poland, for example, has an intervention price higher than in the EU, at 141 ECU per ton compared with 119 in the EU. In other sectors the picture is very different with prices being considerably lower in the CEECs. Even after the Agenda 2000 reforms beef support prices, for example, will still be 45% higher in the EU.

Table 4. Differences in support prices EU-CEECs

	Ratio of EU to Polish intervention prices, 1997/09
Beef	1.812
Milk	1.938
SMP	1.427
Butter	1.678

Source: European Commission (1998c)

Münch (1999) calculates, using a simulation model, that after accession agricultural production will exceed domestic demand for most agricultural products in the Central and Eastern European countries. These production surpluses will have to be exported outside of the Union. These calculations were based upon the reforms in the Agenda 2000 proposal. The actual reforms agreed at the Berlin Summit were less bold and so will accentuate this problem of production surpluses in the Union. Using a similar modelling approach, Swaminathan et al (1997) predict strong increases in agricultural production in the CEECs after integration into the CAP. For example, production of wheat rises by almost one quarter in Eastern Europe whilst output of milk products increases by over 70 per cent.

However, for certain products, particularly processed foodstuffs, current variations in prices will only partly reflect differences in agricultural policies, food quality issues are also likely to be significant. In addition there are a range of structural barriers which may be constraining current agricultural output in many of the CEECs. Agricultural production in the CEECs is characterised by relatively low mechanisation levels and by a low level of training of the workforce. The quality of rural infrastructure is also poor, with a low density of roads, telephone lines, electrification, water supply and sewage disposal.

Pouliquen (1998) discusses the problems of lack of investment and hence slow progress in capital intensification of agriculture in the CEECs. The problem is seen not to be transitory in nature, that is not related to the transition period to a new competitive status, but reflects deeply set structural problems, which discourage investment and growth. Inefficiencies remain in the upstream and downstream sector, where the process of restructuring and privatisation has been rather slow. In the food processing and marketing industry, the poor state of the marketing and distribution channels represents a major problem.

In countries such as Poland and Slovenia, the fragmented farm structure is an additional problem, which prevents the utilisation of efficient production techniques, and poses a major obstacle for agricultural investment, since small land plots are rarely accepted as collateral for loans. On the other hand, the European Commission (1998b) estimates that the average size of the former state owned farms is decreasing, which will contribute to increased efficiency as these large units reach proportions that are more manageable. In fact, former public state owned farms could be regarded as the most promising production units for agriculture in the CEECs. However, the development of agricultural production in these farms still requires the conclusion of the restructuring and privatisation process. In relation to this last aspect, a major challenge that most CEECs are still facing is to increase the degree of certainty over property rights.

On the other hand, there are reasons to suspect that agricultural production in the CEECs may expand more quickly in response to the incentive of higher prices. Fertiliser use has collapsed in the CEECs due to the lack of supply and distribution chains, absence of finance and lack of farmer education and training. Data from the International Fertiliser Industry Association show that the CEECs are exporting most of their fertiliser production due to lack of internal demand. A return to normal levels of fertiliser use would lead to a greater increase in output than a number of models are predicting. In addition, rural infrastructure will improve and awareness of techniques and skills will spread more widely.

Ultimately, the issue reduces to assumptions concerning the position and slope of the supply curve of agricultural products in the CEECs. Transition initially led to an inward shift of the supply curve as fertiliser use evaporated and structural constraints materialised. The issue now is to what extent the supply curve will shift out as transition is intensified and to what extent these structural barriers can be ameliorated. In addition, as farmers in the East adjust to the new market conditions in which prices are the main signal, their responsiveness to changes in prices may increase, so changing the slope of the supply curve. We return to discuss this issue below.

The Next Round of Agricultural Negotiations at the WTO

The commitment to further negotiations on agriculture has not been challenged by any of the Contracting Parties. The task of defining exactly which issues will be on the agenda is being undertaken by the WTO Committee on Agriculture but is still to be fulfilled. The 1994 Uruguay Round Agreement of Agriculture states that the next negotiations should take account of:

- the experience of implementing commitments made under the agreement;

- the effects of these agreements upon trade in agricultural products;
- non-trade concerns……;
- special and differential treatment to developing countries;
- the objective of establishing a fair and market-oriented trading system and the further commitments that are required to meet this objective.

As noted above, the principal features of the Uruguay Round Agreement on Agriculture were the conversion of non-tariff barriers into tariff equivalent measures, which were to be reduced in stages, and commitments on the levels of domestic support and export subsidies. The Committee on Agriculture has noted that in the main members have complied with their commitments on market access and domestic and export subsidies. However, the agreement has only had a limited effect on trade barriers and its primary contribution has been to bring agriculture within world trade rules for the first time and provide the foundations for further liberalisation (Luyten and Pelkmans (1999)). Hence, it is likely that the forthcoming negotiations will be dominated by bargaining on further reductions in customs tariffs, including the size of tariff quotas, and the search for additional commitments on limiting levels of domestic support and export subsidies.

The positions of the different Contracting Parties are likely to be somewhat similar to those adopted during the Uruguay Round. Essentially the EU will be seeking to defend the Common Agricultural Policy from attempts by the Cairns group of agricultural exporters and the US to gain improvements in access to the EU market and to obtain commitments for greater discipline on domestic subsidies and export subsidies. Indeed the US has stated that one of the objectives of the next WTO negotiations on agriculture should be the elimination and subsequent prohibition of all remaining export subsidies as defined in the Agreement on Agriculture.[6] In addition it is generally recognised that the Uruguay Round, whilst improving transparency, did little to reduce the levels of border protection. Hence, negotiations on

[6] Preparations for the 1999 Ministerial Conference: Negotiations on Agriculture; Communication from the United States (WT/GC/W/286).

market access, including tariff reductions and the expansion of tariff quotas, are likely to figure high on the agenda of a number of members.

There are three key issues which the EU will be seeking to preserve.[7] Firstly, the EU will seek to continue the 'peace clause', which asks for restraint in challenges to countries' agricultural subsidies if they remain below levels agreed upon during the last round of negotiations. Secondly, the EU will negotiate for the continuation of the special safeguard provisions, which allow for an additional tariff to be levied on specified products following a surge in the volume of imports or a fall in the import price. Thirdly, preservation of 'blue box' payments will be of crucial importance to the EU in seeking to justify the current system of agricultural support in Europe.

Thus, it would appear that the thrust of the next negotiations will involve the seeking of market access commitments and commitments on export and domestic subsidies from the EU in return for the continuation of the peace clause and the preservation of the blue box. As noted above the EU appears to have quite a large degree of scope for additional commitments on domestic subsidies providing that the current system of excluding blue box payments from the calculation of the AMS is maintained. Without preservation of the blue box a deal on agriculture would appear to be infeasible.

It is with regard to market access and export commitments that the scope for significant liberalisation by the EU appears to be limited under current EU policies. In these areas the position of the EU after enlargement would seem to be subject to rather extreme bounds of uncertainty. This will make precise commitments as part of the negotiations extremely difficult for the EU to define, particularly in areas such as wheat. The ability to meet commitments will depend upon developments in world market prices together with the response of EU farmers to changes in those prices and to the liberalisation of the CAP. Specifically, the EU has to make some assumptions concerning the extent to which the currently planned cuts in

[7] 'Communication from the Commission to the Council and the Parliament' Com (1999)331 and 'EU Ministers Prepare to Man Farm Subsidies Barricades', Financial Times, 28 September 1999, p8.

intervention prices and the system of compensatory payments will curtail output in the EU. As we have discussed above recent experience would suggest a very low degree of sensitivity of output to price reductions.

For the Central and Eastern European countries the degree of uncertainty over future output levels is probably even greater. Farmers in the East are adapting to new market conditions where prices rather than centrally determined output targets are the principal signal. Thus, the extent to which farmers in these countries respond to changes in prices is likely to be changing as the transition proceeds. In addition, if the response to large changes in price is proportionately greater than the response to small changes in prices (see Orcutt (1951)) then accession to the CAP could have a substantial impact upon output of certain products in the CEECs and one that is greater than could be expected on the basis of responses to recent changes in prices in these countries. In terms of the position of the supply curve in the CEECs, we discussed above a number of arguments which suggest that the supply curve has shifted inwards under the transition and also reasons why the curve could shift outward as these countries accede to the EU.

These considerations show that there is considerable uncertainty concerning future production levels in an enlarged EU. However, most analysis suggests that the CEECs will have an exportable surplus of most agricultural products by the middle of the next decade. Thus, with existing policies, enlargement will make it more difficult for the EU to meet existing commitments on export subsidies and to define a position on market access and export subsidies in the next round of agricultural negotiations.

The above analysis has concentrated upon the cereals sector, although it is applicable to a number of sectors facing similar issues. For example, the beef sector reforms appear to be too conservative. Stocks in the EU reached over 500,000 tonnes in 1998, whilst exports, as the table above shows, were at the maximum allowed for 1997. The milk sector also appears to be particularly problematic since to date it has remained outside of the reform of the CAP which will make any concessions in this area at the WTO impossible, something which will be compounded by enlargement to the CEECs.

A partial reform of the milk sector in the EU has been postponed until 2005. Thus, reform will occur after an initial enlargement to Central and Eastern Europe and the EU faces the prospect of introducing and enforcing the current system of quotas in the CEECs. This will be necessary to control the export volumes of cheese, butter and SMP, where, as we showed above there will be problems in meeting existing WTO commitments. The Commission (1998) itself has predicted excess milk production for all five of the first wave CEEC entrants in 2003 of over 1 million tonnes in total.

The introduction of quotas in the CEECs will be difficult and contentious. On the one hand the EU will impose strict quota limitations, during a period in which the sector will still be undergoing significant restructuring. This is particularly important in Poland. On the other hand, the high prices which will prevail under the scheme will provide a strong incentive for farmers to produce more, while technical improvements will relentlessly increase yields. In Poland the sector is still highly fragmented and underdeveloped and yields are considerably below their potential level. For example, yields per cow are approximately one third below those achieved in Hungary and the Czech Republic. If Poland achieves yields similar to Hungary after accession, excess supply of milk products in the CEECs could be as much as 5 times larger than is currently being predicted by the Commission.

The problem in the milk sector is that quotas need to be strongly enforced to avoid this increase in surpluses. However, this is completely at odds with an orderly restructuring of the milk sector in the CEECs. This will be compounded if, soon after having implemented a system of quotas in the CEECs the EU, under pressure from the WTO, agrees to reform the sector and dismantle the quota system. This in turn will bring additional difficulties since the associated fall in prices as quotas are removed will probably entail the provision of compensatory payments. These will have to be provided to <u>all</u> member states, including the CEECs. If compensation were to be provided in full the cost of such a policy would be very high and of a similar magnitude to the cereals payments, amounting to perhaps more than 12 billion Euro. Even partial compensation would entail substantial budget outlays.

Conclusions

The EU will enter the next WTO negotiations on agriculture having reformed the CAP for the second time in the 1990s and with the background of a forthcoming enlargement to Central and Eastern Europe. Both of these issues will make it very difficult for the EU to make significant concessions towards the demands of other WTO members for continuing reductions in export subsidies and in improvements in market access.

Indeed, our very simple analysis highlights that the EU will violate existing commitments on the volume of subsidised exports unless there is a strong turnaround in world prices for key agricultural products. The principal problem that the EU faces, is that it has decided upon piecemeal reform of the CAP in terms of partial movements towards world prices together with partially decoupled compensation for the implemented price falls. We suggest that years of being sheltered from changes in market conditions mean that EU farmers have become desensitised to reductions in prices. Thus, the fall in the intervention price in the EU has not had any significant effect in curtailing output. At the same time the nature of the compensation scheme appears to be encouraging intensification of land use and thus generating rising levels of output.

In the Central and Eastern European countries, farmers are in the process of major restructuring and of adapting to new market conditions. Here a substantial increase in price can be anticipated upon accession to the EU and the CAP. We argue that farmers are likely to be very responsive to large upward movements in price so that by the time of accession there will be large exportable surpluses of a number of key agricultural products in the CEECs. Again this will generate problems in meeting existing commitments and make it very difficult for the EU to define a credible negotiating position for the next WTO round.

This, all suggests that a successful conclusion to the next round of agricultural negotiations for an enlarged EU will require additional reform of the CAP. There will have to be a much more bold policy with regard to price reductions, with internal prices having to move to the world price. Partial price reform has not generated the supply responses that are required for the EU to meet existing obligations. In addition, there needs to be a review of the system of compensatory payments in the EU. The rationale for the current approach of partially decoupling compensation payments is not entirely clear or coherent. The EU needs to consider more carefully a move to complete decoupling. This then would provide for a significant move by the EU at the next round of agricultural negotiations.

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Annex

Table A1 Trends in EU Imports of Agricultural Products 1995 –1998						
	Change in Import Values (%)	Change in Import Volumes (%)	Change in Import Unit Values (%)	Change in Export Values (%)	Change in Export Volumes (%)	Change in Export Unit Values (%)
Fresh Bovine Meat	11.0	17.7	-5.7	-29.4	-9.2	-22.2
Frozen Bovine Meat	6.2	3.1	3.1	-19.4	-31.7	18.1
Skimmed Milk Powder	29.8	55.0	-16.3	-52.0	-53.5	3.1
Cheese	19.0	52.4	-21.9	5.9	-15.3	25.0
Other Milk Products	22.0	8.6	12.3	9.5	-3.4	13.3
Wheat	28.6	34.9	-4.7	-20.8	-23.7	3.7
Barley	-60.6	-63.5	7.8	14.7	32.9	-13.7
Maize	-30.7	-48.3	34.0	-1.7	24.8	-21.2
Other Cereals	-25.1	-48.8	46.4	-37.3	-38.6	2.2
All Agricultural Products	12.8	-6.3	20.4	6.7	-2.0	8.9

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