The Eastern enlargement of the EU : the agricultural challenge

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Introduction

The upcoming entry of the Central and Eastern European Countries (CEEC) into the EU will be a major step in the history of European integration. Compared with the recent and previous enlargements there is much more at stake in the prospective extension of the EU to the East for the economic and political future of Europe.

(1) The enlarged Europe could have enough size and power to play a greater role in the world geopolitics. This potential role will however materialise only if member countries find the political will to co-ordinate their national interests and allow the common interest to prevail. In order to reach this goal in a Union with many members, adequate institutions need to be designed.

(2) Economic issues will also be at stake in the enlargement ; for the CEEC's[1] first, since as a result of linking their economy to the EU, the transition to a market economy will be boosted where it is already faring steadily, and will be more firmly held in place where the course of events is more uncertain ; for the current EU countries as well, since their economies will in the short and medium run find new opportunities in more secure Eastern European countries to stimulate their growth. In the longer run, they will be in a position to take advantage of an internal market large enough to foster industrial competitiveness through the capture of scale economies which are the likely greatest benefits of economic integration in the long run. Furthermore, in a world context where trade tends to become increasingly organised into regional blocks, the bargaining power granted by the size is a valuable asset in negotiations seeking to open international markets.

(3) In the process of economic integration of the CEEC's into the EU, agricultural issues are likely to be sensitive and to raise special difficulties, as recent or older experiences of creation of free trade areas have amply shown. The sensitivity of farm issues is observed in general in industrial countries because the primary sector is often highly protected and the farming interests fear the loss of support they managed to obtain from their national governments. It is already clear that some EU Member Countries, where the farm sector is viewed as relatively important, have expressed concern and hesitation with regards to the agricultural content of the European Agreements and of the upcoming integration process. The recent reform of the CAP has used up part of the disposition for change among European farmers, even though the reform has turned out to be much more favourable than expected.

There are several reasons for agricultural policies to be a problem in the Eastern enlargement. First, the magnitude of the increase in EU agricultural production will be large due to the size of the CEEC's taken as a whole and to their potential efficiency gains. These countries will eventually become competitive within Europe and their large agricultural potential may make it harder for the EU to comply with its GATT commitments. Second, agriculture accounts for a larger share of the GNP and food is more important in the consumer budget in the incoming members than in EU countries. Third, the per capita GNP is low in the CEEC's and therefore the fiscal base available for taxation to provide agricultural support is much smaller than in the

[1] The focus is on the 6 countries which have signed agreements with the EU namely, the Visegrad-4 (Hungary, Poland and the Check and Slovak Republics) and the two Balkanic countries, Bulgaria and Romania.

current EU Member States. Fourth, agriculture tends to play a specific role in the transition to the market economy. As agricultural policies tend to evolve in the process of economic development, and therefore to differ widely among heterogeneous countries, the integration process between countries which are so different tends to place these policies in conflict.

For the current members of the EU, the two main issues of extending "a" common agricultural policy to the East are (i), the resulting implications on the cost of agricultural support and on the recent GATT commitments and (ii), the willingness to accept a new source of competition "from the inside" after the enlargement. For the CEEC's, competition is also a threat for large, albeit different, segments of the agroindustrial complex. But their main challenge is to discipline the temptation to divert their agricultural policy from long-run soundly based goals. It is also to conduct their transition with the least possible loss of time in retrieving their economic potentials and otherwise to look towards East as well as to West in designing their integration strategy.

The paper first documents the comparative features of the farming sectors in the CEEC's and in the EU. Then it reviews some of the challenges of the transition in the CEEC's which will impact on agricultural policy, giving rise to needed compromises. Tentative assessments of budget costs are provided in section three which also elucidates the challenges to be met by the EU itself regarding the GATT. Section four discusses a possible scenario taking into account numerous existing constraints.

1 - Background and issues of the Eastern enlargement

As far as agriculture is concerned, the EU enlargement to the CEEC's is quite unique when compared to previous experiences in the history of European integration. The land area and yield potentials of several countries are very large. Incomers are currently more agriculture oriented than the EU countries and their wealth is considerably smaller. Accordingly, the enlarged Europe will become a lot more heterogeneous. The Central and East European countries suffer in their transition to the market from an acute economic and political stress which exacerbates the difficulties of harmonisation of their institutions with the "acquis communautaire".

1.1 - A large agricultural potential

Agricultural production of the CEEC's would add large volumes to the output of the EU for most products (Table 1). The increase would range between 15 and 50% in the major subsectors and would be larger than the increase in population (about 27%). In 1993, the volumes of production in the CEEC's amount to 40% of the output in EU for grains, 30% for pigs, 22.3% for dairy and 14.7% for beef. Poland is the largest producer of grains(23.4 million tonnes) followed by Romania (15 million) and Hungary (8.3 million). The latter three countries are also the major meat producers (Poland accounts for the most part with nearly 40% of the total).

Table 1. Agricultural Production volumes, European Union (12) and Central and East European Countries (1993, million tonnes).

Products	EU-12 (1)	CEEC	% increase
Grains	168,1	66,9	+ 39,7
Bovine meat	8,4	1,2	+14,6
Pork meat	14,4	4,3	+30,0
Dairy production	112,3	25,0	+22,3

Source : OCDE, 1994 ; La Situation de l'Agriculture dans la Communauté, 1994 ; (1) : année 1992.

These figures underestimate the agricultural potential of an enlarged Europe as can be seen by the size of the land area suitable for agriculture (more than 53 million hectares for 130 million hectares of utilised area in the EU, see annexe table A.1) and the average grain yields which are currently lower in all the CEEC's than in EU. Wheat yield is now on average close to 6 tonnes in the EU and lower than 4 tonnes in the CEEC's. Given the quality of the soils, the potential for productivity growth seems to be quite large and the relative share of the CEEC's in European output is bound to increase in the long run. As an illustration, if the yields were the same across all Eastern and Western Europe, CEEC's grain production would reach 100 million tonnes while the EU-12 output is currently about 170 million.

CEEC's are in general viewed as having natural comparative advantages in arable crops, dairy, pork and some fruits. However farm structure and entrepreneurship, as well as the technology incorporated in farm inputs and services, are increasingly the main sources for comparative advantages in industrial countries. This brings us to the question of the transition to the market economy. Even if the potential in many CEEc's is not realised in the short run, there is little doubt that, allowing for time, this potential will become effective. Inter-regional competition in the enlarged Europe will surely take place and force European farmers, in the longer run, to chose between (i), preserving support and dividing the European market as a cartel and (ii), playing the competition game on the world markets.

1.2 - CEEC's are more agriculture oriented and less wealthy than EU southern members

In contrast to agricultural production, the GNP of the CEEC's would currently add very little to the GNP of the EU. Taken together, the CEEC's account for about 4% of the GNP of EU-12 at the prevailing exchange rate (see table 2). Per capita incomes have been estimated at 10 to 20% of the EU average at current exchange rates. Disposable incomes are much smaller than in Greece and the other less industrialised EU members. The gap has also increased in the short run during the transition process.

Another feature likely to impact on the integration process is the wide heterogeneity between the potential candidates. Economic development has been slower in Romania and Bulgaria than in Hungary and the Tcheck republic. First, the integration between economic zones as different as the CEEC's and the EU will raise even greater difficulties than those experienced in the successive enlargements. Moreover, the heterogeneity of the CEEC's could also be a problem and readiness to meet the required criteria for admission will be more difficult to achieve in the Balkanic countries.

The CEEC's are also more dependent on the agricultural sector than the current EU members. About 12 % of the GNP comes from agriculture compared to 3 % in the EU (see Table 2). The share of total employment in agriculture is also much larger as a general rule in these countries. It runs from a low 6.5% in the Tcheck Republic to a high 32.2% in Romania while it is only 5.8% in the EU. Again the situation varies drastically among the CEEC's as some countries like the Federal Tcheck and Slovak Republics (FTSR), Hungary and Poland are less biased towards agriculture than some current EU members in spite of their lower GNP. The latter group can be considered as less agricultural than Greece, Portugal and Ireland.

Being more agriculture oriented does not necessarily mean that comparative advantage lies in agricultural products. Without dealing properly with this issue, it may be noted that farm labour per hectare in the CEEC's is twice the level in the EU on average, as noted by Ferenczi (1994). However, This may reflect the low level of overall productivity rather than comparative advantage in relative terms between agriculture and the rest of the economy. The relative productivity between the farm sector and the whole economy[2] ranges in the EU from 0.21 (Ireland) to 0.78 (Nederlands), with an average of 0.43. In the CEEC's the index varies between 0.26 and 0.92 (see table 3). From this standpoint CEEC's do compare well, with the exception of Poland. The farm structure has evolved rather more rapidly in the former socialist countries than the rest of the economy. It certainly has in most cases evolved faster than in several western market economies. This evidence is an indication of a potential agricultural efficiency attainable after a successful transition is completed.

Table 2. Comparative economic structure, European Union-12 and Central and Eastern European Countries (1992 data)

	GNP/head (US $)	Total GDP (10^6 US $)	Population (millions)	share of agriculture in GNP	share of agriculture in Employment (2)
Poland	1 910	83.8	38,4	7	26,9
Hungary	2 970	35.2	10,3	7	8,1
Check R.	2 450	26.1	10,3	6	6,5
Slovak R.	1 930	9.9	5,3	6	10,3
Bulgaria	1 330	10.8	8,5	14	17,4
Romania	1 130	24.4	22,7	19	32,2
Total CEEC's	1885	190.2	95,5	-	-
E U- 12 (1)	16 800	7417.2	346,0	3	5,8
Greece (1)	7 680	67.3	10,3	17	21,4

Source : Banque Mondiale, 1994; save for (1) : Baldwin, 1994 ; et (2) : OCDE, 1994 (1993 data).

Poland is an interesting case where the preservation of the main part of agriculture in privately operated small farms appears as a mixed blessing. On the one hand, this predominant private farm subsector has clearly been a key factor in the transition to a market economy. On the other, the fragmentation of farms using labour intensive techniques may handicap a rapid catching up of farm structures towards the type prevailing in the northern countries of the EU which is necessary to capture potential productivity gains.

[2] As measured by the ratios of the share of agriculture in GNP to the share in employment.

Table 3. Index of relative agricultural labour efficiency in EU and in CEEC's (share in GDP/share in employment)

CEEC-6		EU-12		EU-12	
Poland	0.26	Belgium	0.70	Ireland	0.21
Hungary	0.87	Denmark	0.54	Italy	0.43
Check R.	0.92	Germany	0.38	Luxemb.	0.6
Slovak R.	0.58	Greece	0.64	Nederlands	0.78
Bulgaria	0.80	Spain	0.29	Portugal	0.26
Romania	0.59	France	0.55	Un. Kingd.	0.61
Total CEEC's				total EU-12	0.43

Source : Derived from Table 2 for the CEEC's and from European Commission (1995), for the EU countries.

Due to low income levels, food expenditures take a large proportion of the consumer budget in CEEC countries (Table 4.2.). This raises two issues in the context of both the transition and the integration process. First, any sharp increase in agricultural prices, due either to temporary shortages or to permanent boosting of price supports is likely to place a heavy burden on the living standards, and particularly so for the poorer section of the population. An extreme case is Romania which spends more than half of its disposable income on food. This situation constrains privatisation policies which are bound to generate unemployment and to threaten day to day availability of food supplies.

Second, the expected improvement of incomes after the transition could be seen as providing great potentials for agricultural product outlets. This is far from being obvious however, when account is taken of the very high level of food rations reported in all the CEEC's with regards to their level of income (Table 4.1. and Annex fig. A1 and A2). Even meat consumption is close to european standards. Sugar and Grain rations are also high. As a consequence the full expression of the agricultural potential of the CEEC's can only rely on external outlets and this is enough to give some worries to the farmers of Western Europe[3].

Table 4.1. Food Consumption per person, 1985

	Calories	Proteins	Meat	Dairy	Sugar	Grains prod.
Poland	3289	101,8	67	403	41	118
FRTS	3473	103,3	86	239	35	111
Hungary	3541	101,7	77	175	35	110
Romania	3358	104,3	60		26	143
Bulgaria	3634	106,3	77	250	35	144
France	3273	111,3	106	84	34	80
Germany	3476	101,0	100	112	37	74
Un. King.	3218	88,0	74	141	37	83
Spain	3365	96,5	75	102	33	77
Finland	3080	95,6	68	182	37	73

Source : Jackson et Swinnen, 1993, p. 46 ; calories per day, proteins in grammes per day, other data in kg per year.

[3] As illustrated in the Annex fig. A.1 and A.2 the CEEC's appear as a-typical as far as their food consumption - income relationship.

Table 4.2. Food share of consumer budget in the CEEC's

	1989	1993
Bulgaria	30	36
Check Republic	32	31
Slovak Republic	n.a.	n.a.
Hungary	25	25 (1)
Poland	40	36
Romania	n.a.	58

Source : based on Jackson et Swinnen, 1993 ; (1) : 1992.

The data on the agricultural situation in the CEEC's shows overall that these countries have a clear potential for exports of agricultural commodities in the long-run for reasons stemming from both supply and demand. It is also clear that they lack wealth, and hence fiscal resources to afford high levels of agricultural support. Running a costly farm policy, as in the EU, is not feasible. If they follow a similar track as the CAP, someone in the longer run will have to pay.

2 - The challenge for the CEEC's : Transition for Integration or Integration for transition

The objective of reforms in the transition is to rectify the major deficiencies of the centrally planned system. In other words, the nature of the adjustment problem is to "get prices right", while at the same time investing in public goods and institutional change that lowers transaction costs and advances countries' production possibility frontiers to a point that is competitive with other countries having similar primary factor endowments.

Four years after the dismantling of the communist regimes, radical transformations have occurred in the CEEC's, including agriculture. Privatisation is widely initiated everywhere. However implementation and speed vary greatly according to countries. Collective property and farm structure, which prevailed everywhere save in Poland, have been dismantled, at least in the legal texts. The process however faces many obstacles and in many cases the privatisation is yet more apparent than actual. The shocks of the transition bear upon the food trade balance and the farm sector suffers from macroeconomic instability. How would integration impact on the course of events ?

2.1 - Privatisation is often a façade.

In spite of the diversity of the methods used, the privatisation of agriculture and the related sectors is often more theoretical than effective. It appears that the extent of privatisation and demonopolisation of firms is inversely related to their distance to the farm product in the food chain. Privatisation appears more effective when firms can avoid the dependence on controlled segments of the marketing channels. It seems easier, for example, to create retail stores largely based on imported products and to develop specific shops like bakeries in towns able to get their grain supplies directly from farms or parallel markets than to actually liberalise firms which are still imbedded at intermediate levels of the food chain.

At the farm level, a fairly small share of the land is really privatised or owner operated. When mass privatisation was used as in Romania, or when land is restored to former owners (Bulgaria, FRTS and partly in Hungary) the definitive titles of ownership have been granted very slowly due to challenges in court and lack of proper land register. Consequently the published figures on privatised shares are often misleading (table 5).

Table 5. Changes in the legal status of farm land

	Bulgaria	Hungary	Poland	Romania	SlovakR.	Check R.
Status before privatisation (1)						
Socialised sector (%)						
Total	85	85.4	22.2 (25)	86	93.9	
State farms	n.a.	14.9	18.6 (20)	28	30.3	
Cooperatives	n.a.	70.5	3.6 (5)	60	63.6	
Private Sector (%)	15	14.6	77.8 (75)	14	6.1	
Status after privatisation (2) in 1993 (Poland, 1992)						
State farms (%)	n.a.	20	(20)	17	n.a.	28
Cooperatives (%)	n.a.	53	(4)	93 (3)	n.a.	55
Individual farms (%)	n.a.	27	(76)		n.a.	17

Sources : (1) Based on Economie et Finances Agricoles, mai-juin 1993 ; save for figures in parentheses for Poland, ITP, 1994 ; (2) ITP, 1994, based on national Sources and OCDE, 1994 ; save for Roumania : OCDE, 1994. (3) covers the last two (producer' associations and individual farmers).

In Romania for example, by the end of 1993 about 93% of the land area was officially privatised. But out of the 10 million hectares "distributed" in 1990, two millions hectares only had definitive titles of ownership, the other titles being provisional. At the current rate of privatisation, 15-20 years will be required to achieve a fully privatised sector. Moreover, the property rights are granted on very small sizes, which is not suitable for efficient farming. The lack of a land market, in part due to unsettled rights and to economic instability, has caused owners to choose between two alternatives : farming for autarky, as several have done, and renting. Family farms with a large enough size to make a living are still quite rare.

Similarly, in Bulgaria, most of the newly created co-operatives (1230 on 547 000 hectares in 1993) are installed on land granted on a temporary basis and cannot be considered as stable farm structures (OECD, 1994). When the extreme fragmentation of land structures was feared, changes in the statute of the collective farms to private corporations or farmers associations was favoured. But the changes in leadership, behaviour and management have been limited (99% of collective farms in Hungary chose to become corporate or private co-operatives in a transformation which is only "façade", OCDE, 1994). The predominance of temporary titles has also encouraged the preservation of the existing farm structures to which the land is rented (Romania).

It is difficult under these conditions for a land market to emerge and for a family farm structure to develop. The privatisation and, more importantly, the development of competitive markets is also moving slowly upstream, in the farm input industries and, downstream, in the food processing sector. Even if the demonopolisation is officially decided, local monopolies still exist *de facto* before new firms are created in sufficient numbers. The difficulty is increased by the size of the "integrators" (e.g., in Romania) which detained very large equipments and facilities (silos), which cannot be easily split into decentralised competitive units. Privatisation is also slowed by the will of the authorities to keep a sizeable share of the food supplies under physical control to ensure a minimum food security and to prevent food prices from booming in the presence of temporary scarcities. Processing margins is still often controlled and the larger part of the equity of food processing firms are in the hands of Public Funds. This structure may deter investors from purchasing the firms, for example, by overvaluing the assets of plants which in many cases are obsolete.

Again, the situation varies a lot according to countries, and Poland seems to be the front runner, probably because of the pre-existing size of the private sector which allows for a more rapid development of market connections with upstream and downstream firms. Entrepreneurship can then develop and agricultural growth take momentum.

2.2 - The agricultural potential has not yet recovered and the trade balance deteriorates.

The economic stress resulting from the institutional changes has generated many perverse effects which delay agricultural growth recovery. Uncertainties due to the changes of the rule of the game, to unsettled property rights and to the mere division between members of working assets in some collective farms (livestock, machines etc...), have generated a general fall of the gross agricultural output which has nowhere recovered the levels prevailing before the reforms (Table 6).

Table 6. Evolution of the Gross Agricultural Output 1989-1994; in the CEEC's

Countries	Index in 1993 Base 100 en 1991	Index in 1993 Base 100 in 1989	Index in 1994 (2) Base 100 in 1989
Poland	98,5	96,5	93.5
Hungary	74,4	66,4	68.3
Check R.	97,1	86,4	88.2
Slovak R.	80,4	69,1	70.5
Bulgaria	70,4	65,9	68.0
Romania	97,5 (87,9)(1)	95,6 (81,1)(1)	99.5(84.3)(1)

Source : calculations based on Jackson and Swinnen, 1993 (these authors mention large discrepancies between sources) ; (1) : source FAO, figures between parentheses ; (2) : OECD, 1995.

Poland seems to be an exception, where, first, the fall was more moderate than in most other cases (the figures for Romania are to be considered with caution). The output fall in Bulgaria and Hungary are particularly impressing. These figures may be however partly due to bad crops and overly pessimistic since the production of small autarkic farms and of the informal sector is underestimated. Accordingly the food situation may have not deteriorated as much as it looks at first glance. Recent figures for 1994 reveal an upward trend in agricultural output and positive general economic growth nearly in all the CEEC's.

One of the most striking features of the transition is the deterioration of the agricultural trade balance (Table 8). This is in part due to the lack of domestic output mentioned above but also to demand effects and to perverse short-run induced implications of the liberalisation of trade. Creation of retail stores in cities was easier and quicker than the privatisation of the whole food chain. These stores can easily import due to the demonopolisation of external trade and also to pervasive over valuation of the currencies in spite of the nominal devaluation. A class of well-off consumers has developed, partly made of successful private entrepreneurs, partly made of clever or well informed speculators who benefited from the distribution of titles and assets. A dualistic economy is developing in which the higher income citizens are prepared to buy foreign goods including food products which offer a variety and an image that domestic firms cannot yet provide. This is particularly true for high value products, while primary agricultural products are not supplied in large enough quantities for the CEEC's to fulfil the import quotas into the EU opened under the European Agreements.

These circumstances add a new burden to the painful transition of the agro-food sector. The food processing sector suffers from a somewhat unfair competition just at the time when it is trying to adjust to market incentives and to consumer demand. There is a good case here for the CEEC's to set, at least for a few years, a fairly high tariff on the more processed and expensive food imports. This would boost the demand for domestic products and trigger entrepreneurship in such market outlets, while in the same time it would contribute to alleviate the burden of unemployment created by the deregulation of the overmanned state firms in the more obsolete sections of the food chain.

Positive side effects of such a policy of taxing imported luxury goods on income distribution and on fiscal resources should also be obtained. It would appear in this respect that the European Agreements are overly constraining, since they imply that protection increases on food products should only be based on the "agricultural element". This is one aspect of these agreements which could be revised along with the way licences are administered, to ensure that more benefits can be captured by the CEEC's, rather than by western trading firms.

Table 7. Agricultural Trade balance of the CEEC's

	Exportations		Importations		Balance		
	1990	1993	1990	1993	1990	1993	1994 (2
Bulgaria	2026	422	571	1942	1455	228	n.a.
Check R.	726	1005	761	969	-35	36	-268
Slovak R.	210	365	208	416	2	-51	-123
Hungary	2382	1778	735	759	1647	1019	n.a.
Poland	1903	1666	666	2254	1237	-588	n.a.
Romania (1)	247	262	771	813	-524	-551	-188

Source : OCDE, 1994 ; (1) : 1991 ; (2) : OCDE, 1995.

2.3 - Macroeconomic Sources of Instability that Threaten Reform in Agriculture

A successful transition to a market economy requires that resources move between sectors according to long-run efficiency potentials and that a stable environment reduces the uncertainty facing firms and entrepreneurs. In order to increase the productivity of resources in agriculture, it will also be necessary to rectify deficiencies in other sectors of the economy as well. One pervasive observation of the development and growth of nations is that labour must be pulled from agriculture, which is then accompanied by capital deepening in the sector.

For the adjustment to occur in the CEEC's, the non-farm sector must grow, develop and pursue its comparative advantage so as to pull this labor from agriculture. Labor will be pulled from primary agriculture as the non-farm sector expands to moderately sized towns and villages that provide support services and access to labor and primary materials. The industrial sector will need to expand into the production of services, light manufacturing and other non-farm activities that, relative to the current structure, employs more labor relative to capital.

The speed and rate of this transition will be influenced by the stability of the country's macroeconomic policy, a typical precursor to attracting foreign capital and multinational enterprises. The experience of Russia in particular, but of many other East European nations as well, has clearly shown that macroeconomic instability is a serious impediment to reform. In the case of Romania, instability comes from large -though unofficial- budget deficits that exceed 21% of GDP in 1993 (World Bank, 1993). Consequences include high rates of inflation (averaging 200% per year during 1989-93)[4], negative real interest rates, and a volatile real exchange rate that is frequently grossly over valued, and a sharp decline in tax revenues. The major extra-budgetary items include exchange rate transfers to enterprises, infrastructure investments and other expenditures financed by foreign loans, and the quasi-fiscal activities (as in the case of the Romanian National Bank). Such quasi-fiscal activities entail the transferring of resources to enterprises through the provision of refinancing credit to banks at negative real rates of interest. The root of this problem lies in the non-performing loans of state firms. The non-profitability of many of these enterprises is being met by transfers through the Romanian banking system, which exceeds the countries ability to finance these expenditures from fiscal revenues. The result is an inflation tax.

Macro Economic Adjustments : The general direction of macro economic adjustments will be to increase the prices of traded goods. Since agriculture is a major traded goods sector in theses economies, agriculture should receive incentives to expand production. This presumes of course that increased price incentives are realised at the farm level, and that institutional and factor market rigidities do not prevent or restrict an output response to new incentives. The production of light manufacturing and services should also expand. Evidence suggests that these directions of adjustment in services has risen since 1989. In the short run, real food prices to consumers will continue to rise, placing increasing pressures on the disposable incomes of urban households, particularly those employed in the public and state enterprise sectors. The medium term growth prospects for many of the CEEC countries will depend on their ability to access international capital markets to finance the requisite investments in plant and equipment. On this front, many countries have yet to meet this challenge. In the case of Poland, for example, its capital account was in deficit during 1991-92 and in small surplus in 1993. In 1994, the small surplus in the capital account has been sustained, suggesting an increase in foreign investor confidence. Nevertheless, fiscal deficits, over-valued real exchange rates and relatively high levels of inflation and low real interest rates continue to plague many of the CEEC countries.

Fiscal Deficits : A fundamental challenge facing all of the CEEC countries is to reorient government to intervene in areas where markets fail to allocate resources efficiently, to develop a broader based source of fiscal revenues in order to carry out this reorientation while rectifying

[4] The IMF World Economic Outlook for 1993, p.49 reports the results from a cross-country analysis of 50 developing countries. The results suggest than an increase in inflation by 10 percent a year reduces the growth of capital stock by around 3 percent, and the rate of productivity growth by about 0.15 percent.

the structure of the state enterprise system that continues to be a major cause of macroeconomic instability.

As mentioned, state enterprises tended to be a major source of fiscal revenues prior to reform, a source of revenue that must be replaced if reform is to proceed. Efforts to reform and develop a more modern banking system when state enterprise arrears require refinancing is particularly problematic. Efforts to attract domestic savings in order to finance deficits tends to decreases the level and the proportion of savings available to the private sector. This crowding out effect is made even more detrimental when earnings on savings deposits are held artificially low to lower the cost of servicing the domestic component of public debt. The pool of savings tends to decline.

The presence of fiscal deficits invariably increases the opportunity costs of increasing the deficit even further to invest in public goods which are not adequately provided by the market system (roads, infrastructure, education, rural electrification, public administration, etc.). As noted above, public goods are particularly important for the reform of agriculture.

Exchange Rate : Throughout the period 1991 to present, all of the CEEC countries have experienced rising real exchange rates even though the nominal value of their currencies are depreciating. The over pricing of the currency in many CEEC countries has contributed significantly to the taxing of the traded goods sectors of their economies. Since agriculture is likely to be a major traded goods sector in most of the CEEC countries, and since many of the country's poor reside in this sector, the over valuation amounts to a tax on the more poor elements of society.

An over valued currency has numerous other affects that "work against" reform. First, an over valued currency often leads to currency speculation, currency flight, and the holding of liquid assets outside of the country. An over valued currency tends to lower the domestic price of imported capital (such as agricultural machinery, chemicals) relative to the price of domestically produced inputs. Invariably, an over valued currency leads to some form of foreign exchange rationing. These lower relative prices can in turn encourage the substitution of imported inputs for domestically supplied inputs for those firms that have, through various political connections, access to the rationed foreign exchange. This unequal access to limited foreign exchange is unlikely to work in favour of the new emerging private farm sector.

The end result is that growth in the production of traded goods tends to lag behind its potential growth rate, while their consumption rises, leaving fewer goods to export but more goods to import. If exchange controls are maintained and/or the nominal value of the currency is not devalued at a rate to maintain a relatively constant real rate of exchange, the result is an imbalance in the country's external accounts. Further, as in the case of Poland, political pressures tend to evolve to ration foreign exchange through import quotas, licensing or other means that induce additional distortions in the economy.

Inflation and real Interest rates : The experience with inflation in the economies in transition is that households tend to respond by protecting the few assets they have from inflation, (and possible future devaluation) through capital flight and dollarization, while state enterprises tend to engage more in barter trade. Because high rates of inflation tend to be dynamically unstable, the seeds are planted for even greater inflation in the future. For example, firms tend to react by forestalling investments, thus forestalling the supply response that reform is hoped to encourage.

As mentioned, controls on domestic capital markets are also coincident with financing the arrears of state enterprises. Interventions in domestic capital markets have given rise to negative real interest rates, in part, because nominal rates are low and held fixed during periods of high inflation.

The macro-economic shocks of the transition have put agriculture as well as other sectors under stress. The situation is now improving in many countries . But it is yet to be stabilised so as to buttress structural adjustment in the farm and the related sectors for the agricultural potential to reach momentum.

2.4 - The CEEC's challenges and expectations from integration

The CEEC's attitude toward integration may be overly optimistic about the economic benefits of integration, at least as far as agriculture trade is concerned. Full free trade in farm products would mean competition both ways and, particularly in the transition phase, to cope with the western farm and food products which have shown to penetrate the Eastern urban markets quite swiftly in the last few years. Also, the ability to capture the benefits from the limited trade concessions under the European Agreements has proved deceiving overall since the tariff-reduced quotas have not been filled up and because the benefits do not seem to have reached the Eastern trade partners, partly because of the way licences have been administered. Moreover, the necessary adoption of the rules and regulations on quality standards for food products, and the design of institutions to run the CAP will be a major challenge for the CEEC's.

From a long-run perspective, the CEEC's face the risk of looking too much to the western protected-high price outlets which may be deceiving over time. Support policies in CEEC countries triggered by domestic farm interests and inspired by the CAP to ease integration, may contradict the long-run comparative advantage of the CEEC's by keeping or attracting too many resources into the farm sector. Similarly East-East trade relationships tend to be given less attention than bilateral connections with the EU. Again, in the longer run, these Eastern neighbouring trade relationships should not be neglected, however difficult it is now, given History and the inadequate functioning of markets. In this context, a contradiction may arise between short-run integration efforts focusing on speedy entry on an individual basis rather than on a global strategy for the CEEC's as a whole which would better fit their comparative advantage.

As regards institutional reforms in the CEEC's however, the perspective of integration into the EU, will definitely provide a strong external pressure and political incentives to reduce the remains of the command economy and to implement more rapidly the preconditions necessary for a real decentralised market system to function properly. Some leaders in the CEEC's have rightly stated that this change in the economic and political context is more important in the long-run than the benefits of the CAP.

3 - The challenge for the EU : openness, consistency and leadership.

Agriculture will clearly be a sensitive issue in the process of enlargement. Areas of concern are the potential increase in competition on the enlarged internal market and the threat of the CAP due to expected further budget costs and to new constraints on the compliance with GATT.

3.1 - National attitudes in the West : competition for trade and for support.

Looking at the ongoing debate in the various circles on the issues raised by agricultural problems in the Eastern enlargement, it seems fair to say that Western attitudes are characterised by "cautious ambiguity". For the EU as a whole, the eastern enlargement raises three main issues as far as agricultural interests are concerned. The first is the feared competition from supposed low cost producers. This type of argument was already put forward vigorously by the farm pressure groups before the enlargement to the Southern countries of Europe and has proved since to be grossly overstated. The competitiveness of Eastern countries is also overstated in the current circumstances due in part to the shocks of the transition period in particular. In fact, the recent deterioration of the agricultural trade balance between the EU and the CEEC's has greatly nullified, this prediction and the fears have somewhat subsided in European agricultural circles. In the long-run however, the potential of the CEEC's is great as was suggested above and increased competition will be a real issue to be faced by Western and Northern farmers. The competitiveness should however be more effective on basic products than on high-value processed food products unless, thanks in particular to closer association, rapid reclamation of the food industry of the CEEC's takes place by joint ventures and rapid capital inflow.

In the current EU members, at the risk of over simplification, two basic positions can be identified. Some countries are worried that the contemplated enlargement will put an excessive pressure on the post-reform CAP. These countries are keen to maintain the current CAP's essential features namely, the type and level of support on one hand, and the financing by community funds, on the other. Other Member States would not mind more fundamental changes in the European agricultural policies. The former group, less open to CAP changes, includes mainly the southerners and Ireland, more protective in general of agriculture and very concerned by the increased pressure that the Eastern enlargement will put on the EU budget, both on the Guarantee and the Structural chapters. France is essentially worried by the likely re-examination of the compensatory payments installed by the new CAP and also by increased competition on the European market, as well as the threat on so-called "dynamic export policy" i.e., on export restitutions. The renationalisation of the financing of some payments made currently by the FEOGA under the "financial solidarity principle" is also a matter for concern as it is viewed by the farm interest groups as threatening the continuation of support in the long-run.

The Northern Member States are in general more open to changes in the CAP and less reserved with regards to the agricultural issues raised by the Eastern enlargement. But this group is quite heterogeneous. The extreme may be the UK, with a very modern farm structure, traditionally opposed to the excessive support and expenditures of the CAP albeit opposed to any discrimination of subsidies in favour of smaller farms of which she has a small proportion. A general move towards payments attached to environmental practices and away from common financing is sought by this country. The new members, previously in EFTA, stand on rather similar positions but have poved to be defensive of their potential share of community funds in the payments for the Less Favoured Areas of which they have a lot. Denmark and the Nederlands, which have modern agricultural structures, intensive farming techniques, and are export oriented like France, are essentially worried by the risk of cartellisation of the European Market, and by supply control measures which would hamper their conquest of world markets. They also oppose social criteria for payments in favour of poorer farmers and seem more open to some degree of renationalisation of the budgetary expenditures. Germany is another case dominated by internal contradictions of interests enhanced by the recuperation of the Eastern länders with large structures and arable crops stakes to defend. Germany is traditionally quite supportive of its farmers, but is becoming tired of providing a large share of the funds spent in essentially other Member States. As Germany favours the Eastern enlargement for other reasons, she would welcome a move towards the renationalisation of CAP and structural payments, and not to let agricultural trade issues block the integration of the CEEC's into the EU.

3.2 - The budget issue

The second issue relates to the additional expenditures generated by a full fledged extension of the rules of the current CAP and of the rights to the Structural Funds. Several estimates of potential costs have circulated. Baldwin quotes figures of a budget cost due to the CAP extended to the visegrad-4 of 37 billion Ecus (based on Anderson and Tyers (1993) estimates) to which a potential 25 billion Ecus of Structural Funds should be added. Given a gross contribution of 5.5 billion the net cost of the Eastern Enlargement could reach up to 58.1 billion Ecus. Rollo (1995) quotes estimates of up to 25 billion for the CAP extend to the visegrad-4 together with the two Balkanic and the Baltic States, and 30 billion for the structural funds[5]. Smaller figures also exist, and it is obvious that the assumptions made on the growth of output and on the rules applied to Structural Funds are crucial in these calculations. They are however indicative of a potentially sizeable problem, hence the fears of farmers groups and net beneficiary Member States to see the pressure on further CAP reform growing as a result of the enlargement.

The evaluation of additional budgetary costs due to the enlargement is not an easy task. The results are bound to be sensitive to the time horizon and to the effective modalities of implementation. A major source of uncertainly comes from the speed of recovery of the production in the CEEC's and from its response to the new incentives created by the extension of the CAP to the East. Another major matter for discussion is the rule applied to the CEEC's for the Structural Funds, as their level of income makes them potentially eligible for the maximum rates.

Table 8 provides a fairly rough and probably underestimated evaluation of the additional expenditures due to a full extension of the post-reformed CAP to the 6 CEEC's, under four different assumptions on the date of integration and on the speed of agricultural growth.

[5] Assuming the new members reach the EU productivity levels.

Table 8. Evaluation of additional expenditures due to the full extension of the current CAP to the CEEC's (in billion Ecus)

Expenditures by the FEOGA (Guarantee Section)	1993 base (2)	Integration in 2000		Integration in 2005	
Type of scenario (1)		SQ	ST	SQ	ST
Export Restitutions	9,5	0	1	0	4,75
Intervention - retrait - storage - dairy	7,2 1,1 5,2 0,9	1,5	1,8	1,5	3,0
Compensatory payments(crops)	6,5	3,8	5,0	3,9	6,9
Beef and sheep paym.	3,2	1,25	1,25	1,25	1,55
Total	26,4	6,55	9,05	6,55	16,20

Source : Mahé et al., 1995 ; (1) type of scenario SQ = Statu Quo (i.e., transition stalled) ; ST = successful transition ; units are Budget Ecus ; (2) Total section A expenditures is 34 billion.

If integration takes effect at the turn of the century under the current CAP, it is unlikely that the transition would then be completed. In such a perspective, large exports from the CEEC's would not become a problem for the EU. The most likely event then is a near Statu Quo. Greater success in the transition[6] would increase the potential restitution costs. However, the GATT constraint would then bite since the CEEC's do not have significant allowances for subsidised export in their schedules that could be added to those of the EU (see infra). Subsidised exports of the enlarged EU would hurt the GATT ceiling so that FEOGA spendings on restitutions would be kept under check whatsoever. One billion Ecus of additional restitution costs are retained as a base line. Of course quite larger expenditures would result from both public storage and "market intervention". Expenditures are assumed to be proportional to additional output brought by the CEEC's.

Compensatory payments on arable crops and livestock are the major cost items in the event of such an early enlargement. Premiums costs have been estimated proportionally to areas and cattle numbers. Some growth in references eligible for premiums was allowed for in the case of arable crops since yields will likely increase. One can expect that the negotiations would, as it was the case in the previous enlargements, end up in accepting references eligible for subsidies higher than the historical figures of the past. Direct CAP costs estimates amount to about 9 billion in this case corresponding to a rapid enlargement and a successful transition.

Calculations for delayed, and more realistic, enlargement in year 2005, are even more conjectural. The main difference is that transition has a better chance to have succeeded at that time with the resulting output and export growth potentials. Intervention and compensatory payments would increase significantly, as well as potential restitutions. Ten billion Ecus would be needed in addition to the Statu Quo assumption. The estimate of a 50% increase in restitutions is also questionable since it is unlikely that, after the end of the present GATT accord, the EU would be allowed to increase restitution expenditures. These calculations have however the merit, if any, to identify where the CAP extension may be biting.

6 According to OCDE (1995) Gross output has increased by 1.5% in the CEEC's in 1994.

The other major item of cost is related to Structural Funds. If the maximum figures were retained (25 to 30 billion Ecus as in Baldwin or Rollo), such a transfer would account for 12% of the (forecast) GNP in year 2000 and still 10% in year 2005. So-called "cohesion countries" from mostly Southern Europe receive only 1 to 2% of their GNP through structural Funds[7]. Its seems more realistic to us to consider that a maximum of 4% of GNP would be granted to each new member which would lead to a cost of about 7 billion ECU in 2000 and 8 billion in 2005 for the six CEEC's under consideration (Annexe Table A.2). Of course the FEOGA guarantee payments would be added to this amount.

Under these assumptions the total cost of the agricultural enlargement, including the Structural Funds could range between 13 and 24 billion Ecus. If the contribution of the CEEC's to the EU budget amounts to 4 billion, the net cost would range between 8 and 20 billion ECU.

3.3 - The compatibility with the GATT

The third issue is the GATT. Under article XXIV-6, a Customs Union should offer compensations if trade barriers are raised in the process of integration. Moreover specific commitments have been made in the Uruguay Round (UR) by the EU and the CEEC's as well on the three aspects of agricultural and trade policies (Domestic support, Market Access and Export Restitutions). If the CEEC's are to join before 2001 the new Europe will have to endorse the new eventual constraints added by the new members. It is likely that the current CAP can more or less satisfy the UR commitments, with little if any adjustments (for dairy and sugar in particular, less likely for grains, Guyomard et Mahé, 1993). Are the prospects for output growth in the CEEC's and their schedules tabled at the GATT going to add new constraints on the EU commitments ?

It should be first noted that the CEEC's GATT commitments would have to be assumed by the EU only if integration occurs before 2001. The first area of commitments in the Uruguay Round deals with domestic support. It is measured by the Global Measure of support (GMS) which includes price support and payments coupled with supply decisions (output or input tied). The CEEC's had included in their schedules only limited amount of support for the base period 1986-88, in comparison with the GMS of the EU. Therefore their integration into the EU would not "bring" significant references to be added to GMS of the base period. Although their agriculture benefited from subsidies (on inputs in particular) under the centrally planned system, it was penalised by currency overvaluation and monopolisation of the farm input industry and of the marketing channels for outputs. Moreover, the choice of a relevant exchange rate to convert the GMS in Ecu is far from obvious given the artificial exchange rates before 1990. Poland is again an exception since the GMS that she included in her GATT schedule is expressed in dollars.

In spite of these uncertainties, as far as GMS is concerned, compatibility should not be a major problem because the EU holds a fairly wide margin due to the classification of the compensatory payments of the post reform CAP into the so-called blue box as they are associated with supply control policies (see Buckwell et al.). The ceiling should however be close by year 2000[8]. The most constraining aspect in this regard might come from the Peace

[7] According to Baldwin the figures for 1990 are 0.7% (Italy), 1.3% (Portugal), 1.6% (Ireland), 2.5% (Greece).

[8] Buckwell et al. (1994) find an estimate of 59 billion ECU in 2003 which is close to the ceiling of 64 billion in 2001.

Clause which does not allow for any increase of the GMS on individual products above the level reached in 1992.

With respect to tariffication of import barriers, minor problems could be expected. First the tariff equivalents included in the schedules are in general higher than the tariffs actually implemented. It is the case in Poland and Romania, but not in Hungary and in the FTSR[9]. It is unclear now whether the maximum or the actual tariffs will be retained as a basis for possible compensations according to article XXIV-6. Weighted tariffs should be close to the EU tariffs because of the EU economic weight, or even equal in some cases like Poland whose tariff schedule follows closely the EU tariff structure.

Market access is yet a grey area, since it seems unclear how EU-CEEC's trade would be accounted for, but minimum access of 5% does seem to be reached now for the CEEC's as a whole for many products and countries.

On the export side things look less favourable. The EU now exports more than the year 2000 authorised ceilings in virtually all products. CEEC's already seem to export more than their maximum authorised (with subsidies), since they had little references in the base period if any. For the main products (grains, beef, pork, powder, milk and sugar) the Visegrad-4 overshot their ceilings in 1993 by 30 to 80% (Buckwell et al.). Only some of these exports are subsidised (in Hungary, for example), but it would be the general rule under an extended CAP situation, hence a potential significant problem.

As the potential for exports was considered as rather large, subsidised exports would cause significant problems for the enlarged EU who is already bound to bite her ceilings by 2001. This situation would even become more serious if CEEC's imitate the price support of the EU in the transition, without supply controls, as a strategy to approximate the CAP before integration[10].

4. Conclusion : enlargement scenarios

The Eastern enlargement is a challenge for the West as well as it is for the East. Present and Future Common Agricultural Policies are bound to raise problems. For the current EU, the weight of producer interests but also of national interests will tend to stress the budgetary issues, the allocation of entitlements to produce with subsidies introduced by the reformed CAP and transfers from the "cohesion funds" between current and future members of the EU.

However, the CAP is under pressure from international competitors through the WTO which will discipline agriculture more than in the past, even after 2001. It is also under domestic pressure from environmental and rural development pressure groups who work to promote a more legitimate base for the subsidies granted to the farm sector. As a consequence, the CAP will have to be further reformed particularly for the crop subsidies which will face the challenge of justifying the generous payments granted per hectare, since they have become increasingly visible and, hence, subject to increased pressure by the political process. Industry and trade

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[9] Tangerman and Josling (1994) do find that adjusting the CEEC's tariff on EU would break the ceilings in Hungary and FRTS.

[10] Buckwell et al. mention the fact that, for powder milk, Poland (127 Million tonnes) and the Check Republic (85 million) exports would add to the 392 Million tons of the EU whose 2000 ceiling in 243 !

interests are already pushing to relax the overly tight quota system for dairy. Beef and sugar policies may have a longer life. The induced effects downstream of sugar quotas may not be sizeable enough to trigger countervailing power and induce reform as in the case of dairy policy which is more likely to evolve.

The increased cost due to the enlargement will also contribute to strengthen the anti-CAP groups and countries. The pressure for renationalisation of compensatory payments will also increase, and this means bad news for many of the current beneficiaries.

The CEEC's challenge is also substantial. They cannot, certainly not all of them, achieve simultaneously the transition and the required approximation of economic policies in only a few years while it took 30 years or more for the current members. Approximation of legislation and standards will take time, as well as the design of institutions to monitor the market mechanism.

The CAP as it stands now would mean very large transfers in favour of the farm sector and significant increase in consumer food prices for societies where incomes are bound to stay low for some time. The transfer from the EU could amount to 10% of the GDP of the CEEC's if current rules would apply. As they are geared toward the farm and rural sectors they would imply about doubling of the current gross agricultural product and even much more for the value added by the farm sector. This would disrupt factor markets and asset markets in a way which will be costly in term of resource allocation in the long-run. There is a paradox and a real risk for the CEEC's to try to adjust to the current CAP, and to approximate it, while they will later be faced with the future, less protective, CAP. New adjustment efforts will then be required.

Rapid or delayed integration ? rapid integration has many virtues since the economic environment can be a major asset for the successful conduct of the transition, as expectations would be highly improved. But a rapid integration cannot possibly be a full integration, at least for all possible candidates. Again the risk of a such a scenario would be that the EU might not have enough leadership to deal with national interests and lobby groups to provide the right signals to the CEEC's.

Simultaneous or individual integration for the various CEEC's. The record of the transition shows that countries have reached different stages and that their "integrability" into the EU is inversely related to the size of their farm sector. It may be the case that the Tcheck (and Slovak) Republics or even Slovenia raise fewer problems and be admitted first. Poland's transition - and approximation of EU farm policies - is also moving fast. But she is a big agricultural power and therefore she will raise more problem. A piecemeal integration may not be the best thought off long-run scenario for the EU. The structure of institution and the accumulation of derogations and special regimes in a sort of "Europe à la carte" will result in less of global coherence. But this scenario is now the most likely.

In order to alleviate the political barriers from the West to the Eastern enlargement, and to provide a clear perspective to the CEEC's, the targets of further CAP reform and for the application of CAP policies to the CEEC's, should not be set too high.

This is why an early step of integration with intermediate regime is somewhat attractive. A Free Trade Area including agriculture would be first implemented and completed by a "Marshall Plan" i.e. "reasonable" extension of the Structural Funds. Compensatory payments would not be extended to new comers, since they are to be adjusted down and decoupled from assets in the present EU as well. As a way of compromise dairy and sugar quota could be extended but with support prices cut down, e.g. by the same rate as the one applied to grains. Support prices in the EU would then become much closer to world prices and the costly and inefficient intervention system would be reduced to its initial vocation i.e. to stabilise and not to support prices.

Such a scenario -probably overly Cartesian from both an economic and political viewpoint- would provide a fairly balanced compromise between short and long-run economic stakes and between private interests and the common good in an enlarged democratic Europe.

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Annex Table A.1

Table 1. Agricultural situation in the CEEC's before 1990

	Bulgaria	Hungary	Poland	Romania	Checoslovakia
Agricultural land area, 1989, 100 hectares	6165	6511	18791	15038	6778
Arable land area, 1987, 1000 hectares	3825	5046	14403	9994	4755
State sector (%)	85	85,4	22,2	86	93,9
Share of agriculture in :					
national income (1988):	13,1	13,8	14	18	7,1
GNP (1985-87)	20,5	24,2	26,2	29,5	15,3
employment (1988)	19,2	20,4	27,7	28,5	11,9
investment (1989)	8,5	14,7	15,6	17,1	18,5

Source : Based on Economie et Finances Agricoles, mai-juin 1993.

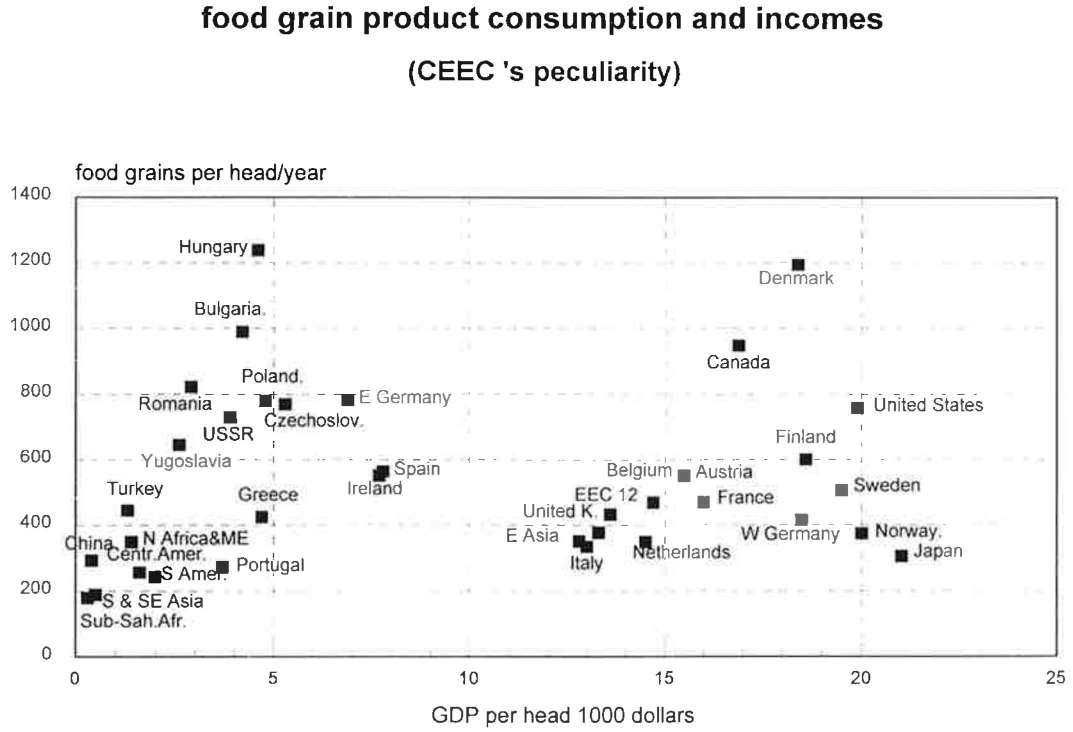
Annex Table A.2

Gross National Product and transfer of Structural Funds

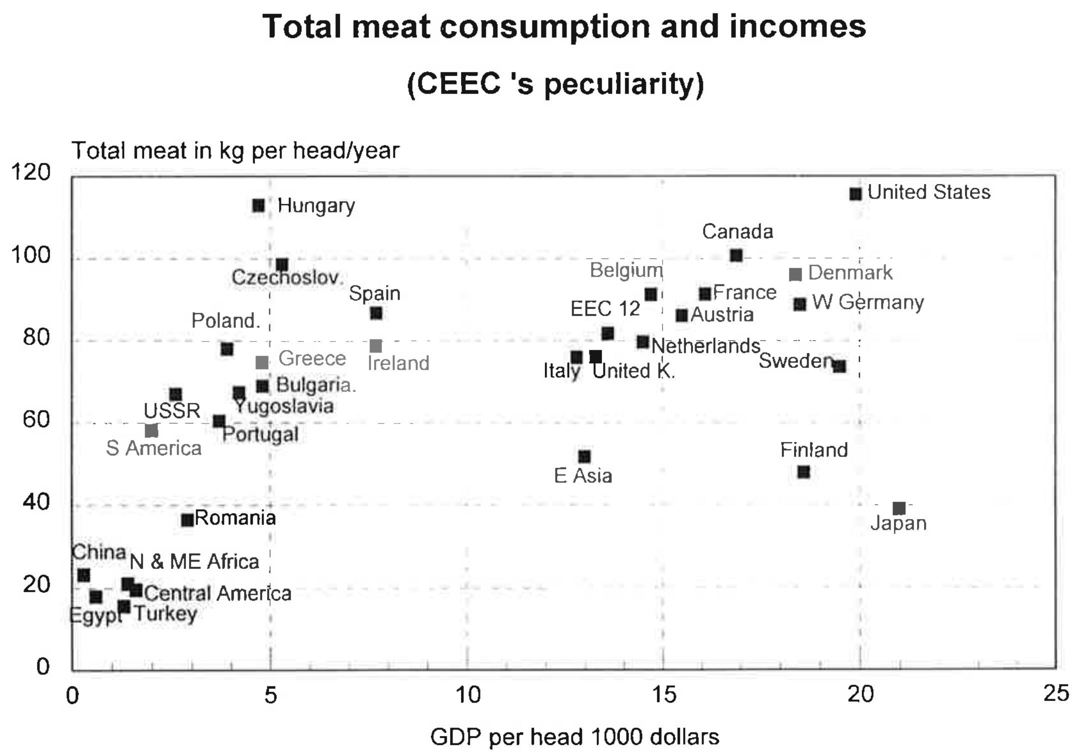
	Integration in 2000				Intégration in 2005		
	PNB 1992	PNB 2000 (	FS 2%	FS 4%	PNB 2005 (	FS 2%	FS 4%
Poland (2)	83.80	98.19	1.96	3.93	108.40	2.17	4.34
Hungary (2)	35.20	41.24	0.82	1.65	45.53	0.91	1.82
Tcheck R. (2)	26.20	30.70	0.61	1.23	33.89	0.68	1.36
Slovak R. (2)	9.90	11.60	0.23	0.46	12.81	0.26	0.51
Bulgaria (2)	10.80	12.65	0.25	0.51	13.97	0.28	0.56
Romania (2)	24.40	28.59	0.57	1.14	31.56	0.63	1.26
Total (dollars)	190.30	222.97	4.46	8.92	246.17	4.92	9.85
Total (ECU)	152.24	178.37	3.57	7.13	196.94	3.94	7.88

(1) annual growth of GNP : 2% ; (2) in US dollars, source : table 2.

Annex Fig. A1 : CEEC's "overconsumption"



source: USDA-WATIVIEW data base from FAO; 1988 data



sources: USDA-WATIVIEW data base from FAO (GDP/head), 1988 data, World livestock situation 93-04 (beef and lamb meat), World poultry situation 92-08 (poultry meat).