

The Impact of Changes in the European Community on World Trade in Agricultural Products*

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I am told there is an old Chinese curse that says: "May you live in exciting times." If so, then the present citizens of the European Community (EC) must feel truly under a spell, because for the third time in this century the political, economic and military map of Europe is being rewritten. Changes are under way that will affect the lives of those in Europe and outside it, just as the events following World War I affected my father's generation, and the events of World War II and its aftermath affected my generation.

This time, however, these changes are occurring without war and military conquest. They are occurring because millions of people in Central and Eastern Europe want to have a more open and responsive political system and a more productive economic system. This is occurring at a time when the member countries of the EC already have taken major steps to deepen the economic integration begun under the Treaty of Rome more than 30 years ago. Now they must consider how they are to respond to the political and economic changes taking place on their borders. Moreover, after 40 years of successful military response to military threats from the East which were led and heavily financed by the United States, Western Europe is going to have to both lead and finance the economic and political responses to the new changes.

POLITICAL DECISIONS AND TRADE LINKS

I want to focus my comments on three issues: two are general and one is specific. First, I want to comment on the implications of the future political and economic arrangements between the current Economic Community and the newly emerging democracies in Central and Eastern Europe. It appears there are three directions the present EC can go. One is to expand its economic integration to include most or all of Central and Eastern Europe at some point. A second option is to provide certain favored access to EC markets for some products from these countries. The third option is for the present EC to treat these former communist countries as they do the rest of the world in terms of political and trade ties.

If the decision is made to fully integrate these countries into the EC, it will mean that the countries will have strong reason to defend the EC trade policies, and little reason to be concerned with the wider world trading system. If the EC decides to establish a truly integrated trading block from the Atlantic to the Urals, it is inevitable that other countries will follow in their spheres of economic interest. It is easy to envision a Western Hemisphere Common Market and a Pacific Common Market following close behind, early in the next century. In that event, the interest in and support for GATT (General Agreement on Tariffs and Trade) would almost certainly decline, and the political dynamics of trade would certainly change.

Conversely, if these countries remain outside the EC but heavily dependent upon it for markets, they will continue to push for greater market access, as they already are doing. This would give them a great incentive to participate in GATT and to push for trade liberalization within that forum. If, however, the EC gives these countries some preferred access on some products, this can be used to induce countries to mute their criticism of EC trade policies, just as the EC sugar policies mute the criticism by the CAP (Common Agricultural Policy) countries by giving them favored access to the EC market at the expense of the rest of the world market.

MACROECONOMIC ISSUES

Turning to a major macroeconomic issue, it is surprising to me how little attention is being paid to the implications of having a huge geographical area with over 500 million people suddenly enter the world market system. We already have seen the impact of the reunification of Germany on world capital markets, as the savings of one of the world's major capital exporters suddenly were diverted to the former East Germany. It appears likely that this huge area, newly opened to world capital markets, will have a significant effect on the cost of capital by increasing the demand for capital and, absent an increase in world savings, driving up the real price or interest rates.

The likely effect on world capital markets is clear. The likely effect on world labor markets is less obvious. What does it mean to have a huge, relatively well-educated labor force suddenly competing in world markets? Will workers from the East replace the existing guest workers in the EC labor force? Will investors looking for low-cost manufacturing sites from which to export to Europe now invest in these countries instead of in Asia, Africa or Latin America? Many of the answers to these questions will depend on how the political leaders in the EC answer the questions regarding the future political and economic relations with these eastern countries.

REFORM OF THE COMMON AGRICULTURAL POLICY

At long last it appears that some significant reforms of the CAP are under way. These are in response to internal political problems rather than to the GATT negotiations, although they may make the GATT negotiations politically easier. I want to comment on four things: 1) What the CAP reforms apparently involve, 2) Some of the internal and external effects of the reforms if they are adopted as proposed, 3) Some problems which EC policy makers may not expect, and 4) The effects of the reforms on trade and on the GATT negotiations.

It is said that imitation is the sincerest form of flattery. If so, the United States should be flattered, for according to the Director-General for Agriculture of the EC Commission, the new policy is modelled after U.S. agricultural policy. If that is true, the EC would do well to look carefully at some of the problems the U.S. policy has created, and consider how they can be avoided.

As I understand the proposed policy, its main feature involves dropping the EC's internal support level for grains by some 35 percent. To compensate grain producers for the decline in internal prices, direct compensation would be paid in the form of deficiency payments. In the case of producers with a larger area of grains, the payments will depend on the maintenance of a set-aside of a certain percentage of their area under grain production. The program for oilseeds would be revised to try to meet the objections of the 1989 GATT panel to the previous program. Deficiency payments would be made directly to farmers to bridge the gap between an EC reference price and the EC target price. If the world price deviates more than 8 percent from the reference price, the payment will be adjusted for the additional difference.

The internal support level for dairy products would be reduced by 10 percent, with the reduction largely in the support level for butter. In addition, the individual production quotas for milk will be reduced modestly. Farmers will be compensated via direct payments for the reductions in quotas.

The support level for beef will be reduced by 15 percent. Payments to producers using extensive beef production methods (forage) will be increased. Changes in the sugar policy were left for further consideration.

I want to examine three aspects of the proposed new policy. First, I will discuss the consumption effects of the changes. Second, I will speculate on the production effects of the changes and suggest some problems that might be encountered in light of the U.S. experience. Finally, I will comment on the trade effects of the changes and the possible links to the current GATT negotiations.

The EC has been demanding an opportunity to 'rebalance' protection at the border to reduce the demand for imported grain substitutes and to reduce the internal demand for imported oilseeds. All attempts at rebalancing by increasing the border protection on the present duty-free imports of grain substitutes and

oilseeds have been rejected by the exporters of these products, although Thailand and other cassava exporters were forced to accept an export restraint agreement on cassava. The proposed CAP reform would bring about rebalancing and, moreover, it does it in a way in that exporters cannot object to or challenge in GATT.

The reform will achieve rebalancing by eliminating the distortions that created the artificial import demand for grain substitutes. Internal grain prices will fall and EC feed users will use local grain and oilseed meals to produce the least-cost feed mixes. The least-cost mix will no longer consist of imported grain substitutes and excessive quantities of oilseed meal. The use of EC grain will expand and the cost of production of EC livestock and poultry products will be reduced. This allows the support level of dairy products and beef to be lowered, but it will have little or no effect on the retail price and the consumption of these products.

Thus, on the demand side, the effect on the demand for agricultural products within the EC will be increased modestly, but the demand for feedstuffs will be switched heavily from imported grain substitutes to domestic grains. This, in turn, will reduce the quantity of grains that enter export markets from the EC.

On the production side, the reform program does not decouple the deficiency payments from current production. It is true that the payments are not made on current individual farm yields, but they are made on the current area planted to grains or oilseeds. Moreover, since the payments are made on recent average regional yields, by definition many of the farms will be receiving higher income from growing these crops than they received before. In any case, as long as the payments are conditional on growing the crops involved, there will be a powerful incentive to continue to produce the crops concerned. The use of past regional average yields should reduce the very high levels of fertilizer application that have contributed to very high yields in the Community and to its considerable pollution problems.

The EC is depending on set-asides to reduce and control cereal and oilseed output. It is likely to be surprised at what a blunt tool this is to achieve output control. First, the EC is not requiring farms that produce less than 92 tons of grains and oilseeds to participate in the set-aside program. According to Community figures, these producers account for 80 percent of the holdings and 40 percent of the area in cereals. Thus the 15 percent set-aside required of the larger farmers will at most involve 15 percent of 60 percent, or 9 percent of the land in these crops. I would suspect that the officials will be surprised to find out how little output reduction is achieved when each farmer takes his poorest land out of production. They also may be surprised to find out that they have fewer large farms than they thought. In the U.S., when limits were put on the amount of direct payment that could go to an individual farm, a whole new legal industry grew up which made small farms out of big farms for government payment purposes. I would be surprised to learn that EC farmers or lawyers were less enterprising, or EC officials more effective, at writing regulations to prevent such circumvention of intent.

In the case of the EC, there will be less incentive to use set-asides as an effective production control tool. In the U.S., larger set-asides save public expenditures because there is no compensation to producers, but in the EC the savings will be less because there are payments to compensate for some or all of the set-aside requirement. Since there presumably will be no export restitutions required under the new policy, there will not be appreciable savings by reducing the set-aside and there are likely to be a number of pressures to keep them low. EC officials will find that producers of inputs do not like set-asides, nor do owners of storage facilities or the owners of export facilities. Many groups develop an interest in maintaining high levels of farm output and moving the excess into export markets.

SURPRISES AND PITFALLS

When the United States embarked on its use of deficiency payments for major program crops, it did so with an established base acreage of the crops concerned on individual farms. The EC starts without such a base and I predict that they will find out that the total acreage of grains, oilseeds and protein crops claimed by producers substantially exceeds the global estimates of area in recent years. Establishing a base while paying for it is bound to lead to increases in the base.

Second, the EC is going to have to deal with the complex issues of whether size limits apply to ownership or operation, whether payments go to landowners or renters, and a series of other complex legal-economic questions. Moreover, because laws, traditions and practices vary widely between member states, there are likely to be wide differences as to national interpretation. This will raise major political problems of equity between areas.

Third, the proposed reforms are likely to affect land prices, whether intended or not. This raises the question of whether the payments go with the land or the individual. If farms with large land area are treated less favorably under the new program, the incentive for farm consolidation will disappear. That should depress land prices. However, if the stream of deficiency payments is tied to land and transferable with the land, regardless of the size of the resulting unit, it might bolster the price of small farms.

Finally, as has been the case with the U.S., the EC is bidding against itself to achieve conservation and environmental improvements. By making high payments to land in crops, they guarantee it will cost more to convert it to pasture or forest.

TRADE AND GATT

On the trade side, the CAP reform could solve one of the EC's most difficult problems—the need to use export subsidies to export an ever-increasing quantity of surplus grain. EC export subsidies have been a sore point in international agricultural trade for decades and have been a major sticking point in the present GATT negotiations. The reform would allow the EC to accept the demands of the U.S. and Cairns Group to scale back or eliminate export subsidies. Moreover, since the export subsidies on meat and poultry products are supposed to merely off-set the higher cost of domestic feed, these could be reduced or eliminated also.

The CAP reform will make a second contentious issue irrelevant. The EC has demanded rebalancing as their price for accepting tariffication. Now they can drop rebalancing and move on to more important issues.

The CAP reform clearly revolves around the cereals policy. EC documents make several assertions and the proposed reforms clearly are based on certain assumptions. They assert that the deficiency payments are unrelated to current production, thus implying that they are decoupled and should be included in the 'green box' for GATT purposes. They assert that the oilseed reforms meet the GATT panel's objections to the current program. They suggest that land set-aside will be effective production controls for grains.

However, before becoming too enthusiastic about the reforms, one should remember that the changes do nothing to increase access to EC markets. They do not remove community preference or variable levies, so that despite claims of greater competition in internal markets there is no indication of how or why it would occur. As long as EC production policy aims at self-sufficiency or more, and pays producers well above world market prices to produce that amount, there is no great break-through in access in the policy.

It is true that the proposed system is similar to that used by the U.S. I would suggest that EC officials ask Thai or other members of the Cairns Group about their views of the U.S. deficiency payment system as a trade distorting policy. My impression is that they view deficiency payments on exported products as being almost as bad as direct export subsidies, and they certainly view them as trade-distorting subsidies because of their output effects.

If the proposed EC policies were to be classified as production-neutral and not trade-distorting, it would be relatively easy for the EC to agree to large reductions in trade distorting subsidies, especially if they were allowed to use an aggregate measure which aggregated all agricultural products. I would be surprised if other countries would agree to this definition, especially as the U.S. appears to be in the process of challenging the revised oilseed program for not removing the impairment of the EC binding on oilseeds.

Thus, in summary, I would view the proposed EC revisions of the CAP as having a modest positive effect on trade because it would remove direct export subsidies as a method of export competition. It would

destroy the artificial market for grain substitutes in the EC, and have an adverse impact on those dependent on that market. However, the most these exporters can expect is sympathy because their market has depended on bad policies within the EC and it is too much to expect the EC will continue to run such a policy for the benefit of others. I think the proposed changes will have only a minor effect on the ability to reach a satisfactory GATT agreement. If all that the U.S. and the Cairns Group wanted was a scale-back of export subsidies, this would go a long way toward allowing it. If, however, as I believe, they also want a substantial scale-back in trade-distorting domestic subsidies, these CAP reforms are unlikely to be accepted as a substitute for real reductions in output-increasing domestic programs. And, the reforms clearly do not allow greater access to EC markets.

On the side of political speculation, I would think that the reforms might make GATT changes harder to accept among EC producers, especially large producers. These producers already are greatly concerned by the proposed reforms. If there is an attempt to impose GATT-agreed cuts on top of unwanted reforms, it seems to me that opposition to the changes might increase to the point where EC political leaders are unwilling to enforce them. As I understand, the German government has agreed to negotiate reductions in subsidies in GATT, if EC farmers are fully compensated for any potential reductions in income. Since the proposed CAP reforms already are scheduled to increase the cost of the CAP by a significant amount, it appears that any significant GATT agreement will carry a major budget cost for the EC at a time when it wants to spend less, not more, on agricultural income transfers.

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