European Union ENLARGEMENT to the East

The Background for Agriculture

by John Malcolm

The early years of the new millennium will see the fifteen-member European Union (EU) expanding to include up to ten new members from the Central and Eastern European Countries (CEECs). The ten candidate countries are likely to join in two or more groups. The first group includes the Czech Republic, Estonia, Hungary, Poland, and Slovenia; countries likely to join later are Bulgaria, Latvia, Lithuania, Romania, and the Slovak Republic. The first countries are not expected to join until 2003–2005.

This enlargement will usher in the most significant changes to the political map of Europe for half a century. It will bring new opportunities and new challenges for the EU and could have a profound impact upon the EU's common agricultural policy (CAP) as it adds substantially to the pressure for CAP reform. Taken togerher, the agricultural area of the ten CEECs equals 44 percent of the EU's existing agricultural area and more than half its arable land. After the extension, the EU's agricultural labor force will double, mainly due to the large agricultural populations of Poland and Romania.

The average per capita income of the 100 million plus CEEC citizens is only 32 percent of the EU income level when measured at purchasing power parity exchange rates. Although the Czech Republic and Slovenia have per capita incomes close to that of Greece, the poorest member state at present, enlargement will add significantly to income imbalance within the EU.

Here I review the problems faced by the agricultural sector of the CEECs in their transition from command to market economies and outline some of their prospects. The implications that this will have for reform of the EU's Common Agricultural Policy will be dealt with in a later article.

Problems of liberalization

Since the collapse of Communism in the late 1980s, the CEECs have all started to liberalize their economies. However, the move from centrally planned production, administered prices, state trading, and an artificially determined exchange rate to a market-orientated production system, private ownership, and a convertible currency is proving neither speedy nor costless.

Each CEEC has seen its GDP fall and its rate of inflation and unemployment rise. The discomfort was particularly noticeable in 1990 and 1991, with most of the CEECs finding their GDPs some 20 percent lower in 1991 than in 1988. Although the officially recorded unemployment rates have come down in the past two years to EU levels, most commentators expect further labor market adjustments.

Inflation everywhere has been prevalent, which was probably inevitable as many goods, notably foodstuffs, had been subject to consumer price subsidies while being produced by methods which by Western standards were antiquated and inefficient. Given the pain of the adjustment process, it is not surprising that there has been a backlash in some countries, with some people looking back nostalgically to the old communist order. It is clear that in the euphoria which greeted the collapse of Communism, people's expectations were unrealistically high. However, the past three years have seen more hopeful signs, with some fall in inflation as well as unemployment rates and an improvement in output levels.

The changes have been particularly difficult for the agricultural sector. Under Communism, farmgate prices had been tightly controlled and consumer food prices heavily subsidized. The removal of these subsidies caused a substantial rise in consumer prices which, coupled with rising unemployment and falling GDP, caused a considerable drop in food demand. It was inevitable, given the distortions of the command economy, that in the transition to a market-led agricultural sector production would fall significantly, which it did in all the CEECs in the early 1990s.

In common with the economy in general, agriculture has suffered from a continuing lack of capital, resulting in the capital stock becoming run down, with little investment in new machinery over the past ten years. In Poland, for example, the average age of tractors is now nineteen to twenty years, and at current investment rates it will take over twenty years to replace the capital stock (Gill).

Output remains below the pretransition levels in all but Slovenia and Romania. However, until domestic incomes rise bringing increased demand for the higher-valued foods, the CEECs' farmers will have to look to external markets as their outlet for increased production. Moving into the heavily protected EU market would give CEEC producers prospects for steady, if slow, growth of output for several years (EU Commission).

In the food processing sector, the opening of the borders to trade with the West led to a considerable inflow of high-quality and well-marketed processed foodstuffs which rapidly gained market share at the expense of the inefficient domestic processing sector. This in turn depressed the CEECs' own processors' demand for farm produce. A lack of adequate financing and access to working capital has hindered the CEECs' domestic processing industries as they struggle to modernize and improve their productivity.

In the early 1990s, the CEECs' trade with the former Soviet Union (FSU) plummeted due to the FSU countries' own economic collapse. In 1996 and 1997, trade with Russia in particular recovered toward former levels, but the ruble devaluation in the summer of 1998 has again crippled trade with the East. Despite increased access to the EU granted by the Europe Agreements, the CEECs' trade with the West has barely risen, and certainly not sufficiently to offset their loss of eastern markets. Lack of coordination in supply and failure to achieve the requisite quality standards have prevented the CEECs from filling their reduced-tariff quotas of EU imports. Moreover, since those preferential imports are allocated on an individual-country basis, the few success stories within the CEECs have been hindered by the nontransferability of quotas within the CEECs as a whole.

On the input side, real prices of purchased inputs increased, especially for internationally traded inputs such as fertilizers, fuel, and machinery. High levels of internal inflation and currency instability exacerbated the situation, especially in the early years of transition. Although remaining high by Western standards, the rate of inflation has now fallen everywhere and the hyperinflation of the early 1990s seems to be under control. However the terms of trade have moved against CEEC agriculture as farmgate prices in most countries have risen very much less than agricultural input prices and the general price level.

Productivity problems

The fundamental problems facing CEEC agriculture are those of land reform and low productivity throughout the agrifood sector. The latter arises from using outdated production methods coupled with overmanning. The communist command economies seem to have used farming and the food processing sector as a major reservoir for surplus labor, with underemployment and overmanning rife.

Different CEECs face very different problems and one should beware overgeneralization. Under Communism, countries such as Hungary and Romania had established large, inefficient collective farms with a low output per hectare and per person, but which performed an important role in the local and regional economy. Poland, on the other hand, has always had a substantial private farm sector. Other countries emphasized small-scale production but denied farmers access to modern equipment and to capital needed to improve productive efficiency.

In common with the economy in general, agriculture has suffered from a continuing lack of capital, resulting in the capital stock becoming run down, with little investment in new machinery over the past ten years. In Poland, for example, the average age of tractors is now nineteen to twenty years, and at current investment rates it will take over twenty years to replace the capital stock (Gill).

The problems have been exacerbated by the inadequate infrastructure in agriculture's associated industries. The infrastructure problem is perhaps worst in Romania, which in 1989 had some 4,000 state farms. Following land privatization and the break-up of the state farms, there are now 4 million farms in that country. The impact on the agricultural supply industries has been substantial. Whereas ten years ago the Romanian fertilizer industry supplied fertilizers by the lorry load to the 4,000 farms, they now find the demand from those of the 4 million who can afford to use fertilizer is for 50 kilogram bags! A whole new wholesale and retail distribution network needed to be established for this and other inputs (Gisselquist). Not surprisingly, the total usage of chemical fertilizers fell from 1.16 million tonnes nutrient equivalent in 1989 to just over 435,000 tonnes in 1996.

The transfer of ownership of land and other assets from the public to the private sector is taking much longer and creating far more problems than expected. Some of the policies pursued up to now may have damaged production potential in the medium term as it has certainly done in the short term.

The first-hand buyers of agricultural output have found similar problems. Millers and other processors find that they must source product from a myriad of small producers with many and varied quality standards. Unless and until new producer marketing organizations develop, the food processing and manufacturing sector is bound to face high procurement costs. Many of these extra costs are in practice passed back to the farmers by way of lower farmgate prices. In a number of countries, most notably Hungary, there has been substantial investment by foreign companies in the food processing and manufacturing sector, resulting in Western practices being introduced, thus raising efficiency.

Table 1. Gross Agricultural Output (1989 = 100)

	1990	1991	1992	1993	1994	1995	1996	1997
Bulgaria	94	88	83	68	74	86	73	96
Czech Rep.	98	89	78	77	72	76	75	70
Estonia	87	83	68	63	56	55	50	49
Hungary	95	89	71	65	66	68	73	72
Latvia	90	86	72	56	45	45	48	47
Lithuania	91	86	66	62	50	53	58	62
Poland	95	93	82	85	79	87	84	84
Romania	97	98	85	94	94	98	100	102
Slovak Rep.	93	86	75	68	75	77	79	79
Slovenia	103	104	94	94	112	117	118	118

Source: EU Commission DG VI Working Documents and OECD.

Note: Volume of gross agricultural output measured at constant prices.

Land reform

Land reform is the other fundamental problem for a number of CEECs. The transfer of ownership of land and other assets from the public to the private sector is taking much longer and creating far more problems than expected. Some of the policies pursued up to now may have damaged production potential in the medium term as it has certainly done in the short term. For example, in Hungary, with a population of just above ten million, land reform created some one and a half million new landowners. One million of them own less than one hectare (two and a half acres), sometimes split into two or more parcels. Clearly such plots are too small to be viable farming units. Although as in the Czech Republic and Slovakia many of these small plots are leased to cooperatives and other large-scale farms, a fully functioning land market has not yet developed.

The absence of a properly functioning land market has hindered progress since farmers in most countries lack adequate capital—even working capital. Lacking a proper title to their land, farmers cannot use the land as collateral for loans. Added to this, in general rural banking and financial institutions are not well developed. One of the most notable deficiencies is in rural bank managers experienced in agricultural risk assessment.

Continuing trade imbalances

Recent years have seen some recovery throughout the CEECs in both agriculture and other sectors. In general, arable production has recovered to the levels of the late 1980s and shows the prospect of further growth over the next five to ten years. However, livestock populations remain around half the levels of the late 1980s, reflecting an adjustment from the heavily subsidized production levels of the Communist era.

Contrary to the expectations of the early 1990s, the CEECs' food imports from the EU have risen, food exports to the EU have fallen, and all but

Bulgaria, Estonia, and Hungary have become net importers of agricultural and food products in recent years. Moreover, despite the recovery in agricultural output, the net agrifood trade deficit between the CEECs and the EU has risen from 1 billion ECU (U.S.$1.1 billion) in 1995 to 1.5 billion ECU (U.S.$1.65 billion) in 1997.

A number of CEECs had increased their exports to Russia and the FSU in the later 1990s, but many producers and processors—especially of dairy products and fruit and vegetables—suffered from the dramatic collapse of the ruble in late August/early September 1998. Moreover, too many of the CEECs' exports—especially to the east—continue to be subsidized. It is remarkable that low-income countries should continue such munificence toward their former communist masters. Their governments of course argue that they are subsidizing their own farmers rather than their customers and that they have to subsidize to compete with the EU. The difference is that, however misguided, the EU can afford to subsidize its exports; the CEECs can ill afford to do so. That they do is probably more a reflection that central planners live on in agricultural ministries than that a desire exists to build up the maximum agricultural base prior to entering the EU!

Many problems of transition still remain, but recent EU Commission studies suggest that, taking the group as a whole, by around 2006 the CEECs are likely to be producing significantly more of the key agricultural commodities than they consume.

Future outlook

Many problems of transition still remain, but recent EU Commission studies suggest that, taking the group as a whole, by around 2006 the CEECs are likely to be producing significantly more of the key agricultural commodities than they consume. This means that the acceding countries will add to EU's already substantial surpluses of high-cost produce. Export-orientated countries such as Hungary will contribute most to these surpluses, which may be greater than the country's allowable volume of subsidized exports under the Uruguay Round Agreement on Agriculture.

Enlargement will, therefore, create additional pressures on the EU's Common Agricultural Policy in two ways. First, there will be more surplus product to be disposed of onto world markets. Second, there will be a substantial increase in the number of hectares and the number of livestock which will become eligible for EU area and headage payments. These points will be explored in a future article on the pressure for future CAP reform and the prospect for the World Trade Organization's next round of trade liberalization negotiations.

It is notoriously difficult to make comparisons of potential productivity and thus of competitive advantage, the more so for countries still struggling with transition to a more market-oriented approach. Unlike the United States but in common with much of the EU, the CEECs have a substantial proportion of their total population living in rural areas. While no longer the dominant form of employment, farming and its associated industries remain significant for the well-being of local communities. Moreover, policy makers in the CEECs are only too well aware of the potential, at least in the medium term, for substantial income transfers for their farmers once they join the EU. Perhaps only time will tell whether such dreams will be realized. ■

John Malcolm is European Union policy adviser to the Hungarian Ministry of Agriculture and Regional Development.

■ For more information

European Union Commission. *Agricultural Situation and Prospects in the CEECs: Summary Report: DG VI.* Working Document, June 1998.

Gill, S. *Agricultural Machinery in Poland During Transition.* New York: World Bank Trade Support Programme, June 1998.

Gisselquist, D. *Common Issues for Input Industries During Transition and EU Accession.* New York: World Bank, June 1998.

Malcolm, J. "CAP Reform and Enlargement: A View from Central Europe." University of Arizona seminar, October 1998.

The author would like to thank two anonymous reviewers for their constructive comments.