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The European Community: Agricultural Policies Create Tension

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An Intelligence Assessment

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EUR 86-10015
May 1986

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An Intelligence Assessment

This paper was prepared by analysts from the Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, European Issues Division, EURA

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The European Community: Agricultural Policies Create Tension

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Key Judgments

Information available as of 1 May 1986 was used in this report.

The European Community's Common Agricultural Policy (CAP) ensures trade rows with the United States and other agricultural exporters, threatens to throw the EC into recurring budgetary crises, diverts resources away from the industrial restructuring effort, and undercuts LDC efforts to boost agricultural output. By encouraging production through high support prices in the face of intensive farming techniques and slow growth in consumption, the CAP has taken the Community well beyond the original goal of food self-sufficiency and made it a major world agricultural producer and exporter—in value terms second only to the United States.

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The highly organized EC farm lobby has blocked efforts to limit production, and the Community has found it far cheaper to subsidize exports of surplus commodities than to purchase them outright and store them indefinitely. We expect the Community will be very aggressive in promoting grain exports in all markets, but especially to the Soviet Union because of its size and nearness to EC producers. In our view, this will enhance Soviet leverage over the EC and possibly lead Moscow to link the purchase of increased EC commodities to conditions such as greater EC purchases of Soviet natural gas.

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We believe US exporters will be hard pressed when competing with the EC's aggressive pricing and marketing efforts, particularly during periods of dollar strength. Even during periods when the West European currencies are strong, we expect the Community to come up with the necessary export subsidies because of the need to reduce production surpluses.

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The new GATT (UN General Agreement on Tariffs and Trade) multilateral trade negotiations this year will be complicated because of the impact of growing EC exports on the external and domestic markets of developing countries. EC sales of poultry and red meat are cutting particularly into exports from Brazil and Kenya, while farmers in a score of other developing countries—including India, Pakistan, Morocco, Tunisia, and Algeria—are threatened by rising food imports from the EC priced below their own production costs. Given the renewed emphasis on agricultural self-sufficiency in these and many other LDCs, debt-ridden Third World governments are likely to protest EC agricultural policies in the new round.

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The Community's agricultural policies will have a strong negative impact on the EC's competitiveness in other areas. Its continuing support of agricultural production and exports through the budget will divert resources that could be used to promote more advanced industries—an area in which the EC now lags behind the United States and Japan. In 1985 the Community spent nearly $4.9 billion—nearly one-fourth of its budget—subsidizing exports. It spent $755 million alone on grain refunds—50 percent more than what it has earmarked over the next five years to develop the area's information technology industry.

We expect the EC, despite recognizing the need for reform, will bring agricultural production under control only slowly. Because all four major West European governments face national elections during 1986-88, we doubt that little more than marginal reform will take place over the next two years. Budgetary shortfalls—caused by the falling dollar and the integration of Spain and Portugal into the CAP over the next 10 years—will probably give a boost to incremental reforms such as price cuts, production quotas, and production taxes. We believe, however, that EC member states over the next three to four years will not tolerate a fundamental reform of the CAP—that is, a change away from a subsidized system to a free market system—because of the overriding political imperative of guaranteeing farm incomes.

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The European Community: Agricultural Policies Create Tension [redacted] 25X1

Production Surplus

The European Community has become a major world agricultural producer and is the second-largest agricultural exporter after the United States.[1] The EC's remarkably generous system of price supports and high import levies under the Common Agricultural Policy (CAP) has helped agricultural production outstrip consumption since the late 1970s (see appendix A). EC farm response to guaranteed high prices, import protection, and no production limits has been a sharp increase in overall production—20 percent by volume in the 1970s. Grain production rose 33 percent; wheat production, 48 percent; and meat output, 25 percent (see table 1 and appendix B). Thus far in the 1980s, production volume of these commodities has increased another 10 percent. Meanwhile, EC food consumption has risen very little. Population growth averaged only 0.4 percent a year in the 1970s and is expected to average only 0.2 percent a year in the 1980s. Rising incomes have encouraged only limited increases in per capita consumption because, to begin with, EC consumers were well fed (see table 2). [redacted]

With production up and consumption relatively flat, the Community, long a major food importer, has met one of its original goals of becoming self-sufficient in most foodstuffs (see table 3). Indeed, substantial unsold surpluses—purchased and stored at Community expense—have accumulated in dairy products, meat, sugar, wine, and grains.[2] The Community remains an important importer of feedstuffs, such as corn gluten and soybean meal. [redacted] 25X1

Rising Prices and Expenditures

The CAP's support prices are set at levels to provide politically acceptable incomes for farmers, not to clear internal markets or to equate to world commodity prices. Each year politically powerful farmers' organizations put great pressure on EC farm ministers to raise prices while consumer groups offer little organized opposition.[3] For example, last year West Germany for the first time used its veto to block a proposed cut of 1.8 percent in the subsidized grain price rather than raise the ire of Bavarian farmers. Taking into account the previous record harvest, the EC Commission had originally proposed a cut of 3.6 percent, which the agriculture ministers bargained down to the vetoed 1.8 percent. The veto ended all ministerial consideration of the price level, so the Commission unilaterally cut the grain price by 1.8 percent. To placate the West Germans, a package of financial management measures for grain farmers 25X1 was also implemented, largely canceling the effect of the price cut. [redacted] 25X1

[1] The European Community is composed of 12 members: West Germany, France, Italy, Belgium, Luxembourg, the Netherlands, the United Kingdom, Ireland, Denmark, Greece, Spain, and Portugal. Since Greece joined the Community only in 1981, and Spain and Portugal just this year, all aggregate data are for the EC Nine and all trade data refer to extra-EC Nine trade. Data and information for this assessment were largely drawn from published EC Commission documents, [redacted] and studies by the US Department of Agriculture. [redacted]

[2] The "butter mountain" now stands at 1.1 million tons, more than the combined weight of the entire population of Belgium; the "wine lake" exceeds 2.4 billion gallons; and beef supplies exceed 750,000 tons. Despite substantial sugar surpluses, the EC continues to import about 5 percent of world sugar exports—1.3 million tons in 1985—from African, Caribbean, and Pacific (ACP) developing countries under the Lome Convention at prices above world market prices. [redacted] 25X1

[3] Although the number of farmers has dropped from about 16 million in 1960 to about 8 million today, EC farmers still constitute a sizable voting bloc in each country. The EC farm population is nearly two and a half times that of the United States. Farm employment accounts for 8 percent of total employment in the EC, compared with 3 percent in the United States. [redacted] 25X1

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Table 1
EC: Production of Major Agricultural Commodities, Crop Years 1970-85

Million tons

	1970	1975	1980	1981	1982	1983	1984	1985 [a]
Grains	95	112	126	123	131	123	152	139
Wheat	37	48	55	54	60	59	76	69
Beef and veal	6	7	7	7	7	7	7	7
Pork	7	8	9	10	9	10	10	10
Poultry	3	3	4	4	4	4	4	4
Dairy (fluid milk equivalent)	92	99	104	105	108	112	109	106
Eggs	4	4	4	4	4	4	4	4
Sugar	8	10	13	13	16	15	13	13

[a] European Community and USDA estimates.

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Table 2
EC: Consumption of Selected Agricultural Products

Kilograms per person

	1968/69	1982/83
Cereals (excluding rice)	85	83
Wheat	76	73
Potatoes	90	75
Sugar	36	34
Total vegetables	99	107
Total fresh fruits	65	59
Wine [a]	51	45
Fresh milk products	103	102
Cheese	9	13
Butter	6	6
Eggs	13	14
Beef and veal	25	24
Pork	28	37
Poultry meat	9	14

[a] Liters per person.

Table 3
EC: Self-Sufficiency Ratios for Selected Agricultural Products [a]

Percent

	1968/69	1982/83
Cereals (excluding rice)	86	109
Wheat	94	124
Potatoes	100	101
Sugar	82	141
Total vegetables	98	99
Total fresh fruits	80	84
Wine	97	102
Fresh milk products	100	101
Cheese	98	107
Butter	91	147
Whole milk powder	NA	317
Skimmed milk powder	NA	133
Eggs	99	103
Beef and veal	90	105
Pork	100	102
Poultry meat	101	111

[a] Production as a share of consumption.

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Not surprisingly, gains in EC prices for selected commodities have usually outpaced world price rises. During the period 1975-83, EC producer prices increased at an average 7.6 percent annually. In contrast, world food prices fluctuated around a trend rate increase of 1.8 percent annually and are currently below the 1982 peak (see figure 1). EC butter prices were four times higher than New Zealand prices in 1978, while beef and wheat prices were nearly double Argentine beef prices and US wheat prices. Only during the period 1983-85 did EC and other producers' prices become more nearly comparable in wheat, butter, and beef, in large part because of the appreciation of the dollar. This year, however, the declining dollar is again causing EC prices to start outpacing world prices. EC sugar prices remain nearly five times the level of Caribbean prices because of high EC support prices. To protect its farmers from these lower world prices, the CAP uses import levies to equate import and domestic farm prices. 25X1

Rising prices have meant increased CAP expenditures.[4] In the late 1970s the widening gap between most world and EC prices, reinforced by the weak dollar, caused CAP expenditures to rise at an annual rate of nearly 13 percent. In 1983 they jumped almost 25 percent, and in 1985 total CAP spending reached about $15 billion (20.5 billion ECUs—European currency units), or nearly three-fourths of the EC budget. The bulk of these expenditures, 70 percent, went for price support and export refund payments. Three commodity categories—dairy, meat, and grains—accounted for over half of the payments (see figures 2, 3, and 4). 25X1

By late 1983 expenditures were clearly outpacing revenues. The Community escaped insolvency through a number of stopgap measures, including the suspension of advance payments on export subsidies and producer aids, as well as raising loans from member states. To stave off another budget crisis, EC agricultural ministers in March 1984 passed several

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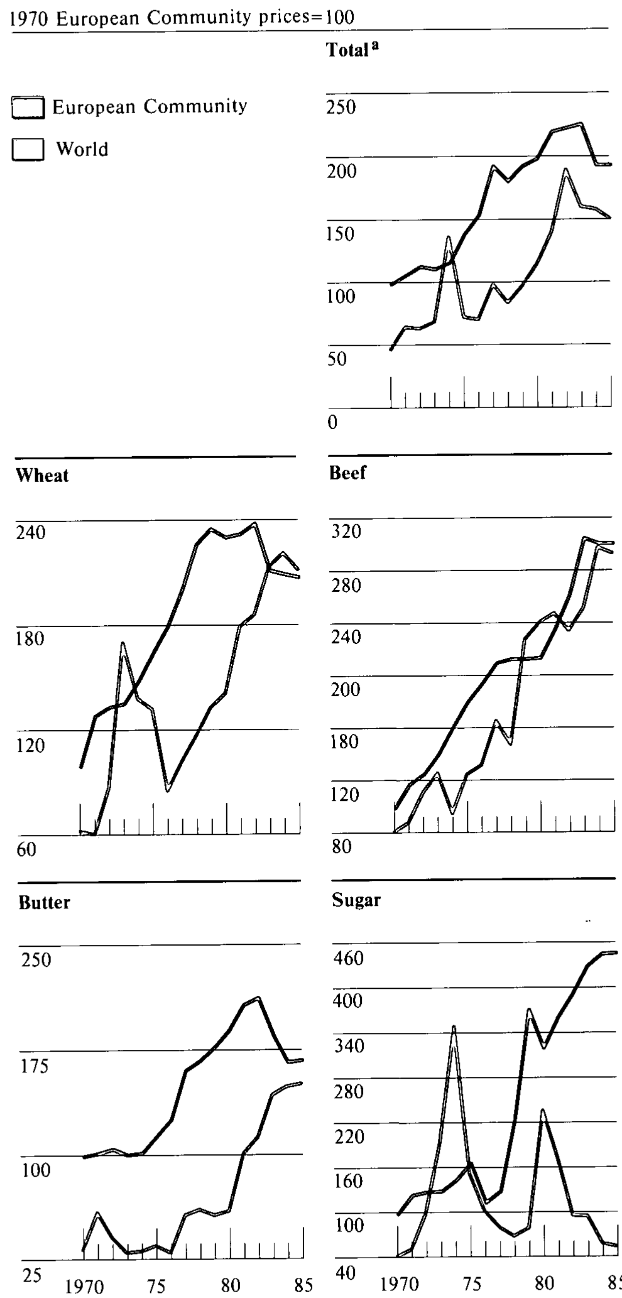
Figure 1
European Comunity-World: Prices of Selected Agricultural Commodities, 1980-85



[a] Weighted indexes of EC and world prices of wheat, beef, butter and sugar.

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Figure 2
European Community: CAP Spending, 1970-85

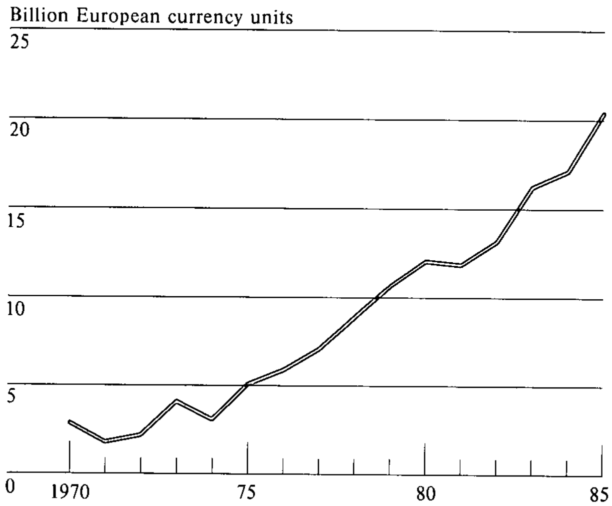

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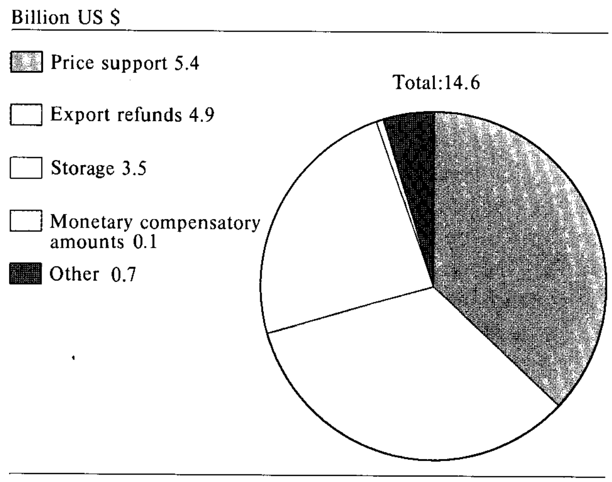
Figure 3
European Community: CAP Expenditures by Type, 1985



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unprecedented measures to retard spending, particularly on dairy subsidies (see inset). On the revenue side, EC leaders agreed in June 1984 to raise the take from members' value-added tax (VAT) revenues from 1.0 percent to 1.4 percent as of January 1986.

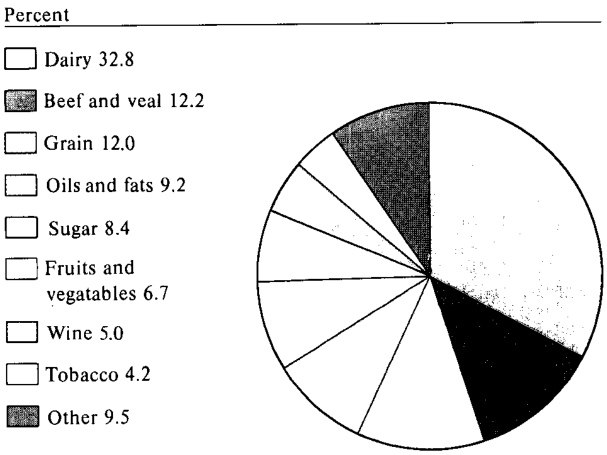
Other Factors Boosting Production

High farm prices have encouraged production increases in nearly all commodities by stimulating more intensive and efficient use of land and capital:

- The EC accounts for only 2 percent of the world's utilized farmland but roughly 15 percent of world's fertilizer use.
- EC agriculture has become one of the most mechanized in the world; the Community is the largest user of tractors and milking machines and the fourth-largest user of combine harvesters.

The certainty of price support policies has given farmers an incentive to increase yields and to gear production patterns for the long term. Expanded use of new seed varieties has raised grain yields, especially in the United Kingdom. Dairy farmers have used genetic improvements and better herd management to boost output per cow 2 percent annually since 1970. In the case of meat, guaranteed CAP subsidies have also enabled the EC farmer to view the purchase of livestock and breeding stock as a long-term investment and have encouraged high output over the long term. By contrast, many US farmers raise pigs for a few years while prices are high, and then liquidate their stock when prices drop.

Figure 4
European Community:
CAP Expenditures by Commodity, 1985



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The Export Push

The EC has increasingly turned to selling off the growing surpluses in world markets in order to recoup some of the cost of production and storage. Because EC prices almost always exceed world prices, the EC has made its products competitive by paying refunds to exporters. Since 1970, as EC exports have grown and EC commodity prices have remained above world prices, export refunds have quadrupled. In 1985 the Community spent $4.9 billion on export refunds—$755 million on grain export refunds alone. Although the rapid appreciation of the dollar from mid-1980 to early 1985 made EC prices more competitive with world prices, the rise of EC producer prices in the past two years and the overall growth in EC farm export value kept export subsidies high (see figure 5).

Because export refunds are paid out of EC revenues rather than national budgets, individual countries are encouraged to export as much as possible. French

Major Features of Common Agricultural Policy Reform Measures Adopted March and June 1984

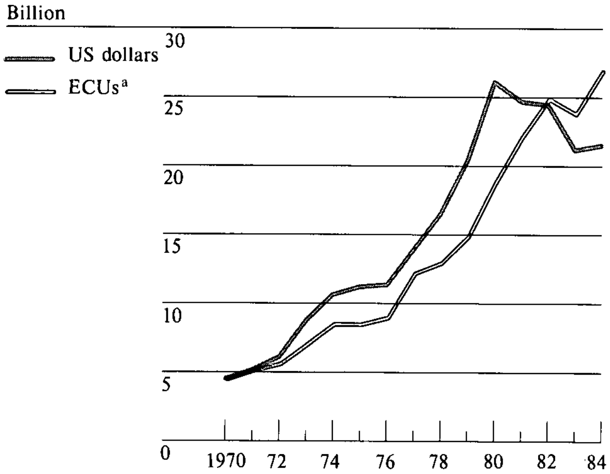
EC farm support prices were lowered—for the first time since the early 1970s—an average of 0.5 percent in terms of the European currency unit for the April 1984–March 1985 period. In national currency terms, price increases ranged from a 17.6-percent rise for Greece to a 0.6-percent decline for West Germany and the United Kingdom. For all EC countries, price changes were lower than the EC's forecast of inflation. 25X1

The EC agreed to dismantle positive monetary compensatory amounts (MCAs) by 1988. Through subsidies, positive MCAs compensated agricultural exporters in strong currency countries—West Germany and the Netherlands most recently—for the higher price of their products in foreign currency terms. To importers, MCAs leveled out the effects of currency fluctuations on agricultural products, making farm imports from strong currency countries equally price attractive. 25X1 25X1

The EC imposed a "superlevy" on excess milk production. The Council established an overall 98-million-ton annual quota on milk deliveries for five years, allocated to the member states either among farmers or among dairies according to Community criteria based on 1981 production, except for Ireland. Overproduction is penalized; dairy farmers producing over quota receive only 25 percent of the target price and no support at all if the milk is produced by a collective or large dairy producer. 25X1

Agricultural and Trade Ministers have been particularly aggressive about expanding their agricultural markets. In late 1982 they signed an unprecedented wheat trade protocol with the USSR that called for the Soviets to purchase between 1.5-3.0 million tons of EC-subsidized French wheat annually for the next three years. The United Kingdom was a net wheat importer just seven years ago, but British wheat exporters anxiously sought non-EC markets to sell their 1984 bumper crop. 25X1 25X1

Figure 5
European Community: Agricultural Exports Excluding Intra-European Community Trade



[a] The appreciation of the US dollar between 1980 and 1985 distorted the value of European Community agricultural exports. A more accurate measure of value is the European currency unit (ECU), a weighted average of all European Community currencies.

[redacted]

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Primarily as a result of the CAP, the growth in EC agricultural exports has outpaced the growth in world trade over the past 15 years. The volume of world agricultural trade in the 1970s grew at about 4 percent annually and slowed to about half that rate in the 1980s; EC exports grew 4.5 percent annually in the last decade and have not slowed appreciably this decade. Growth in world grain trade has slowed even more during the same intervals, from 7 percent annually to an estimated 0.4 percent, while EC grain export growth dropped from a robust 10 percent annually in the 1970s to a still-strong 4.2 percent in the 1980s.[5] [redacted]

[5] The slowdown in grain trade in the first half of the 1980s has occurred in part because many former importers—India, Pakistan, and the EC—have become self-sufficient, while major exporters—Canada, Australia, and Argentina—have significantly boosted output. Faced with mounting surpluses, grain traders are fighting over fewer customers. [redacted]

The EC and the United States since 1970 have both increased their shares of the world agricultural market at the expense of a large number of countries. The Community's share of world farm exports climbed from 8 percent in 1970 to nearly 11 percent in 1983, while the US share rose from 14 percent to 19 percent. These gains have brought the EC and the United States increasingly into direct competition in home and third-country markets.[6] The EC, for example, has now surpassed the United States as a supplier to the Soviet Union, and the EC share of the OPEC market has climbed 8 percentage points since 1970, while the US share has dropped by an almost equal amount. [redacted] 25X1

EC export gains have come in several product categories (see figure 6):

- The EC in 1983 has nearly tripled its share of *wheat* exports to the world, to 16 percent from 6 percent in 1970. A net wheat importer as recently as 1977, the EC now trails only the United States and Canada as a wheat exporter. EC gains have come at the expense of Australia and other small exporters, while the US world market share has remained stable at 38 percent. 25X1

- Already the number-one exporter of *poultry, wine, sugar,* and *dairy products* in 1970, the EC since then has enlarged its share of world markets in all four categories. In dairy products, the Community now accounts for more than 50 percent of world exports (see figure 7). Butter sales to the Soviet Union in 1982 and 1983 were at prices as much as 50 percent below world market prices. Australia, New Zealand, and the United States claimed these sales violated the GATT as well as the International Dairy Agreement. To retaliate, the US Government subsidized sales of butter and cheese to Egypt in 1983. 25X1

[6] Former EC Director General for Agriculture Claude Villain said in early 1983 that the Community intended to hold its sales of wheat and wheat flour to 14 percent of the world market. However, Community sales exceeded 14 percent in 1983 and 1984, and were close to 17 percent of the world market last year. [redacted] 25X1

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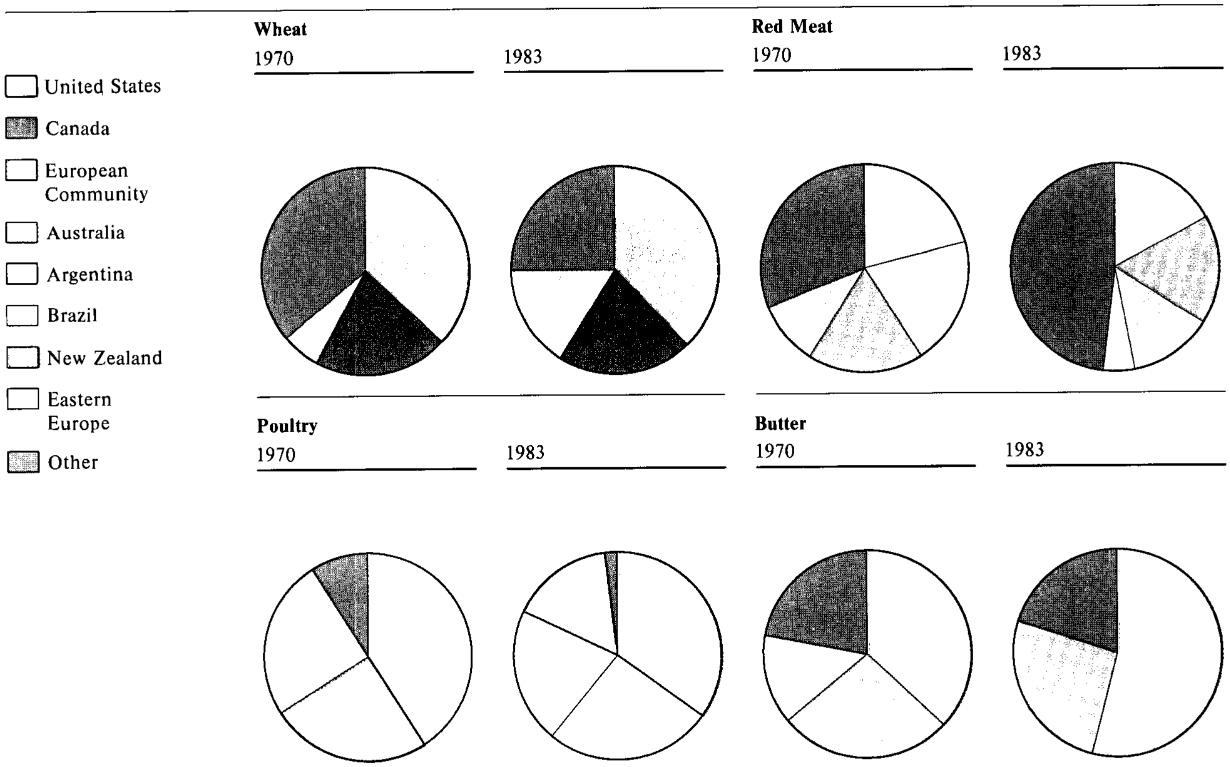
Figure 6
Agricultural Commodities: Trends in World Export Shares, 1970 and 1983



[redacted] 25X1

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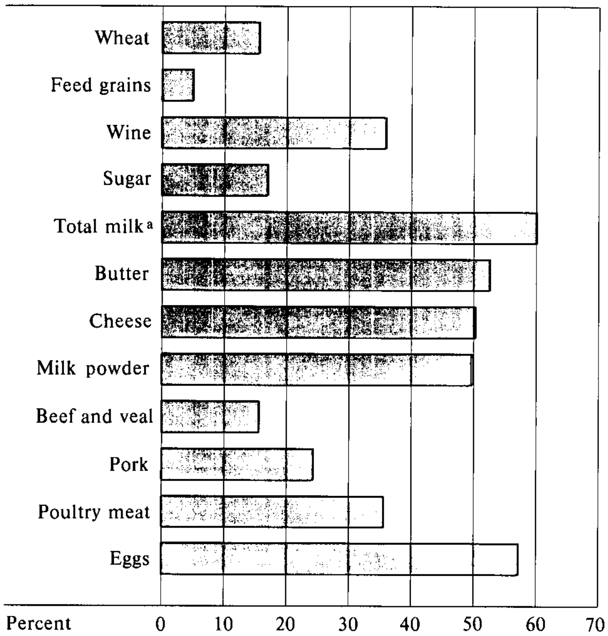
- Community *red meat* exports have climbed to third place by volume from fourth place in 1970. EC subsidies and aggressive marketing are threatening producers in Brazil and Kenya, while traditional beef exporters such as Australia, Argentina, and Canada have lost market shares. Brazil and other developing countries had been looking to expanded beef production to conserve foreign exchange. Australia is particularly concerned that rapidly mounting EC beef surpluses are causing the EC to look to some of Australia's traditional customers in Asia. Canadian beef producers are outraged at the quadrupling of EC beef exports to their own country in 1984 and have demanded much tighter import quotas. [redacted] 25X1

Against this background of EC gains in a slowing world market, Australia, New Zealand, Brazil, and especially the United States have criticized the European Community's system of export subsidies for distorting competition in world markets by keeping world prices lower than they otherwise would be.

Figure 7
European Community: Principal Agricultural Exports as a Share of World Market, 1980-82 Average



a 1980 only.

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Lower prices have forced some farmers out of business, particularly in LDCs, where many farmers are barely above subsistence levels. The EC has agreed to study the question of export subsidies in the GATT, but the Community has publicly stated that it is not willing to discuss "fundamental" changes in the CAP during the new trade round.

Near-Term Outlook

Under the current EC price structure for agricultural commodities, the Community has the technology and resources to continue boosting production faster than consumption. We expect the Community will continue to purchase as much surplus meat and grain as farmers can deliver, thus ensuring expanding supplies for export. Because of recently imposed dairy quotas and the EC's preferred trade with Lome countries in sugar, we expect sugar and dairy export supplies to remain stable. 25X1

We have projected EC production, consumption, and export supply trends for grains, meats, dairy products, and sugar through 1987 based on USDA and European Community forecasts. Our forecasts assume normal weather conditions and we believe the forecasts are conservative in all cases (see table 4). 25X1

Grains. Following a production decline of about 10 percent last year because growing conditions returned to normal after exceptionally good weather in 1984, we expect grain production to increase by nearly 1.5 percent during 1987. Better seed varieties and management practices are the primary reasons for the expected increases. Wheat and coarse grain consumption growth, however, should average about 0.2 percent and 0.7 percent per annum, respectively, and, assuming that EC grain imports remain stable, EC export supplies by 1987 could rise by 20 percent over crop year 1983—the most recent year with normal growing conditions. 25X1

Meat and Poultry. We expect meat production to remain stable at 22 million tons through 1987, up from 21 million tons in 1984. Consumption increases 25X1
should slow to perhaps half or three-fourths of past rates as more and more EC consumers become satisfied with present consumption levels. As in the 1970s, population growth will have little impact on overall consumption. Continued improvements in feed varieties and stock management will cause supplies of meat and poultry available for export to grow steadily in the next few years, probably to 2 million tons by 1987 from 1 million tons in 1985. We expect poultry 25X1
exports to continue to be a particularly bright spot for EC exporters. Poultry consumption is growing faster than consumption of any other meat in a number of LDCs—particularly the OPEC countries, which already purchase about one-fourth of total EC farm exports. Despite policies in many of these countries to stimulate domestic production, only Libya is expected to be self-sufficient by 1990. In the view of the

Table 4
EC: Supply/Demand Balance for Major Agricultural Commodities, Marketing Years [a] 1980-87

Million tons

	1980	1983	1984	1985	Projections	
					1986	1987
Grains						
Production	118	132	123	152	139	140
Imports	19	10	9	6	6	7
Consumption	122	117	118	121	122	120
Exports [b]	15	20	20	26	24	24
Change in inventories [c]	NEGL	5	−6	11	−1	3
Meats						
Production	20	21	21	22	22	22
Imports	1	NEGL	NEGL	NEGL	0	0
Consumption	20	20	20	20	20	20
Exports [b]	1	1	2	1	2	2
Change in inventories [c]	NEGL	NEGL	−1	1	NEGL	NEGL
Dairy products						
Production	105	112	109	106	103	103
Imports	NEGL	NEGL	NEGL	NEGL	0	0
Consumption	91	92	92	93	93	93
Exports [b]	14	19	17	13	10	10
Change in inventories [c]	NEGL	1	NEGL	NEGL	NEGL	NEGL
Sugar						
Production	13	15	13	13	14	14
Imports	2	1	1	1	1	1
Consumption	9	9	9	9	9	9
Exports [b]	4	7	5	5	6	6
Change in inventories [c]	2	NEGL	NEGL	NEGL	NEGL	NEGL

[a] Marketing year is assumed to be the year following actual year of crop production.
[b] Projections are amounts available for export out of production; historical data are actual exports.
[c] Includes rounding error.

Sources: Historical: USDA and EC data.
Projections: Based on USDA and EC forecasts.

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USDA, poultry imports by many OPEC countries should double by the end of the decade as these countries continue to upgrade their diets.

Dairy. The "superlevy" imposed on milk production exceeding set quotas in 1984 should reduce milk production over the next few years, perhaps to 103 million tons by 1986 from the 1983 level of 112 million tons. At best, however, the levy will only stabilize the amount of surplus milk and milk products available for export. Even if EC dairy production stabilizes in 1987 at 103 million tons as estimated by the EC, surplus output will still be about 10 million tons because internal EC consumption is expected to remain stable at about 93 million tons.

Sugar. The EC is unlikely to encourage growth in domestic sugar production, and output should average 14 million tons per annum over the next few years. We expect the EC to maintain limits on sugar production and, despite self-sufficiency, to continue to import sugar at above-market prices from African, Caribbean, and Pacific (ACP) countries under the Lome Convention as a way of strengthening those countries' economies. We also expect the EC to continue exporting slightly over 6 million tons of sugar annually through 1987; the bulk of these exports go to the Middle East and Africa.

Impact of EC Enlargement

The accession of Spain and Portugal this year will probably mean a gradual increase of EC-10 farm exports to those countries, largely at the expense of the United States. We expect present EC members to raise exports of feedgrains, nonfat dry milk, other dairy products, beef, and poultry to the new members as tariffs are reduced between Spain, Portugal, and the EC over a 10-year period. Spain especially will be looking to the other EC members for some feedgrains until its own production increases. In the early 1980s both Spain and Portugal purchased about half their farm imports from the United States and close to 80 percent of their foodgrains and feed imports. In 1983 the two countries purchased a combined total of nearly $2 billion of US agricultural products, including over 6 million tons of grains and 3 million tons of soybeans. The shift toward EC farm imports will begin to cut into US farm trade with Spain and Portugal this year.

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In the longer run, once Spanish and Portuguese agriculture are brought under full CAP support, the gradual rise of their farm prices will, in our view, stimulate additional production, dampen domestic consumption, and add to the increasing surpluses the EC-12 must export. Spain has the greatest potential to increase durum wheat and barley production, partly because EC prices exceed Spanish prices by 25 to 30 percent in these commodities. Fruit and vegetable production should also increase, but probably not enough to reach self-sufficiency in these commodities. Increased Spanish and Portuguese olive oil production will, in all likelihood, simply add to EC surpluses because there is practically no potential for expanding exports to third countries. Enlargement will also worsen the EC's present wine surplus problem, although the impact on world markets should be minimal because world wine demand is fairly stable and the Community does not subsidize wine exports.

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Prospects for CAP Reform

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EC member states are increasingly aware that the CAP as it now functions is a threat to the stability of the EC and its trade relations and that something must be done to reform it. Yet reform of the CAP is most likely to occur incrementally on the margins of its provisions—in ways such as freezing or cutting support prices and fiddling with production and intervention regulations—and in an evolutionary manner that is highly unlikely to achieve a totally free market for farm goods. We believe the fundamental goals of the CAP—to guarantee a supply of food for consumers and high incomes for farmers—and the means of its implementation—a controlled market based on common pricing and the variable import levy—will not be questioned by any member state because they are at the core of the Community's identity and the workings of its economy and politics. We also deem unlikely that any member state would totally abandon the CAP and renationalize its agriculture policy because the risks this would entail—the possible unraveling of other EC policies—would be enormous.

National elections in all of the largest EC members within the next two years—West Germany next January and France, the United Kingdom, and Italy by 1988—will tend to stymie incremental reform efforts as governments seek to avoid antagonizing the farm vote. The current round of reform initiated by EC Agriculture Commissioner Andriessen has already succumbed to member state politics. The Commission's green paper published last July called for a radical change toward a more market-oriented approach to the CAP, yet in practice this has meant only a price freeze for the 1986/87 marketing year and modest proposals for the grain, beef, and dairy sectors that might merely stop surplus production from growing larger still. Even these measures are a source of dissension as members perceive them unfairly impinging on their own unique agricultural problems. The United Kingdom and France, with relatively large and efficient grain farms, for instance, are opposed to a production tax weighted in favor of small producers more prevalent in West Germany.

On the other hand, we expect looming budgetary shortfalls will provide a significant impetus for incremental reform. Now that Spain and Portugal have joined the EC, Community officials expect CAP expenditures to rise significantly as price supports are gradually extended to Spanish and Portuguese agriculture and 3 million more farmers are integrated into the Community—an increase of 40 percent. A continuing fall of the dollar will probably exacerbate a budget shortfall and increase the pressure to control CAP spending. Already in 1986 the EC is facing an estimated deficit of at least $3 billion caused in large part by the widening of the gap between EC domestic farm prices and world prices as expressed in ECUs, necessitating larger export subsidies. Community officials expect EC expansion and the relatively weaker dollar to exhaust revenues this year. Budgetary pressures, which bring EC finance ministers into the CAP decisionmaking process, have in the past put a brake on rising CAP expenditures.

Attempts to solve the impending budget crisis by raising still higher the EC's share of member-collected VAT revenues—requiring unanimous consent of member country parliaments—are not likely to succeed because of strong opposition to raising revenues. In 1984 the move to boost the EC share to 1.4 percent was held up on the question of budget rebates for the United Kingdom. West Germany—the largest contributor to the EC budget and increasingly seeing itself as the EC's paymaster—and the Netherlands are expected to lead the opposition on the grounds that the increase to 1.4 percent was touted as taking care of enlargement, and that a further increase so soon points strongly to the need for curtailing expenditures, not increasing revenues. They might be joined by the United Kingdom, which has already called for more budgetary discipline, and perhaps by France, which will see its status change this year from a net beneficiary of CAP expenditures to a net contributor.

Other options the EC will probably consider include an expansion of production controls beyond dairy products, price cuts, and introduction of new taxes on agricultural output, such as the recently proposed 3-percent "coresponsibility levy," or tax on grain production, to help fund export subsidies.

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Implications

As EC agricultural export supplies continue to grow and world demand for agricultural exports slows, competition for world market shares is likely to sharpen during the rest of this decade between the Community and its competitors, especially the United States. We expect intense competition with the United States, especially over grain trade, to continue fueling bilateral trade disputes, such as the US and EC complaints in the GATT against each other's grain export subsidies. The Community is likely to try to negotiate market sharing arrangements for grain with the United States and other major exporters as a way to control the competition, and might try to cite its unusually large 1984/85 export level as its "normal" market share.

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Others pinched by EC sales, especially Australia, New Zealand, Canada, and some developing countries, are also likely to have disputes with the EC. Complaints from LDCs that rising EC agricultural exports are depressing world agricultural prices are likely to grow and affect relations between the EC and a score of developing countries. Ironically, many of these countries—including India, Pakistan, Brazil, Kenya, Morocco, Tunisia, and Algeria—have benefited from EC agricultural development aid. Their renewed emphasis on agricultural self-sufficiency by carefully building up the productivity of the farm sector will come into conflict with subsidized imports from the EC. We believe pressure by farmers in these countries for protection from EC products is likely to embroil the Community in numerous political quarrels.

CAP-inspired trade disputes between the EC and the United States and a lack of progress on reform of the CAP could, in our view, jeopardize the inclusion of agriculture in the new round of GATT negotiations. The EC says it is willing to work at the new round within the existing GATT framework to improve agricultural trade, but it refuses to discuss the fundamental objectives and mechanisms of the CAP during the trade talks. France, insistent on ensuring its EC and external farm export markets, wants the internal EC issue of CAP reform settled before the Community begins to negotiate about agriculture in the new round. Paris, believing Washington will attempt in the talks to ban or severely curtail farm export subsidies, fears being isolated on the topic of agriculture, and might use its national veto to delay EC agreement on the agenda. Procedurally, Paris wants to contain the discussion of agricultural subsidies in the GATT round to just one committee and fears Washington's effort to broaden discussions is an attempt to undermine the CAP.

We expect the EC's need to push agricultural exports will make the Soviet Union a more important customer for the Community in the years ahead. As the United States and a nearly CAP-bankrupt EC compete in the grain market, the USSR's number-one position as world grain importer will enhance its leverage over the EC. The Soviets, for example, may link the purchase of EC commodities for foreign exchange reasons to increased sales of Soviet gas to the EC-12. In 1983 the EC spent $200 million in export subsidies for grain sales to the USSR. 25X1

We believe the CAP, because of the halting pace of the incremental reform effort—moving ahead at times of budgetary crisis, but stopping for national politics—will continue for several years to be the major problem crowding other issues off the Community's agenda. The continued absorption of three-fourths of EC funds and of considerable time and effort on agricultural issues will serve to divide EC members over petty national interests instead of bringing them together to solve the serious problem of revitalizing the West European industrial base and improving international competitiveness. In contrast to the nearly three-fourths of the EC fund spent on agriculture, only slightly over 2 percent of the 1986 EC budget is committed to research and new technology innovation. In 1985 the Community spent $4.9 billion on export refunds—$755 million on grain export refunds alone—or about one and a half times the total it has earmarked over the next five years for the ESPRIT program on the development of information technology. 25X1

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Even if the EC manages to curb price support hikes, we do not believe such restraint will necessarily curb production. The effects of the nominal price support freeze in 1984 were outweighed by unexpectedly good weather and higher yields because of the growing use of new plant strains. In addition, Community efforts to restrain production will be compounded by another paradox common to farm sectors in developed countries. Many EC farmers—particularly the smaller producers—are marginally efficient and would probably have gone bankrupt years ago without the hefty price increases of the 1970s. If prices in the Community do indeed trend downward and force these farmers out of business, their land probably will not be taken out of production but be transferred to more efficient users, resulting in a net increase in productivity and output. Just as in the United States, the 25X1 newer, larger farms will be better able to take advantage of economies of scale and expensive new technologies to operate profitably at lower price levels than their predecessors. This structural change is already evident in southwestern England, southwestern France, and the Paris Basin and makes the upward course of EC production and exports almost inevitable in the short and medium term. 25X1

Appendix A

A Primer on the Common Agricultural Policy

The Common Agricultural Policy (CAP) is the largest EC-wide program, accounting for over two-thirds of the EC budget and probably an even larger share of EC policymakers' time and energy. Formulated by the original six signatories—France, West Germany, Italy, the Netherlands, Belgium, and Luxembourg—of the Treaty of Rome in 1957, the CAP assumes the need for governments to intervene in the farm sector to increase farm productivity, stabilize markets, ensure a fair standard of living for farmers, guarantee regular supplies, and ensure reasonable prices for consumers.

To accomplish these goals, the Community during 1962-67 set down a series of basic regulations for grains, poultry, pork, eggs, fruits, and vegetables. Since then, regulations for practically all other agricultural commodities have been added except alcohol and potatoes. All these regulations are centered around three principles: Community preference, common pricing, and common financing.

Community preference establishes within the Community a preferred market for EC-produced agricultural products. The EC does this by charging fixed import duties on some products and variable levies on other products such as wheat and corn. These variable levies come into play when world market prices fall below the minimum import prices established by the EC. If the EC price should go below the world price, which rarely happens, the Community uses an export levy to keep products within the Community.

The second principle of the CAP, *common pricing,* requires the price of an agricultural commodity to be the same throughout the Community, without interference from either national duties or subsidies. The Community has established a system of border taxes and subsidies—called Monetary Compensatory Amounts (MCAs)—to offset currency fluctuations.

To work toward common pricing as well as to support farm income and stabilize markets, the EC uses a complex system of target, intervention, and threshold prices, and open-market buying and selling by intervention agencies. Target, intervention, and threshold prices are fixed each spring, based on proposals of the Commission, and approved by the Council of Ministers of Agriculture. For the basic product groups—grains, rice, dairy products, olive oil, oilseeds and oil-bearing materials, and sugar—full producer-price guarantees apply. For fruits and vegetables there are partial or no producer-price guarantees. The three prices apply to the season beginning 1 August and ending 31 July of the following year: 25X1

- The target price is the wholesale market price that the EC believes provides a fair income for the average farmer. It is generally 15 to 20 percent above the intervention price because it includes a "market element" (profit) and transport costs. 25X1

- The intervention price is the price at which a producer is assured a buyer, because the intervention agency in each EC country is obligated to buy at that price. It is the primary support mechanism and is similar to a support price in the United States.

- The threshold price is a set minimum import price. The prices of agricultural imports are raised to this level by applying the variable import levy. 25X1 25X1

According to the third principle, *common financing,* the EC obtains its revenues from Community-wide resources. The EC must balance its expenditures with these revenues annually. These revenues are obtained from the Community-wide value-added tax (55 percent of total revenues in 1984), customs duties (30 percent), import levies and sugar levies (9 percent), and miscellaneous contributions (6 percent). At present, the VAT revenues earmarked for the budget cannot exceed 1.4 percentage points of each country's VAT revenues. 25X1 25X1

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Appendix B

Profiles of Major EC Agricultural Commodities

	Dairy Products	Grains	Red Meats	Poultry	Sugar
Production	Equal to 20 percent of value of EC agricultural production—single-largest EC farm sector; over 50 percent of EC farms have dairy cows, although over 70 percent of these farms have less than 15 cows. The number of dairy cows has remained constant at 25 million since early 1970s, but milk production has increased about 1.4 percent annually since 1970. France and West Germany together account for nearly half of total EC milk production.	Equal to 13 percent of value of EC agricultural production, grown on nearly 60 percent of EC arable land, composes 70 percent of animal feeding stuffs. Land devoted to grains has been constant since early 1970s, but production has increased 2.6 percent annually due to better seeds and increased fertilizer usage. Wheat accounts for one-half of grain production value, barley for one-fourth and corn for one-fifth. France and United Kingdom lead in barley production, France in corn production, and Italy in rice production.	Combined red meat production equal to 29 percent of value of EC agricultural production; beef and veal production contribute 14.6 percent; pork production, 12.0 percent; and lamb and goat production, 2.0 percent to value of EC agricultural production. Beef production increased 2.4 percent annually in the 1970s. France and West Germany account for half the beef and veal production and 46 percent of pork production.	Poultry production equals 4.5 percent of value of EC agricultural production. France and Italy together produce nearly 60 percent of EC poultry. As a proportion of total farm production, UK production ranks highest at about 12 percent. Poultry production increased about 4 percent annually in the 1970s. Production declined in 1983 due to sluggish export demand and increased competition from Brazil.	Sugar beet production equal to 2.4 percent of value of EC agricultural production. West Germany and France together produce over 55 percent of EC sugar beet production.
Surpluses	Surpluses are large and expensive to maintain. Butter stocks hit 1.1 million tons in November 1985 and dry milk powder supplies are 500,000 tons.	Surplus stocks at end of 1985 stand at about 24 million tons.	Beef stocks amounted to 750,000 tons at the end of 1985 due to the culling of dairy herds in response to milk quotas and sluggish internal demand. Pork stocks are negligible.	Poultry surpluses are almost 100,000 tons.	Surplus stocks are negligible.
Exports	$4.1 billion in 1983. Dominates world dairy market; nonfat dry milk, butter, and cheese each account for about 50 percent of world exports.	$4.2 billion in 1983. Third-largest wheat exporter after US and Canada; 17 percent of world wheat market.	$0.9 billion in 1983. Fourth-largest meat exporter; 18 percent of world meat market.	World's largest poultry exporter; $0.4 billion in 1983, or 36 percent of world poultry market.	$1.9 billion in 1983. World's largest free market exporter with 14 percent of world sugar market.
Direction of Trade	70 percent to developing countries, primarily Africa and Middle East, especially Algeria, Nigeria, Saudi Arabia, Iran, Egypt; 13 percent to other West European countries; 10 percent to United States, Canada, and Japan; 3 percent to Communist countries and remainder of other countries.	50 percent to Africa and Middle East, especially Saudi Arabia, Algeria, Morocco, Libya, and Egypt; 33 percent to Communist countries, especially USSR; 17 percent to other West European countries, especially Scandinavia, Switzerland, and Austria.	50 percent of meat exports to developing countries, primarily Middle East and Africa with Algeria, Libya, Iraq, and Iran largest markets; 25 percent to Communist countries, especially Soviet Union; 25 percent to other developed countries, especially Greece.	75 percent of poultry exports to developing countries, especially Middle East and Africa; 20 percent to Communist countries; remainder to other developed countries, especially Switzerland.	60 percent of sugar exports to developing countries, especially Middle East and Africa; 20 percent to Communist countries, primarily Soviet Union, remainder to other developed countries.

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