

(b)(3)

Central Intelligence Agency



Washington, D.C. 20505

| | |
|--------|----------|
| DATE | 5-2-90 |
| DOC NO | 90-20095 |
| OIR | 3 |
| P&PD | / |

DIRECTORATE OF INTELLIGENCE

30 April 1990

EC Agricultural Policy: Impact of German Unification,
East European Reforms

(b)(3)

Summary

German unification and East European economic reforms are unlikely to alter the European Community's (EC) protectionist Common Agricultural Policy (CAP). At least in the GDR, increased demand for food is expected to outstrip any rise in agricultural output in 1990. Thus, the EC is unlikely to reassess its position on agricultural trade in response to East European developments in the GATT Uruguay Round. The Community will remain wedded to a gradualist approach to liberalization and will oppose US efforts to eliminate subsidies.

(b)(3)

By the late 1990s, however, revitalization of East European agriculture may force fundamental reform of the CAP. Some leading European agricultural experts anticipate a 20 percent rise in East German farm output. If such an increase materializes, CAP spending will have to rise to deal with mounting surpluses in such commodities as grain. Eastern Europe's expected transformation from a net importer of agricultural goods to a net exporter by the end of the decade is likely to

This typescript was prepared by [redacted] the Regional Economics Issues Branch, and [redacted] the German Working Group, Office of European Analysis. Comments and queries are welcome and may directed to the Chief, Issues and Applications Division, EURA, [redacted]

(b)(3)

(b)(3)

(b)(3)

EUR M 90-20095

(b)(3)



~~CONFIDENTIAL~~

(b)(3)

(b)(3)

add to the CAP's budget woes by pushing down global food prices. Such a development would put further pressure on the EC to scale-back agricultural subsidies dramatically.

(b)(3)

Nonetheless, member state demands for some continued protection of agriculture might lead the Community to contemplate policies troublesome to the United States. We believe the influential Germans may push for market-sharing arrangements that could limit access of US agricultural products to the Community. Soybeans and non-grain feedstuffs are obvious targets, although we believe the EC--fearing US retaliation--would not support measures directly limiting US exports. Rather, it may indirectly reduce US exports by granting East European products larger access to the EC market.

(b)(3)

DISCUSSION

We expect Eastern Europe's transition to market economies to pose two challenges to the EC's Common Agricultural Policy (CAP). The CAP uses price supports, export subsidies, and variable levies to provide preferential treatment for EC farmers' output. This protection is costly; it claimed 60 percent--or \$30 billion--of the EC budget last year. As market reforms boost Eastern Europe's capacity to export food, the CAP is likely to become even more expensive. The immediate "challenge" for the EC will be East Germany's absorption into the Community and hence the CAP. In addition, a surge in agricultural output from other East European countries--viewed as likely by many experts--will eventually increase pressure on the EC to improve market access for Eastern foodstuffs and may lower world agricultural prices enough to push up CAP subsidies to prohibitive levels.

(b)(3)

German Unification: Limited Near-Term Impact on Agriculture

Over the next year or two, we expect German unification to provide more opportunities than problems for Western farmers. East Germany's demand for more varied and better quality food products almost certainly will surge with economic recovery. The GDR's desire to strengthen its domestic food processing sector is viewed by many observers as indicative of this pent-up demand. Eastern Germany has little capacity to respond quickly to a sizeable increase in demand; last year's wheat harvest was substandard and this year's crop has already been planted. Moreover, the US

(b)(3)

(b)(3)

Embassy reports the GDR cannot currently produce adequate quantities of high value products like fresh fruits and vegetables. Greater demand in conjunction with limited scope for boosting supply in the short-term probably will create greater sales possibilities for European and US food producers and widen the GDR's \$1.2 billion deficit in agricultural trade, already one of the highest in Eastern Europe. [redacted]

(b)(3)

The likelihood that East Germany will remain a net agricultural importer in the near-term should ease the GDR's absorption into the CAP, especially in the important dairy and grain sectors.¹ These two sectors, along with meat and oilseeds, account for the bulk of CAP spending at present (see Figure). To keep spending in check, the EC instituted dairy quotas and grain production stabilizers in 1984 and 1988, respectively. The Community must decide how to adjust the existing production limits to take account of the GDR's entry. [redacted]

(b)(3)

We expect the EC to be generous when making these decisions, in part to avoid antagonizing Bonn at a time when most Europeans want to "anchor" Germany more firmly in the Community.

- With Europe's famous butter and cheese mountains now virtually eliminated, the EC probably will decide that it has scope to raise the milk quota to accommodate the full level of East German milk production--an estimated 8 percent of present EC production.
- Similarly, the EC probably will have little trouble expanding the grain production limit because the GDR at present is a large net-grain importer. Nonetheless, the Community is unlikely to agree to any German demands to suspend the rules mandating automatic price cuts if the new production limits are breached.

Counterbalancing these increased costs will be the likely expanded sales to the GDR of EC surplus products, such as fruit, vegetables and wine. [redacted]

(b)(3)

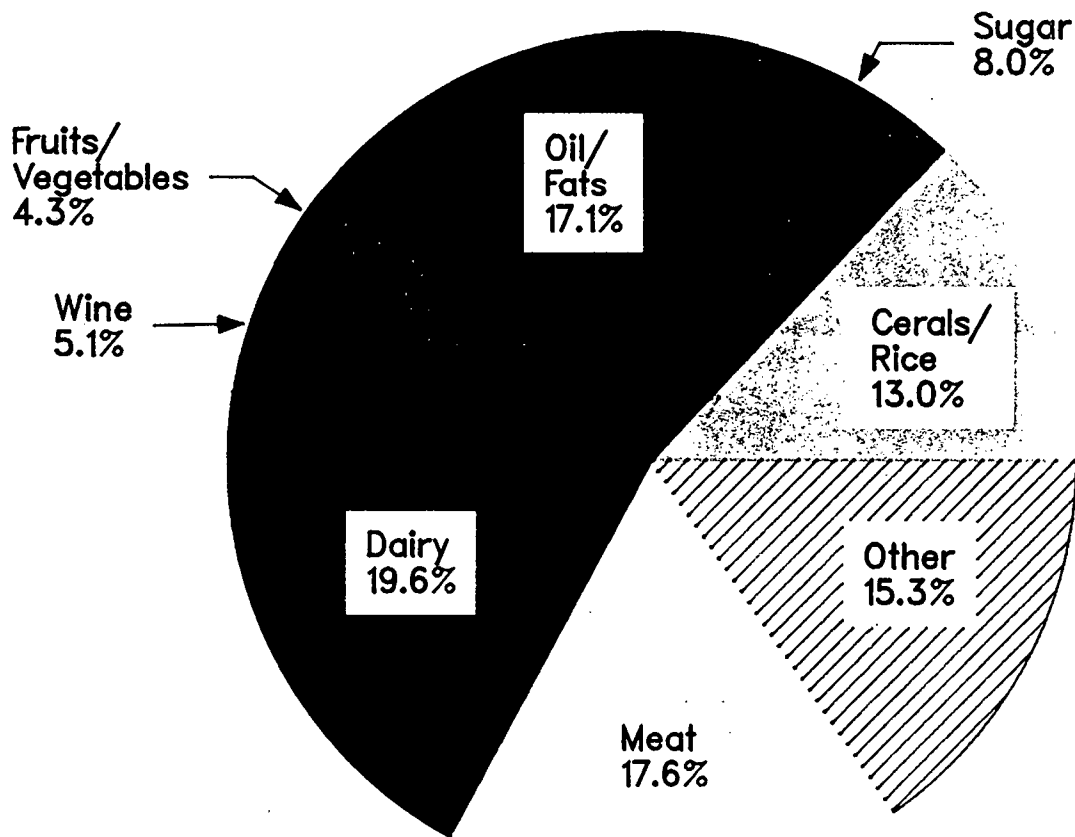
German unification is unlikely to have a significant impact on the EC position on agriculture in the GATT Uruguay Round talks. The EC already has submitted its proposal for the talks, which are scheduled to end in December. The Community feels it has already made a major concession by accepting partial tariffication--an idea favored by Washington whereby non-tariff barriers such as import quotas are converted into tariffs and then reduced. While the EC may be reluctant to make major concessions because of the

¹ East Germany's absorption into the CAP is likely to come in phases. East German farmers will receive increasing benefits and responsibilities for adhering to EC rules at each stage, but no schedule has yet been set by the Community. [redacted]

(b)(3)

(b)(3)

1989 EC CAP Budget, by Product



This Figure is UNCLASSIFIED

(b)(3)

uncertainty of incorporating the GDR into the CAP, we believe the Community still places a high value on successfully completing the GATT talks and will give the high-level political attention necessary to make last-minute concessions when negotiations enter the homestretch in December. [REDACTED]

(b)(3)

The Medium Term Impact: Competitive Challenge Likely

By the mid-1990s, East German agriculture could pose a major competitive challenge to West German farmers. West German agricultural specialists note that parts of the GDR were once considered the "granary of Germany" and that some of its land is still the most productive in Germany. Soil around Leipzig, for example, scores close to 100 on West Germany's 100 point scale. The GDR also enjoys better climatic conditions. Even more important, the economies of scale made possible by East Germany's large farm cooperatives confer significant advantages (see Table 1). Many of the collectives' component farms are likely to be reprivatized as part of the reform effort in the GDR, but we expect East German farms to remain much larger than those in West Germany.

(b)(3)

Economic reforms and modernization accompanying unification will allow East German farmers to exploit these advantages. Market-determined prices will strengthen incentives for the production of goods in which East Germany is most efficient. East German farmers will be able to apply Western know-how to improve yields on their superior land; at present, crop yields are roughly 20 percent below West German levels. Moreover, investments in transportation, storage, and distribution systems will remove bottlenecks that currently limit production and raise costs in the GDR farm sector. Analysis by *Agra-Europe*, a leading European journal on agricultural issues, projects increases in GDR production of 20-30 percent within a few years as a result of such reforms, with the greatest gains in grain, meat and milk output. Embassy reporting, however, indicates the East German Foreign Trade Director specializing in EC relations, Hans-Heinrich Beyer, believes Western analysts are overstating the GDR's potential to expand agricultural output. [REDACTED]

(b)(3)

The Kohl government is committed to aiding East Germany's agriculture in order to avoid economic dislocation and emigration, even though enhanced competition for West German agriculture may result.² West German Agricultural Minister Kiechle is focusing on the modernization of the GDR food industry, rationalization of agricultural production, and conversion to environmentally sound practices. Admittedly, the emphasis placed on the environment

² Regional farm associations in West Germany are pitching in as well. The Bavarian Farmers' Association is organizing seminars and providing information to GDR farmers as well as providing assistance to the newly-organized Saxon farmers' association.

(b)(3)

(b)(3)

Table 1

West and East German Agricultural Sectors: A Snapshot*

| | <u>FRG</u> | <u>GDR</u> |
|--|------------|------------|
| Size | | |
| Hectares (million) | 12.0 | 6.0 |
| Farms | 685,000 | 4,000 |
| Employment (million) | 1.5 | 0.9 |
| Average Farm Size (hectares) | 17 | 1,500 |
| Grain Production (million tons) | | |
| Wheat | 12.0 | 4.0 |
| Barley | 8.4 | 4.2 |
| Rye | 1.6 | 2.2 |
| Yields | | |
| Grains | 50.6 | 45.6 |
| Winter Wheat | 60.0 | 54.2 |
| Barley | 49.9 | 47.1 |
| Potatoes | 332.0 | 272.7 |
| Sugar Beets | 507.1 | 350.2 |
| Producer Prices | | |
| Wheat | 36.6 (DM) | 66.5 (OM) |
| Feed Barley | 33.15 | 60.3 |
| Rapeseed | 89.0 | 149.0 |
| Potatoes | 26.0 | 48.67 |
| Milk | 69.35 | 163.03 |

This table is UNCLASSIFIED

* Data is from 1987.

(b)(3)

could limit GDR yield increases and dampen the anticipated competitive challenge. For example, the Agricultural Ministry in Bonn is likely to urge the GDR to pursue extensification-- substituting less potent natural fertilizers for chemicals. [redacted]

(b)(3)

Should Bonn's help allow East Germany's agricultural output to significantly outstrip its demand for food, a surge in CAP spending by the mid-to-late 1990s is probable. Surpluses in commodities such as grain would accumulate, forcing the EC to spend vast sums to subsidize exports--if still permissible under post-Uruguay Round GATT rules--or store the excess.³ The size of the increase in CAP outlays will depend on world agricultural prices and the health of EC economies. The greater the decline in world food prices, the more untenable high EC support prices are in the face of rising production surpluses. Increases in outlays for the CAP are restricted under a February 1988 agreement to 74 percent of the Community's GNP growth rate; hence the importance of European economic health. [redacted]

(b)(3)

A similar, if less speedy transformation of other East European countries into substantial agricultural exporters would add to the pressure on the CAP, even if the EC does not open its doors to Eastern agricultural produce (see Box). Poland and Czechoslovakia have abundant pasture and meadow land that is ideal for animal husbandry, especially dairying, and orchard production. Hungary, Romania, Yugoslavia, and Bulgaria already are relatively important food exporters and have broad, fertile land conducive to grain and oilseed crops. These in turn can support intensive hog and poultry feeding complexes. We project that Eastern Europe could increase the value of agricultural exports by as much as 11 percent, to \$14.8 billion, over the next five years. [redacted] According to a USDA study, the region has the capability to become self-sufficient in most foods, at higher consumption levels than at present, and to become a substantial overall net exporter of agricultural products by the end of the decade. Should the region close its agricultural productivity gap with the West by even half, for example, the USDA believes it would become a net grain exporter (see Table 2). This could put downward pressure on world grain prices, increasing CAP costs. [redacted]

(b)(3)

(b)(3)

The magnitude of Eastern Europe's competitive challenge to West European agriculture may depend on the development of East European trade with the USSR. For the foreseeable future, the region will continue to obtain most of its energy and raw material imports from the Soviet Union in exchange, in part, for food and agriculture products. Many East European officials fear that, at

³ The USDA estimates that bringing East German yields up, and feed use levels down, to West German levels would make approximately 3-4 million tons of wheat and barley available for export each year. [redacted]

(b)(3)

(b)(3)

(b)(3)

Table 2

EASTERN EUROPE: SUPPLY AND DEMAND OF WHEAT AND COARSE GRAINS

| | Area Harvested (hectares) | Yield Million Metric Tons per Hectare | Production | Net Imports |
|-------------------------|---------------------------------|---|------------|----------------|
| Wheat and Coarse Grains | | | | |
| 1979/80 | 29.0 | 3.14 | 91.1 | 14.7 |
| 1980/81 | 29.0 | 3.35 | 96.9 | 11.5 |
| 1981/82 | 28.8 | 3.31 | 95.1 | 8.2 |
| 1982/83 | 28.8 | 3.70 | 106.5 | 3.9 |
| 1983/84 | 28.9 | 3.54 | 102.3 | 2.4 |
| 1984/85 | 29.0 | 3.96 | 114.8 | -0.6 |
| 1985/86 | 28.7 | 3.56 | 102.1 | 4.6 |
| 1986/87 | 29.1 | 3.86 | 112.3 | 2.4 |
| 1987/88 | 28.5 | 3.61 | 102.7 | 4.3 |
| 1988/89 | 29.1 | 3.59 | 104.3 | 3.0 |
| 1989/90 | 29.2 | 3.73 | 108.9 | 4.7 |

This table is UNCLASSIFIED

(b)(3)

least for the next several years, the region's terms of trade with the USSR may well deteriorate as more and more of their trade is put on a hard currency basis at world prices. If these concerns prove true, the volume of Eastern Europe's exportable surplus in agriculture going to the USSR almost certainly will not diminish and may well increase. This, in turn, may well limit the increase in East European food exports to the world market. [redacted]

(b)(3)

Agricultural Surpluses: Sowing the Seeds of CAP Reform

The Germans, who have been among the most determined defenders of the CAP, would probably respond constructively to pressures for CAP reform that we expect to emerge during the latter half of the 1990's.⁵ The impact of unification on Germany's complicated balance of regional power, even more than economic forces, is likely to be decisive in changing Bonn's traditionally hard-line agricultural policy. At present, West German policy is shaped by the politically influential south--Bavarians have held the Agriculture Ministry for over twenty years--rather than the more efficient north. The addition of more efficient farmers in eastern Germany will eventually dilute Bavaria's influence on agricultural policy and probably tip the balance in favor of greater market liberalization. Northern farmers are likely to find common cause with their eastern counterparts and be more supportive of a more market-oriented agriculture regime. [redacted]

(b)(3)

Other Community members are also likely to view more favorably fundamental reform of the CAP--that is, increased production quotas, and virtual elimination of the dual-price system--by the end of the decade. Indeed, Paris--a frequent hardliner--already is indicating that it believes French grains are competitive in a free market and occasionally espouses making the CAP more market-oriented. Other factors will probably work to weaken political support for subsidization of agriculture in Europe:

- Concerns over the environmental effects of agricultural overproduction are likely to grow in coming years, pushing the EC to implement reforms that would reduce its agricultural surpluses.

⁵ Bonn's troublesome stance on agriculture is influenced by a mix of political, social, historical, and economic factors, including the homage paid to small family farms as an integral part of West German rural society. At least half of West German payments to farmers are social security payments designed to limit pressures on them to leave farming, even if they are no longer competitive. These policies have been followed by German governments through the years; indeed, German agricultural trade has been tightly controlled since Bismarck's chancellorship a century ago. [redacted]

(b)(3)

(b)(3)

- Demographic trends--especially the expected retirement of the majority of farmers during the next decade in both Germany and France--will reduce the farm lobby's political influence.
- Over time, the EC-92 program of deregulation is likely to help liberalize the agricultural sector as the European food industry is changed because of the resulting increased investment in the sector. This could build demand for more specialized agricultural products and divert resources away from traditional agricultural goods that currently are in surplus. Cheaper Eastern products in these traditional areas might, in turn, find a larger EC market. [redacted]

(b)(3)

Nonetheless, the EC will remain committed to some residual protection for agriculture. Over the next several years, as the scope of Eastern Europe's challenge to the CAP and world agriculture trade becomes clearer, we expect to see discussion of options ranging from retargetting subsidy policies to market-sharing arrangements. This debate may move Community agricultural policy closer to US preferences; however, at least one option that may appeal to the highly influential Germans could pose a major obstacle to US exports to Western Europe.

- One possibility is greater regionalization of the CAP. This idea, which is opposed by many Europeans as a step away from a "common agricultural policy," would grant national governments more latitude in providing aid. We believe Bonn is likely to stop short of embracing regionalization, as a concept, but that it would be likely to boost direct subsidies to its farmers.
- Alternatively, the Commission and member states might opt to substitute direct income supports to farmers for price supports to farmers--a policy long supported by Washington, although strongly resisted by the EC in the past.
- The German government may be increasingly attracted to the idea of the United States and the EC carving out markets for themselves. In this vein, proposals to limit the access of US agricultural products to the Community--particularly soybeans and non-grain feedstuffs--could receive increasingly serious attention. Although this policy choice has been primarily pushed by southern German farmers, conservative leaders in the north have backed it as part of a global market sharing arrangement. Although this idea probably would find favor among several of the member states, we believe the EC would be reluctant to push openly for direct limits on US agricultural products out of fear of retaliation.

(b)(3)

(b)(3)

But EC liberalization targeted at East European products may leave US farmers with a smaller share of the European market. [redacted]

(b)(3)

East European Food Exports: Knocking on the EC's Door

East European countries view agriculture as an important sector of their economies, and will emphasize it in their reform programs. It accounts for about 20 percent of the region's GNP and employs nearly 22 percent of the labor force. This compares with 2.3 percent of GDP and 8 percent of the labor force for the EC. Moreover, exports of food and raw agricultural products have been both a major earner of hard currency on Western markets and important in barter trade with the USSR to acquire energy and raw materials. [redacted]

(b)(3)

The East Europeans are pressing for increased access to the EC market--particularly in the meat, dairy, and grain sectors--in order to earn badly needed hard currency to modernize their economies. A Hungarian economic official, for example, has expressed concerns over EC protectionist tendencies, arguing that the EC needs to open its agricultural markets and abandon its agriculture subsidies if it is serious about aiding the East. The EC has always been a key market for East European agricultural goods, taking around a third of the region's agricultural exports. In fact, Eastern Europe is a net exporter of foodstuffs to the Community despite protectionist EC policies, such as quotas on East European beef that were imposed in 1974. [redacted]

(b)(3)

The EC probably realizes that it will have to make concessions to the region in agriculture or face the anomaly of supporting liberalizing economic reforms in the East European countries while still protecting the EC's own highly managed agricultural system. In our view, the EC is likely to grant the East Europeans "controlled access" to its agriculture market--potential East European food exports are in sensitive EC sectors--working out new voluntary restraint-type agreements with the individual East European countries or expanding old ones. These would most likely be in the meat and dairy sectors, along with some grains. It already has increased the beef quotas granted to Hungary, Romania, Poland and Yugoslavia, and suspended import levies for sheep-meat and goat-meat for all the East European countries except Romania. [redacted]

(b)(3)

(b)(3)

