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ENLARGEMENT OF THE EUROPEAN UNION

The European Union (EU-15) is in the process of enlarging eastwards, as 10 Central and Eastern Europe Countries (CEEC) prepare for membership into what will eventually be the EU-25. The impact on world cereal, oilseed and livestock markets in the short-to-medium-term is expected to be minimal, due in part to agricultural policy reforms introduced in the EU-15 and the slow pace of economic reform in the CEEC. Over the medium-to-long-term, internal studies to the EU forecast an increase in the production of cereals, milk, beef, pork and poultry, but a decrease in the production of oilseeds for the EU-25. The impact on Canadian grain producers is expected to be minimal over the medium-term as the EU-25 is not expected to increase the exportable surplus of cereal grains significantly. Although livestock related issues will play a major role in the enlargement, this issue of the *Bi-weekly Bulletin* examines some of the major implications of enlargement for cereal and oilseed markets and discusses some of the impacts on Canada.

INTRODUCTION

The EU embarked on an eastward expansion following the breakup of the Former Soviet Union, motivated by a desire for a peaceful Europe after generations of division and conflict and to consolidate the political and economic transition that has taken place in CEEC since 1989. For further discussion on some of the issues driving the enlargement of the EU, refer to *Bi-weekly Bulletin Volume 9, Number 6, (March 15, 1996).*

To date, negotiations are nearing completion with Hungary, Poland, Czech Republic, Slovakia, Slovenia, Lithuania, Latvia, Cyprus, Malta, and Estonia. Three other countries, (Turkey, Bulgaria, and Romania), are also interested in joining the EU. Bulgaria and Romania submitted negotiating positions in 2001 and are scheduled to join in 2007. The following discussion focusses on the CEEC-10.

COMPARISON: EU-15 AND CEEC

	Total Population [1] (million)	GDP [3] (billion euro)	Inflation [4] %	Agriculture Production (billion euro)	Agriculture Employment [5] %
Czech. Rep	10.285	55.0	3.9	2.52	5.2
Cyprus	0.755	9.5	4.9	0.58	9.2
Estonia	1.439	5.5	3.9	0.34	7.0
Hungary	10.043	49.5	10.0	4.40	6.5
Latvia	2.424	7.7	2.6	0.44	14.4
Lithuania	3.699	12.2	0.9	0.92	18.4
Malta	0.388	3.9	2.4	0.14	1.7
Poland	38.654	171.0	10.1	10.88	18.7
Slovakia	5.399	20.9	12.7	1.38	6.9
Slovenia	1.988	19.5	8.9	n/a	9.6
CEEC-10	**75.074**	**354.7**	**6.0**	**21.60**	**n/a**
Bulgaria	8.191	13.0	10.3	3.36	9.0
Romania	22.456	20.9	45.8	7.78	45.2
Turkey	64.818	217.4	54.9	n/a	34.9
EU-15 [2]	**386.455**	**8,526.0**	**2.1**	**274.02**	**4.3**

[1] Jan 01, 2000 [2] 2000 [3] 1999
[4] Non-harmonised (national) index for Malta and Turkey. Annual variation of the harmonised index of consumer prices in 2000 (%) [5] % of total employment
Source: European Commission, Eurostat, " *Key Data on the Candidate Countries*" and " *Preliminary Economic Accounts for Agriculture in twelve Candidate Countries, '1998-1999*"

For the EU, the CEEC offers a market of well-educated people with low labour costs and forecasted strong economic growth over the next decade. Conversely, the EU can aid the CEEC in their economic recovery with crucial links to democracy, markets and capital. The agriculture sector plays an important role in the CEEC, accounting for, on average, 5% of CEEC Gross Domestic Product (GDP) and 22% of the work force.

Enlargement Process

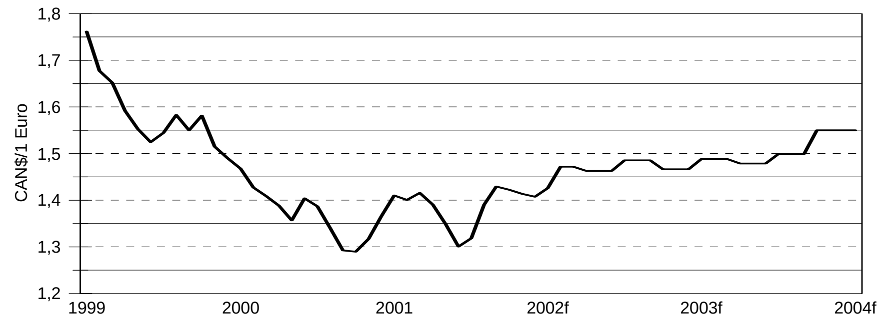
Membership negotiations are currently ongoing between the EU and the CEEC with the timing of each country's accession depending on its progress in meeting the following criteria: (1) stability of its democratic institutions, rule of law, human, and minority rights; (2) developing a market economy competitive with the EU and (3) the ability to adopt the policies and rules of the EU (the '*acquis communautaire*'), along with adequate administrative structures to implement and enforce these policies. The entry of each CEEC into the EU is governed by a series of bilateral "Accession Partnership" agreements in which each CEEC has to undertake a clear framework of political, economic and bureaucratic reforms. These reforms have to satisfy conditions set out in 1993 along with a series of benchmarks that were established to gauge each country's readiness for membership. The progress of reform in each country is monitored and reported on annually in a series of reports issued by the EU.

Since 1992, the CEEC have undertaken reforms to assist the transformation from centrally planned into open market economies. These transformations have proven to be more difficult than anticipated, and the EU has had to provide about 3.2 billion Euro (€) of assistance annually through three funding programs, the Phare, the Special Accession Programme for Agriculture and Rural Development (SAPARD) and the Instrument for Structural Policies for Pre-Accession (ISPA). Each program focuses on separate aspects of reform and development including: institutional reform, strengthening democratic bodies and the bureaucracy that implement and enforce the legislation of the EU.

Prior to joining, each candidate country has to hold a referendum on whether or not to join the EU. Some countries may vote not to join, particularly if the costs of acceptance are perceived to exceed the benefits. Various disagreements are expected to delay the date of entry of the first CEEC to 2004, at the earliest. While agricultural production makes up only a small portion of the economy for the EU-15, it is much more important in the CEEC. Consequently, agriculture issues continue to be controversial in the enlargement process.

Agriculture Issues
One of the major issues concerns how "area based payments" will be handled. Approximately one-quarter of the total EU budget is currently spent on direct-aid schemes for grain and oilseed producers.

EXCHANGE RATE: EURO VERSUS CANADIAN DOLLAR



f: forecast, Scotia Bank Group, CAN$/US$& US$/Euro, April 2002
Source: Pacific Exchange Rate Service

For example in 2000, the EU budget was €95.8 billion, of which €39.9 billion was spent on agriculture through the European Agriculture Guidance and Guarantee Fund, of which, in turn, half was spent on arable crops in the form of direct area aid and set aside payments.

The decision to expand to an EU-25, would increase direct aid subsidies by about €5 billion , on an additional 80 million tonnes (Mt) of production. However, since the EU budget is funded mainly through Value Added Taxes, contributions of the CEEC will be much smaller because of significantly lower GDP levels than for the EU.

An EU recommendation to phase-in direct farmer subsidies over a 10 year period, has outraged the applicant CEEC. The proposal is for producers in the CEEC who join in 2004 to receive 25% of the level of subsidies received by EU farmers, 30% in 2005 and 35% by 2006. This proposal includes using the lower 5 year average yields and seeded areas from the CEEC, which the CEEC argue is abnormally low. The phasing-in proposal is designed to allow the EU to absorb the additional costs of the new member states. It would reduce initial anticipated direct area payouts by about €3.8 billion a year.

Another dilemma for policy makers is the dualistic farm structures in the CEEC whereby a large number of small scale subsistence producers compete against an emerging commercial farming sector. This problem is exacerbated by the expected growth in rural unemployment and poverty, in the absence of off farm jobs or business opportunities, and the lack of social safety nets such as unemployment insurance. As a result, the EU has proposed to fund early retirement pensions for producers in the CEEC. The funds for early pensions are designed to speed up the modernization process in eastern Europe and to compensate producers for not receiving the full direct area payments.

European Union: Economic Situation
While the EU-15 supports the addition of new member countries, it continues to struggle with re-structuring internally. Generally, the net contributors to the EU are increasingly balking at the growing bureaucratization and cost of operating the EU, while the net beneficiaries, especially France, continue to support the status quo. With the adoption of Agenda 2000 in 1999, the EU sought to streamline some of its cost of operations, partly in preparation for enlargement. For a fuller discussion, refer to *Bi-weekly Bulletin, Volume 14, Number 14, August 2001.*

The economic growth in the EU in 2000 was one of the best in the last decade as GDP growth reached 3.4%, 2.8 M jobs were created and inflation remained relatively subdued. Economic growth in 2002 is expected to average slightly under 3%, due to increased world demand. In spite of continuing wage moderation, inflation is not expected to fall much below 2% in 2002, while total employment is expected to grow, although at a slower pace than in 1999 and 2000.

Since its launch in January 1999, the Euro has depreciated by about 25% against the Canadian dollar to about €1=CAN$1.41, comparable to its depreciation against the United States (US) dollar. Many factors have contributed to the weakness of the Euro against the dollar, including differences

EU PRE-ACCESSION ASSISTANCE PROGRAMS

Phare	1.587 billion euro/year	Institutional and Infrastructure Development - 30% of the budget. Investment Support - 70% of the budget.
Structural Policies for Pre-Accession (ISPA)	1.058 billion euro/year	Funds up to 75% of eligible public expenditures. Transport and Environmental Issues - particularly upgrading drinking water standards, water treatment, solid waste management and air pollution.
Special Accession Programme for Agriculture and Rural Development (SAPARD)	0.529 billion euro/year	Restructure agriculture and rural sectors of CEEC Implement political and bureaucratic structures; sustainable agriculture and rural development.

Source: European Commission

in growth rates, interest rates and relative economic and financial outlooks.

Agricultural Situation
Since 1990, the EU has implemented a number of changes to agriculture policy with the general goal of reducing commodity surpluses and easing the strain on the budget. These changes culminated in 1999 with the passage of Agenda 2000, which phased in lower direct area payments over several years, aligned subsidies for cereals and oilseeds and sets aside 10% of productive agricultural land.

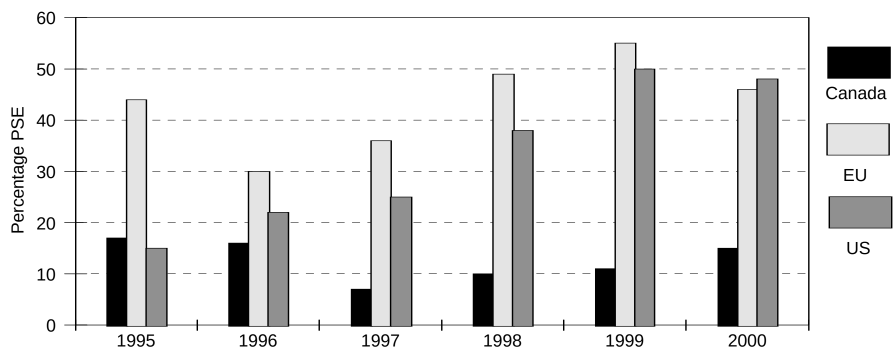
For 2001-2002, **cereal** output in the EU-15 decreased by 7% as abnormally wet conditions across key growing regions in continental Europe resulted in a modest drop in seeded area and a major decline in yields. Supplies of cereals are expected to decline only moderately, as a sharp rise in imports has largely offset the lower production. Domestic usage of wheat and coarse grains and exports are expected to fall slightly, resulting in a 4 Mt drop in carry-out stocks.

Similar to cereals, **oilseed** production declined sharply, to slightly under 14 Mt, for 2001-2002, versus 16.7 Mt for 2000-2001. Rapeseed production fell by one-quarter, to 8.6 Mt, for 2001-2002, while the output of sunflower seed decreased slightly to 3.2 Mt, versus 3.3 Mt in 2000-2001. By contrast, the production of soybeans increased marginally, to 1.2 Mt. Imports of soybeans are expected to increase by 9%, to a record 19.7 Mt for 2001-2002, as the EU seeks to satisfy a growing demand for protein meal and vegoil.

The consumption of soymeal is expected to reach 30 Mt for 2001-2002, a rise of 2 Mt from 2000 to 2001, largely due to the EU-wide ban on the use of meat and bone meal in livestock rations. Total protein meal usage, on a soymeal equivalent basis, is projected to rise to 45.0 Mt from 43.4 Mt, in 2000-2001. Similarly, the EU consumption of vegoil oil is forecast at 13.4 Mt for 2001-2002, versus 13.2 Mt for 2000-2001. This is due to a sharp increase in soyoil and palmoil consumption, more than offsetting a decline in the consumption of rape oil, sun oil, olive oil and other oils.

CEEC: Economic Situation
Nominal GDP growth in the CEEC averaged around 3.6% during 2000, a sharp increase from 0% growth in 1999. In 2001, there was a slowdown in economic growth, in line with the deteriorating EU economic performance. Nine CEEC have grown at a faster rate than the EU, narrowing the income disparity between the two sets of countries. The growth has occurred at the expense of a high inflation rate, which exceeded 15% in 2001 and increased unemployment in the CEEC of 12.5% compared to 11% in 1999. The rise in unemployment is the result of structural labour shedding reforms and high productivity growth. Current account deficits have improved for most of the countries, despite a deterioration in the terms of trade, with the largest change occurring in Latvia and Lithuania. The CEEC are still grappling with setting up the legal and institutional framework needed for the functioning of a market economy, including the enforcement of judicial decisions.

WHEAT: PRODUCER SUPPORT ESTIMATE



Source: Agricultural Policies in OECD Countries: Monitoring and Evaluation, OECD 2001
AAFC, Research and Analysis Directorate

CEEC-10: Agricultural Situation
Since 1990, the agricultural sector has undergone dramatic changes including price and trade liberalization, privatization, the abolition of consumer subsidies and the loss of traditional markets. Consequently, output decreased sharply and there was widespread decapitalisation, as production assets were sold to generate short-term income. To-date, each country continues to develop at different rates and displays different specializations.

CEEC-10 **cereal** production has increased significantly, from 63 Mt in 1992, to 77 Mt in 2001. A drought in 2000 resulted in a crop of only 63 Mt. The growth in cereal production is due to the 15% rise in yields, from 2.7 t/ha 1992, to 3.3 t/ha for 2001-2002, as the area seeded to cereals has remained relatively constant since the mid-1990s.

Total food use of cereals in the CEEC-10 has increased slowly over the past decade, due to a slight increase in per capita consumption and in population. It is estimated at slightly over 19 Mt for 2001-2002. By contrast, the use of cereals in livestock rations has declined, particularly in 2000, as the result of drought and reduced livestock populations. Feed use is expected to recover as a result of growing pork and poultry production in Poland and Hungary.

Oilseed area in the CEEC-10 is highly sensitive to market prices. After peaking at 3.7 million hectares (Mha) in 1999-2000, area dropped to 3.0 Mha in 2000-2001, due to the low market prices for rapeseed, sunflower seed and soybeans compared to wheat and coarse grains, before rebounding slightly to 3.1 Mha in 2001-2002.

For 2001-2002, the production of oilseeds rebounded to 5.1 Mt, from 3.9 Mt the previous year, due to a return to near-normal

EU-15 AND CEEC-10: CEREALS* SUPPLY AND DISPOSITION

	EU-15			CEEC-10		
July-June crop year	**2000 -2001**	**2001 -2002e**	**2002 -2003f**	**2000 -2001**	**2001 -2002e**	**2002 -2003f**
Harvested Area (Mha)	37.65	36.36	37.20	22.21	23.63	23.80
Yield (t/ha)	5.70	5.49	5.70	2.82	3.25	3.27
	.........................million tonnes.........................					
Carry-in Stocks	34.99	35.16	31.28	9.19	6.48	10.85
Production	214.56	199.56	212.04	62.63	76.80	77.90
Imports	43.39	47.82	58.00	4.98	4.30	4.00
Total Supply	**292.94**	**282.54**	**301.32**	**76.80**	**87.58**	**92.75**
Exports	60.94	57.49	65.00	3.28	7.8	13.11
Domestic Usage	196.84	193.77	204.32	67.04	68.86	69.64
Total Use	**257.78**	**251.26**	**269.32**	**70.32**	**76.73**	**82.75**
Carry-out Stocks	**35.16**	**31.28**	**32.00**	**6.48**	**10.85**	**10.00**

* cereal includes wheat, barley, oat, corn, and rye.
e: estimate, USDA-PSD, May 2002
f: forecast, AAFC, based on *"EU Medium-term Outlook"*, May 2002
Source: USDA, Production, Supply and Disposition Statistics, May 2002

yields following the drought of 2000-2001. Most of the increase in output is expected to be consumed locally due to a growing demand for oil for food use and protein meals for livestock feed. Exports, mostly to the EU, are estimated at about 0.8 Mt for 2001-2002.

Impact of Enlargement.
Over the medium-term, the changes introduced under Agenda 2000 are expected to result in a shift to a higher cereal area at the expense of oilseeds and an expansion in voluntary set-aside in regions where the profitability is low. Exports to the EU are expected to be dominated by issues such as limits on imports of genetically modified oilseeds and other products.

The European Commission recently released a study analysing the possible impact of enlargement on agricultural markets for the main commodities grown within the CEEC. It was assumed that all 10 CEEC had entered the EU by 2007. The baseline assumed non-accession and *no change* in agriculture policies within the CEEC. Three simulated alternative policy scenarios were analysed against the baseline. The first scenario was the implementation of the Common Agriculture Policy (CAP) *without* direct payments, but including production quotas based on recent yields and harvested areas. The second scenario implemented the CAP with *full* direct payments and quotas, with the reference quantities based on recent reference periods. The third scenario implemented the CAP with full direct payments and quotas and the reference quantities based on *negotiations* between the CEEC and the EU.

The scenarios, in comparison to the baseline, are summarized below. For all scenarios, domestic prices for cereals in the EU-25 are expected to rise over the medium-term on support from higher world prices, which are expected to keep domestic prices above support levels. Cereal export subsidies should be minimal, although remaining highly sensitive to the value of the Euro.

By 2007, total production of **cereals** in the EU-25 is projected to be 6-10 Mt above the baseline for an independent EU-15 and CEEC, to 310-315 Mt. The increase in output was lowest for the second scenario of full CAP benefits without direct area payments. However, both second and third scenarios, of including direct area payments, and of accepting the CEEC negotiated terms, increased cereal output by 5 Mt over the baseline within the CEEC. Total cereal exports would rise by about 4-6 Mt a year, to 39-41 Mt, versus the 34 Mt projected under the status quo scenario.

The largest increase in exports is projected for wheat, which rise by 3-4 Mt over the baseline, to 23-24 Mt by 2007. By contrast, the projected large rise in coarse grain production would be largely offset by a rise in feedgrain consumption, as a result of expanded livestock production in the former EU-15. Therefore, exports of coarse grains from the EU-25 would rise by only 1-3 Mt over the baseline scenario, to 15-17 Mt over the medium-term.

The production of **oilseeds** is projected to decline by about 1 Mt, to around 17 Mt, in the EU-25 by 2007, compared to the baseline EU-15 and CEEC. However, output in the EU-15 is forecasted to increase slightly, while production in the CEEC declines sharply. With the consumption of oilseeds expected to remain stable over the medium-term, the CEEC is projected to become a net importer of oilseeds, compared to an exporter under the baseline scenario. Consequently, EU-25 imports of oilseeds are expected to increase over the medium-term as a result of enlargement, compared to the baseline scenario of no change.

Livestock production and exports are expected to increase in the CEEC over the medium-term, as producers, and the meat processing industries modernize, increase efficiency and grow in size. Analysis by the European Commission suggests that poultry and pork production in the EU-25 will rise slightly upon accession, as technical constraints slow down the expansion in output spurred by higher prices. Producers and processors in the former CEEC will face more stringent regulations regarding animal welfare and product quality, which will raise production costs. As a result of increased livestock production in the CEEC, internal demand for feedgrains is projected to grow at a moderate pace.

The enlargement of the EU-15 and the CEEC to an EU-25 includes many issues that have to be negotiated and progress is expected to be slow. Previously optimistic forecasts for increased agriculture production in the former CEEC have been scaled back in light of a lack of functioning economic institutions such as banks, courts and clear property titles.

The EU has scheduled a mid-term review of Agenda 2000 for 2002 to consider further reforms of the CAP. In addition, elections for the European parliament are scheduled for 2004, when 10 applicant CEEC are expected to vote. Other outstanding issues include additional reforms of the political and financial structure of the EU-15 as it expands to the EU-25, the speed of the adjustment to a market economy in the CEEC and forging a consensus for trade negotiations at the World Trade Organization.

For Canada, the major issues of concern are what role production and export subsidies will play in the enlarged EU and the growing importance of the CEEC in world agriculture markets. Over the medium-term, the impact on Canadian cereal and oilseed producers as a result of the EU enlargement is expected to be minimal.

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