



The CUSMA: Impacts on the Dairy Sector

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The revision to the NAFTA (now termed the CUSMA) has followed an erratic and unpredictable path. But, now that the dust appears to have settled, it is possible to consider the impacts of the changes that have occurred to the original agreement. Unusually for a trade agreement, its agriculture provisions have attracted a great deal of attention, particularly those applying to the dairy sector. In this note, we will focus on two key aspects of the dairy component of the agreement, summarizing what has been agreed and how significant those effects are likely to be.

The headline news was that the Canadian dairy market will be opened up to increased dairy product imports from the U.S., via an expansion of those tariff rate (import) quotas. The widely used estimate of the size of this increased market access is 3.59 percent of the Canadian (consumption) market,¹ which can be compared to a 3.25 percent increase in market access agreed in the CPTPP Agreement. A second key feature is that Canada will eliminate two classes of milk from the classified milk pricing structure used in Canada, classes 6 and 7. The importance of this latter change is that it will turn back the clock on Canada's long-standing efforts to cope with a domestic surplus of non-fat milk solids. It poses the more significant challenge of these two changes.

Increased milk product imports via TRQ expansion

To understand these changes, one can start with the fact that milk prices in Canada are about 30 to 40 percent higher than those in the U.S. at current exchange rates. When combined with very restrictive tariff-rate quotas (TRQs) and their high over-quota tariffs, mostly exceeding 200 percent, this gives U.S. milk producers the impression that the Canadian market is served by a high-cost producing sector and that U.S. producers could easily penetrate this market if only existing trade barriers were removed. Other recent product flows and policy measures only strengthened their resolve to pry open the Canadian market within the NAFTA negotiations.

In addressing the opening of the Canadian dairy market, there are only two policy changes of importance that are available. These are to increase the levels of the TRQs, and to lower the over-quota

tariffs. If either of these changes were large enough it would spell the end of the supply management system as we know it, and some U.S. negotiators argued for a change of this magnitude. But the serious negotiations always have been, and were in this case, more incremental in nature.

Despite there being two policy tools that could have been changed, the only change pursued here, and in all other trade negotiations since the 1980s that have included dairy trade rules, is an increase in TRQ levels. To some it might seem odd to ignore over-TRQ tariffs as a negotiating option, given that Canada's over-quota tariffs are so high and could be reduced substantially without resulting in any imports, at least for most observable exchange rates and relative Canada-U.S. milk prices (i.e., those tariffs have so much water in them). Canada has vigorously opposed any reductions in those tariffs, partly to provide insurance against any milk price fall within Canada. This also has been the Canadian policy for decades. And the U.S. likely realized that with all that 'water,' it would take a very large cut indeed of those tariffs to benefit them with more exports. TRQ increases would give an immediate increase in their market access, independent of the degree of water in the tariff and independent of how efficient the Canadian industry might be in warding off imports if domestic prices fell.

The new CUSMA once again involves an increase in TRQs, and these increases vary considerably by product category. This is shown in Table 1 for the largest five milk product categories in the CUSMA, measured in metric tons. The incremental TRQs in the CUSMA are compared to WTO TRQ levels in the last column. These TRQ levels are for the last year of the phase-in period for each agreement. One observation is that the CUSMA TRQ levels in these categories are quite similar to the CPTPP levels, the exception being creams where the CUSMA TRQ is 16 times the CPTPP level (and 30 times the WTO level). Another observation is that when looking at these quantities in tons, the increases appear to be quite large. But if we examine all dairy product TRQs (not only these five categories) in aggregate, expressed as a share of total Canadian dairy market consumption, the CUSMA import levels are equivalent to a rather modest 3.59 percent.

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Table 1. TRQs by agreement (by Year 19: CPTPP, CUSMA; by Year 6: CETA) (metric tons)

Product	WTO	CPTPP	CETA	CUSMA	CUSMA/WTO
Fluid milk	64,500	56,905		56,905	88%
Creams	394	734		11,950	3041%
Cheeses	20,412	16,502	17,700	14,226	70%
Butter	3,274	5,121		5,121	156%
Nonfat dry milk	--	11,014		8,536	n.a.

The effect of this increased market access granted to the U.S. is not obvious because it depends on the response of the Canadian industry. Facing increased TRQs, the Canadian industry basically has two choices. It could keep domestic (farm-level) milk quota at its current level, or it could reduce that quota, kilogram for kilogram, with the increase in TRQ access (translating the increased TRQs by product into raw milk equivalents). If the first approach is chosen, farmers will experience no reductions in their milk production quotas, but with this increase in aggregate milk supply, the domestic price of milk must fall. With the priority we observe given to maintaining domestic farm milk prices, this approach is not followed. Rather, the industry chooses to keep the milk price at its current level and absorb a decrease in farm level quotas compared to what they otherwise would be.

From this choice, several results can be noted. First, there will be no resulting decrease in milk product prices on average facing consumers. There may be more variety in some product categories (e.g., cheeses) available due to these increased imports. But even that increase will be more limited than one might assume due to the fact that some of these increased TRQs are restricted to imports into industrial channels, in bulk to further product processors, not into standard retail channels.

Farm quota cuts

In addition, the quota cuts to producers are likely to be much more modest than expected. The import increases noted above

are the total increase that will occur, but they are phased in over a number of years. The phase-in period in the CUSMA is typically 19 years, but about 90 percent of the ultimate TRQ level is reached in six years. Looking at the overall (aggregate) increased TRQ, using a six-year phase-in of a 3.59 percent TRQ would mean a 0.6 percent increase in the TRQ, a slightly more aggressive phase-in than what is mandated in the agreement. Following the process noted above of cutting domestic farm quotas to compensate for the increased flow of imports, the 0.6 percent increase in TRQ levels means a 0.6 percent decrease in domestic production quotas at the farm level, occurring each year for six years. Then no further cuts will be needed.

Such cuts appear modest, but they should be compared with the normal fluctuations in industrial milk quota holdings that occur in reality. Recall that industrial milk quota levels fluctuate annually with changes in demand, to keep supply equal to expected demand. Over the past ten years, from 2007/2008 to 2016/2017, the average increase in industrial milk quota was 3 percent per year.² In other words, due to growth in the demand for butterfat by Canadian consumers, the real and significant dynamic is that farm quota allocations have *increased* on average in the last ten years at a rather healthy rate.³ In this context, the cuts in quota that would be due to the CUSMA are tiny enough that there would still be quota growth: quota allocations will increase by 2.4 percent per year during the six-year phase-in, before reverting back to the longer-run 3 percent per year growth.

¹ https://www.bennettjones.com/en/Publications-Section/Updates/Introducing-the-US-Mexico-Canada-Agreement-CUSMA?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original

² Canadian Dairy Commission Annual Reports, various years.

³ Even extending the time period over the past twenty years, the growth rate in this farm quota is only 0.8 percent per year less (i.e., 2.2 percent increase per year). So this is a situation that has been sustained for some time, even if the growth rate has been faster in the more recent decade.

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Even if we add the increased TRQ allocations under the CPTPP and CETA, this would mean an additional 0.9 percent cut in each of the six-year phase-in periods, leaving quota holdings still growing at 1.5 percent per year during the six-year phase-in periods, again assuming the 10-year pattern is sustained (or +0.7 percent per year if you prefer to focus on the 20-year pattern). What appeared at first to be a cut in farm quota holdings in fact is only *slower growth* in those holdings, and even that for only six years.

This is the average picture across the whole dairy sector’s many products. In specific product sectors, the effect of increased imports will be less or more significant, a fact of interest to milk product processors. The most striking case is cheese, due to the fact that the whole dairy product market opening in the CETA is for cheese. The combined cheese quota for the CETA, CPTPP and CUSMA is 2.3 times the prior WTO cheese quota, or 46,728 tons. To soften this impact on cheese processors, a significant share of this TRQ increase will be allocated to cheese manufacturers or other industrial users. This effectively transfers the import quota rents to those industrial users. In the case of the CETA and CUSMA, half of the cheese TRQ is allocated in this fashion (69 percent in the CPTPP).

Class 7 changes

It is widely acknowledged that the potentially most damaging feature of the CUSMA for the Canadian dairy sector is the removal of ‘Class 7’ pricing. This class of milk was introduced nationally in 2017 to provide discounted milk prices to processors for a variety of skim milk components, including milk protein concentrates, skim and whole milk powders, and casein. Its purpose was to deal with the long-term, and growing, surplus of skim milk produced in Canada. It was also designed to allow processors to compete with newly rising imports of milk protein isolates (which substitutes for ‘conventional’ skim milk in several milk products), a category of non-fat solids whose import is not restricted by tariff-rate quotas. The reason the milk in this special class allowed processors to compete with such imports was that it was priced at world price levels.

The significance of Class 7 pricing⁴ is that it provides a means of coping with the growth of an excess supply of non-fat solids

within Canada that was threatening to destabilize the whole milk policy regime. Even though this surplus has existed since at least 1980, it has grown more seriously with the increased demand for butterfat and the inability of Canada to export the surplus due to a series of past WTO decisions. It would appear that there are only two alternatives to deal with this large surplus and clear the skim milk market, a (likely significant) reduction in the price of non-fat solids, or to set aggregate milk quotas based on non-fat solids instead of the current butterfat-focused quota. Both would entail large revenue losses to Canadian dairy farmers, either from a fall in price or in production. To make matters worse for Canada, the phase-in period for class 7 removal in the CUSMA is six months after entry into force of the agreement.

Conclusion

It is clear that the increase in TRQs, in the context of growing farm quota allocations and six-year phase-in periods (for most of the increased TRQ access), is a negligible adjustment in comparison to the serious restructuring that is likely from the removal of Class 7 pricing.

Some would argue even the demise of Class 7 pricing was forecast, outside the CUSMA. There were arguments by a variety of our trading partners that the Class 7 pricing mechanism was a thinly disguised export subsidy and that this policy would end up being successfully challenged through the WTO dispute settlement process. Similarly, the increasing restrictions on dairy exports from Canada through WTO decisions since 2000 is outside the CUSMA, as is the even older ‘structural’ surplus of skim. What the CUSMA has really done is brought forward in time the need to resolve these skim milk surplus difficulties in a more sustainable and long-term manner.

Finally, there are a variety of other details and changes in the CUSMA affecting the dairy sector that were outside the limited scope of this review. These include export surcharges for milk protein concentrates and skim milk powder exports beyond specified thresholds, notification requirements for certain changes in classified pricing, and transparency of procedures used in the administration of TRQs.

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The Emperor's New NAFTA

By Joseph W. Glauber, Senior Research Fellow, International Food Policy Research Institute and former Chief Economist, U.S. Department of Agriculture

On September 30, 2018, the United States and Canada announced they had reached an accord in their renegotiation of the North American Free Trade Agreement (NAFTA). That agreement followed the announcement in August that bilateral negotiations between Mexico and the United States had been concluded. The new treaty, the United States-Mexico-Canada-Agreement (USCMA), if approved by Congress, will replace the 25-year-old NAFTA, an agreement that President Trump had often derided as the “worst trade deal maybe ever signed anywhere.”

So, for the U.S. agricultural sector, how does this “wonderful new Trade Deal...a great deal for all three countries” compare to its predecessor, NAFTA? Perhaps the best thing that can be said about the new USCMA is that, effectively, most of the key provisions of NAFTA will remain largely in place. There are changes – some good, some bad – but the USCMA does not change the bulk of the original agreement. That is a good thing, as most farmers and ranchers agree that U.S. agriculture has benefitted significantly under NAFTA.

NAFTA comparison

Importantly, all food and agricultural products that currently enjoy zero tariffs under NAFTA will not be subject to new tariffs. Under the U.S.-Canada portion of NAFTA (the Canada-U.S. Trade Agreement), each country continued to protect a handful of agricultural commodities from competition by imports from the other member countries. Canada maintained tariffs on dairy, poultry and egg imports from the U.S., while U.S. tariffs protected dairy, sugar and peanut producers from Canadian imports. Under the USCMA, Canada will provide additional access for U.S. dairy, poultry and egg producers, while the U.S. will provide new access to Canada for dairy, peanuts, processed peanut products, and a limited amount of sugar and sugar-containing products. Canada also agreed to make changes to their pricing system for dairy products that the U.S. dairy industry argued were harming U.S. exports interests.

Unfortunately, most of the increased access for U.S. exports to Canada, and U.S. imports from Canada, will be provided in the form of limited quotas, not tariff elimination, so prospects for liberalization of those sectors are modest. Under USCMA, Canada will provide increased market access for dairy products and poultry and eggs.

Tariffs will remain unchanged but duty-free access will be provided through tariff-rate quotas (TRQs). Assuming 100 percent fill rates for the new TRQs, and based on 2017 per unit export values, the increased dairy access when the TRQs are fully phased in (19 years) is valued at about USD 275 million, an increase in U.S. exports to Canada of about 43 percent over 2017 levels. That increase would seem substantial but increased exports reflect less than a 5 percent increase in total U.S. dairy exports (which totaled about USD 5.4 billion in 2017) and less than 1 percent of U.S. milk production.

Increased access of poultry and eggs are also relative to total U.S. exports of those products. Assuming TRQs are filled and using 2017 per unit export values, increased U.S. egg and poultry exports to Canada are valued at less than USD 200 million when TRQ levels are fully phased in (Year 16), and the export volumes reflect less than 1 percent of U.S. production.

U.S. concessions were granted for a similar range of dairy products and TRQ levels, however the increased access is not expected to have much impact on U.S. prices. Assuming 100 percent fill rates, increased access would be far less than 1 percent of U.S. dairy production. Moreover, U.S. WTO fill rates for many of those TRQ categories are typically low, which would further reduce access. Nor are new U.S. TRQs for sugar and sugar-containing products and peanuts and peanut-containing products expected to provide significant access to those markets.

Impact on Canadian dairy producers

Increased U.S. access to Canada’s markets will likely be far more consequential for Canadian dairy producers than for dairy producers in the United States. New dairy TRQs under USCMA, combined with access provided under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and Comprehensive Economic and Trade Agreement between Canada and EU, will increase dairy supplies and likely pressure supply control policies currently in place. Elimination of Class 7 will make it more difficult for Canadian suppliers to compete in the growing market for milk protein concentrates.

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The new USCMA is notable for what was not agreed to in the negotiations. Importantly, Mexico was successful in fending off U.S. demands on the part of Floridian and other southeastern horticultural growers for new provisions that would have allowed the imposition of additional duties on seasonal U.S. imports of commodities like tomatoes and melons. Those changes could have substantially reduced benefits for U.S. consumers who currently enjoy year-round access to fresh fruits and vegetables from NAFTA partners at globally competitive prices. Moreover, many U.S. fruit and vegetable producers had been concerned that they would also be adversely affected if such provisions were used against seasonal exports of their products to Canada and Mexico in order to protect farmers in those countries. In the end, the Trump Administration relented and the demands were dropped.

Chapter 19 provisions

No changes were made to what are known as Chapter 19 provisions. Those provisions allow NAFTA members to challenge another partner's trade remedy actions (for example, the imposition of anti-dumping or countervailing duties) before an independent body if they feel the actions are without merit. The Trump Administration had argued that USCMA member countries had sovereign rights to impose such remedies without facing challenges from the other two countries through dispute settlement procedures. Canada argued that an independent body to resolve disputes was essential to any new agreement and, in the end, the United States relented. Ironically, over the past 25 years, U.S. agriculture has benefitted from the Chapter 19 provisions included in NAFTA. For example, the United States successfully challenged anti-dumping actions by Mexico against U.S. pork exports in 2005.

The U.S. also originally insisted on a sunset clause provision that would have required that the new agreement either be renewed every five years or terminated, with termination as the default option. That proposal was opposed by Canada, Mexico and many U.S. companies who argued that the clause would introduce too much uncertainty into making long-term investment decisions.

In the end, the parties agreed that the USCMA would only have to be renewed every 16 years.

So what is problematic for U.S. agriculture? For U.S. producers the most troubling aspects of the new agreement affect sectors that provide key inputs to farmers. The new domestic content provisions for vehicles will raise farmers' production costs in both the U.S. and Canada as they will end up paying more for trucks and other machinery. Since the agreement does not include a resolution to the dispute over steel and aluminum tariffs, U.S. producers and consumers will continue to pay higher prices for products that contain steel and aluminum. In addition, to the extent that U.S. farmers face higher retaliatory tariffs for pork, dairy products, select fruits and vegetables, and other food products, they will face lower prices. U.S. cheese and pork exports to Mexico totaled almost USD 1.8 billion in 2017. In the end, the new trade agreement between Canada, Mexico and the U.S. is much like the Emperor's new clothes. Despite all the self-congratulatory tweets and pats on the back, the differences between the "new" USCMA and the "old" NAFTA are strikingly modest, and farmers will benefit from the fact that potential changes to the original agreement that would have been costly were, in the end, largely excluded from the new deal. Happily, from the perspective of U.S. farmers and consumers, the USCMA looks a lot like the old NAFTA, which, given the Mercantilist attitudes of some advisors in the current Administration, should be viewed as a great victory for U.S. agriculture.

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CUSMA: Expected, Unexpected & Peculiar

By: Bruno Larue, Professor, CREATE (Centre de Recherche en économie de l'Environnement, de l'Agroalimentaire, des Transport et de l'Énergie), Université Laval

The expected

The CUSMA negotiations were acrimonious, but the outcome was never in doubt. The CUSMA is a “NAFTA tweak,” building on the involvement of the U.S., Canada and Mexico in the negotiations of the Trans-Pacific Partnership (TPP), which was once billed as the “NAFTA-upgrader.” The U.S. decided not to implement the TPP, could have tried to renegotiate it, but chose to renegotiate NAFTA instead. CUSMA is the first step of President Trump’s trade strategy favouring bilateralism and calling for the review of “bad” trade agreements. CUSMA negotiations had to succeed *and* be completed before the U.S. mid-term elections. In hindsight, the split of the three-way talks into sequential U.S.-Mexico and U.S.-Canada negotiations was a clever move by the U.S. to speed up the negotiations.

Many of the provisions of the CUSMA are NAFTA-like or TPP-like. There were areas where U.S. positions departed from TPP and NAFTA, and Canada and Mexico were expected to reach for middle ground. These areas include domestic content requirements in the automotive industry, the inclusion of sunset/termination, dispute settlement mechanisms and review provisions and higher minimum thresholds below which on-line transactions are exempt from tariffs. U.S. auto parts manufacturers would have been exposed to fiercer competition under the TPP because it involves more countries capable of producing auto parts and because of the 45 percent TPP content, which contrasts with the NAFTA rule that exempts cars from being taxed if at least 62.5 percent of the parts come from NAFTA countries. The CUSMA increases the North American content to 75 percent and adds a 70 percent North American content on steel and aluminium used for automotive manufacturing and a labour value standard that limits the amount of parts that can be sourced from low-wage NAFTA plants. Canada rightly fought to maintain Chapter 19 on dispute settlements regarding the contestation of anti-dumping and countervailing duties before a trilateral panel as opposed to a domestic court. Unfortunately, Chapter 19 does not apply to section 232 measures of the *Trade Expansion Act* of 1962 motivated by national security interest, like the ones applied on

Canadian exports of steel and aluminum to the U.S. In agriculture too, Canada was expected to make concessions.

The most contentious agricultural issue revolved around U.S. and Mexican market access in Canadian agricultural sectors governed by supply management (SM) programs. U.S. and Mexico, like the EU at the beginning of the negotiation of the Comprehensive Economic and Trade Agreement (CETA), called for the dismantlement of Canada’s SM programs. These programs restrict domestic supply and imports to generate higher prices for producers of milk, chicken, table eggs, hatching eggs and turkey. The dismantlement of Canada’s SM programs was highly unlikely because of the political support in Canada for these programs, the budgetary expense needed to implement adjustment and compensation programs,¹ and the absence of a well-thought-out policy alternative. Canada made concessions in CETA on cheese imports and in the TPP over a wide range of dairy, chicken, turkey and egg products under the assumption that the U.S. was going to implement the TPP. In this context, Canada could not secure an agreement without making market access concessions on SM products.

The unexpected

I expected the U.S. would insist on getting at least as much as it would have under the TPP because President Trump regards the TPP as a bad deal. It turns out that dairy TPP tariff-rate quotas (TRQs) are more often than not larger than their CUSMA counterpart. Under CUSMA, TRQs increase at varying rates in the first six years and then increase by 1 percent thereafter while under the TPP most TRQs increase at varying rates during 19 years (14 years in few cases) and stay constant thereafter.

It is important to note that Canada has WTO and CETA TRQs that add to the import tally for some dairy products. For whey powder and yogurt, Canada’s WTO commitments add 3,198 and 332 metric tons, respectively. It is equally important to note that while imports still make up a small portion of the domestic market, they are irritants for dairy producers because domestic demand for milk is not growing fast.² More annoying for the industry is the

¹ In a SM phase-out scenario, production quota value would decline rapidly. Farms with low production costs would still be able to generate a stream of profit which would then be capitalized in other assets like land and buildings. Spending on adjustments programs and implementing regulatory changes now can lower production costs and lower the amount spent on compensation in a future phase-out.

² Between 1994 when NAFTA was implemented and 2017, milk production has grown at an average rate of 1.38 percent/year, against 5.8 percent/year and 2.63 percent for chicken and eggs productions. However, milk production has grown faster than chicken production between 2013 and 2017 (3.6 percent/year vs 1.6 percent/year), while the comparable growth rate for eggs was 4.1 percent.

“Canadian egg imports will grow over the next 20 years because of the CUSMA and TPP egg TRQs that will allow 1.67 and 2.78 million dozen in Year 1 and will gradually increase to 11.4 million and 19 million dozen by Year 19, respectively.”

elimination of milk Classes 6 and 7 in Canada’s milk pricing system. These classes were introduced to crowd out imports of diafiltered milk from the U.S. with domestically manufactured products and help export surplus non-fat milk ingredients. Giving up milk Classes 6 and 7 was not a major concession because these

classes would have been the object of a WTO dispute that Canada would have lost. Milk Classes 6 and 7 constitute a concession impairment under WTO rules. Canada had committed to let diafiltered milk imports enter duty-free and it cannot renege on its commitment by introducing what amounts to a production subsidy.

Table 1. TRQs under the Trans-Pacific Partnership and CUSMA for dairy products (metric tons)

Product	Year 1		Year 6		Year 19	
	TPP	CUSMA	TPP	CUSMA	TPP	CUSMA
Milk	8,333	8,333	50,000	50,000	56,905	56,905
Cream	500	1,750	580	10,500	734	11,950
Skim milk powders	1,250	1,250	7,500	7,500	11,014	8,535
Butter, cream powders	850	750	4,605	4500	5,235	5,121
Milk powders	1,000	115	1,051	690	1,138	785
Concentrated milk	333	230	2,000	1,380	2,587	1,571
Yogurt buttermilk	1,000	689	6,000	4,135	7,762	4,706
Powdered buttermilk	750	87	828	520	970	592
Whey powder	1,000	689	6,000	4,135	unlimited	4,706
Natural milk const.	667	460	4000	2760	4552	3141
Indus. cheese	1,329	1,042	7,975	6,250	9,076	7,113
Mozz., prep., all types cheese	1,087	1,042	6,525	6,250	7,426	7,113
Ice cream	1,000	115	1,051	690	1,138	785
Other dairy	1,000	115	1,051	690	1,138	785

Canadian egg imports will grow over the next 20 years because of the CUSMA and TPP egg TRQs that will allow 1.67 and 2.78 million dozen in Year 1 and will gradually increase to 11.4 million and 19 million dozen by Year 19, respectively. These TRQs add to the WTO TRQ of 21.3 million dozen eggs. To put this in perspective, domestic production in 2017 was 774.53 million dozen, the Year 1 CUSMA add-on representing a fifth of 1 percent.

The peculiar

For turkey and broiler hatching eggs, there are surprisingly no changes relative to NAFTA. The turkey TRQ is set as the maximum between 3.5% of Canada's anticipated production and 5.6 million kg while the broiler hatching eggs TRQ is set as the maximum between 21.1% of Canada's anticipated production and 95.4 million egg-equivalent. The percentage component is the NAFTA TRQ and the hard component is the WTO TRQ. Canada picks the largest of the WTO and NAFTA TRQs to respect its commitments under NAFTA/CUSMA and WTO. Defining a TRQ in percentage is advantageous to an exporting country when the domestic market of the importing country is growing steadily as for Canada's chicken production. The U.S. was well-served with its NAFTA TRQ of 7.5 percent of Canada's domestic production in the previous year. Between 1994 and 2017, the value of Canada's chicken production increased at a rate of 5.8 percent/year. Though growth has slowed down in the last eight years to 3.6 percent/year, it is odd that the U.S. decided to replace its NAFTA TRQ by a CUSMA TRQ growing from 47,000 tons in Year 1 to 57,000 tons in Year 6 and that increases by 1 percent thereafter. Assuming that Canada WTO TRQ of 39,900 tons used to import U.S. products, the U.S. would export 86,900 tons in Year 1 of the CUSMA which is less than Canada's 2018 NAFTA TRQ of 90,100 tons. Canada's domestic production may no longer grow as fast as it once did because of the aging of the population, consumer trends favouring fruits and vegetables at the expense of meat, and TPP concessions. Still, if Canada's domestic production was to increase at 2 percent/year, U.S. market access under NAFTA 19 years into the future would be 128,685 tons or 25 percent more than under CUSMA. Peculiarly, the Office of the United States Trade Representative

refers to Canada's CUSMA TRQ as a "key achievement."³ Chicken Farmers of Canada argues that U.S. market access will rise by 12,000 tons.⁴ Canada's CUSMA TRQ will indeed grow over time, but not as fast as Canada's NAFTA TRQ, except if one is very pessimistic about the prospects of domestic chicken production in Canada.

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What's next

Canadian trade negotiators have done better than expected to limit U.S. market access in SM sectors, capitalizing on the Trump administration's intent to finalize CUSMA negotiations before the mid-term U.S. elections. While the SM lobby must feel relieved, it is important to keep in mind that Canada is foregoing billions of dollars in net gains from trade liberalization. The federal and provincial governments must put in place productivity-enhancing programs and regulations to make SM sectors more competitive before an eventual transition toward a more liberalized environment. The transition toward trade liberalization would be far easier if Canadian SM farms had much lower production costs. Regulations enabling market segmentation within Canada, a pillar of Canada's SM programs, must be replaced along with any other productivity-reducing SM regulations. These are far more dangerous to the long-term competitiveness of SM sectors than TRQ concessions.

I acknowledge the insightful comments of James Rude. Any remaining errors are mine alone.

³ See <https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2018/october/united-states%E2%80%93mexico%E2%80%93canada-trade-fact>.

⁴ See <https://www.newswire.ca/news-releases/CUSMA-secures-greater-us-access-to-canada-chicken-sector-694835111.html>



Trading with the Middle Kingdom

By: James Rude, Associate Professor, Resource Economics & Environmental Sociology, University of Alberta

With CETA, CPTPP and CUSMA¹ negotiations out of the way, Canada can again refocus on China as a trade partner. However, the current prospects for closer economic cooperation with China seem ever dimmer. In December 2017, Prime Minister Trudeau was rebuffed by Premier Li Keqiang for his desire for a closer economic partnership because of Canada's position promoting a "progressive trade" agenda.² In mid-October 2018, after the announcement of the CUSMA, Chinese Foreign Minister Wang Yi pushed for immediately advancing negotiation of a FTA to reaffirm Canada's trade sovereignty. Article 32-10 of the CUSMA requires that any one of the three signatories that negotiates with a "non-market country" provide the other partners with advanced notice and full disclosure of the details, and if there is disagreement others can withdraw from the CUSMA with six months' notice. This was the motivation for China's urgency to negotiate. Moreover, as 2018 drew to a close, Canada found itself in a dispute with China over the extradition of Huawei executive, Meng Wanzhou, to the U.S.

"Canada could gain a first-mover advantage as the first major agricultural exporter from the Americas with a preferential trade arrangement if it is able to negotiate a Chinese agreement."

Groups such as the Public Policy Forum (2018) prescribe a gradual approach to trade liberalization using sectoral agreements and suggest starting with agri-foods and natural resources. Whether a sectoral approach would run afoul with Article 32-10 of the CUSMA remains an open question. Nonetheless, China is an attractive market for Canada's agricultural products given its rapid economic growth, a relatively small land base given the size of the population, and urbanization with a growing middle class. Canada

could gain a first-mover advantage as the first major agricultural exporter from the Americas³ with a preferential trade arrangement if it is able to negotiate a Chinese agreement. China accounts for 6.4 percent of Canada's total agricultural trade, and with growing exports, it is our second largest import market (AAFC 2017). Despite the potential bilateral trade growth, China has signed a trade agreement with a major competitor: Australia. The China-Australia Free Trade Agreement (ChAFTA) creates a threat in that concessions to Australia may begin to push Canada out of meat and other markets.

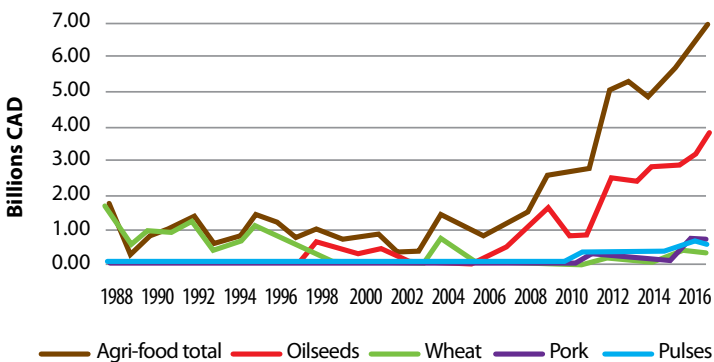
Empirical evidence on the benefits of a preferential trade agreement with China is sparse. Dawson and Ciuriak (2016) estimate that with an agreement similar to the ChAFTA, Canadian agriculture and agri-food exports would grow by \$3.1 billion. The growth in exports is dominated by oilseed and vegetable oil exports (\$1.74 billion) and meats (\$331 million for beef and \$304 million for pork and poultry). These are very optimistic numbers and largely driven by tariff liberalization. However, the Chinese trade policy landscape is complex, less than transparent and therefore difficult to assess. Chinese agricultural policy combines import tariffs, and tariff-rate quotas together with domestic procurement/stockholding, direct payments, and input subsidies to maintain desirable domestic prices and achieve target self-sufficiency ratios for strategic sectors. The challenge is to understand the interaction between trade policy, domestic policy and discretionary administrative actions. The question is: are Dawson and Ciuriak's estimates a true picture of the potential for liberalized trade? The objective of this commentary is to look at some of the subtleties of these markets and assess the potential for closer economic relations with China in agricultural markets.

Fairytale market access for the Cinderella crop

Figure 1 illustrates the value of Canada's agri-food exports to China between 1988 and 2017. Exports of oilseeds (primarily canola) dominate Canadian exports for most of this period. However, from 1988 to 1996, Canadian exports were dominated

1 These acronyms are defined as Comprehensive and Economic Trade Agreement (CETA) Comprehensive and Progressive Trans Pacific Partnership (CPTPP) U.S. Mexico, Canada Trade Agreement (CUSMA).
2 A progressive trade agenda includes gender, labour, and environmental rights.
3 Chile has signed an FTA with China.

Figure 1. Canadian agri-food exports to China (source: Global Trade Tracker)



by wheat exports. During that time period, China was the world’s largest importer of wheat and regularly imported over 12 million tonnes per year from Canada, Australia and the U.S. In 1994, Chinese grain policy took an about-face. The Chinese government issued a proclamation targeting 95 percent self-sufficiency for wheat, corn, and rice. The “Governor’s Grain Bag Responsibility System” (1995-2004) directed the provincial governors to balance supply and demand for these grains within each of their jurisdictions so as to stabilize prices. The outcome

“...since 2012 Canada’s agricultural exports have become much more diversified. Exports of pulses, malt barley, frozen french fries, and maple products all represent significant potential growth.”

discouraged oilseed and cotton production in favour of grain production (Carter and Rozelle, 2002). Land was moved out of oilseed production into wheat, corn and rice production. Global annual Chinese imports of wheat fell below two million tonnes. Initially, Canadian trade with China stabilized and then fell. Because China was growing fewer oilseeds, and because increased livestock production required more protein meal, China started to import oilseeds. Most of these imports were American soybeans, but a significant volume of these imports included Canadian canola. Canadian canola production expanded and overtook wheat production because of improved varieties, changing relative prices, and other technological improvements. Canola filled the void in Canadian shipments to China.

In 2001, China became a member of the WTO. To conform to WTO disciplines, import quotas and other quantitative restrictions were converted to a two-tier tariff, known as a tariff-rate quota (TRQ) where low tariffs (in-quota) apply up to a fixed volume of imports (quota) and then much higher (over-quotas) apply for all additional volumes of imports. Although TRQs apply to wheat, corn, and rice, we will only consider the case of wheat. The in-quota tariff is 1 percent, the quota volume is 9.63 million tonnes, and the over-quota tariff is 65 percent (Janzen, 2002). Fill rates are the proportion of the quota that is imported. Fill rates range between 35 and 40 percent. The low fill rates can be explained by the fact that 90 percent of the quota is allocated to a state trading enterprise, the Cereal, Oil & Foodstuffs Importing and Exporting Corporation (COFCO). COFCO has a dual role and is both a trading company and a commercial enterprise. As a result, the administration of the wheat TRQ is not transparent, predictable, or even considered fair.

Oilseed imports are not subject to TRQs. However, until 2006 there was a TRQ on canola oil. The quota volume grew to 1,243,000 tonnes while the over-quota tariff declined to 9 percent. Currently, the 9 percent tariff also applies to canola seed (Janzen, 2002). A reoccurring problem is that China is hesitant to approve new genetically modified canola varieties for import and this limits Canada’s ability to boost production and trade.

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“Meat”ing China’s protein demand

Just about all pundits predicting the potential of the Chinese market point to rapid urbanization and the resulting growth of the middle class, leading to significant potential growth for meat exports. However, most Chinese dishes call for small intense flavour cuts and a preference for meat (especially pork) from local breeds. Therefore, most of Canada’s exports involve offal or variety cuts. Chinese consumption of pork dominates other meats (60 percent of consumption). There is a strong desire among Chinese policy makers to achieve pork self-sufficiency. Given the overall size of the market, imports only grew from 1 to 2 percent of domestic consumption over the last five years. Over the same period, Chinese imports grew from 11 to 20 percent of world trade (USDA-FAS PS&D 2018). Tariffs range from 12 percent for pork offal to 15 percent for frozen pork to 20 percent for fresh pork (Janzen, 2002). There are no import quotas, so importers need only pay the tariff and value-added taxes. However, rising imports are linked to Chinese domestic fluctuations. Policy makers are increasingly concerned with price cycles and a “price alert stabilization” program is used to acquire stocks when prices are falling and stocks are reduced with rising prices. Imports also follow the price cycle and rise when Chinese domestic pork prices are higher. So, price instruments are not the only barriers to trade. Chinese authorities actively use technical barriers to trade. China maintains a zero-tolerance policy on pathogens and drug residues. Chinese authorities have shown inconsistency in applying SPS regulations as they try to promote self-sufficiency and price stabilization.

Beef makes up a much smaller portion (5 percent) of the Chinese diet. Nonetheless, recent growth rates in beef consumption exceed those for pork. As a result, imports have been growing as well. However, Brazil, Uruguay and Australia dominate the market for

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Chinese imported beef. Australia ships eight times as much beef as Canada. The competitive edge reflects Australia’s location advantage, the fact that their exports were not hindered by BSE related border closure, and in 2015 the ChFTA was implemented. Chinese import tariffs range from 12 percent for offal and frozen beef to 20 percent for fresh beef (Janzen, 2002).

Implications and the way forward

At this point in time, a Canadian FTA with China is only a distant possibility. It is not section 32-10 of the CUSMA that is standing in the way of an agreement. Rather, it is the perception that China still does not play by international rules – whether it is in the WTO or the IMF. State-owned enterprises still dominate the market while the operations of these firms are not transparent, and their behaviour is driven by hidden government subsidies. Canada and China may be able to negotiate a more limited sectoral agriculture agreement, but even here the major drivers of Chinese imports are not transparent border measures, like tariffs, but a combination of domestic policy and discretionary trade policy. If overnight, China was to decide to abandon its self-sufficiency targets for grains and encourage oilseed production Canada’s canola exports would quickly dry up. Given land and production constraints China will have to eventually decide to either pursue self-sufficiency in meats or grains; it cannot continue to pursue both. However, the path to this decision will likely be winding, with surprises, and negative impacts for potential exporters. These policies would not be affected by any form of trade agreement. Figure 1 shows that since 2012 Canada’s agricultural exports have become much more diversified. Exports of pulses, malt barley, frozen french fries, and maple products all represent significant potential growth (AAFC 2017). However, whether this growth occurs within a FTA or with current market arrangements is an open question, but there is no doubt that the growth will continue.

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The *FARE Share* Newsletter features research and analysis from faculty and students in the Institute for the Advanced Study of Food and Agricultural Policy in the Department of Food, Agricultural and Resource Economics (FARE).



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