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Trump and Agri-food Trade

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In a few short months, President Trump appears to have been able to do what years of negotiation and economics research has been unable to do – unite the political left and right in Canada in defence of regional free trade. After nearly 30 years of deepening economic integration between the U.S. and Canadian economies (and later Mexico), it is difficult to conceive of an alternative arrangement. Still, President Trump has asked to renegotiate the North American Free Trade Agreement (NAFTA) – and Canada and Mexico have agreed to his request. The renegotiations are scheduled to begin on 16 August 2017, and the U.S. has tabled its objectives for the talks as required by their legislation.[1] Canada has no such legislative requirement to make its objectives public and most commentators expect the negotiations to be challenging, taking up to a year to complete.[2] Many of the negotiating objectives specified by the U.S. are vague and largely consistent with Canadian wishes. However, some of the specific objectives will require careful negotiation including those focused on agriculture. I will address the agricultural issues with a particular emphasis on our supply managed commodities.

Given the rhetoric coming from Washington, one could be forgiven for thinking that trade relations between Canada and the U.S. are in a sorry state and badly in need of repair. Given the evidence, nothing could be further from the truth. Since 1995, the U.S. has taken six trade disputes against Canada to the World Trade Organization (WTO). All but one of these cases was settled by 2006 and no new cases were initiated between 2006 and 2016. Between 1995 and 2017, Canada has taken 16 disputes against the U.S. to the WTO. Five of these disputes concerned agricultural products and six dealt with softwood lumber. Since 2006, only three new cases have been initiated. For two countries with a combined annual cross border trade of C$673 billion, trade relations seem to have been – dare I say it – dull for a decade.[3]

Given that NAFTA is going to be renegotiated, what are the concerns? First, no one is arguing that jobs are leaving the U.S. for Canada because of low labour costs and lax environment rules. In the manufacturing sector, rules-of-origin will be revisited and it remains to be seen what actions the U.S. will request of Mexico. NAFTA's dispute settlement provisions, investor-state provisions, government procurement, trade in services, intellectual property, investment measures, and on-line cross border trade are a few of the issues highlighted by the U.S. for renegotiation.

In agriculture, wheat, poultry, red meat, wine and dairy trade have been mentioned in media reports as points of concern by the U.S. However, no specific agricultural commodities are mentioned in the U.S. negotiating document. For Canada, our goals will be focused on deepening the integration agreement with better rules and border measures. Although the U.S. does not explicitly mention our supply managed sectors (dairy, poultry and eggs), these were the commodities largely exempted from liberalization in the CUSTA/NAFTA negotiations. Clearly, the U.S. stated objective in agriculture: "to expand competitive market opportunities..., by reducing or eliminating remaining tariffs" is targeted at our supply managed commodities. For political and economic reasons, the dairy industry will be the most challenging for Canadian negotiators.[4]

Dairy Trade

Canadian milk production is strictly regulated through our supply management system that consists of three key "pillars:" 1) producers receive administered prices; 2) output is tightly controlled through production controls; and 3) domestic prices are protected through high import tariffs.

Does the renegotiation of NAFTA mean the end of supply management in Canada? Definitely not, but it might further strain the regime. Concerns about Canadian dairy policy have been raised by a small group of milk producers in Wisconsin who claim they lost a $150 million market for ultra-filtered milk in Canada. President Trump won the traditionally democratic state of Wisconsin by just over 20,000 votes in 2016 and Speaker of the House Paul Ryan is from the state – so the voices of a few Wisconsin dairy farmers will certainly be heard.

The issues surrounding dairy trade in a renegotiated NAFTA are a complex mix of market realities, trade rules and politics.

Market Realities – Fluid milk is processed and sold as it comes from the cow, but the standard 3.6% fat whole milk now sits on the shelf with 2%, 1% and many other variations of fluid milk and milk substitutes. Raw milk is mostly water but contains fat and high protein non-fat components that are mixed in various proportions to make butter, cheese, yogurt, ice cream and skim milk powder. As a result, it is possible to simultaneously have a surplus of one milk component and a shortage of another. An attempt is made to balance the supply and demand for components by charging different prices for raw milk depending on its end use. In recent years, Canada has typically had a shortage of fat and a surplus of non-fat milk components. The excess non-fat is usually exported, using export subsidies, as skim milk powder, or sold domestically as animal feed as a part of our dairy policy.

Enter ultra-filtered milk – a new product consisting of high protein milk components that can be used as ingredients in making cheese and yogurt.[5] Because ultra-filtered milk did not exist when NAFTA

1 *Summary of Objectives for the NAFTA Renegotiation.* 2017. Office of the United States Trade Representative, 17 July.
2 Trade negotiations, even those with specified deadlines, have historically taken much longer to complete than expected.
3 For an earlier and more complete analysis of NAFTA trade disputes see: Wainio, J., L. M. Young and K. D. Meilke. 2003. "Trade Remedy Actions in NAFTA: Agriculture and Agri-Food Industries." *The World Economy* 26(7):1041-65.
4 For a dated, but still relevant study of cross border trade in milk and dairy products see: Meilke, K. D., R. Sarker and D. Le Roy. 1998. "The Potential for Increased Trade in Milk and Dairy Products Between Canada and the United States." *Can. J. Agr. Econ.* 46(2):149-71.
5 For a description of ultra-filtered milk see: http://www.thinkusadairy.org/assets/documents/Customer%20Site/C3-Using%20Dairy/C3.7-Resources%20and%20Insights/03-Application%20and%20Technical%20Materials/Spec_UFmilk_1005.pdf; For the Canadian dairy industry's opinion on ultra-filtered milk imports see: https://www.dairyfarmers.ca/farmers-voice/dairy-products/what-is-diafiltered-milk

and the most recent WTO agreements were signed, ultra-filtered milk imports are not subject to Canada's high tariffs on "traditional" dairy products. Canadian dairy processors began importing ultra-filtered milk displacing domestic milk and exacerbating the surplus of non-fat. To combat this problem, Canada created a new milk class (Class 7) allowing domestic processors to buy milk at a much lower price if they made ultra-filtered milk to replace the product being imported from the U.S.[6] Processors complied and the market for ultra-filtered milk from the U.S. declined, much to the chagrin of the Wisconsin dairy farmers and processors who lost sales. This provides the setting for the dairy trade negotiations in the renewed NAFTA negotiations.

Trade Rules – It is important to understand that the U.S. argument is not with supply management but with its lost sales and limited access to our dairy market. Canada's trade and domestic policies are currently WTO and NAFTA compliant but challenges lie ahead. In 2020, Canada will no longer be able to subsidize exports and this will make disposal of skim milk powder even more difficult.[7] Canada has also offered additional access to our dairy market in the yet to be concluded Canada-EU trade agreement. Finally, if the issue of ultra-filtered milk imports and our new pricing regime is not resolved in the NAFTA renegotiations, it will likely be challenged at the WTO. The outcome of a WTO panel is difficult to anticipate. Multiple pricing schemes in milk markets are not uncommon but the policy change did cause import displacement. A suit under NAFTA's investor-state provisions might also be considered.

Politics – I have no inside information on what positions Canada's negotiators will take in the NAFTA renegotiations, but our chief negotiator, Steve Verhuel, is very experienced and knows the agriculture file well. NAFTA is supported by most of the major segments of U.S. agriculture so it may be possible to reform NAFTA in ways that benefit the agri-food sectors in all three countries. Huff, et. al., and Meilke, Rude and Zahniser discuss ways to improve the NAFTA in considerable detail.[8] In the dairy sector, Canada has three intertwined options: 1) hold the fort; 2) give and take; and 3) reform.

Hold the Fort. This will be Canada's opening position. In the CUSTA negotiations, the U.S. had agricultural products it wanted to take off the table – namely sugar, cotton, peanuts and dairy. Since then, the U.S. has reformed their peanut program and made changes in their sugar program. Consequently, there appears to be less room to trade-off protection in Canada's dairy and poultry markets with agri-food sectors where the U.S. wants to maintain protection. The danger of this negotiating stance is a WTO challenge to the products made from our Class 7 milk. Consequently, some type of "give and take" seems a more likely outcome.

Give and Take. If the U.S. end game is an additional slice of the Canadian dairy market, then there are a number of options. In the poultry sector, global tariff-free import quotas were defined in CUSTA that allow imports up to a fixed percentage of domestic production and this could be an option in dairy. Most of these low-cost imports are filled by the U.S. and it allows for import growth as the Canadian market expands. Alternatively, the U.S. could be granted preferred access for a fixed quantity of dairy product imports. In either case, the quid pro quo could be an agreement not to challenge Class 7 dairy products at the WTO or in NAFTA – whether sold domestically or exported.[9] However, this type of a managed trade agreement would continue the practice of giving up a part of our domestic dairy market to exporters in exchange for maintaining supply management as was the case in the Canada-EU negotiations. Instead, reform of the supply management system could begin to move it away from a regime so dependent on border measures and, in the case of dairy, a relatively stagnant domestic market.

Reform. There are many domestic reasons to begin the reform of our supply management regime and, starting the process now rather than waiting until international pressure makes it mandatory, seems wise. The reasons and options for reform are well documented by Barichello, Cranfield and Meilke[10] as well as in early analysis by the Food Prices Review Board[11] in the 1970s and the Economic Council of Canada in the 1980s.[12] Currently, milk quota transfer rules in Ontario and Quebec make it nearly impossible to enter the industry, expand existing dairy farms or to change the location of milk production.[13] The industry desperately needs the opportunity to consolidate and move milk production from its current location and into the hands of its most efficient producers. In this way, it will be better positioned to meet additional foreign competition.

Conclusion

The NAFTA renegotiations provide an opportunity to modify the original agreement in ways that benefit all three signatories. The renegotiations are likely to set the rules that will govern regional trade for the next 15 to 20 years. It is essential that we get them right. This might require difficult changes in our domestic and border policies that will none-the-less serve us well in the future. Now is not the time to be timid and defensive. As has often been said, a good offense is the best defence and a carefully crafted list of "asks" will be essential to success. An efficacious outcome is crucial to our continued economic growth and wellbeing. Is a borderless customs union twenty years hence a goal worth striving for?[14]

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6 There is no definition of Class 7 milk on the Canadian Dairy Commission's website, but Dairy Farmers of Ontario provide a definition for their Class 6 milk, which is believed to be the same or similar to the federal Class 7. Ontario Class 6 milk is: "Milk used to process skim milk components or condensed skim milk components, wet or dry, into an ingredient to be used in processed milk products. For example, skim milk powder, milk protein concentrate, or ultra-filtered milk."

7 Meilke, K. D. 2016. *Agricultural Export Subsidies: RIP.*

8 Huff, K. M., K. D. Meilke, R. D. Knutson, R. F. Ochoa and J. Rude, eds. 2007. *Achieving NAFTA Plus*; Meilke, K., J. Rude and S. Zahniser. 2008. "Is "NAFTA Plus" an Option in the North American Agrifood Sector?" *The World Economy* 31(7):925-46.

9 A potential problem with this strategy is that countries other than the U.S. have taken note of our Class 7 milk including Australia, New Zealand and the EU. Bridges Weekly 21(21) reports that more than 80 questions were posed about our Class 7 milk during a recent WTO Agricultural Committee meeting.

10 Barichello, R., J. Cranfield, K. Meilke. 2009. "Options for the Reform of Supply Management in Canada with Trade Liberalization." *Canadian Public Policy* 35(2):203-217.

11 Food Prices Review Board. 1976. *Final Report: Telling it like it is.*

12 Barichello, R. R. 1981. *The Economics of Canadian Dairy Industry Regulation*. Technical Report E/12. Ottawa: Economic Council of Canada.

13 Additional rules and regulations on quota transfer have been added since Cairns and Meilke examined the issue. Cairns, A. and K. D. Meilke. 2011. "Price Ceilings on Milk Production Quota Values: Future or Folly." *Canadian Journal of Agricultural Economics* 60(1):93-112.

14 A customs union is a trade bloc composed of a free trade area with a common external tariff.

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