Global Trade Policy in Disarray: What Risks for Canadian Agri-Food?

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The Issue

The situation confronting Canadian agri-food in the spring of 2019 looks increasingly ominous. There is increasing awareness that African Swine Fever (ASF) in China, now spread across the country, could be a generational event in terms of a profound meat supply disruption, with risk of spread to other countries, including Canada. There are also secondary market effects- notably depressed Chinese demand for oilseed imports- that has the effect of placing a ceiling on, and sharply reducing, soybean and canola prices. This, in turn, has triggered a response of escalating domestic agricultural support by the US. Canada is in the midst of a debilitating situation facing canola exports to China, due to an issue relating to pests raised by China, but as of yet unspecified.

The US and China remain embroiled in an escalating trade war, encompassing agri-food products, technology, steel and aluminum, as well as many other products, with the prospect that the conflict could spread to even more products and services. The US is also engaged in a trade standoff with the EU, with ongoing threat of escalation. India is also in the US sights as a potential target in bilateral trade relations. The US has threatened Mexico with tariffs over concerns with Mexican immigration policy.

With the negotiations for the Canada-US-Mexico Agreement (CUSMA) now concluded (but not yet ratified), Canada is not a direct participant in these battles among much larger players in global trade. However, Canada is hardly uninterested, as it could be profoundly impacted whether or not there is a resolution to these trade tensions, in terms of the ultimate effects on the global trade environment and the rules-based governance of international trade. In fact, the current situation points to the prospect of a wholesale change in how Canada operates in agri-food, to many of the assumptions made and premises held, and to the prospective need for shifts in Canada's agri-food strategy.

The markets for agricultural and food products are among the most distorted of all, with tariffs, tariff-rate quotas, domestic supports, export subsidies, and a range of differential trade barriers relating to sanitary and phytosanitary (SPS) measures. A range of motivations and associated domestic policies exist that provide unique treatment for agri-food across countries. The issues are sufficiently complex that it allows for significant overreach in regulation, support, protection and disguised protectionism, and trade disputes. It makes agricultural and food products among the most difficult to address in trade negotiations, and agri-food is almost always over-represented in trade negotiations and disputes, and the tariff wars that ensue.

The uncertainties created by this fluid situation create protracted risks for Canadian agri-food; some are direct and impact specific commodities and markets, such as that being experienced by Canadian canola, and others are indirect or systemic- impacts on the overall operation of the international trading system that affect how markets in Canada can operate, and the nature of associated risks.

The purpose of this policy note is to explore the potential systemic effects of the current disarray in global trade policy, and how it could impact Canadian agri-food. While not a “forecast”, the policy note attempts to identify the serious implications for Canada that could stem from current policy directions pursued by US and China, and the potential erosion of rules-based trade under the World Trade Organization (WTO).

* The authors acknowledge the benefit of comments from two expert reviewers
Risks to International Trade Governance

The existing rules-based system of international trade under the WTO has been in place since the mid-1990's. The Agreement on Agriculture and the various agreements that established the WTO have facilitated increased trade in agri-food products globally, and Canada has been a major beneficiary of this. At the same time, the successful completion of the Uruguay Round that resulted in the Agreement on Agriculture and the WTO could only go so far; some acknowledgement of this is that successive rounds of negotiations- the unsuccessful Seattle Round and the ongoing (and struggling) Doha Round- were initiated to further develop and deepen international cooperation on trade.

Some of the major accomplishments of the WTO and the Agreement on Agriculture include the following. WTO members agreed to the establishment of a Dispute Resolution Process that provides for a quasi-judicial body and appellate process to sort out trade disputes; WTO members agreed to be bound by the decisions rendered from this process. Another aspect is the establishment of the Most Favored Nation (MFN) concept and like treatment, extended from the General Agreement on Tariffs and Trade (GATT). This provides for equity of treatment by WTO members to all others whom they designate as Most Favored, with the exception of formal trade agreements and customs unions between countries.1,2 The Agreement on Subsidies and Countervailing Measures (SCM) set out rules within which WTO members agreed to abide by in disputes between members through conciliation, the approach and burden of proof required in dispute resolution, allowable provisions for retaliation, and other aspects. Fundamentally, these provisions allow small countries to be protected from the overwhelming power of large countries, facilitating an opening up of world trade.

The WTO and Agreement on Agriculture established a rubric within which to classify protection in agriculture- based upon domestic support, export competition, and market access. Within this structure, limits were agreed to by members. On domestic support, developed and developing countries face a somewhat different structure, but each face hard caps on specific forms of agricultural support- specifically current Aggregate Measure of Support (AMS).3 Under export competition, export subsidies were initially capped, but with most eliminated as of 2016 and will be banned entirely as of 2021. Market access provisions codified border measures into tariffs and tariff-rate quotas (TRQ's), and specifically ruled out the use of binding import quotas by WTO members.

The broad direction and conceptual basis for the WTO and Agreement on Agriculture is not under direct attack today. However, the evolution of trade, friction in the system, economic development and policy directions in some countries place it under threat. The difficulties in getting traction among WTO members in the Doha Round has highlighted the problems with the existing approach to negotiations. These concerns are shared across many countries.

The US has expressed concerns, since well before the current administration, that decisions rendered under lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners — whether rich or poor, weak or strong”.4 The current Aggregate Measure of Support is the amount of “most distorting subsidy” provided that the de minimis threshold has been breached.

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1 See GATT Article XXIV
https://www.wto.org/english/docs_e/legal_e/gatt47_02_e.htm#articleXXIV and WTO guidance document
https://www.wto.org/english/docs_e/legal_e/10-24_e.htm

2 The interpretation guidance on Article XXIV from WTO: “Some exceptions are allowed. For example, countries can set up a free trade agreement that applies only to goods traded within the group — discriminating against goods from outside… In general, MFN means that every time a country
the WTO appellate panels have overreached its mandate, and that it requires reform. The desired reforms have not occurred, and the US has recently turned to blocking the re-appointment of existing panelists and the approval of new panel members to pressure reform. As it stands, due to the inability to appoint or re-appointment panel members, the WTO dispute settlement function will effectively cease as of December 2019.

The fallout of the US-China tensions, which has taken a toll on US trade in many commodities, and particularly in agriculture, has prompted emergency support to US agriculture. In 2018, US $12 billion was pledged by the US government to assist US agriculture. Very recently, a further US $16 billion has been pledged by the US government to offset the effects of its trade war with China. In announcing the most recent emergency funding, US President Trump said, “The $16 billion in funds will keep our cherished farms thriving and make clear that no country has veto on America’s economic and national security.”

However, the US agreed to a hard cap of just over US $19.2 billion in its AMS payments in the Agreement on Agriculture. The structure and timing of the newly announced funding will determine how much of the available space the emergency funding takes up within the WTO cap for the US. However, the tone of the president’s remarks, consistent with previous remarks, suggests that the US administration may not see its WTO limits on agricultural support as an important constraint. If this is correct, increased subsidy funding for US crops could push the US WTO support caps, and promote existing acreage and production levels regardless of the trade and storage stock situation, exacerbating already low crop prices—unless other provisions such as claiming payments as disaster relief, or notifying payments over different years exempting them from AMS notification are employed.

Bilateral actions taken by WTO members against one another outside of WTO processes threaten the integrity of the WTO institution itself. In this regard, the current trade conflict between the US and China appears to be a product of years of frustration on behalf of the US (as well as others, including Canada) with various aspects of Chinese economic policy operating in such a way as to attract implicit government subsidy, but outside the full disciplines of the SCM agreement, such that WTO rules do not (or perhaps cannot) address the concerns. This relates to State-Owned Enterprises (SOEs) in China, of which a number operate in agri-food. China views SOEs as central to its plan for economic development and as a domestic policy matter. The escalation initiated by the US brings the issue to the forefront, but by seeking to remedy the situation with China directly, it circumvents WTO structures based on the interests of WTO members as a whole and designed for this purpose.

China self-declared as a developing country in its accession to the WTO and has not been formally challenged in doing so. Today, China is the world’s second largest economy, perhaps well beyond what many would regard as “developing”. Furthermore, there is no provision in the WTO for developing countries to graduate from the rules established for developing countries to those for developed countries, nor is there a middle ground for progression from developing to developed country.

As part of the US desire to remedy specific trade irritants with China directly, it is widely expected that a US-China “deal” may also include certain terms of trade, such as committed trade levels or preferential tariff rates for specific products. However, it appears product and non-product specific support once the de minimis threshold of 5 percent of market value has been exceeded.

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4 See transcript of announcement https://twitter.com/kannbwx/status/1131654192538562560
5 Specifically, limits on the current portion of the Aggregate Measure of Support. The annual expenditure limit applies to
that what is envisioned is an agreement to address trade irritants and limit or manage trade, rather than facilitate trade as per a customs union or free trade area within the scope of the WTO agreement. This would seem to be at odds with WTO/GATT Article XXIV that makes accommodations for bilateral agreements that will facilitate trade. Logically, it will lead other countries that are WTO members to question the validity of the MFN concept, if large countries can negotiate bilaterally and cut them out, effectively abrogating rights provided under the WTO.

GATT/WTO has always allowed bilateral/plurilateral free trade agreements and customs unions provided “substantially” all trade is covered. Concerns about preferential agreements undermining the MFN principle have increased as the number of preferential agreements has proliferated. Canada and the US have been among the leaders in this trend, starting with the Canada-US Trade Agreement.

More generally, if major proportions of international trade by the largest national economies begin to operate outside of WTO jurisdiction, or flaunt it, other countries will surely question why they subject themselves to the restraints of multilateral trade rules and/or caps on domestic agricultural support when the big players are not bound by it. Increasingly they will look to a more defensive posture as they protect their own industries and citizens against the unrestrained behaviour of others, and the risk of leverage being used against them by larger economies, particularly with the demise of WTO dispute resolution protection on the near-term horizon.

**Canadian Agri-food**

Canadian agri-food can be broadly characterized as follows. It is largely export oriented and/or exposed to international competition, using external market references for pricing- with the exception of segments intentionally structured to a domestic orientation. The farm segment, and much of the processing segment, operate as small and medium-sized businesses in an open domestic and international economy, in which they are largely price-takers. Adjustments in scale and output mix on behalf of farm and processing segments are based largely on relative world prices, and expected revenues and costs.

Trade and export market access are fundamental to Canadian agri-food. Canada’s extensive natural resource base and agricultural production capacity exceeds the food demand of Canadians, and in order to fully use its endowment of resources, Canada’s farm and food outputs need export markets. Moreover, Canada’s exports are sought out and counted on to contribute to the food supply in other countries. Agri-food exports are a major element of economic prosperity, especially in rural areas. Investments in Canada have occurred in the supply chains for a range of products in which Canada has expanded to be a global player- notably in canola, western grains, pork, beef, pulse crops, soybeans, potatoes, and greenhouse vegetables (as well as others)- based on profitable export demand.

At the same time, as a northern country with an affluent and cosmopolitan population, and with diverse tastes and preferences, Canadian demands for food extend beyond the depth and range of products we can produce efficiently. Agri-food imports provide Canadians with food products that cannot be produced efficiently here, and cater to the diversity of food demand in Canada. Equally, food products that are produced here are enhanced by other foods, ingredients and seasonings obtained from elsewhere. As such, the preponderance of Canadian agri-food markets are global for both imports and exports, based on competitive world prices. Relatively stable, low transaction costs domestically and internationally facilitate this price arbitrage and/or potential arbitrage that underscores market prices for agricultural and food products in Canada.

**Potential Changes to Precepts**

The current situation, and the worrying prospect that rules-based international trade could somehow begin
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to erode or unravel, confronts a Canadian agri-food sector vulnerable to changes in international trade conditions. This also holds even in cases where actual exports and imports are minimal but where international competition and price references are an important factor.

The emerging environment may act to undermine critical international institutions and domestic policy foundations upon which the Canadian agri-food economy is based.

First, the situation threatens to increase and/or make much more uncertain international transactions costs. The WTO rules-based trade environment codifies and establishes agreed upon concepts of trade, such as like-treatment, agreed upon processes—such as SCM and dispute resolution—as well as measurement and levels of product/service attributes, as embodied in SPS standards, and the work of international standards bodies such as Codex Alimentarius and the World Animal Health Organization (OiE). Aspects of the above are under threat today—notably dispute resolution, and like treatment (as embodied in the MFN concept). It can be expected that if these were to come seriously into question, the demise of other important dimensions of trade rules would follow. Clearly it would add significant uncertainty to international transactions relative to domestic transactions if the trade environment were to evolve in this way.

In turn, the increase in cost and uncertainty of international transaction would act to constrain or remove international price arbitrage. What draws commodity prices in different geographies together is actual movement of product or the latent threat thereof, based upon costs of transportation and transaction. If the transaction costs element dramatically increases or becomes unpredictable, the resulting noise impedes the practical ability of product to move and bring prices across countries in synch with one another.

The motivation for arbitrage behaviour in trade is the expectation of profit. However, some players in international agricultural trade are not motivated only by profit, or even primarily by profit, and these are increasing in their significance in international markets. A case in point is COFCO and Sinograin, both Chinese SOEs that trade a range of agricultural products. It is expected that the trading assets of Sinograin will be merged into COFCO, making COFCO the largest oilseed crushing entity in Asia, and a dominant player in regional and/or global trade in a range of farm commodities. As an SOE, COFCO and other organizations like it are unlikely to be opposed to profitability; however, they can be expected to have other objectives as well, notably the maintenance of national food security in China. Transactions made by these entities, given their significance, can distort global prices and impede price arbitrage from functioning. This was evident through the latter half of 2018 and early 2019, in which global soybean prices did not converge, and US prices remained well below South American prices.

The instruments of trade protection codified in WTO operate in the expectation that behaviour will be reliably influenced by trade policy according to a profit motive. For example, all other things held constant, the increase in a tariff should reduce imports; conversely the lowering of a tariff should increase imports. However, if competition driven by a profit motive is not the only objective of an importer or exporter, this is less evident. An SOE need not

7 The effect of Chinese duties against US soybeans surely played a major role. However, when duties are placed on products imported by SOEs, it is unclear how significant the true effect is, as it is much like government taxing itself. China has both SOEs and private firms that import soybeans, so the effect of duties is likely mixed with different effects for private importers vs. SOEs. Another aspect influencing price arbitrage is that importing SOEs can simply choose not to purchase from certain suppliers, in spite of profit incentives.
reduce its imports because its government has raised the applicable tariff, because the collection of the tariff amounts to the government taxing and then paying itself with the proceeds. Furthermore, the tariff effect may not be exposed to consumer demand and the price-quantity purchased tradeoff. By the same token, reduction in the tariff rate charged for SOE imports need not facilitate increased trade as it would with a private firm, as the price benefit need not be passed on to consumers- as it would through competition and a profit motive.

The rise in the relative significance of international purchasers and competitors not motivated primarily by profits can have other impacts on an open-economy, agri-food exporter. One is that SOE importers can simply choose to minimize or avoid imports from certain suppliers, or be directed to do so, in a form of tacit or informal trade discrimination. Private importers could face lost profits from doing so, but this effect has less influence over SOE’s. The effect on exporting countries can be sudden and severe, throwing markets out of balance, and fundamentally altering relative prices and equilibrium acreage/production balances. This appears inconsistent with the like-product philosophy enshrined in WTO, but may not be in violation of it.

A similar effect can result from foreign direct investment in agri-food assets. Private firms make investments on the expectation of earnings, with the markets for the product derived from the investment driven by expectation of the highest (marginal) earnings. Competition among firms in Canada (foreign owned or otherwise) ends up facilitating a sharing of the resulting earnings in Canada, and potentially increasing the profitability of all involved.

However, if foreign investors are not motivated by earnings, and do not make operating decisions guided only by earnings criteria, the implications of the situation become less clear. In particular, if investments are made in Canada primarily for the purpose of securing the end food product for export back to the investing country, the implications are somewhat different. One is that through ownership, the investor hopes to secure the product for sale in its own domestic market. The effective demand facing the Canadian investment by the foreign firm is driven by the supply/demand conditions in its own country, in place of the broader market-based demand and competition for output that would otherwise face its Canadian operation if it were motivated by earnings. This, in turn, derives a demand for farm products in Canada that is much more focused on the investing firm’s domestic market than would otherwise be the case, carrying the risk of distortion to relative farm product prices and associated production levels.8

Potential Implications

The environment outlined above suggests the following. Canada should expect greater difficulty exporting and importing products in the future. This is especially the case for agri-food products as they are commonly the most targeted of products in trade disputes. The rationale for this observation is the risk of broad breakdown in international trade rules, protections and understanding that requires like treatment of countries (the MFN concept), the like treatment of products regardless of origin, and the breakdown in the dispute resolution process.

Escalations in most-distorting domestic support create the risk that supply responses will drive down world prices. At its most extreme, the prospect is that international trade expectations and norms will fluctuate with the state of international politics, with much less of a basis in certainty from which Canada can export and import agri-food products.

8 Clearly, any country has the right to limit or embargo exports. However, if the in-bound investment is dedicated to using local raw product for the production of intermediate or consumer goods of particular interest/demand to the importing country and of little interest/demand locally, it can lower the price of imports and change the price relatives among products for the raw product and related markets.
With the prospect of reductions in reliability and increases in transaction costs, and with the rise of major agri-food traders with agendas extending beyond profit, price arbitrage in agricultural commodities may not function as effectively as it has. The rationale for this is that with the decline of international institutions that facilitate trade will come costs of transacting internationally that greatly exceed domestic transfers, and exceed current costs of transactions internationally, with increasing prospect of sudden changes. This is significant for Canada since it makes extensive use of external reference prices (especially US dollar denominated markets) in its pricing mechanisms. The decline in arbitrage through trade or latent trade thus creates the prospect of difficulty obtaining satisfactory price discovery mechanisms for Canadian farm products. In virtually all farm products, Canada simply lacks the volume and liquidity in markets to have conventional “made in Canada” pricing models.

The growth of large international importing players with agendas extending beyond profit ushers in the risk of tacit or informal discrimination among suppliers. The expectation in Canadian agri-business has been that if one meets or exceeds a customer’s product specification with a competitive price, it can secure export business. However, that is the logic of markets, competition, and profit-seeking. The coming future stands to include major import purchasers that are not disciplined by this logic, and act in part to advance their national interest. This dynamic is amenable to export market access rationed by leverage and international courtship politics- an environment in which Canada is less suited to succeed.

Moreover, investments made in Canadian agri-food by others with agendas outside of profitability will tend to limit competition for food outputs, as the output is destined for the investing country, and will tend to project the supply-demand balance conditions of the investing country on its Canadian operations, in lieu of broader market considerations. Thus, it can threaten existing norms in terms of crop rotations, relative price ratios, etc.

The above aspects of this environment expose Canadian agri-food to previously unseen/unanticipated risks to investments, and in developing Business Risk Management (BRM) programs intended to mitigate economic risks and secure investments at the farm level. The current situation, quite apart from the prospective risks, is one in which Canadian BRM programs have come under increasing strain under low farm prices, some lasting several years. The BRM principles, funding and design my need to be adapted to the emerging disruption in established trade relationships.

Conclusion

The current situation suggests three potential outcomes, focusing on US-China trade tensions. One is that the US and China come to a mutual understanding that leads to a renewal of multilateral trade institutions though the WTO- addressing the range of concerns highlighted by the US to its satisfaction and meeting China’s needs for economic development. As a component of this scenario, the concerns relating to WTO dispute resolution could be settled, or conversely the US could draw back its pressure on this issue. This scenario would retain a strong rules-based system for global trade, and allow for the status quo in terms of agri-food trade and marketing to be retained.

A second potential outcome is of a US-China agreement that is bilateral and exclusive, focusing narrowly on the trade irritants articulated by the US and managed US-China trade. A third potential outcome is a breakdown in the US-China dialogue, further escalation of retaliatory duties, and a longer-term disequilibrium developing of reduced trade and increased protection. Either of these two scenarios will logically weaken the WTO rules-based trade system and usher in the concerns for Canadian agri-food articulated above.
If each of these scenarios were assigned equal probability, then we have a two-thirds probability of serious erosion to the multi-lateral trade system under WTO forthcoming, and the prospect of major adjustments facing Canadian agri-food. The worry is that China views its SOE’s as a matter of domestic policy on which it is simply unwilling to make concessions, and that the concerns raised by the US essentially imply precisely these concessions. Moreover, the current US administration is more inclined toward bilateral agreements rather than multi-lateral- as exemplified by the US withdrawal from the Trans-Pacific Partnership (TPP), but now courting bilateral negotiations with Japan (a CPTPP member, having now ratified the Comprehensive and Progressive Trans-Pacific Partnership).

With the US occupying center stage in the current trade turmoil, it is tempting to write off the many elements of disruption as the international projection of an overtly populist and narrowly self-interested US administration. This would be a mistaken conclusion. The US is advancing, or bringing to a head, issues that are of concern to many market-oriented, open-economy WTO members, including Canada. These include the WTO appellate body, the treatment of SOEs, and self-declaration of developing country status- among other concerns. In other respects, the credibility of US trade policy has been undermined by the current administration’s cavalier use of “national treatment” exceptions, and the use of tariffs for non-trade policy reasons- such as to threaten Mexico on its immigration policy. The US is no longer seen as the driving force behind the renewal of WTO.

Canada has been engaged in a leadership role to work multilaterally to find updated and re-invigorated international institutions like WTO to maintain the balance between small and large economies, to rectify many of the operational problems in WTO that have surfaced since 1995, to broaden the scope of WTO to new and different industries that have arisen since 1995, and to clarify the rules for open and balanced trade more generally.

The situation regarding international rules-based trade cannot be considered apart from the African Swine Fever situation in China, the prospect of major production disruptions forthcoming due to late or prevented planting in the US Midwest, and infestations of army worm in China- within a global situation of ample to surplus grain and oilseed stocks entering 2019.

The global agri-food market situation stands to create greatly increased volatility in the immediate future, independent of the risks of change in the global trade environment. The prospect of additional risks from the erosion in rules-based trade, or even the collapse of the WTO, greatly escalate the risk. The Canadian agri-food policy dialogue should reflect this source of risk, acknowledge Canada’s vulnerability to it, and begin the process of developing a contingent strategy to mitigate its potential effects.