Priorities for Agricultural Policy in a Precarious Time

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The Issue

Globally, agri-food is in the throes of potent disruptions, still developing, that threaten existing structures.

- The loss of pork production in China and throughout East Asia due to African Swine Fever is a developing threat to food security in the region, and perhaps globally.
- The integrity and architecture of the world trading system has been weakened through the emergence of managed trade agreements (US-China; yet to be confirmed and ratified), the weakening of the most-favored nation concept (US-Japan; yet to be ratified) and the imminent demise of the WTO appeals mechanism as a component of the Dispute Settlement Understanding under filibuster by the US.
- Turning back a trend at least 20 years strong, major increases in agricultural support have occurred in the US, and there is a likelihood that the precedent and distortionary effects on agricultural markets will induce other countries to respond in kind.
- The immediate term effects of the tariffs enacted under US-China trade war on the participants are inflationary, and stand to spill over into smaller countries like Canada. Inflation due to increasing meat prices could exacerbate the situation. [1] But the effects of quantitative easing and exceptionally high debt levels leave countries with few macroeconomic tools to address inflation.
- It is increasingly evident that through its investments in South America and through the Belt and Road Initiative in Africa and throughout Asia, China is aligning an international chain to supply itself with products and resources, and reducing its reliance on North America, which gives China leverage through market denial.
- A number of major issues remain open from the previous Canadian government. The Business Risk Management (BRM) review is ongoing, and is now under increased scrutiny and urgency given largely disappointing farm returns in 2019 across the country. Relief from trade injury is a specific outstanding concern for canola, soybeans, beef, and pork, and pulse crops but with a program already initiated for supply managed industries related to CPTPP. Ratification of USMCA/CUSMA has not yet occurred in the US (or Canada) and extra uncertainty regarding US passage has been created by impeachment proceedings.

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[1] The situation in China appears to be more protracted, with both deflation in industrial prices and inflation in food, driven by pork. Data released by the National Bureau of Statistics in China in mid-October showed that the Consumer Price Index (CPI) and Producer Price Index (PPI) diverged in September 2019. CPI increased to 3.0% year over year (a five-year high), but food CPI climbed 11.2% as pork prices surged 69.3% http://www.stats.gov.cn/english/PressRelease/201910/t20191016_1702923.html The PPI, by contrast, contracted 1.2% (vs.-0.8% in August) due to declining prices in the chemicals and energy industries. http://www.stats.gov.cn/english/PressRelease/201910/t20191016_1702928.html

Agri-food trade issues are tightly bound to a much larger set of both domestic and international policies far beyond trade wars- in which agri-food has emerged as the preferred weapon in trade retaliation- in addition to the broader dilemma as to how best Canada can engage China, how to provide a more certain investment climate, and how to handle the decline in international organizations.

Without the bulwark of robust international trade rules, we must assume that domestic agri-food policy will need to become more aligned with trade and foreign policy. The erosion of rules-based trade effectively removes some of the boundaries governments have in structuring domestic policy, as constraints shift from legal and high-certainty, to more political and economic power-based directions, and lower-certainty. Conversely, progressive domestic policy will require accompanying trade policy, rather than fitting within the reliable, established rubric of WTO trade rules.

The challenge, or contradiction, facing Canada is to move forward with progressive climate change policy, given a popular mandate, but to protect producers helping to advance this objective from lower priced imports that do not carry the same environmental standards- and yet carry on its work with other countries attempting to revitalize the WTO.

Canada has just undergone an election viewed by many as polarizing, resulting in a minority government. The election clarified that clear divisions between federal and some provincial governments and regions exist regarding policies to mitigate climate change, pipelines, deficit spending, and transfer payments. By all appearances, the new government faces western alienation that rivals or exceeds the level confronted by previous governments including those of P.E. Trudeau, Mulroney and Harper, as well as an emboldened Quebec separatist movement as evidenced by the recent electoral success of the Bloc Quebecois.

The resolution of the impasse/juxtaposition regarding the “pipeline” sought by Alberta and Saskatchewan supported by Liberals and (western) Conservatives on the one hand, and on the other, the necessity of advancing the climate change agenda not supported by Conservatives but strongly supported by the Liberals and the NDP - a party that strongly resists any pipeline – is exceedingly difficult to reconcile during a minority government.

The purpose of this policy note is to outline the new priority pressure areas for Canadian agri-food policy facing the new government, and its apparent constraints moving forward on them.

Some Precepts

Section 95 of the Constitution Act leaves agriculture as a shared jurisdiction of federal and provincial/territorial governments. Within this jurisdictional structure, the evolution of Canadian agricultural policy over the last 25 years has been, broadly speaking, toward greater harmonization among provinces/territories and the federal government in programming, and equity in allocation of federal funds. But this is a loose arrangement, potentially prone to splintering across provincial/territorial and/or commodity lines. Conversely, because of the unique Federal-Provincial-Territorial relationship, agriculture could be a key instrument of re-engagement for the federal government with regions, notably the west.

In the previous government, much of the role assigned to the Minister of Agriculture was to support major policy initiatives and collaborate with other departments- notably Transport, Infrastructure, Natural Resources, and Environment. This was made clear in the mandate letter provided to former agriculture Minister Lawrence MacAulay in November of 2015.

The urgency and significance of the issues facing Canadian agriculture and food that the new government will need to address extend well beyond a supporting role to other ministries. The agriculture portfolio includes immediate, daunting challenges relating to farm incomes, export market access issues- both short and long term, and planning for agricultural marketing, investment, and regional economic development from agriculture and food. It will also need to address the Canadian impacts of African Swine Fever in China and East Asia, unknown at this point, but with the potential to threaten food security globally. Significant progress on climate change will require intimate involvement from agriculture. None of these issues are neutral from either a commodity, political party, or regional standpoint.

The Liberals elected very few members of parliament in rural agricultural regions of Canada; none in Alberta and Saskatchewan and four in urban ridings in Manitoba. The role of the Minister of Agriculture in the current government will need to differ substantially from the previous four years. The Minister must become an active, major player within a domestic and foreign policy dialogue across trade, environment, foreign affairs, regional development, industry and commerce, and finance. Equally, the Minister has an important role in fostering consensus and accommodation among regions, provinces, commodity and farm organizations.

Some Apparent Priorities

It is becoming increasingly evident that Canada will need an alternative agri-food trade policy. Under a world of managed trade, market access governed by bilateral leverage, and much looser dispute resolution, Canada must assume that it will need to evolve, sharpen, or target its positioning on agri-food trade. In concept, this involves overturning 25 years of accepted assumptions and industry positions encrusted around them- while at the same time continuing efforts with like-minded partners to revive multilateral trade, and the WTO in particular. This will make for a confusing situation as we must embrace and redouble efforts toward the maintenance of freer trade, and yet prepare ourselves for a world in which liberalized trade as we have known it is no longer attainable. It is both a conceptual and a communications challenge.

Agri-food will be central in answering the question, “how will Canada engage China?” African Swine Fever dramatically ups the ante on meat demand, but regardless of this China cannot feed itself, and food is a source of vulnerability for China. As a producer of surplus farm and food products relative to its own demand, Canada could be a solutions provider to China.

However, the matter is nuanced. Does China need Canada? China is far larger than Canada and as a result, in almost all its agri-food exports, Canadian product could only ever serve as a minor or narrowly targeted source of China’s requirements.

Does Canada need China? The Chinese market is massive to Canadians. Entry points to the Chinese market are through a range of state-owned enterprises (SOE’s), firms mostly privately-owned with some state ownership, and fully private firms- and the distinctions among these can at times be blurred. It presents the prospect of a very large and potentially fickle customer that can suddenly choose or be pressured to turn its back on Canadian suppliers (especially the SOE’s). Scaling up to serve such customers can be risky, but ignoring them risks loss of opportunity.

Moreover, to be meaningful in China will require a large proportion of Canadian export volumes, requiring a trade-off between China and other customers- both domestic and export- in order to muster the volume required for China. In fact, the Chinese demand for some products is apt to be so large, notably in meats, that any country could find itself short if it over commits export sales to China, spawning food security and inflationary concerns in Canada. Conversely, the risks of forward purchasing and stockpiling in anticipation of major sales to China that may not materialize in time or at scale assumed is also fraught with risks.

Agri-food will thus be a sensitive strategic matter in Canada's broader foreign relations with China.

The new government has a mandate to continue to support climate change policy. In its previous mandate, the government envisioned a carbon tax as its approach to reducing greenhouse gas emissions, broadly supported by economic research as the most efficient approach. The principal policy alternative is cap and trade, but this is now under fire with legal action in the US, with the US federal government alleging that the state of California overreached its authority through its cap and trade agreement with Quebec.[2] Following the federal election, New Brunswick dropped its Supreme Court Challenge to the federal carbon tax, leaving Ontario, Saskatchewan, and Alberta as the formal opponents to the federal carbon tax.

Agriculture has been largely left out of the climate change dialogue, except as a consumer of fossil fuels and fertilizer, and through a persistent and frequently repeated misunderstanding of the role of grazing livestock on greenhouse gas emissions. As such, many segments of Canadian agriculture have lined up to oppose the carbon tax.

But the potential for agriculture to be a solutions provider has been left out of the discussion. Understood properly, much has been achieved in agriculture that serves to reduce greenhouse gas emissions, and grazing livestock are a part of a solution.[3] The new government has an opportunity to endorse this, and in so doing support emissions reductions and sequestration in agriculture; by nature the bulk of this opportunity will fall on western Canada.

With some competitors offside with climate change initiatives, domestic agricultural policy supporting climate change may require accompanying trade policy. Canada's efforts at carbon emissions reduction in agri-food cannot be undercut through imports from other countries that do not undertake analogous efforts and incur associated costs. The framework to address environmental standards in international trade does not currently exist but has been contemplated in academic research for some time. Work will be required to make the concepts real and capable of being implemented.

The decline in rules-based trade upsets many of the fundamentals of Canadian agri-food policy. Access to export markets that can be relied upon as similar or near-equivalent to domestic market access has facilitated specialization and scaling up a range of selected farm enterprises in Canada- notably canola, wheat, soybeans, pork, beef, potatoes, and greenhouse vegetables. This specialization occurred in lieu of a past with more diversified farm enterprises and a broader portfolio of crops and livestock. Much has been gained through specialization and scale up for export-in terms of profitability in farming, processing, and economic development- much as David Ricardo envisioned in his theory of comparative advantage. In turn, agricultural policy federally and in provinces has facilitated growth and investment through specialization. In some cases, our specialization may be based on such significant comparative advantage that Canada can remain an export leader even in a highly skewed price/policy environment- although this is unlikely to attract investment unless a pathway can be established to eventually returning to more genuinely open markets and rules-based trade remediation.

However, the re-emergence of agricultural protectionism and support, and the erosion of international trade institutions and access based on rules acts against specialization and scale up, due to the implied increase in risks in marketing and investment. The alternative is diversification. This is not a simple nor subtle shift- the challenge being to retain all existing capacity working (ultimately

[2] https://www.cbc.ca/news/canada/montreal/quebec-california-cap-and-trade-1.5331865

[3] See https://capi-icpa.ca/explore/resources/efficient-agriculture-as-a-greenhouse-gas-solutions-provider/

measured in acres), redeployed into different products, grades, and extent of processing along the value chain- at existing or better operating returns, and preserving existing asset values. Clearly the potential for significant diversification into new enterprises versus the *status quo* in which export access plays a very significant part will require extensive analysis, support, and development.

In a more protectionist environment, the focus in agri-food marketing must be more balanced between export and domestic markets. This in turn requires a greater focus on competition in the domestic market, and on opportunities for import replacement. The Canadian grocery retail market is known to be highly concentrated, with retailers positioned to place pressure and push costs back on suppliers. If the domestic market becomes relatively more important as an outlet for Canadian agri-food products, the nature of competition in downstream segments (retail, foodservice, and some processing) and its implications in vertical markets will be of increased significance in agricultural and food policy.

Another aspect of an increased focus on the domestic market is processing capacity and investment. It is also an issue for exports, and avoiding exports of farm products that are more vulnerable to trade action and retaliation than the associated processed food product. [4] In some cases new Canadian capacity will be required to process farm products currently exported for processing, with the processed products imported back into Canada. However, breaking up existing international supply chains in favour of establishing processing in Canada for domestic and export sale entails costs and risks, such as being able to operate at efficient plant scale, and competition with existing processed product and perhaps more importantly emerging products in domestic and export markets.

The risks of establishing new/expanded capacity is underscored by Canada's recent record on productivity and competitiveness in food processing (generally poor) and investment in food manufacturing (broadly low)[5]. Increased processing investment as a necessary means to increase domestic marketing will need to confront past observations- if it was profitable, it would already be occurring.

The sharp increase in US agricultural support through the MFP in 2018 and 2019 contains perverse incentives liable to embolden the US toward future support and push the world back toward increased agricultural support. Domestic support has the effect of dampening market signals from low prices to reduce supply, further reducing prices and justifying ever greater levels of support; this is the basis for concern that US farm payments, such as that under the MFP, will only continue. The precedent established by a large country returning to higher levels of support will inspire others to act in kind- out of the inherent interest to provide support to their own producers, or to offset the price erosion due to the support payments of others. These effects tend to feed off each other in a self-reinforcing cycle of escalating support, market distortion and inefficiency.

Acknowledging the pitfalls and perversity of farm support payments, Canada likely has no choice but to protect its producers and follow suit with the US- but with far fewer fiscal resources. Canada is perhaps uniquely vulnerable, with a narrower set of farm products produced impacted by the support programs of others and a relatively large exposure to exports. This makes it all the more important that

[4] An aspect of this is the apparent difficulty- and opportunity for reform in the WTO dispute resolution system making the vertical connection between distortions at the farm product level and the associated processed food product.

[5] As an illustration see Hedley (2014) in a review conducted for CAPI https://capi-icpa.ca/wp-content/uploads/2014/05/Capital-Investment-in-Canadian-Food-Processing-2014.pdf

Canada devise a disciplined approach for *ad hoc* support, but with clear objectives. Developing a plan that responds to US *ad hoc* support but differentiates its purpose from existing BRM programming, meets provincial/commodity needs, and at the same time manages uniformity and equity in payments will be necessary but also difficult.

Moreover, the BRM suite of FPT programs has been under review for about two years now, with industry pressure for reform, particularly on AgriStability. A structurally more volatile situation as is expected will further strain the BRM suite. It seems there will be a need to differentiate between BRM programming that stabilizes producers for rough patches within "normal" variation, as distinct from income strains occurring from non-normal situations- such as structural deviations from accepted trade rules and/or market access- requiring *ad hoc* support. However, in practice, identifying and partitioning the two situations could be quite difficult, and will likely entail extensive cooperation and compromise.

The discussion of *ad hoc* and BRM is incomplete without reference to the funding announced in the summer of 2019 for supply managed industries in relation to CPTPP and future trade agreements, e.g., NAFTA 2. For dairy, the payments are initially $345 million during the first year, with payments forecast for distribution in early 2020. This is the equivalent of about $4/hl. However, there is less clarity on how the remainder of the funds will be used over the following seven years. The timing of these payments creates a distinct awkwardness due to the losses incurred by the canola and meat/livestock sectors associated with constrained Chinese market access- and provided with only nominal relief thus far. The eventual consideration of injury experienced by these sectors in *ad hoc* payments will inherently be compared with the payments to supply management in terms of logic, structure, and magnitude. It will fall to agriculture ministers and farm leaders to manage (or salvage) unity among commodity groups, regions and federal provincial and territorial governments as this situation unfolds.

Conclusions

Policy for agriculture and food in Canada could be viewed as being relatively quiet last 20-30 years, with relatively stable programs under committed federal-provincial-territorial ownership. But governments and agri-food industries face a very different and more uncertain situation looking forward from today, and the rural vote in the recent federal election suggests that agriculture is not happy about "Ottawa". For Canadian agri-food policy, it simply cannot be business as usual going forward as it has been- managing the ebbs and flows of the sector.

The pipeline and transfer payments issues in Western Canada are illustrative of a wider alienation in the region. Beneath these issues are agri-food policy issues that may fracture the federal-provincial-territorial approach to policy built up and maintained for two decades, particularly in light of the sharply changed international scene in trade rules and directions, as well as the announced payments for supply managed commodities.

Fractious debates on these and other issues threaten to consume the new government. Particularly in agriculture, the risk is of a fallback to the 1970s through the 1990s in which it was easier for a Cabinet to simply pay out money rather than really understand and manage the immense complexities and pressures in agri-food. Indeed, the rules within the WTO that encouraged the design of Canada-wide agricultural policies and programs are eroding, thereby weakening the commitment to the Canada-wide common approach to agri-food policy. However, a key difference today is that Canada may not have the public budgets to pay in lieu of understanding the issues and having a strategy for agri-food, risking real suffering and curtailed investment.

The politics of accommodation applied to farm and agricultural commodity groups will not cut it. Major issues will need to be engaged. With the developments of 2018-19 agri-food is no longer a separable portfolio from the overall policy space and its complex of issues.

In addition to being much more prepared with an understanding and strategy for an uncertain world, Canada needs a better understanding of where it can exert influence, or "soft" power. Agri-food, along with energy, would appear to be key components of soft power for Canada.

The reality is that the true capacity for surplus agri-food production is vested with a relatively small number of countries; in certain products Canada is vested with this capacity. For example, in pork, Canada is a large exporter, but not as large as the US or the EU. But both are also large importers, such that their net exports- a measure of true capacity to supply other countries- is significantly lower than the exports that appear. Compared with other leading pork exporters- the US, EU, Brazil- Canada's net exports of pork are relatively large. An implication is that, in a hungry world where some food products are structurally short- if we assume that export suppliers will want to supply themselves first- Canada is a key strategic export supplier. This scenario plays itself out over a range of other farm and food products- canola, beef, soybeans, pulses, wheat, etc.

In addition to capacity, Canada has elements of a platform from which it can deliver farm and food products with specific attributes that people want, on a global basis. These include attributes such as sustainable, healthy, etc. In particular, Canada has capacity and integrity in inspection, grading and data collection that it could leverage in much more of a "food to spec" marketing orientation that others lack- but whose consumers will increasingly seek. The vision for this platform, as distinct from commodities, requires development- the evolving situation in the world may increase the urgency to press this opportunity.

The need for some *ad hoc* assistance could present the opportunity to facilitate transition, to some extent, toward increased production of product with more specialized attributes, and allow Canada to backfill for what the US is doing in terms production and exports of primarily commodity products.

Industry needs to be prepared to pull together to address coming strains and act beyond commodity and regional fragmentation. The dialogue on *ad hoc* assistance for trade injury is unlikely to proceed in the sector's interest if commodity groups approach governments on an individual or fragmented basis. This tends to end in competition for influence, and even conflict, among commodities in the face of government budget constraints. Moreover, to the extent that the broader public has been tolerant of the politics of accommodation applied to agriculture, the appearance of a sector fragmented across a range of commodities and regions, all in need but in competition with one another, is likely to undermine existing public support.

In 2018, Canada's Agri-food strategy table outlined key objectives and constraints facing the sector.[6] While many of these remain, it is remarkable how shifting conditions since that time must shift the economic policy dialogue. For example, its agri-food export target was an annual 3.5 percent growth rate to 2025. This was valid under the assumption of existing rules-based trade and agricultural support; these have now undergone fundamental shifts.

Some fundamental questions will need to be answered going forward from today. What will additional funding for agriculture do that BRM program funding does not? Governments and industry will need to work together to establish what this evolving world will look like. Based upon this, governments and industry can plan how we will use additional funding to *invest* to succeed in agri-food. Making this real and meaningful- commensurate with

[6] https://www.ic.gc.ca/eic/site/098.nsf/vwapj/ISEDC_Agri-Food_E.pdf/$file/ISEDC_Agri-Food_E.pdf

the importance and urgency of the matter- will require leadership on behalf of governments and industry at the most senior levels, facilitated by the federal Minister of Agriculture.