Dairy Farmers Should Not Count On A Doha Round Failure

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Take Home Message

- Even though the Doha Round is treading water as negotiators wait for the new US Administration to re-engage, it is wise to assume, for planning purposes, that the Doha Round will succeed, sooner or later.
- The prospective results suggest that supply management could still continue - despite modest cuts in over quota tariffs and increased import opportunities.
- New import access together with elimination of export subsidies and disciplines on price supports would combine to force (modest) changes to the current support system.
- Up to producers, processors and governments to work together to determine what adjustments would be necessary to ensure a "soft", rather than a "hard", landing.
- Plan A was based on little or no change. At some point the dairy sector will need to explore what a Plan B (Doha succeeds) scenario would involve at the farm and industry level.

Introduction

For over seven years Canada's dairy farmers have watched the Doha Round of World Trade Organization (WTO) negotiations lurch from crisis to crisis. Several times the Round has appeared to be in its death throes but each time some last minute political impetus has enabled it to continue to inch forward in

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fits and starts.

From the outset of the negotiations agriculture has been regarded as the keystone and it has been the political sensitivities and lack of political will surrounding agricultural trade reform that have been largely responsible for many of the difficulties in concluding the Doha Round. The emergence of a global financial crisis in late 2008 gave the negotiations a momentary shot in the political arm as countries seemed to recognize that allowing the Doha negotiations to fail could seriously undermine global confidence as they collectively and individually strive to restore economic growth and stability. However, although the December 2008 attempt to finalize the "modalities" (the approaches and numbers countries would use to simultaneously table offers) ultimately failed, it should not be assumed that the negotiations are dead and Canadian dairy farmers can therefore ignore the progress which was made in the negotiations in 2008.[2]

Given the substantial narrowing of differences that has occurred, many observers find it difficult to imagine that the international community will allow the Doha Round to fail and that it is only a matter of time before the negotiations are brought to a successful conclusion - if not in 2009 then in 2010. It is on this assumption that the following paper examines the implications for Canada's dairy farmers of the deal on agriculture that appears to be emerging - a deal which rejects Canada's opposition to cuts in over quota tariffs and expansion of tariff quotas but recognizes that it needs to have more than the standard number of "sensitive" tariff lines if supply management is to continue.

This paper takes as a given that all political parties want to see supply management continue as the heart of Canada's dairy policy. It is also assumed that Canada will have made every effort to ensure that there are sufficient flexibilities built into the results to minimize the impact the tariff quota expansion and over quota tariff cuts will have on the supply managed sectors. The main question that this paper addresses is whether the prospective WTO results would enable supply management to continue and if so what modifications and what adjustment measures would be necessary to ensure a "soft", as opposed to a "hard" landing.

▪ The Prospective Agricultural Package

The emerging Doha Round result would see substantial progress in building on the agricultural trade reforms first begun in the Uruguay Round. By any measure the prospective results would be impressive, certainly in comparison

[2] This progress is reflected in the latest paper on modalities issued by the Chair of the agricultural negotiating group, December 6, 2008.

to the generally ineffectual pre-Uruguay Round efforts to reduce trade distortions and bring agricultural trade under the rule of law. The main elements of the package would include:

- Elimination of export subsidies, as well as new disciplines on export credits, food aid and export state trading enterprises to ensure that other forms of export assistance do not undermine the export subsidy prohibition.
- Substantial reductions in trade distorting domestic support which would be deeper the higher the initial level. For example, the European Union (EU) would reduce by at least 80%, the US and Japan by at least 70% and Canada and the other developed countries by at least 55%. A major new feature would be agreement to cap commodity specific trade distorting support at the average of the 1995-2000 level. "Green box"[3] domestic support would not be subject to any reduction and would not be capped.
- Significant reductions in agricultural tariffs which would average more than 54% for developed countries. A tariff formula would ensure that the higher the tariff the higher the reduction, with the highest tariffs (over 75 per cent) being reduced by about 70%, and tariffs 50-75 per cent, 20-50 per cent and 0-20 per cent being reduced by 64%, 57% and 50% respectively.
- However, so-called "sensitive" tariffs would only be reduced by around 23%. Most of these sensitive tariffs are protected by "tariff quotas" which enables a certain import volume to enter at zero or relatively low tariffs. Once this within quota amount is filled, a much higher over-quota tariff applies. In order to minimize the erosion effect on the tariff formula, the number of tariff lines which can be designated as sensitive would normally be limited to 4 per cent of the total number of tariff lines. In addition, sensitive tariffs would have to allow additional import volumes to enter at low tariffs. Countries that need a higher number of sensitive tariffs or that want to keep tariffs above 100 per cent would have to pay by further increasing the volume which can enter at low or zero tariffs. The base increase in tariff quota volumes would be 4 per cent of the average 2003-5 consumption but this could increase to 6 per cent, or even slightly higher, if countries wish to take advantage of the maximum flexibilities. This would appear to be the case for Canada which has indicated that it needs to have at least 6 per cent of tariff lines designated as sensitive and freedom to maintain over quota tariffs in excess of 100 per cent.

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[3] Domestic support which has no or minimal trade distorting effects is included in a "green box" category, Support which is highly trade distorting is included in an "amber box" category while certain types of less but still trade distorting support are included in a "blue box" category.

- The least developed developing countries would not be required to make any domestic support or tariff reduction commitments while the more advanced developing countries would, in general, make commitments two-thirds as great as that for developed countries.

Impact On The International Dairy Market

A Doha Round agricultural result along the lines of the above would be expected to have a strong price strengthening effect on the international market as export subsidies are phased-out and market access improvements are phased-in. There is no doubt that over the past 50-60 years the international dairy market, along with those for sugar, rice and cotton have been the most distorted. In fact it was the growing distortions in the world dairy market in the 1950's and 1960's that prompted Canada to re-think its historical dairy export orientation and concentrate instead on controlling supplies to meet identified domestic demand. From this point on, Canada's dairy trade policy was increasingly focused on protecting the domestic market and treating the international market as mainly an outlet for disposing of product surplus to domestic requirements.

Implementation of the prospective Doha Round results would see the elimination of export subsidies by 2013 and the expansion of tariff quotas in four steps over three years. Tariffs would be reduced in six steps over five years. These developments, especially in the major developed economies, will certainly help to further strengthen international dairy prices which are already expected to remain firm as a result of the expanding import demand in the emerging markets, particularly in Asia. Also helping to underpin the international market over the coming decades is the expected decline in EU exports as more of its production is consumed internally and the fact that New Zealand has negotiated duty free entry (over a 16 year transition period) into the Chinese market as a result of its recently concluded bilateral trade agreement with China. Consequently, continuing strong market fundamentals, combined with the Doha Round reforms make it highly unlikely that international dairy prices will fall back to the heavily distorted and depressed levels which characterized the international market for most of the post-World War II period.

Although as a result of the current global economic crisis international dairy prices have weakened considerably from the record highs of 2007/08, the medium and longer term market prospects remain bullish. This suggests that over quota tariff reductions of around 23% on 200-300 per cent Canadian tariffs (phased in over a five year transition period) should still enable the remaining tariff protection to be high enough to continue to prevent over quota tariff imports.

■ Impact On Canada's Dairy Trade Regime

The prospective Doha Round results would have two main trade impacts. Export subsidy elimination would mean the phase-out of Canadian dairy exports made from Canadian milk unless some way can be found to bring more of its end use or component milk prices closer to world levels (or at least down to those in the US). Expansion of dairy import tariff quotas would result in additional low duty import access equivalent to up to roughly 5-6% of consumption, assuming Canada took full advantage of all the flexibilities in order to minimize over quota tariff reductions. The loss of exports and the increase in imports would mean that a worst case scenario would imply that domestic production would have to be progressively reduced by up to 6 or possibly 7%.

A series of WTO panels found that under Canada's highly regulated milk production and marketing system, all dairy exports made from Canadian milk benefit from an export subsidy to the extent that milk for export is priced below domestic prices and below average cost of production. Given the past concern of panels to avoid legitimizing two-price schemes which could undermine export subsidy reduction commitments, it is difficult to see how Canada could continue to export dairy products if it continues to hold its domestic prices so much in excess of world prices (and well above those of the EU and US).

The main ways Canada could continue to export dairy products or foods containing dairy products would be: (1) under a duty free import for processing and re-export program; (2) by pricing milk for production of certain processed foods at the same internationally competitive price, irrespective of whether it is consumed domestically or exported (currently the case for milk used in chocolate confectionary production); or (3) by having all sales of a milk component (for example, skim milk powder) priced at world competitive levels, whether for domestic sale or export.

Expansion of tariff quotas only allows for increased import opportunities - it is not a guaranteed purchase commitment. Actual import volumes will depend on the extent to which Canada's internal prices are higher than world prices. Thus, lowering Canadian skim milk prices to world levels would reduce, if not eliminate, import demand. In contrast, maintaining or increasing the gap between Canada's butterfat prices and world prices would guarantee that the expanded import quotas for butter and cheese would be filled.

Traditionally in Canada (and the US) milk for fluid consumption has been priced at a premium to milk sold for dairy products (so called "industrial" milk). However, imports of milk for fluid consumption in Canada have been limited to imports for personal consumption, although small amounts of milk for processing and re-export have occurred. To-date there has been no commercial imports of milk for fluid use. The Doha Round results would gradually permit imports of raw milk (for fluid or industrial purposes) to increase to up to around 6 per cent of average 2003-2005 consumption.

The new tariff quota for milk raises the important question of how the import licenses associated with the new tariff quotas will be allocated. In the past, the method for allocating import licenses has varied widely within and between agricultural products, including allocation by: processor share of domestic production; freely on demand on a pro rata basis; end-use (for example raw milk imports could be directed to certain industrial uses); and historical import shares. In the case of butter the federal government decided to give the Canadian Dairy Commission (CDC) all of the import licenses after the Uruguay Round.

To the extent that an import license enables the importer to capture the difference between the Canadian and world price they are extremely valuable. Existing cheese importers can be expected to argue that import licenses should be continued to be issued on the basis of historical import shares. Dairy processors could press for allocation of raw milk import licenses on the basis of share of production. Dairy Farmers of Canada could ask that butter and raw milk import licenses be allocated to the CDC or even given to its recently established trading company. The bottom line is that how Canada allocates import licenses has significant implications for a number of industry stakeholders and will undoubtedly precipitate intense lobbying efforts.

▪ Impact On Canada's Dairy Price Supports

The Uruguay Round marked the first time that countries agreed to reduce trade distorting domestic support on an aggregate basis. However, a reduction of only 20% from the record levels of the mid-1980's meant that the commitments represented more of a cap than a reduction for most countries. Moreover, since there were no commitments on individual commodities it was even possible for trade distorting domestic support to have increased for certain products since the end of the Uruguay Round. This was certainly the case for milk in Canada.

The prospective Doha Round results would mean that the product specific "amber box" maximum support limits would be the average of those provided in the 1995-2000 period, as notified to the WTO. Amber box support includes any form of price support, whether in the form of offer to purchase or deficiency payment programs. The way market price support is calculated is to take the difference between the average world prices in 1986-1988 and current Canadian support prices for butter and skim milk powder and multiply this by "eligible" production of the two products subject to CDC offer to purchase prices. However, in addition to providing price supports during the

!995-2000 period, Canada was also phasing-out non-green deficiency payments. The combination of these two forms of non-green support means that the Doha Round cap on Canadian milk price support would be about $576 million at the end of the implementation period.

More recently the Canada Milk Supply Management Committee has instructed the CDC to limit its potential purchases of skim milk powder and butter to certain quantities, as opposed to the earlier open-ended commitment. There has been some suggestion that this action was taken, at least in part, in an effort to reduce Canada's potential exposure to a Doha Round reduction on non-green domestic support. However, while this initiative could significantly reduce the calculation of the Federal price support, it could refocus exporter attention on the fact that the bulk of Canadian milk price support is in fact provided by the administered prices of the provinces which so far have not been included in the domestic support calculation. In a worst case scenario, probably following a WTO dispute settlement finding, Canada could be faced with a requirement to reduce its current support price levels on a provincial and not just on a federal basis.

One way of avoiding exceeding the cap on domestic price support would be to substantially reduce the support price on skim milk powder - something industry participants have apparently been contemplating for some time. Another way would be to move to negotiated pricing between provincial milk marketing boards and processors. Moreover, it should be recalled that there is nothing to stop governments providing "green box" direct income support in compensation, in whole or in part, for any price support reductions.

▪ Impacts On Quota Values

Of great concern to any dairy farmer is how the prospective Doha Round results could affect the value of production quota, which in most of Canada is currently worth something in the order of $25,000 - $30,000 per cow. There appears little doubt that the direction and magnitude of any changes will be heavily influenced by the way federal and provincial policy makers decide to implement the Doha results and the choice of any complementary adjustment assistance measures. For example, if Canada is required to reduce total milk production by up to 6-7 per cent as a result of increased imports and reduced exports, this will force dairy policy makers to choose the best method to achieve this. Will it be achieved by a pro rata reduction in production quota or will there be a program to buy up quota from dairy farmers who decide to exit the industry? Will there be a program of bank guarantees to protect farmers who have taken out major loans to purchase production quota? To what extent will downward pressures on quota values caused by a freeze or even roll-back of milk price supports be offset by the demand for quota by operators who wish to lower costs by expanding the size of their herd? Will there be "green" direct income payments to help compensate for some or all of any declines in blended milk prices?[4] To what extent will any federal adjustment programs be supplemented by provincial programs or will there be a national adjustment policy financed by the federal and provincial governments on the traditional 60:40 basis?

Only the stakeholders can provide the answers to these questions and it will take a coordinated effort by governments, producers and processors to develop and implement a plan to facilitate a smooth transition to the new realities.

Implications For The Supply Management System

While it is relatively easy to quantify the impact of the Doha tariff changes and the implications of eliminating export subsidies, it is more difficult to assess the impact of the limits on non-green domestic support and even more difficult to estimate the effects on quota values without making some assumptions about the adjustment programs which should be in place to cushion any negative impacts. However, the forgoing analysis does illustrate one key fact - a Doha Round result involving over quota tariff cuts, tariff quota expansion, elimination of export subsidies and caps on price supports does not mean the end of supply management.

Surely supply management can survive behind the remaining over quota tariffs which would still range between 154-227 per cent - especially if the international market is less distorted and more demand driven than in the past? Surely it would still make sense for producers to continue to favour a single desk approach (through their provincial milk marketing boards) in dealing with a handful of buyers? It would still be possible to maintain a classified pricing system and blending of fluid and industrial milk prices. The main constraints imposed by a Doha Round result would be that dairy support prices, particularly for industrial milk - whether set by the federal or provincial governments - could no longer be set completely independent of world prices; and new import access and the elimination of export subsidies could reduce current production by up to 6 or possibly 7 per cent, assuming Canada takes full advantage of the flexibilities provided in reducing over quota tariffs for sensitive products. In these circumstances it might make sense to consider shifting away from administered prices using delegated provincial government pricing authority to a system of negotiated prices between producers and processors which could allow Canada's ongoing structural surplus of skim milk powder to be exported without an export subsidy. Under this scenario federal price supports could still continue but would need to be set at stop

[4] So long as the direct income payments meet the criteria for "green box " support there are no WTO limits on how much green support can be provided.

loss rather than cost plus levels for skim milk powder.

It should also be recalled there is a trade-off between minimizing over quota tariff reductions and tariff quota expansion - the smaller the over quota tariff reduction, the greater the requirement to expand the size of the new tariff quota and the greater the need to reduce domestic production quotas.

It must be stressed that this paper has outlined what is probably the worst case scenario and that Canada should be able to moderate these Doha Round consequences by an appropriate choice of adjustment measures. The main challenge is to avoid panic decisions and ensure that all stakeholders understand there is a dairy adjustment game plan that can facilitate a soft rather than a hard landing. Younger producers need to be convinced that there is a future which justifies continued major investments in dairy production. Older producers need to know that there are programs to protect asset values and facilitate their retirement from dairy production if they so wish.

So far no industry stakeholder has expressed a willingness to explore Plan B scenarios for fear of undermining Plan A which is premised on the assumption that over quota tariffs will not be reduced and tariff quotas will not be expanded. While the underlying tactical and political considerations behind this position are understandable, the realities strongly suggest that at some point the industry will be faced with a Doha Round result that involves over quota tariff cuts and tariff quota expansion. For individual dairy farmers it would be far wiser to plan for the worst and hope for the best, rather than planning for the best and ignoring the worst.

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