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Chinese Agricultural Policy and the Future of Grain Imports

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Chinese Agricultural Policy Can Move World Markets

As was noted in my introduction, it has been several months since I have dealt day to day with grain and China. Although, in an unexpected way it has helped my understanding of China's grain sector to come to work on cotton analysis and policy here in Washington. As many of you know, the United States is currently defending itself in a WTO case brought by Brazil against our farm payments. The crux of Brazil's claim against our marketing loan, countercyclical and direct payments is that these programs suppressed world prices from marketing year 1999-2002, and will continue to suppress them in coming years. When we looked at the data however, it was pretty clear that it wasn't the United States that was the main driver for lower prices in this time period but rather it was China--in particular a change in Chinese policy in 1999. After implementing a price support program that allowed government cotton stocks and state-run bank debt to grow to huge levels, the Chinese Government had to cut its losses and systematically dump its stocks on the world market in the form of raw and processed cotton. You in the grain industry know that a very similar scenario was repeated in China for corn, wheat and rice, as the policies for the individual commodities were all interconnected.

My time working on the Brazil case has driven home to me how enormous is the capacity for Chinese policy to affect the world's major agricultural markets. China is after all the world's largest agricultural producer. The Chinese policies significantly distorted world production in grains and cotton throughout the middle 1990's and have depressed world prices for the last 4 years. So any consideration of our future grain trade, or any agricultural trade with China for that matter, must look closely at implications of Chinese agricultural policy.

The Economic Forces Moving China's Grain Sector

To look at policy, I want to first look at what is generally accepted as the key forces at work in China's grain market. I think the consensus is that China, like other developing countries, is consuming more and more livestock products as its per capita GDP increases, and accordingly its demand for feed grains is growing quickly. There is some counterbalance to this because consumption of rice and wheat as food staples is declining. However, assuming China continues to grow at its current clip, in the long term the prospects for grain imports is good. China's arable land on a per capita basis is relatively limited, one-sixth that of the United States, and the demand on the land for other crops particularly for vegetables and fruit, is great. Further, limited water supplies in the arid north where most of the corn and wheat are grown is increasingly constraining production.

Since China abandoned its price support policy in 1999, grain production, particularly in wheat and rice has dropped close to 20 percent. China continues to draw down the huge stocks they built up in the 1990's, but most agree that China will probably need at some point in the future to import a great deal of its grain needs-both directly and in the form of livestock products. The USDA baseline sees China switching from a 10 million metric ton grain exporter to a 10 million metric ton importer within 10 years. And indeed recent news that China intends to reduce its corn exports would seem to confirm what USDA has indicated in its data for some time-that Chinese grain production is already falling well short of consumption.

The question is, however, once the grain stocks are finally reduced to normal levels as they should be within a few years and China becomes as it was in the middle 1990's a big importer of grain are we destined to see a repeat of the policy decisions that hurt markets over the past four years. Or, even failing that particular trauma, how else could Chinese policy affect grain trade.

Agricultural Policy Objectives

To look at this question, it is necessary to understand the objectives of Chinese agricultural policy. Chinese leaders have a concern, as do our leaders, in maintaining farmers income. I think the press, and some analysts even, over-dramatize this-perpetuating a vision of a huge gap between rural and urban China. The Chinese government in its concern with farmer incomes is simply responding to the problems any country experiences as it makes the difficult transition from an agrarian to an industrial economy. Indeed I see some parallels between the post-collectivization development of China's farm policies and our own efforts over the years.

China also has a concern historically in "self-sufficiency" in grains. Although my impression is that as time passes, this becomes less and less of a concern, it doubtlessly was key to the policy decisions of the 1990's, and recently, as stocks have come down, we have heard Chinese officials again talk about self-sufficiency.

Finally, people frequently ignore that China, as it develops, has potential as an agricultural exporter itself. Even though its per capita arable land relative to the United States, Canada, and Australia may be limited, compared to other Asian countries it does much better. Its location combined with cheap labor makes horticultural and livestock exports to nearby countries very attractive. It also has an urban population that has become accustomed to cheap food. So, fostering efficiency in agriculture to promote exports and keep domestic food prices low is also definitely a key government objective.

A Repeat of the 1990's?

These objectives are really not all that different from what they were in the 1990's. So will we repeat the roller coaster ride caused by China's grain procurement program in the 1990's? The program is still on the books, although the procurement prices have for the last five years been set so low that they have become largely meaningless. When the

government gets rid of their current grain stocks, will they be tempted to reintroduce the higher procurement prices and start stocks growing again? My feeling is that they have learned their lesson (as we did with our grain stocks crisis in the 1980's) and will not let their stock situation get out of hand again. China is after all still a developing country that can ill afford costly farm programs. Loans given to maintain the agricultural price support program of the 1990's played a big role in the very serious problems that China's state-run banks continue to face. Also, the Chinese farmer has more alternatives to grain these days. Thriving demand for horticultural and livestock products is reducing the pressure to insure good returns for grain.

Similarly I think that budget worries and the sheer number of Chinese farmers is going to make it difficult for very many years for China to adopt a U.S.-style decoupled program that would avoid production distortions while maintaining farmers incomes.

Controlling Trade to Meet Agricultural Policy Goals

So, as a practical matter, is any income-enhancing agricultural policy available to China? Although China may not have the financial resources to sustain domestic price supports or develop a production-neutral farmer income support program, Chinese officials still realize the value of trade restrictions in meeting policy goals. China has long restricted trade and financial flows in hopes of meeting policy aims. Further, even though now they are members of the WTO, some of their policies and practices may contravene WTO commitments.

Most importantly for the grain industry, ever since China found itself saddled with huge grain stocks in the late 1990's, it has subsidized corn exports as the best and cheapest way to get rid of these stocks with the minimum harm to domestic prices. When it entered the WTO at the end of 2001, it continued the subsidies even though their WTO accession agreement explicitly forbids this. They have also imposed a VAT on all grain imports that is for the most part not levied on domestic grain. The effect is that for grain (and indeed almost all agricultural imports) they have been able to keep a 10-15 percent buffer between imported and domestic prices. In areas outside of grain, the Chinese have placed a de facto quota on imports of chicken meat and offal for 3 years now.

China's Justification

Chinese officials justify these actions based largely on a belief that developed countries often fail to meet their WTO commitments at China's expense. And in China's defense, they probably have some legitimate complaints. Japan has restricted imports of Chinese poultry meat and vegetables on some questionable sanitary and phytosanitary grounds. Also, the Europeans have shut off all Chinese imports of livestock and aquatic products for drug residue levels, even though the United States has continued to import Chinese aquatic products despite having the same standards. These actions by Europe and Japan apparently directly led to China's controls on chicken imports, and the Chinese, reasoning that such restrictions hurt demand for grain, probably use it internally to justify continuing export subsidies.

Of course the United States has had similar problems with both of these trading partners. However, I feel we and most other WTO members have tried to keep our responses to unfair trade practices at least transparent. For instance some may argue about the fairness or economic validity of our anti-dumping legislation, but the process is open. If another country wants to challenge what we do in the WTO the paper trail is there. This is an outgrowth of our legal system which requires a strict adherence to rules and procedures .

For China, the reaction is different. For the corn export subsidies, China simply says that they are giving VAT rebates, which are indeed acceptable under the WTO. The numbers, though, don't add up, particularly considering that no VAT is paid on domestic corn used for feed. However we have no idea of the mechanism for the payouts. It appears to be a transaction between the quasi-public grain bureaus that procure and hold grain and the state-run agricultural bank. Nothing is public. By contrast our export subsidy program when it has been used for grain in the past was completely transparent.

For the quota on chicken imports, Chinese officials simply say that there is no quota-that the mechanism blamed for restrictions on imports is indeed "automatic" for any importer who needs it and in no way limits imports. They feel no need to explain why imports have dropped precipitously and domestic prices have risen for the chicken paws and wingtips that are the bulk of imports.

These actions create a real problem for trading partners. We can argue about whether a country's policy is contrary to the WTO or what the impact of a country's policy is on world trade, but it is difficult if not impossible to argue that a country's policy is simply not what they say it is.

What is frustrating for me when talking to the Chinese however is that they feel that our system is really not any different than theirs. To them our anti-dumping legislation and our sanitary and phytosanitary procedures are just different although equivalent means to the same ends as their practices. To me it is important for grain or any kind of trade that we work to reverse this perception amongst the Chinese. They need to make their process transparent and truly governed by the laws and rules they have set down. If the Chinese would lay out in the public domain the details of the process by which they reimburse their exporters for corn exports, then we could start a discussion on whether they are WTO compliant. Now we are in a situation where they can complain, and do at some length, about our trade actions but we can really say little about theirs.

Chinese Officials Realize the Value of Agricultural Imports

This is not to say that the Chinese Government is entirely capricious in its dealings with trade. I believe its officials increasingly understand that allowing some degree of free trade will help them achieve their objectives in the agricultural sector. The Chinese realize that if they let there own economy get too out of step with the rest of the world, it will hurt them---particularly in the all important export sector. As already noted China

uses differential application of its VAT to keep domestic grain prices 10 to 15 percent above world prices. The Chinese are happy with this situation because it gives their farmers fairly high prices while still maintaining the competitiveness of Chinese exports like poultry meat, which can obtain a VAT rebate. Going beyond this level of protection, Chinese officials probably feel, would jeopardize the export sector and cause an unacceptable drag on the rest of the Chinese economy in the form of higher food prices.

What is interesting to contemplate, and this is looking hopefully down the road a bit, is what will happen if China, even with this premium, runs up against the tariff rate quota maximums for grains (about 5 percent of consumption) agreed to in their WTO agreement. Will the Chinese Government allow prices to rise further domestically or instead raise the quota limits to allow more imports? My feeling is that the need to maintain exports and low food costs will prompt China to allow imports beyond the quotas. Here, China's lack of transparency and loose compliance with regulation may work to our advantage. In support of my views, the Chinese have just in the past few months run up against the quota limit for cotton and have quite readily increased it, simply because the textile export industry needs it. I would also argue that despite biotech concerns and pressure from farmers, China has in the end not significantly curtailed soybean imports which seem to yearly set new records. I think this is in response to the needs of China's huge crushing industry, and the need to keep feed and vegetable oil prices in line.

Chinese Agricultural Exports and Grain Imports

As you can see, the future of grain policy and imports is heavily dependant on development of China's own exports. If China continues to encounter barriers, justified or not, in the development of livestock exports, market forces will reduce China's grain demand and policies will be followed that increase the level of protection given their grain farmers and industry. This extends to Chinese horticultural exports as well. To the extent China cannot find markets for their horticultural products, the pressure to institute policies that maintain domestic grain will be greater. Although I have mentioned the EU and Japan before, certainly the Chinese also complain about our anti-dumping and other safeguard measures, and our at times slow regulatory approvals for imports. Of course on the other hand, even with all these restrictions on exports, China would still have a huge trade surplus with the United States.

Chinese Grain Imports Will Develop If World Trade Develops

So, what do I feel in the end will happen. In the long run I am optimistic. I believe the fundamental economics is there for China to become a significant net importer of grain. The key is whether the trade environment (not just for grain but for all trade) both in China and the world will develop so as to let this happen. Of course the past couple of years have been rough for the development of free trade but I am still confident that the power of the argument for free trade will prevail and that grain trade with China will benefit. In the end, it is after all in everyone's, and in particular China's best interest.