Implications of Freer Canadian-U.S. Trade for Wheat, Dairy and Poultry

by Ronald D. Knutson

The Uruguay Round Trade Agreement under the General Agreement on Tariffs and Trade (GATT) makes eventual free trade in agricultural products between the United States and Canada inevitable. Because of protectionist policies on both sides of the border, the agriculture of both countries will experience substantial adjustment. The magnitude of adjustment and the impacts on trade flows is largely unknown. Associated with this adjustment process, there could be substantial changes in asset values, particularly on supply-controlled commodities.

The purpose of this article is to address the consequences of freer trade for wheat, dairy and poultry. These are major commodities that have received the highest level of protection in Canada. Therefore, it could be anticipated that they would experience the greatest adjustment. The article will end with some suggestions on how trade disputes could be resolved more peacefully.

Ronald D. Knutson is the Director of the Agricultural and Food Policy Center at Texas A&M University, College Station, Texas.

Nature of the Issues

Disputes between countries and the difficulty of resolving them have their origin of differences in the nature of institutions that establish laws, the barriers to trade existing between the countries, and the magnitude of adjustment that would occur if the disputes were resolved. The latter, in part, reflects the comparative advantage of the two countries.

Institutional differences

Free trade is easier to achieve if institutions are compatible. While systems of government may be different, there are those who believe that Canadian and U.S. agricultural policies will have to be rationalized before substantially freer trade can be accomplished.

The starting point for rationalizing policies requires an understanding of differences in the governmental system. In Canada's parliamentary system, the leader of the majority party in the elected House of Commons is the Prime Minister. Therefore, the Prime Minister will always be from the party that is in the majority (Hedley and Gellner). Separation of power between the legislative and executive branches does not exist. Under the parliamentary system, changes in national policy are easier to accomplish than under the U.S. system where the President and the Congressional majority are often of opposite parties, as is currently the case. Therefore, in Canada, big differences in philosophy, normally, do not exist between the majority party and the Prime Minister.

A second major institutional difference lies in autonomy of the provinces relative to that of the states. In the United States, federal agricultural policy for the major commodities applies uniformly to all states. In Canada, where provincial policies are much more important, differences in approaches that influence the magnitude of price enhancement may exist. As a result, provincial barriers to trade may be as important as country barriers.

Institutional differences have led to policy differences. Canada depends on marketing boards to implement some of

its major agricultural policies. Its board's policies are quite different from commodity to commodity. In the United States, subsidies have been a prime policy instrument. In both countries, these policies are controversial and politically sensitive.

Barriers to Trade

The root cause of barriers to trade lies in domestic farm programs (Knutson, Penn and Boehm). Under the Uruguay Round GATT Agreement, all tariff and non-tariff trade barriers were to be converted to tariff rate quotas. While this has been done in both the United States and Canada, U.S. interests argue that the Canadian Boards themselves are barriers to trade.

Economic Distortions

The consequences of policies designed to protect agriculture are distortions in trade patterns, prices, costs, asset values and the number and size of farms. When policies are modified to more nearly conform to free trade, these distortions tend to be eliminated by competitive pressures. The most agonizing changes are those that reduce asset values and cause farm and agribusiness firms to go out of business. Those farms that operate the most efficiently are the ones that are in the best position to survive.

Policy Change

Changes in agricultural policies are mandated under GATT. They also are dictated by the global reality that isolation and protection of agriculture are becoming less feasible. In other words, in a global market economy, it becomes more difficult for governments to stabilize agricultural price and income levels – a prime objective of past policies. Therefore, regardless of GATT, policy reform is increasingly inevitable – although change may come faster under GATT.

Commodity Comparison

Because of institutional, policy and resource differences, the changes resulting from freer trade between the United States and Canada will be quite different among commodities. Wheat, dairy and poultry are utilized to illustrate because they are among the largest in terms of volume of sales and are the most politically sensitive.

Wheat

Wheat is the major contemporary area of dispute between Canada and the U.S. Several policy changes have already been made and more are anticipated.

Canada. In an attempt to reduce costs, in 1995, Canada eliminated the western grain transportation subsidy. The western grain subsidy helped pay for the cost of moving Canadian wheat and barley to its east and west ports (Kirk). It, therefore, deterred movement across the border into the United States. Despite the fact that U.S. farmers encouraged the elimination of this subsidy, its removal will result in increased pressure for Canadian wheat and barley to be sold in the United States (Wilson and Johnson).

Even without the western grain transportation subsidy, the very existence of the Canadian Wheat Board provides an incentive for Canadian farmers to sell in the United States. Under the Wheat Board, Canadian farmers receive an average price that depends on the Board's success in selling wheat and its costs of operation. The U.S. price on a particular day may exceed the expected average price to be paid by the Wheat Board. While the Wheat Board reduces market risk, it takes away the opportunity for producers to utilize their marketing skills to obtain a higher price than that paid by the Board.

The incentive for Canadian farmers to sell in the United States is also enhanced by the higher cost of grain handling and storage in Canada (Wilson and Johnson). Canadian elevators have never had to be competitive because their costs were averaged in the producer price. They are smaller, slower, and most cannot load out highly efficient 25 or 50 car unit trains.

U.S. export subsidies paid under the export enhancement programs likewise encourage U.S. sales by Canadian farmers. Export subsidies raise the U.S. market price. Ironically, they also reduce the world market price, thus tending to reduce

receipts obtained by the Board (Young, Adams and Helmar).

Because of these economic incentives, the Canadian Wheat Board is under serious attack. An open continental barley market comparable to that existing in the U.S. has been proposed (Carter). While initially rejected, pressures for dissolving the Wheat Board remain. From a U.S. perspective, the Wheat Board is itself a barrier to trade because on any given international market sale, it can undercut U.S. private sector sales. However, in doing so, it will tend to reduce the average price that it can return to Canadian farmers.

While the Canadian grain handling system is more costly, Canadian farmers have production advantages over the United States. Wheat and barley are cool weather crops. Therefore, Canada has a climatic advantage. Canada's land prices are lower than in the United States because they have not provided as high a level of producer subsidies. Therefore, Canada's land ownership and rental costs are lower.

United States. U.S. farm policy used to provide cover for the Canadian Wheat Board by maintaining high market support prices and by controlling U.S. production. The turning point for U.S. policy began in the 1985 Farm Bill when market support prices (loan rates) were substantially reduced to a level where they were world-market competitive.

In the 1990 Farm Bill, farmers were given the flexibility to produce alternative crops on 15% of their program cropland. Subsidies were effectively reduced because deficiency payments were not made on this flex acreage.

The proposed Freedom To Farm provisions of the 1995 Farm Bill would provide the transition to a truly market-oriented agriculture without subsidies. It does this by providing farmers decreasing predetermined payments that are related to neither the crops produced nor to the level of market prices. Because the Bill would repeal the permanent legislation that has provided farmers leverage for obtaining subsequent farm bills, it is widely believed that farm subsidies would be zero in year 2003. Likewise, export subsidies would be geared down as required by GATT.

U.S. wheat is produced under considerably more diverse climatic conditions than Canadian wheat. While the United States has several wheat- and barley-producing areas that are fully competitive with Canada, one cannot draw this conclusion as a general rule. Moreover, the relatively stable benefits of U.S. farm programs have been capitalized into the value of land, resulting in higher rental rates, and thus higher production costs, than exist in Canada.

There is at least one area where the United States has a comparative advantage in wheat: elevation and storage efficiency (Wilson and Johnson). Most U.S. grain destined for export is handled by high volume elevators that load out unit trains. Interestingly, a network of these elevators has been located along the Canadian border through the states of North Dakota and Montana.

It is yet unclear how the comparative efficiency of U.S. and Canadian transportation systems going west and south will shake out. With a modernized lock and dam system, the Mississippi River has the potential for being attractive for Canadian movements of grain south. The efficiency of U.S. rail movement of grain to the western ports is not being realized due to a lack of competition. However, U.S. access to the Canadian rail system could increase the level of competition.

Potential Restructuring. Both Canadian and U.S. policies are well on their way toward being restructured. With the elimination of the western grain transportation subsidy in Canada and reduced U.S. farm program subsidies, including export subsidies, the only remaining significant intervention in wheat and barley is the Canadian Wheat Board.

If it is to be competitive, substantial restructuring will occur of the Canadian grain handling system. Some of that already is occurring as new high turnover elevators are being built. Linkage will develop rapidly between the U.S. and Canadian grain transportation systems through increased movement of grain across the border by truck.

U.S. farm subsidies have maintained a significant moderate-size farm segment. In the absence of subsidies, the existence of substantial economies of size will result in rapid consolidation of this segment of the industry. In other words, substantial quantities of land could come up for sale or rent in the next few years. Spillovers will develop in the market for new and used farm equipment.

Dairy

Behind wheat, dairy looms as a major U.S.-Canadian trade dispute area. In this case, Canadian adjustments are likely to be far greater than for the United States. However, both industries will undergo substantial structural change in the next two decades.

Canada. Milk supplies in Canada are tightly managed. Canadian prices are 20% to 50% higher than in the United States. As a result, barriers to trade are extensive – even provincial trade is impeded by regulation. Exports occur almost entirely because of subsidies.

Canadian supply management programs have fostered high asset values. Higher producer profits have been capitalized into the value of a relatively freely traded marketing quota. Quota values often are the largest single asset on a Canadian dairy farm's balance sheet. As a result of this protection, including the barriers to entry imposed by the rationing of quotas, Canadian dairy farms are considerably smaller than their U.S. counterparts. Therefore, the comparative advantage of Canadian dairy farms is limited largely to their geographic access to markets. However, since much of the Canadian population is located near the U.S. border, this advantage can easily be over-estimated.

United States. A dismantling of U.S. dairy programs has begun. Absent supply controls, U.S. and Canadian dairy policy have much in common. U.S. butter, nonfat dry milk (NDM) and cheese prices have been maintained above world market levels, although without supply controls, competitive supply response develops if greater than normal profits exist.

Proposals have been made for the 1995 Farm Bill to dismantle the support price system for butter and NDM, but to keep it for cheese. Milk marketing orders, which set prices on the basis of use, appear likely to survive a serious political attack. But, most experts feel that major changes will be made.

With the elimination of price supports on butter and NDM, the U.S. dairy industry is beginning to talk about unsubsidized exports. Freer trade in dairy will be high on the U.S. foreign trade policy agenda over the next decade or two. Thus, there will be increased pressure on Canada to modify its production controls and lower price supports.

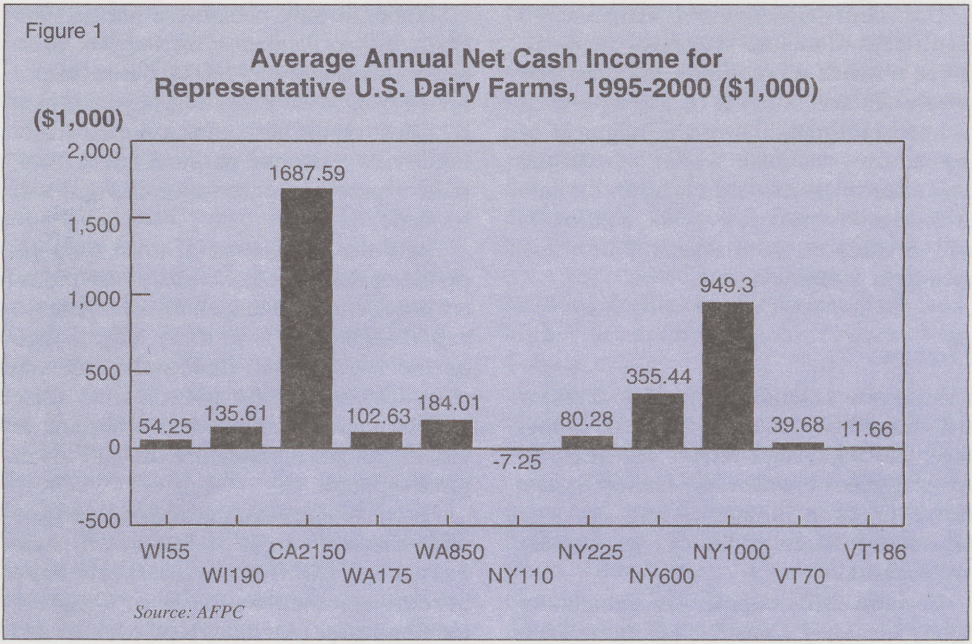
Unconstrained farm growth has led to a wide disparity in U.S. dairy farm size. Farms of 1,000 cows or more have become common on the West Coast, in the Southwest (Arizona, New Mexico and Texas), and in Florida. But, pockets of large-scale dairying are springing up in some of the traditional milk production areas such as western New York, Idaho, and in eastern South Dakota. It has been speculated that the efficient U.S. dairy farm of the future will have at least 500 cows (Outlaw, et al.). Figures 1 and 2 tell a lot about why structural change is occurring in the U.S. dairy industry. Assuming no change in U.S. policy, dairies of 1,000 cows or more have substantial net cash income and achieve a relatively high return on equity. This gives them the incentive and ability to expand. However, as large dairies expand, they crowd out smaller farms.

Geographic shifts in milk production have accompanied the development of large-scale dairies. California overtook Wisconsin as the largest milk-producing state in 1993. New Mexico, Texas and Idaho have steadily climbed in rank while Vermont, Minnesota and Ohio declined.

Potential Restructuring. Structural change is accelerating into traditional production areas of the U.S. dairy industry. Deregulation will put greater financial pressure on moderate size farms.

In Canada, these pressures are bottled up by supply management programs.

Figure 1



Source: AFPC

When these programs come off, there will be phenomenal structural adjustment. The elimination of quota asset values will magnify the rate of change. Many leveraged Canadian farmers who felt that their balance sheet was in fairly good shape will suddenly find their equity base has materially eroded.

The absence of provincial barriers to trade could also result in regional shifts in production. It has been argued, for example, that because of fewer environmental constraints, U.S. milk production could be expected to move to lower rainfall areas of the Great Plains. Could Alberta become a major industrial/manufacturing milk producing area for Canada?

What dairy product trade flows would occur between the United States and Canada if free trade suddenly developed with no subsidies in either country? There are those who believe the United States would export to Canada and vice versa. The results of one study suggest that milk would move from Quebec and Ontario into the northeast United States while the Prairie Provinces would import manufactured products from Minnesota and Wisconsin (Doyon, Pratt and Novakovic). Another plausible perspective is that, while initially the United States would be a substantial exporter to Canada, after structural adjustment, dairy trade will materially diminish with Canada becoming relatively self-sufficient. The reality is that free trade is so foreign to the Canadian and U.S. dairy industries that research models are not very helpful.

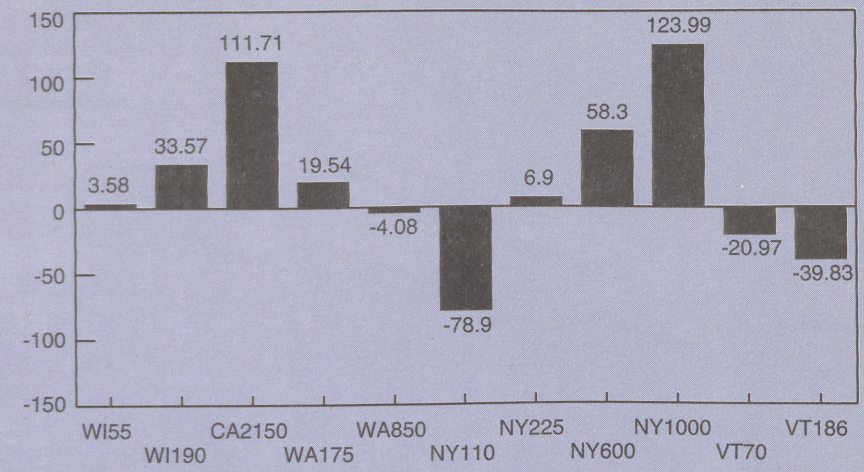
Poultry

For Canada, many of the same issues exist in poultry as in dairy. Differences exist because of vertical integration and the fact that the U.S. poultry industry has been operating in a relatively free market.

Canada. Supply management has not deterred the development of an integrated Canadian poultry industry. However, there is greater diversity in the Canadian industry, apparently due to the higher price umbrella maintained by supply management programs. It also is apparent that the roughly 40% Canadian price premium has been a deterrent to broiler consumption (Figure 3). Figure 3 also suggests that the deficiency of Canadian consumption is widening. The main comparative advantage of the Canadian industry appears to lie in its access to local markets.

Figure 2

Average Change in Real Net Worth, 1995-2000 (Percent)



Source: AFPC

United States. Unconstrained by supply management programs, the U.S. poultry industry has adjusted rapidly to economic forces. The past two decades have been characterized by consolidation into larger integrated entities. While once a dumping ground for excess production, the export market is now being aggressively pursued. Production for exports has become a planned activity. There are increasing indications that the U.S. broiler industry has become sufficiently industrialized that short-run variations in feed prices can be absorbed into the larger margins obtained from high-value-added products. In a sense, this is an industry that has become mature in the sense that it is able to manage its production to control its prices.

Potential Restructuring. While growth in U.S. per capita broiler and turkey consumption continues to be projected, expanded export markets are a major new market outlet. The disintegration of Canadian supply controls will foster considerable interest in these markets as an outlet for value-added broiler and turkey products. Yet, the major U.S. broiler production areas are not as well positioned to serve the Canadian markets as is the U.S. dairy industry. Even so, one can anticipate substantial restructuring and consolidation of the Canadian broiler industry. The magnitude of adjustment depends heavily on what happens to imports.

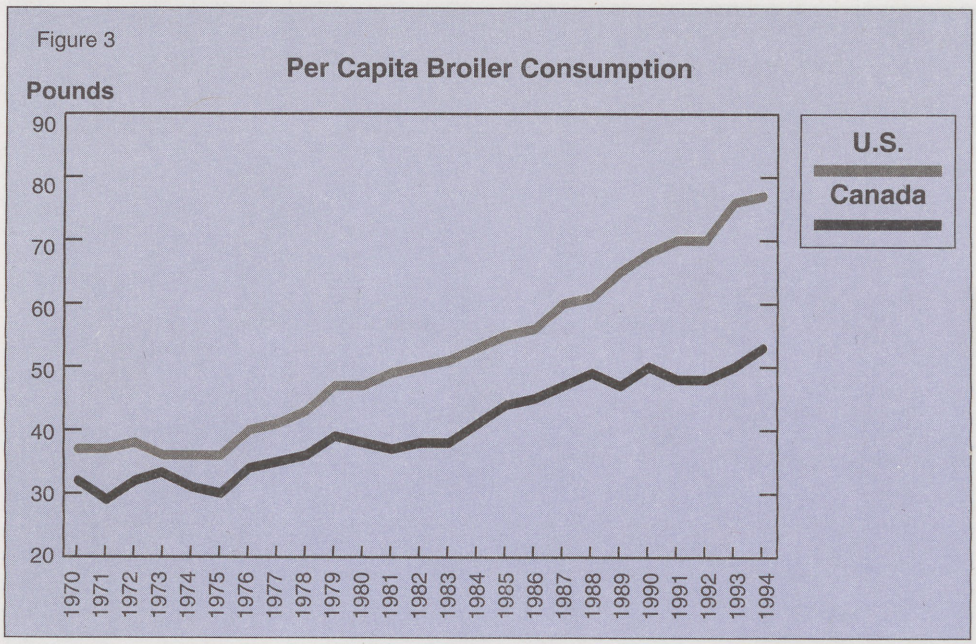
Concluding Remarks

Free trade between the United States and Canada will require adjustment and accommodation on both sides of the border. Certain segments of Canadian agriculture, such as poultry and dairy, have been more highly protected than their U.S. counterparts.

An important factor influencing trading relationships is the comparative value of the U.S.and Canadian dollar. Devaluation of the Canadian dollar has favored wheat exports to the United States. This reduces the magnitude of adjustment required in the event of deregulation of the Canadian dairy and poultry industries.

It is critically important that both farmers and lending institutions build into their strategic plans the implications of NAFTA and GATT for the value of their assets. Alignment of Canadian and U.S. agricultural policies will tend to reduce the value of wheat and barley land in the United

Figure 3



States while increasing Canadian values. Substantial erosion of dairy and poultry asset values will occur in Canada as supply management programs are adjusted to free market conditions. Likewise, agribusiness firms need to assess their competitive position in a freer market setting where direct competitive relationships with U.S. and Mexican agribusiness firms exists.

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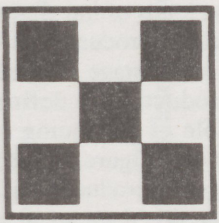

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