FROM DEFENCE TO OFFENCE – POSITIONING CANADA'S DAIRY SECTOR & THE BROADER IMPLICATIONS FOR OUR GLOBAL TRADE STRATEGY

A COMMENTARY BY CAPI[1]

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Supply management polarizes opinions: defend the status quo or dismantle the system. Unfortunately, this masks important strategic choices with implications for the dairy industry and, by extension, Canada's agri-food sector as a whole.

Canada's internal debate keeps the country on a defensive footing. It is time to get offensive by focusing on other countries' agricultural subsidies – that are to date, largely out-of-sight, out-of-mind and entirely detrimental to our long-term competitiveness.

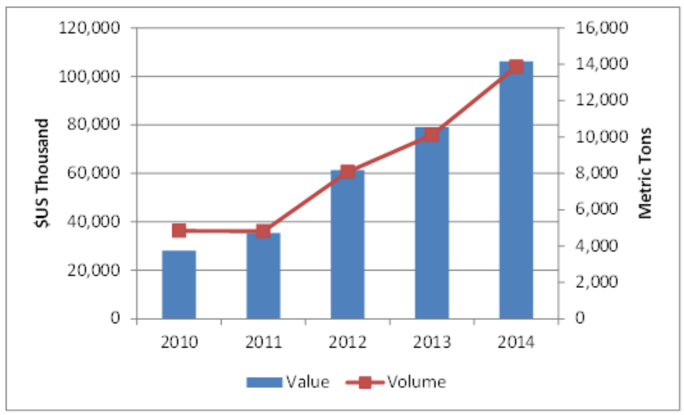
All eyes are now focused on the timelines to conclude the Trans-Pacific Partnership (TPP). But, we need to look at the long game and the evolution of Canada's trade agenda. Global subsidy practices affect beef, pork and many other Canadian sectors. Still, we need to start with dairy.

WHITHER CANADIAN DAIRY?

Canada's dairy sector is being seriously squeezed and faces a growing trade deficit. We're importing large volumes of various milk proteins[2] (known as concentrates and isolates) and our dairy exports are restricted. This is hardly a growth formula for one of Canada's largest agri-food sectors[3] but more importantly is a significant threat to the current system.

Imports from the U.S. of such proteins are up some 300% since 2010 (see chart). This import pressure is likely to continue once the Canada-EU trade deal (CETA) comes into force and possibly also under the TPP.

This trend prompts the commentators from Agri-Food Economic Systems to state: "in the face of growing imports, increasing exports will be necessary in order to avoid shrinkage in the Canadian dairy industry."



Canadian imports of milk protein substances from the U.S. (HS 3504; USDA-FAS GATS)
Chart: Agri-Food Economic Systems

Dairy proteins are important to food processors in order to develop innovative and healthy products, such as yogurts and high-protein beverages – and consumers are lapping up these new products (here and abroad).

Canada's supply management system keeps the price of milk products above "the world price". This makes lower cost imports very attractive to food processors. Lower-priced and uncontrolled imports

[1] This essay draws on a longer paper published by Agri-Food Economic Systems, with the permission of the authors, entitled "Canadian Dairy Exports: The Knowns, Unknowns, and Uncertainties", by Kamal Karunagoda, Douglas Hedley and Al Mussell: http://www.agrifoodecon.ca.

[2] Milk protein isolates are composed of over 85% milk proteins; concentrates have lower levels of milk proteins.

[3] In terms of net farm receipts, the dairy sector is the second largest agri-food segment after meat, at $5.9 billion (2012, AAFC).

of protein concentrates and isolates displace demand for Canada's skim milk powder which results in growing surpluses domestically, some of which are diverted into lower value animal feed – at significant cost to Canadian producers.

Simply labeling supply management as unfairly "protectionist" (and thus deserving dismantling) misses a critical point. Canada can't unilaterally expand its dairy exports. While the Canadian dairy sector's primary concern is to replace these imports, proponents of change largely ignore how we can actually export more dairy products, even if that is desired within the sector.

Under Canada's free trade agreement with the U.S., milk protein concentrates and isolate imports are allowed into Canada "tariff-free" (and it's reciprocal). The problem is that Canada's export potential is restricted based on Canada's 1995 World Trade Organization (WTO) commitment. The export limits were confirmed in the results of the challenge by New Zealand and the U.S., on butter, skim milk powder, cheese, and other products.

Technically-speaking, Canada can export milk products under supply management provided that there is no subsidy on dairy product exports. However, the current structure of our production and pricing arrangements was found to create an export subsidy on dairy products. Canada can only export dairy products up to the limits allowed for in Canada's WTO commitments.

While we debate the need for reform within our dairy sector, our competitors' tactics are designed to keep us on our heels by critiquing the milk supply management system. This is distracting us from assessing just what it would take to export. Time is conspiring against us. Taking the offensive requires a longer time frame to bear fruit. Yet, the domestic system faces immediate pressures. CETA imports will likely begin in 2016, and increase for the following 4-5 years. Larger results of the TPP could begin a few years after that. Domestically, the need to confront change is pressing and real.

Meanwhile, our competitors produce and export milk products by utilizing a complex array of direct and indirect subsidies. We argue that the so-called world price for milk is, therefore, not a true reflection of the real cost of producing these products – and our competitors are taking full advantage of it.

Yet, within Canada, we debate supply management without this larger context in mind. Nor are we fully considering how expansion in export access would actually occur.

THE BIGGER PICTURE

The foreign subsidy issue is immediately relevant to the dairy issue. But, we need to bring to light the destructive effect of agricultural subsidies particularly in the U.S. and Europe as a whole.

Legitimate support is given to agriculture here and abroad for good reason, such as to compensate for crop failures and for research. However, wide-spread use of subsidies in certain countries creates unfair competition. These agricultural subsidies drive down prices. The CEO of a global seed company, Limagrain's Daniel Chéron, noted: "The U.S. Government funds the gap between market prices and objective prices, which includes production costs."[4] In part, this enables American agriculture to achieve scale. Food processors avail themselves of these lower-cost ingredients, helping them to export so successfully. Yet, we sit on the other side of the border and wonder how we can compete against this.

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[4] "Europe will become vulnerable", by Daniel Chéron, Chief Executive Officer, Limagrain; an interview by Dominique Diogon for Momagri provided to La Montagne, April 13, 2015.

Subsidies can encourage deleterious behavior. Dairy production in the American southwest is successful in part because it draws down on the region's aquifers – a "natural capital" benefit that is not factored into the price.

Such practices create a hidden market failure and it's a global phenomenon. They can encourage (at little cost) a broad array of environmental impacts from polluting surface and groundwater, such as what has befallen many European Union (EU) rivers[5], to degrading soils and putting biodiversity at risk. Just recently, an Irish professor of European agricultural policy declared that Ireland's beef farms "are not financially viable without EU subsidies"; Trinity College's Alan Matthews goes on to state that the added costs of greenhouse gases generated from these ventures makes beef farming even more uneconomic.[6]

For its part, Canada's dairy supply management has not created significant surpluses at the expense of eco-systems. Our country's wealth of water and land confers certain comparative advantages (if we manage them correctly). The other issue is about understanding how international subsidies constantly place Canada's agri-food sector at a disadvantage.

SHIFTING FROM DEFENCE TO OFFENCE

We need to consider the merits of opening up a new front – on environmental and resource sustainability – as a basis to help take the offensive. Extended drought is reshaping the U.S. and Australian dairy industries. Soil quality and availability for expansion of the dairy industry in New Zealand may limit future growth there. Canada's water and soil resources are not facing similar pressures, although there are some pressures in certain regions of ours.

Improving sustainable production is not going unnoticed. Global supply chains are now procuring many products, such as palm oil, fish and coffee, only from sustainable sources. But, is there a role for Canada's agri-food sector as a whole to better leverage the sustainability card?

Becoming a global advocate for the elimination of foreign government-subsidized agricultural practices (including their environmental impacts), may be in our national interest. This would be a big step beyond driving down tariffs or increasing market access. But doing away with subsidized production and raising the environmental bar even slightly for our competitors would be a calculated strategic move. Ultimately, it may eliminate some highly inefficient competitors and those requiring massive investment to meet even the most minimal sustainable requirement. However, prices would better reflect real costs which would bode well for our agri-food trade.

Taking a proactive stance on sustainability requires, in part, putting more sophisticated information systems in place to track and trace the origin of food and the impacts of its production steps. While Canada is a food safety leader, its performance on *farm to fork* traceability is uneven. We would need to be a leader in traceability to demonstrate our sustainability footprint on a comparative basis.

With much of the trade access groundwork having been laid, our next trade agenda could assume a three-pronged approach. Unravelling these indirect subsidies and demonstrating Canada's comparative advantages on sustainability performance could become key planks in our future global trade strategy, benefitting the agri-food sector as a

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[5] The OECD has documented where pesticide concentrations in surface water and groundwater exceed recommended national drinking water limits, which is higher in the EU, among other countries, than in Canada in *Compendium of Agri-Environmental Indicators*, figure 9.9, 2013.

[6] "Ireland would profit from opting out of beef, says expert", by Eoin Burke-Kennedy, The Irish Times, June 5, 2015.

whole.[7] And, with the clock ticking for our dairy sector in mind, taking concerted action on dairy export rules may allow Canada to be more competitive on dairy than is commonly appreciated.

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[7] CAPI is going to be considering Canada's strategic options and what can enable change at a major event on November 3-4, 2015, in Ottawa, *The Forum for Canada's Agri-Food Future*.