

MAP

Monitoring Agri-trade Policy



European Commission

Directorate-General for Agriculture and Rural Development

Does the “Trade Talk” match the “Trade Walk”?

Exploding the myths surrounding world trade

CONTENTS

Editorial

Diverging themes of the “trade talk”
Diverging analytical choices
 Misusing the PSE
 Misrepresenting tariff structure
Realities of the “trade walk”:
 What matters to the EU?
 What matters to the US?
 What matters to Brazil?
Conclusions

Tables

Table 1: Causes of trade distortion
Table 2: Contributions of various players

Graphs

Graph 1: EU beef reform and the PSE
Graph 2: EU beef trade and the PSE
Graph 3: Low quality beef tariff structure
Graph 4: High quality beef tariff structure
Graph 5: Structure of agricultural trade
 in EU, Brazil & US
Graph 6: Share of US crops exported
Graph 7: Value of main US crop exports

Annex:

Trade Background
EU-25 Australia
US New Zealand
Canada China
Brazil Japan
Argentina India

The current debate on the potential impact of agricultural trade liberalisation in the context of the Doha Development Agenda (DDA) often appears polarised around two competing approaches.

The US and other main exporters tend to attribute the potential benefits from trade liberalisation almost exclusively to increased market access via tariff cuts and tariff quotas, often downplaying the role of domestic reform on trade.

Others argue that the debate should be exclusively about subsidies. Sometimes this is simply a defensive argument used to justify high tariffs. But it is also used as an argument against any type of policy supporting agriculture in the developed world.

The argument for a more balanced approach, which has to be the basis of any successful negotiation, is often caught in the cross-fire of the partial, yet powerful, “trade talk” of some of the major players. And what is lost in the process is the understanding that the benefits from agricultural trade liberalisation will come from the cumulative effect of cuts in all three pillars of agricultural support (domestic support, export subsidies and tariff protection).

The aim of this MAP is to look at the gap between the rhetoric and the reality, to see whether the “trade talk” matches the facts – the “trade walk”.

Building upon analysis presented in previous issues of MAP, which looked at the evolution and composition of trade for the main players, in this issue we summarise the usual arguments of the “trade talk” and try to get to the bottom of some misunderstandings about the impact of policies on trade.

We look at the trade structure of some key players and its relevance for their negotiating position within the WTO. Finally we try to draw some conclusions about the relevance of all this for the assessment of the EU offer in DDA.



Diverging themes of the “Trade Talk”

That the level of ambition of the various negotiating positions in the DDA is often disputed, is hardly surprising. Ambition is, after all, in the eye of the beholder. During any negotiation there will be times when the different players seem to be drifting apart. What is surprising, however, is the lack of an objective basis to judge the various positions. And what is available often creates more confusion than clarity, especially with respect to the relative contribution of each of the three pillars within the agricultural negotiations (market access, domestic support and export competition).

Take for example studies by the Organisation of Economic Cooperation and Development (OECD 2006), the World Bank (WB 2005) and the US Department of Agriculture (USDA 2001). Although these studies have thrown up widely differing results, one number derived from the World Bank study has dominated the debate.

This study concluded that the lion’s share (93%) of the welfare benefits from trade liberalisation comes from more market access, and seems to be supported by a more recent OECD study, that arrives at a corresponding figure of 79% for market access.

An earlier analysis by USDA¹ comes up with more balanced conclusions on the contribution of each pillar, with over half of the price increase coming from market access and one third from domestic support.

Studies show different causes of trade distortion...

	WB	OECD	USDA
Market access	93%	79%	54%
Domestic support	5%	19%	32%
Export subsidies	2%	2%	14%

Source: WB, OECD, ERS/USDA.

The relative contribution of the various players of course differs, with the EU expected to contribute 38%

¹ refers to impact on prices

of the overall benefits stemming from changes in its trade-distorting policies, while the US contribution is put at 16%.

...and different contributions of EU and US

	EU	US
Market access	34%	44%
Domestic support	45%	50%
Export subsidies	21%	6%

Source: ERS/USDA

It is often argued that the difference in the results of these studies is due to their timing, and that the more recent ones are more representative. This argument is, however, false. Despite being published at different times, these studies essentially cover the same data and time period, based on bound levels of support in 2001, and are therefore comparable, as they all exclude two major developments in agriculture policy i.e. the EU 2003 CAP reform and the US 2002 Farm Bill.

The essential difference between the results of the studies, lies in the manner in which they represent (or rather, fail to represent) actual policies. USDA’s results are more balanced, not because the study was published in 2001, before the DDA negotiations began, but because of the more detailed policy representation in their analytical approach.

Diverging analytical choices

One common theme of both the World Bank and OECD studies, is the manner in which they ignore the impact of changes in domestic support on world markets. Both studies are based on General Equilibrium models, which do not assess the impact of liberalisation for individual commodities. These models share a common feature. Starting from a correct assumption (namely that high domestic support prices imply high tariff protection and the use of export subsidies) these models then impose this assumption



on their results. The outcome is a misrepresentation of the reality of the agricultural policy reform process, since these models suggest that a drop in price support will only have an impact if accompanied by tariff cuts.

In fact, CAP reform demonstrates the opposite. Here we take the case of EU beef, to illustrate the impact that different analytical choices have on results. Since, strangely enough, the beef sector has turned into the litmus test for judging the ambition of the DDA (!), some clarifications as to why results differ so much in this sector, may shed light on what could also happen in other sectors.

In fact, understanding the problem does not require a knowledge of the technicalities of the various models, just a closer look at two issues which have been the cause of a great deal of confusion. The first is the use or rather "misuse" of the OECD's Producer Support Estimate (PSE), as a proxy to measure trade distortions. The second is the tariff structure, whose accurate representation is the essence of market access analysis.

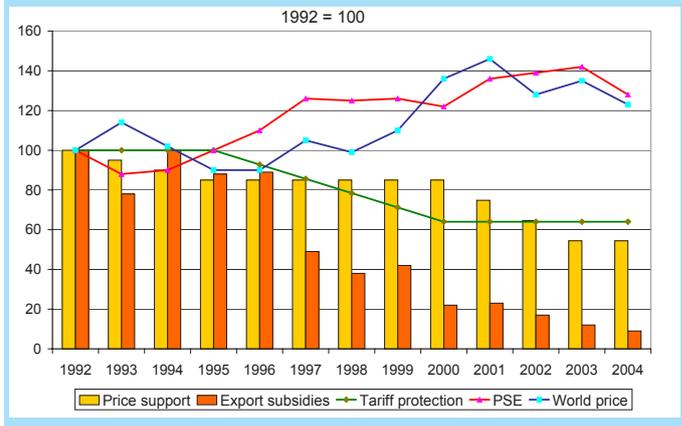
Misusing the PSE

The OECD defines PSE as a measure of the monetary transfer from consumers and taxpayers to producers, provided by agricultural policies and states that "it is incorrect to interpret the PSE as an indicator of protection or trade impact".

An example of how misusing the PSE can easily mislead, is shown by examining EU beef policy reform. Graph 1 depicts the evolution of EU policy instruments (support price, tariff, export subsidies), world prices and the PSE since 1992. To allow comparison, all variables are converted to an index with a value of 100 in 1992. The graph clearly shows that trade distorting support in the EU has fallen dramatically over the period from 1992 to 2004, with every single measure of trade distortion having decreased. Price support has more than halved, border protection has fallen by more than one third and export subsidies have nearly disappeared. If the PSE had anything to do with trade

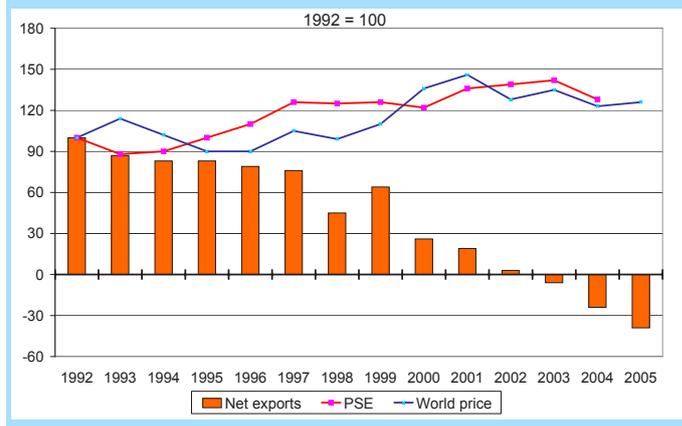
distortions, it should be moving downwards, not upwards as it does in the graph below. And whatever the reasons are for its parallel move with the world price (some of them methodological complexities known only to experts); the PSE should not be used to represent domestic support in models trying to capture the impact of reform on trade liberalisation.

Graph 1: EU beef reform and the PSE



Why this is so becomes more evident from graph 2, which depicts the PSE, the world price and EU net trade (also in index form).

Graph 2: EU beef trade and the PSE





When the largest net exporter turns into one of the top net importers, we can expect a corresponding upward trend in world prices.

Yet the above scenario is not captured in general equilibrium models, such as those used by the World Bank or the OECD, which either incorrectly use the PSE as the domestic support policy instrument, or assume that only tariff cuts will increase trade (while the EU reform process since 2000 demonstrates that this can happen even without tariff cuts). No wonder that domestic reform has no impact on such models, because they are using the wrong policy instrument to look for it. The graphs above clearly show the divergence between the rhetoric and reality.

As EU trade distorting support in beef has declined, the EU has withdrawn from the export market and world prices have risen. The reality is that exporters already have access to the EU beef market (both under large import quotas and at full duty), with the EU25 becoming a net importer of beef (with around 300,000 tonnes) in 2005.

Misrepresenting tariff structure

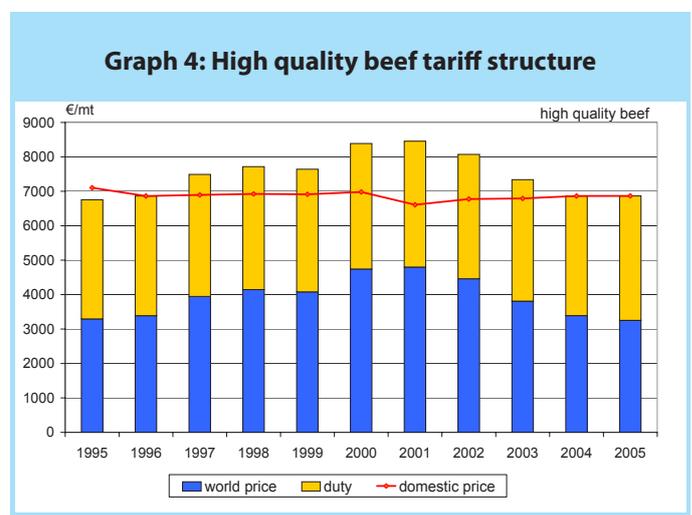
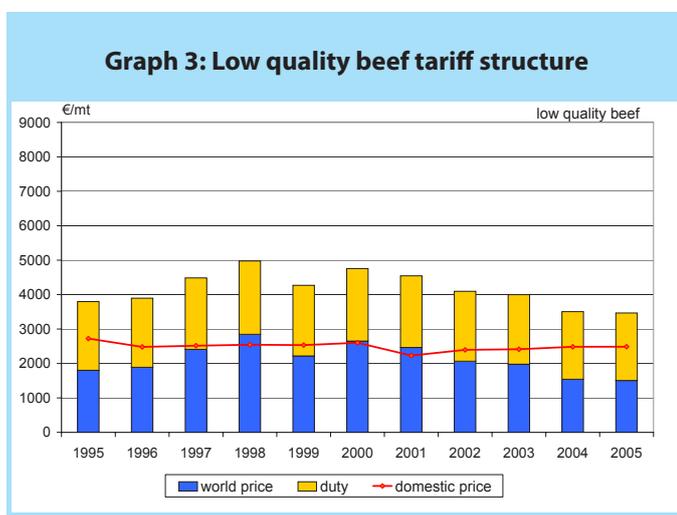
But in order to capture the impact of trade liberalisation on market access, one has to start from the tariff structure of the sector being analysed. Although this is an admittedly complex task, it is also essential for any accurate analysis. Yet the error that many trade models make is to focus on products as if they are homogenous, ignoring the effect that this approach has on their results. This is demonstrated once more using the example of EU beef. Graphs 3 and 4 below indicate how the tariff structure differs between different segments of the EU beef market.

Graph 3 represents the lower quality part of the EU beef market (beef carcasses), and shows the level of world prices, domestic prices, and tariffs. Based on this graph, it is evident that tariffs in this segment of the market do have an impact, as they keep the import price well above the domestic price, effectively preventing any trade.

Trade Models and EU Beef Tariff Structure

While models focus on frozen carcasses ...

...trade is in boneless cuts





In almost all models (with one notable exception being the OECD's partial equilibrium model, which the Commission has adapted for trade analysis), this segment of the market is used to represent the EU beef sector as a whole, and it is argued that only big tariff cuts will generate market access in the EU.

But as indicated above, the EU is a net importer of beef already. And this includes beef of high quality (boneless cuts), which comes in at a much higher price even when tariffs are higher, as indicated in graph 4. (The same applies to many other high value products, which are often treated as commodities.)

Therefore, to extrapolate from an analysis based on one segment of the EU market, that tariff cuts would have no impact on the entire EU beef market, is simply wrong. It ignores the reality that the trade flows are in the high quality beef market, with the EU increasingly a net importer of boneless beef cuts. Although tariffs are higher, they do not succeed in keeping imports out because the domestic price is around the same level as the import price with the full tariff applied. In fact, more than half a million tonnes of beef imports found their way onto the EU market in 2005, including some 300,000 tonnes which entered at full duty (of which roughly half is high quality cuts and half is processed beef).

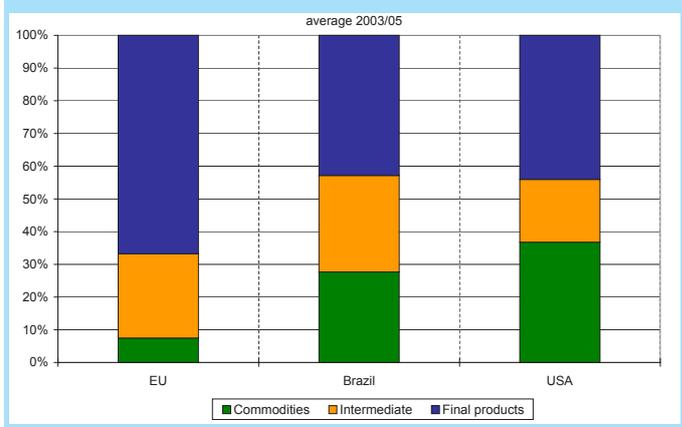
In sectors such as beef or poultry, where the EU already imports significant quantities at full duties, any further tariff cuts will generate additional imports, because lower tariffs imply lower import prices. That EU analysis results in significant market access, even with reduced tariff cuts, should not therefore be surprising, or suspect. Any objective look at the facts and realities of the EU market would come to the same conclusion, provided it reflects these realities. And for the reasons explained above, this has not been the case in both studies that made the headlines. No wonder they found very few benefits from domestic support, and benefits from market access only stemming from much higher cuts than those in the EU offer. They may have asked the right question (where is the beef?), but looked for it in the wrong place!

Realities of the Trade Walk

The inconsistencies of the trade talk cannot be blamed entirely on economic models. After all, major players have the analytical capacity to draw the line between slogans and reality (if not in public, at least behind the scenes). But the rhetoric is also fuelled by the way negotiations sometimes focus on exceptions, rather than what is generally happening in world trade – the actual “trade walk”. In this section, we will try to demonstrate how the debate is often dominated by a one-sided focus on market access.

Two previous editions of MAP (June and July 2006) focused on developments characterising the agricultural trade of major WTO players. This analysis demonstrated the significant changes in world agricultural trade since the signing of the Uruguay Agreement on Agriculture and identified the difference in the structure of trade among the various players. And as graph 5 demonstrates, when it comes to exports, there are big differences in the trade structure of the three largest agricultural exporters, the EU, the US and Brazil.

Graph 5: Structure of agriculture trade in EU, Brazil & US





But this difference in trade structure is not just a reflection of trends, or different comparative advantages, but also of the manner in which domestic policies have been reformed, as well as the extent of reform. The positions on market access taken by various players in this round should not be judged in isolation, but against the background of changes in their respective agricultural policies as a whole. The following examples will try to demonstrate how this may apply to the EU, Brazil and the US.

What matters to the EU?

If the share of commodities in EU agricultural exports has dropped to just 8% of their total value, it is because a process of gradual but continuous reform (along the lines described in the previous section) has resulted in less exportable surpluses of EU commodities and an increase in exports of high value products. Thus the insistence of the EU to get recognition of this reform process in the overall balance of negotiations, from the domestic support pillar to recognition of the specific consumer-oriented attributes of its products (Geographical Indications).

But the same development explains the EU's insistence that it is not only its own trade distorting subsidies that need to be disciplined, but those of others, even if they are different in nature. EU export subsidies and the potential impact of their abolition has been analysed exhaustively, especially where it is expected to have the strongest positive impact on world markets - in cereals and in dairy products. But a closer examination of developments in these markets over the period EU policies were reformed, points to the need to discipline other forms of export support, less transparent and direct but nonetheless trade-distorting.

In wheat markets, for example, two entities with exclusive export monopoly rights granted by the governments of Canada and Australia, together still represent one-third of world wheat trade. In butter, which today has the highest share of subsidised exports in the EU, more than 50% of world trade comes from New Zealand, where just

one private company has the export monopoly rights (via TRQs) in markets around the world.

But the most important element in the EU position is the recognition that the impact of reform is cumulative. Changes in domestic support, in export competition and in market access, when all going in the same direction (as is the case with the process of EU reform and the EU offer), together amplify the positive impact on world market prices, in a manner that is measurable, provided that the analysis accurately reflects this process.

What matters to Brazil?

If Brazil, despite being a major exporter, puts more emphasis on cutting subsidies than on market access in this round, it is partly because of the different interests reflected in the G20. Clearly the composition of the G20, where a major player like India has defensive interests in market access (and a significant gap between its bound and applied duties), plays a role. But the uncertainties surrounding the future path of its growth in agricultural exports (see MAP No2-2006) also make it imperative for Brazil that world prices are not depressed by the trade-distorting subsidies of the developed world players, and especially by US commodity programmes, which are as yet unreformed. Brazil also supports agriculture, mainly via preferential credit schemes (valued at US\$ 30 billion).

Brazil also has, of course, major interests in market access. But these interests are influenced by the destination of its exports, with the EU being the top market for some of the most important commodities. For the 2003-05 period, the EU accounted for 37% of Brazilian exports, while Russia was second with 16%. In fact, in two of the products where Brazil has grown to be the top world exporter, beef and poultry, its exports are largely shut out from developed countries except the EU. The result is that 38% of Brazilian beef and 23% of Brazilian poultry are exported to the EU, accounting for 50% and 75% of EU imports respectively.

This is why for Brazil, the level of TRQ expansion for

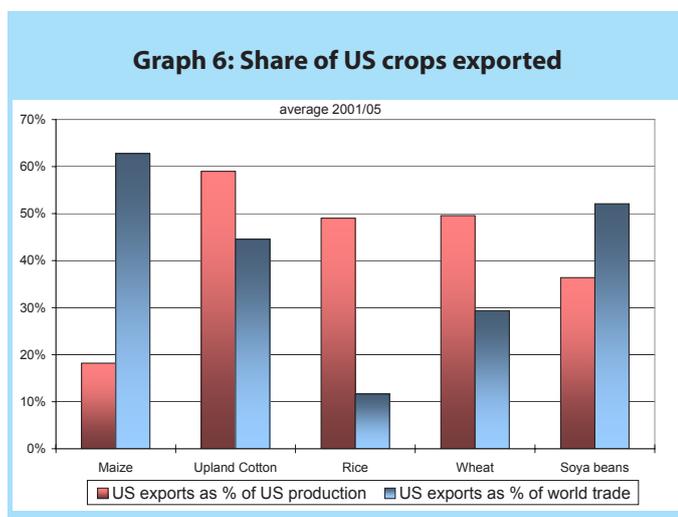


sensitive products is less important, in relative terms, than for other exporters. As long as the exchange rate stays within the range of recent years (a big “if” given recent developments), more market access for Brazil is linked to the combined effect of lower trade distortions from developed exporters in world markets (whether EU export subsidies or US commodity support) and more direct competition with other exporters within a range of tariff cuts, as long as they are effective.

What matters to the US?

For products in which the US is considered to have an offensive interest, it is competing with other major exporters in essentially the same markets. Yet its market access opportunities are more limited than that of other exporters, because the US still relies on exporting bulk commodities – for almost 40% of the value of its exports (see graph 5).

It is no coincidence that the top five US commodity exports correspond to the five programme crops that get 93% of commodity subsidies, suggesting a link between US domestic support and export competitiveness. The dependence of these crops on exports is demonstrated in graph 6 below.

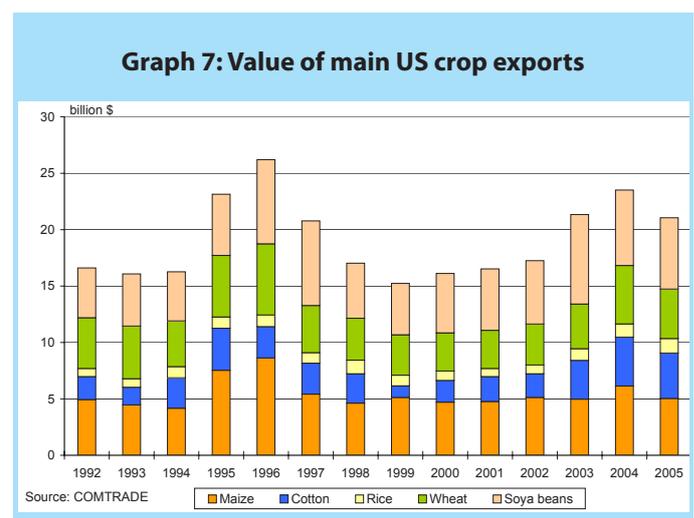


In the past three years, nearly 60% of cotton, half the wheat and rice crops and over one third of

soybean production were exported. And although the share of corn exported was less than 20%, up until recently (before the present ethanol boom) it represented more than two thirds of world exports. Indeed the US is the world's number one exporter of these commodities except for rice.

The export value of these commodities has fluctuated greatly over the past decade as they are heavily affected by the great volatility in world market prices. Graph 7 below demonstrates that from 1992-2004, the export value of the top 5 US crops fluctuated between \$26 bn in 1996, when commodity prices peaked, and \$15 bn in 1999, when commodity prices reached their lowest level during this period.

This dependence on exports and fluctuating world market prices, directly affects the level of commodity subsidies (see MAP No1-2005), but shields US farmers from what happens on the world market, in which they play such a big role.



One consequence of the export dependency of the US programme crops is that the top export markets for the US already include many countries that the US is targeting for greater market access.



This includes China, which has relatively low tariffs, but also Japan with high tariffs, and India, where exporters have limited market access for the size of the country (and where the US also faces the stiffest opposition to its commodity subsidies). In fact as annex graph 4 demonstrates, China is the **biggest market for US soybeans and cotton**, while Japan is the biggest market for maize and wheat.

With this US dependence on commodities, the perceived “exchange rate” that US farm lobbies have developed between domestic policy reform and market access (according to which “1 dollar less in domestic support should equal 1 dollar more in market access”) is problematic from the start. Their aim is to balance the expected “loss” of a potential reform of their domestic

policies with expected gains for US exports.

But the drop in US trade-distorting support is not necessarily linked to a drop in income since other less trade-distorting means of support are available. And the expected gains in market access cannot be viewed in isolation from potential gains of other exporters – because such gains in a WTO context apply equally to all.

It is in fact the present structure of domestic support that is forcing US producers to compete in bulk commodities with the direct (for crops) or indirect (for meats) benefit of subsidies, at the expense of the long term competitiveness of the US farm sector. Hence the paradox of the need to inflate market access demands in order to accommodate unavoidable domestic reform.

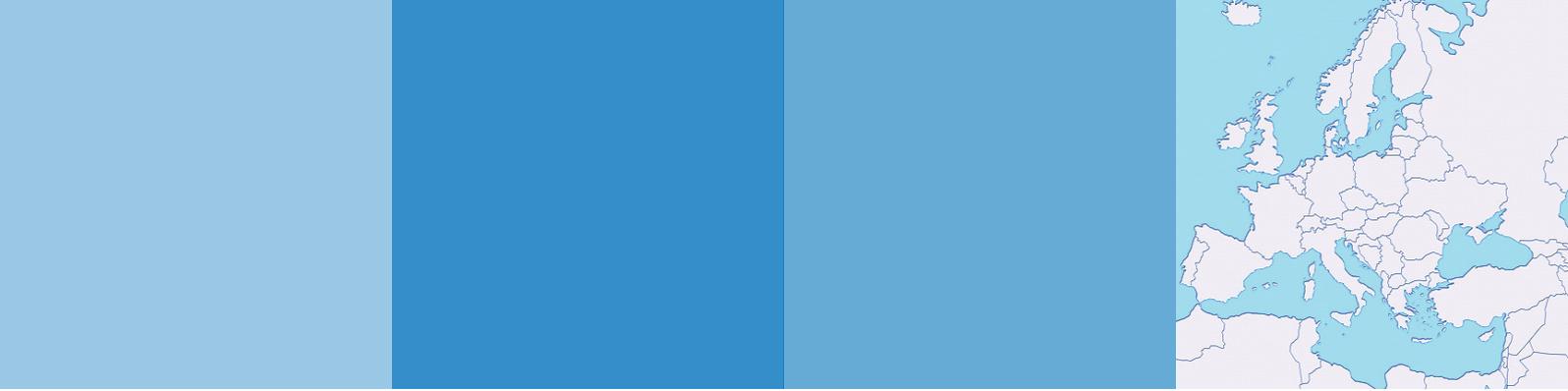
Conclusions

Bridging the existing gap between the “trade talk” and the “trade walk” is essential in order to reach an agreement in the context of DDA. How close such an agreement would be to the former or the latter is for negotiators to determine. The aim of this MAP was to try to shed some light on those factors which cloud the debate and to allow a more objective assessment of this gap. And from this examination, three conclusions seem to be pertinent.

The first conclusion may seem self-evident. Both tariffs and trade distorting subsidies matter - both create trade distortions and both have to be disciplined. Less obvious, however, is the cumulative effect generated by imposing disciplines in these two areas, and especially the impact of domestic reform on trade, which may be positive, even in the absence of tariff cuts.

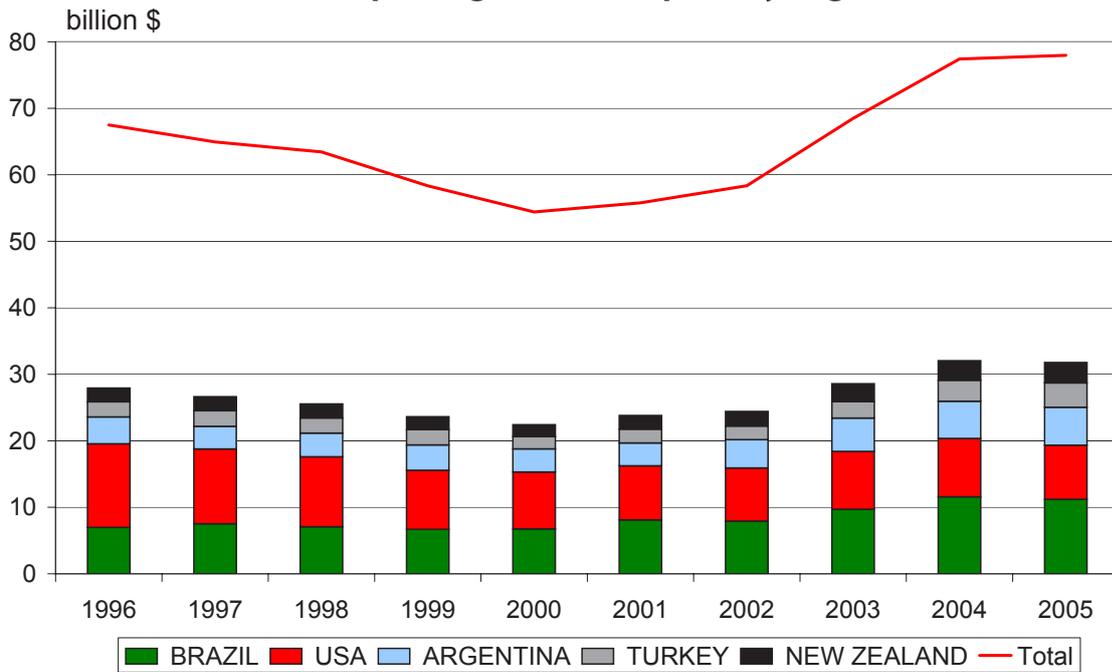
The second conclusion is that the analysis of trade liberalisation, which generates the “trade talk”, fails to capture the cumulative impact of reform, because it ignores the “trade walk”. It is only by looking at actual trade flows and actual markets, including the differences in the trade structure of WTO players, that a clear picture about the potential benefits of trade liberalisation can emerge.

Finally, the response to the question often addressed to the EU “where is the beef?” appears rather straightforward. Trade is already taking place following the EU’s reform process and analysis of the EU offer demonstrates that it will expand further, provided that the realities of the EU market are properly taken into account. But the bottom line is that the capacity of different exporters to avail of that market growth, depends on their ability to compete.



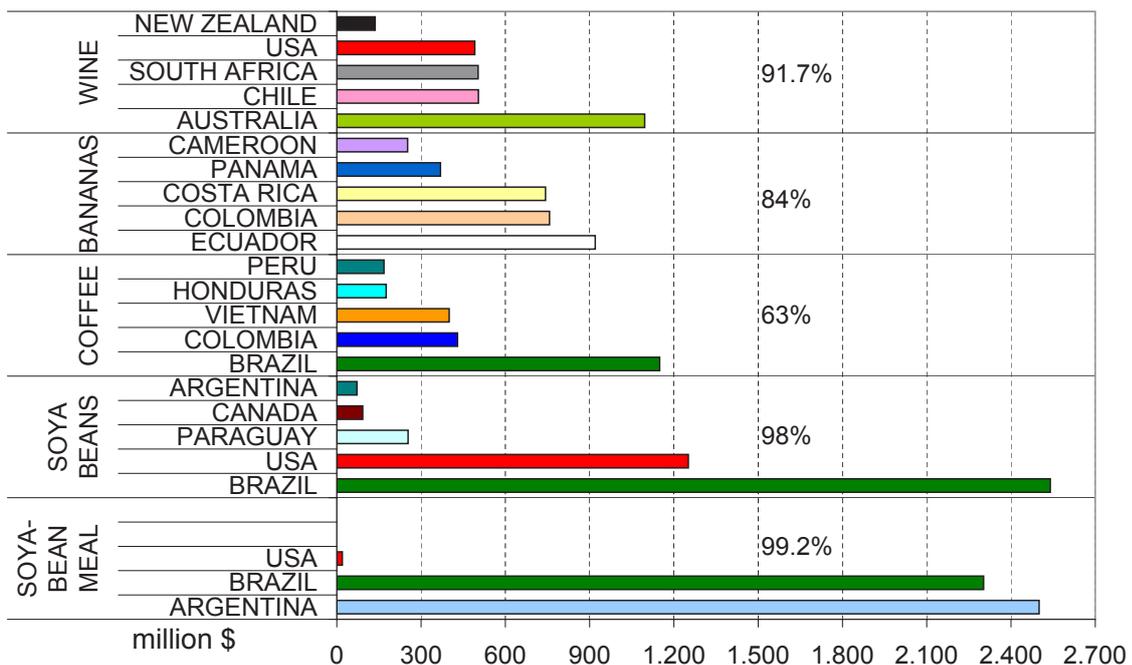
Trade background: EU-25

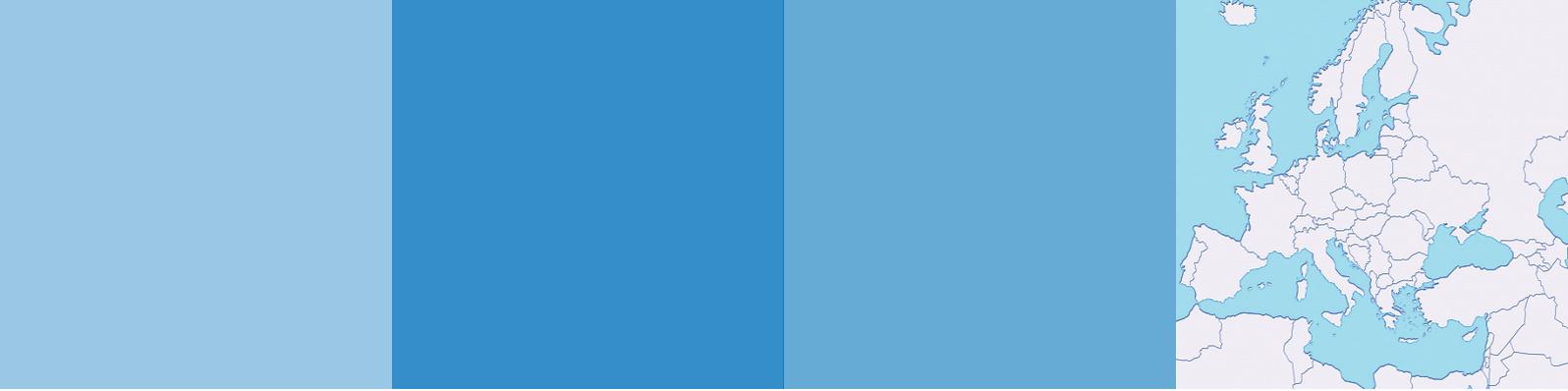
Graph 1: Agricultural imports by origin



Graph 2: Import value of main products by origin

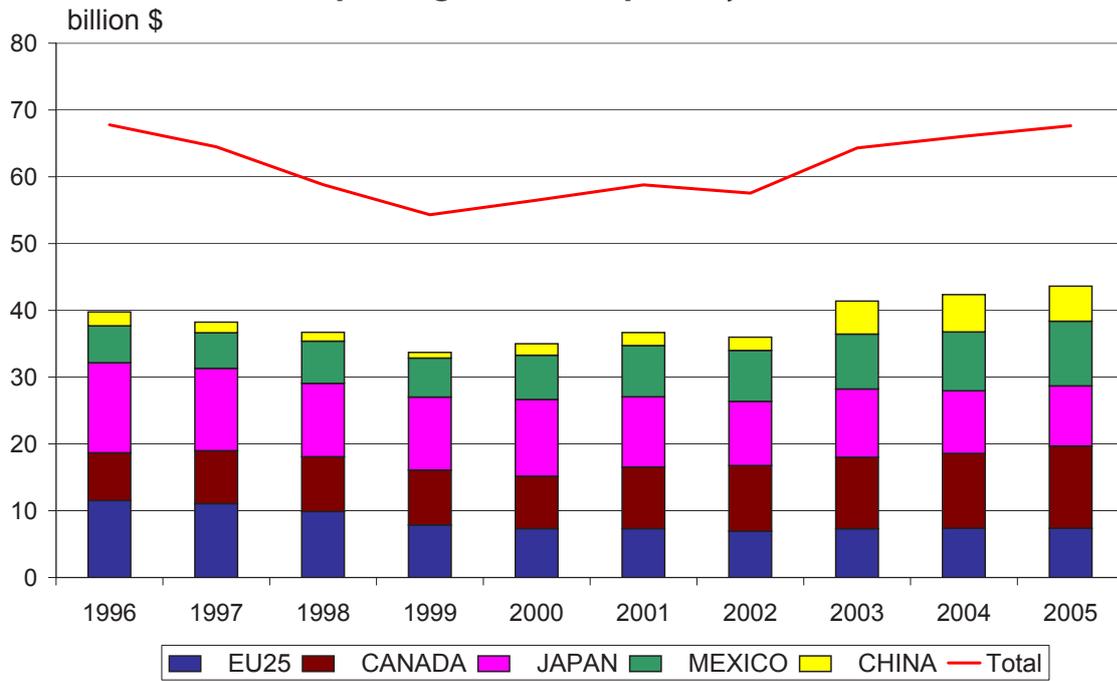
(and % total imports)





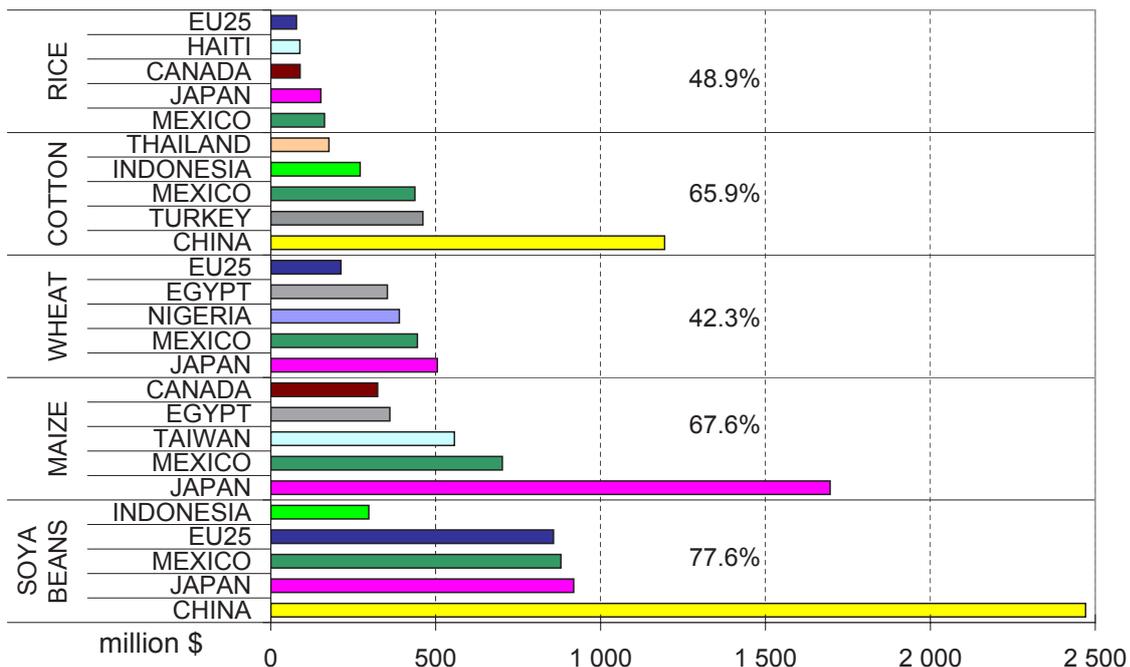
Trade background: US

Graph 3: Agricultural exports by destination



Graph 4: Export value of main crops by destination

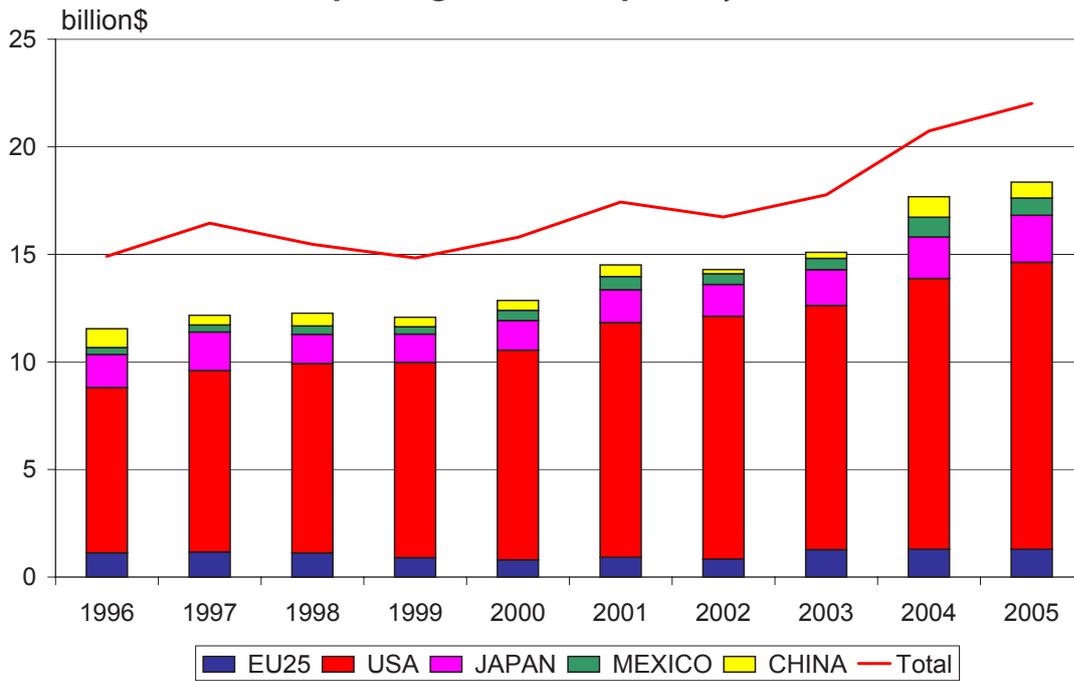
(and % total export)





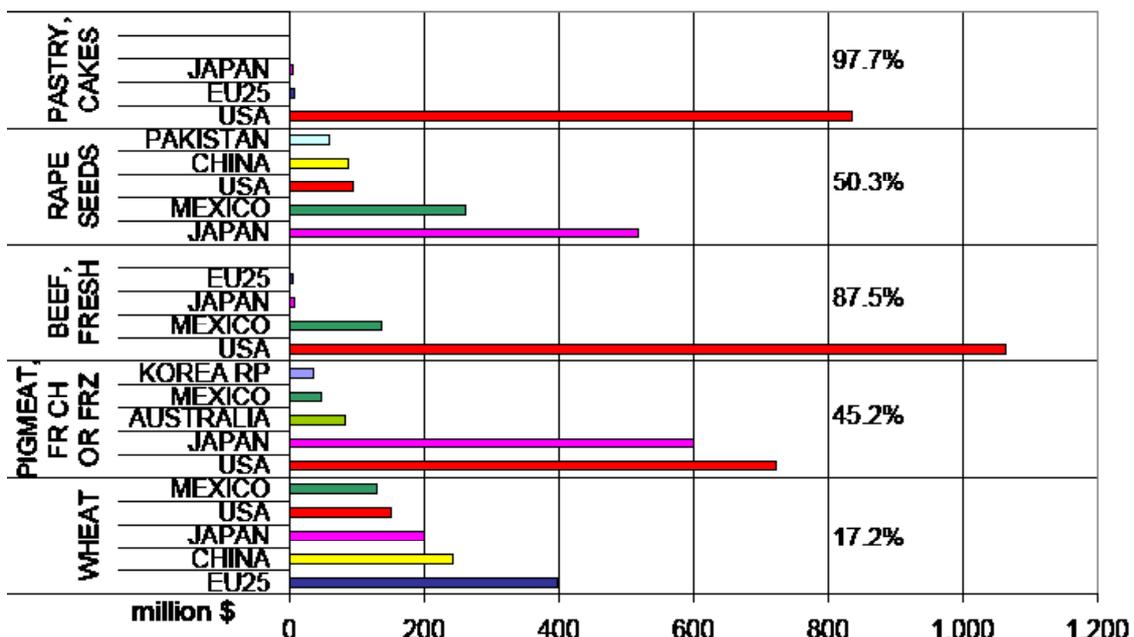
Trade background: Canada

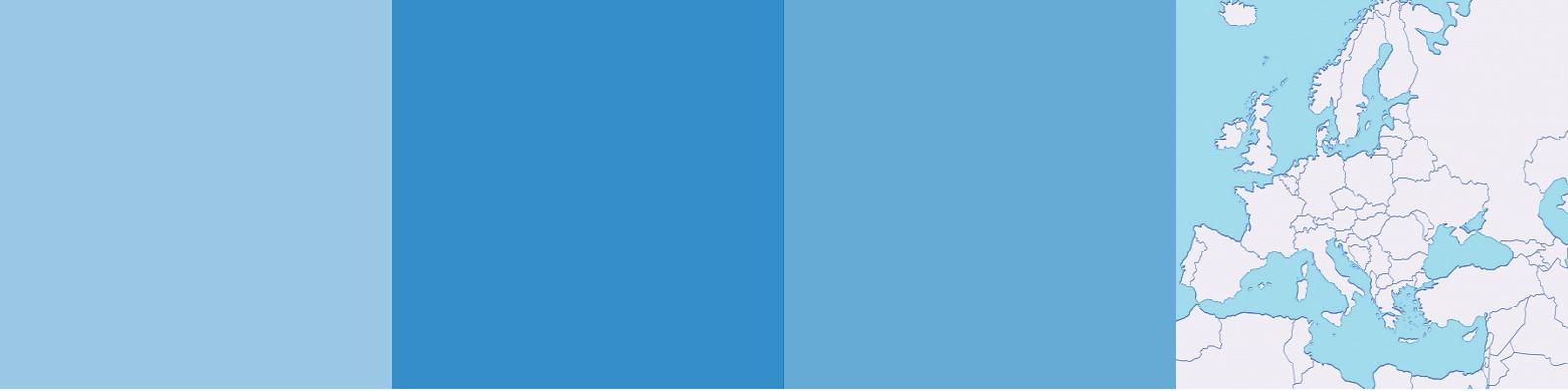
Graph 5: Agricultural exports by destination



Graph 6: Export value of main products by destination

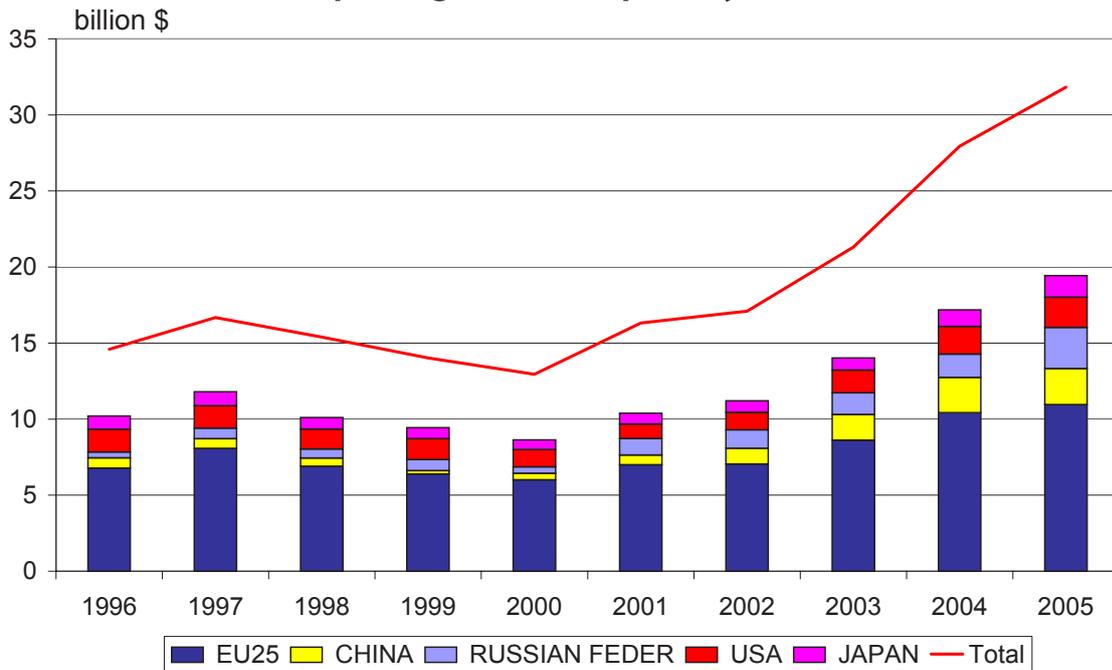
(and % total export)





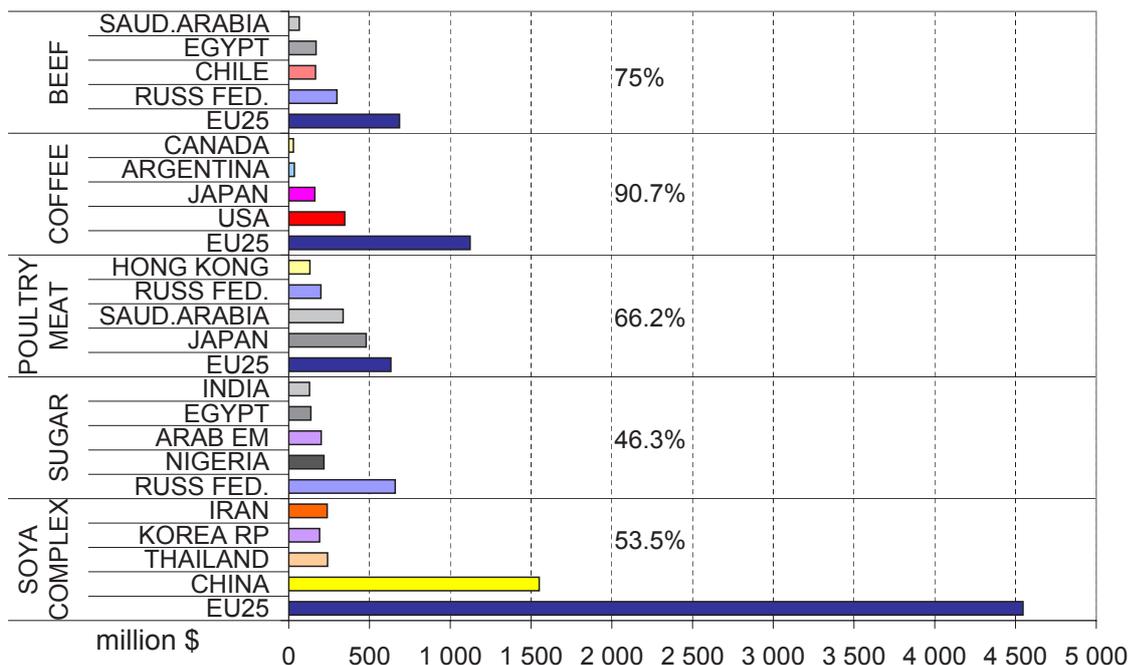
Trade background: Brazil

Graph 7: Agricultural exports by destination



Graph 8: Export value of main products by destination

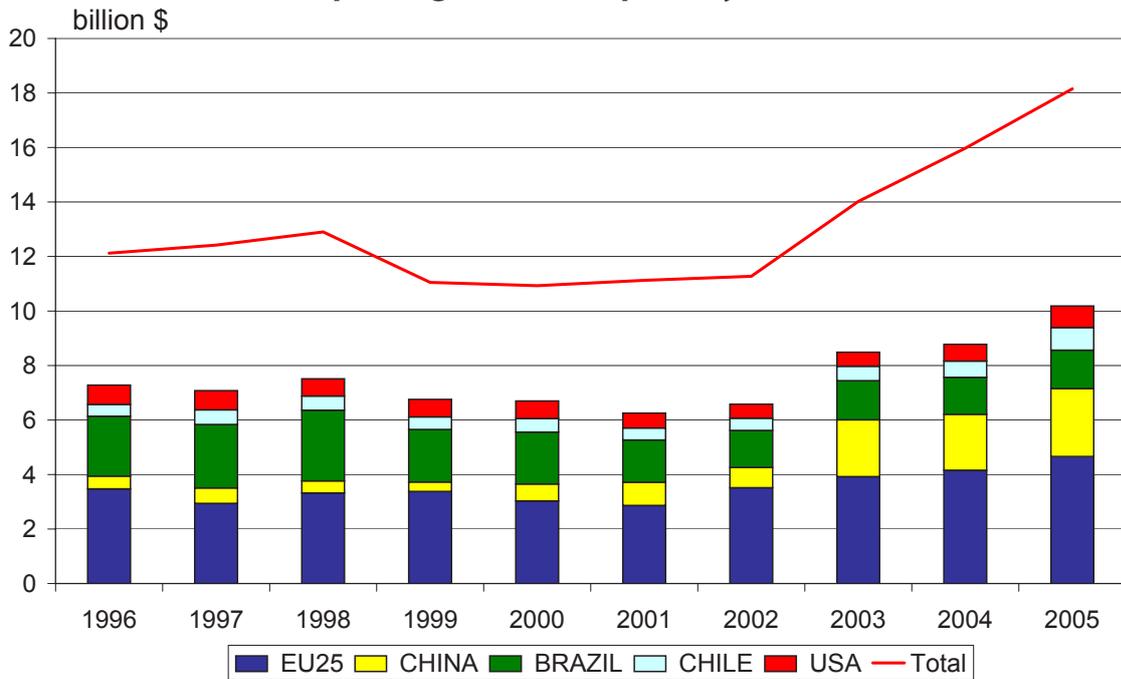
(and % total export)





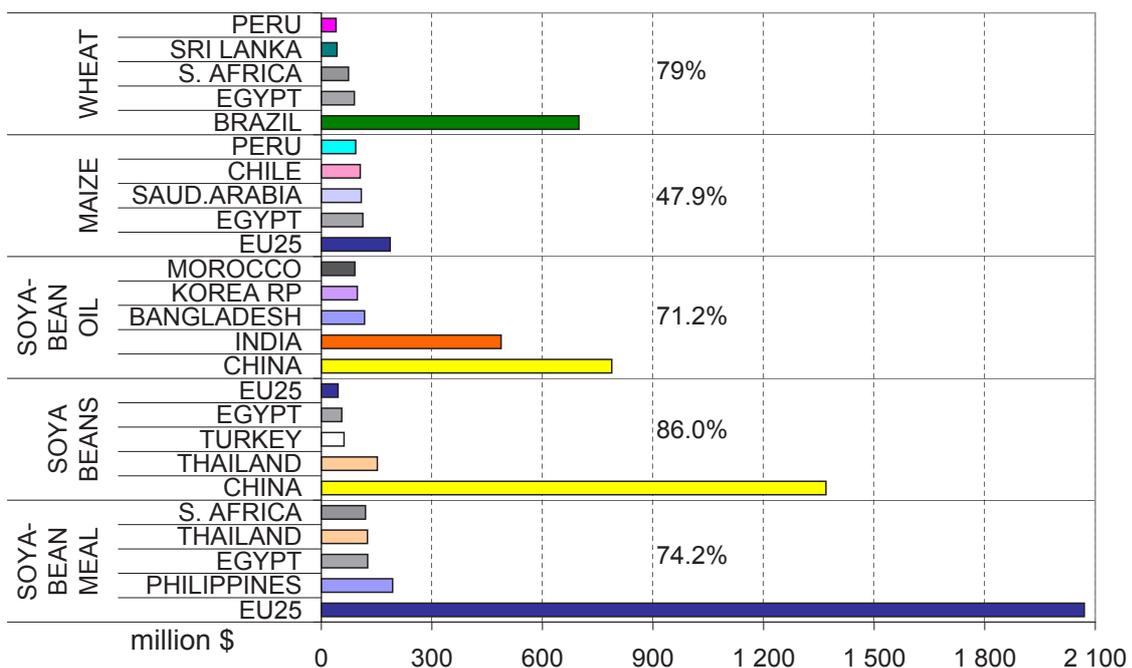
Trade background: Argentina

Graph 9: Agricultural exports by destination



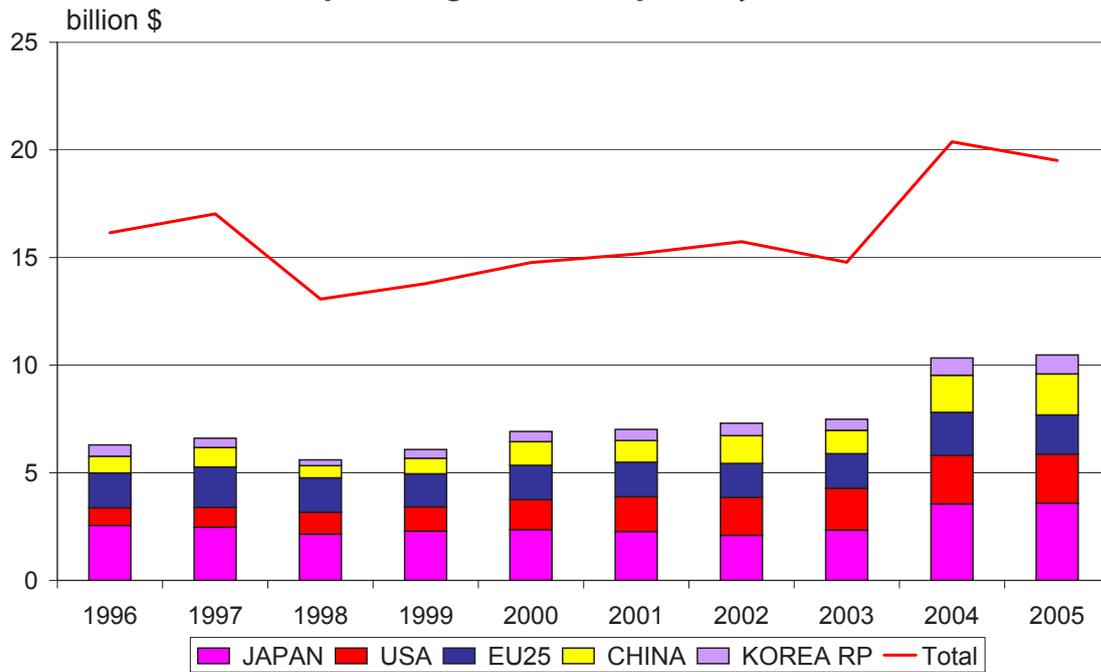
Graph 10: Export value of main products by destination

(and % total export)



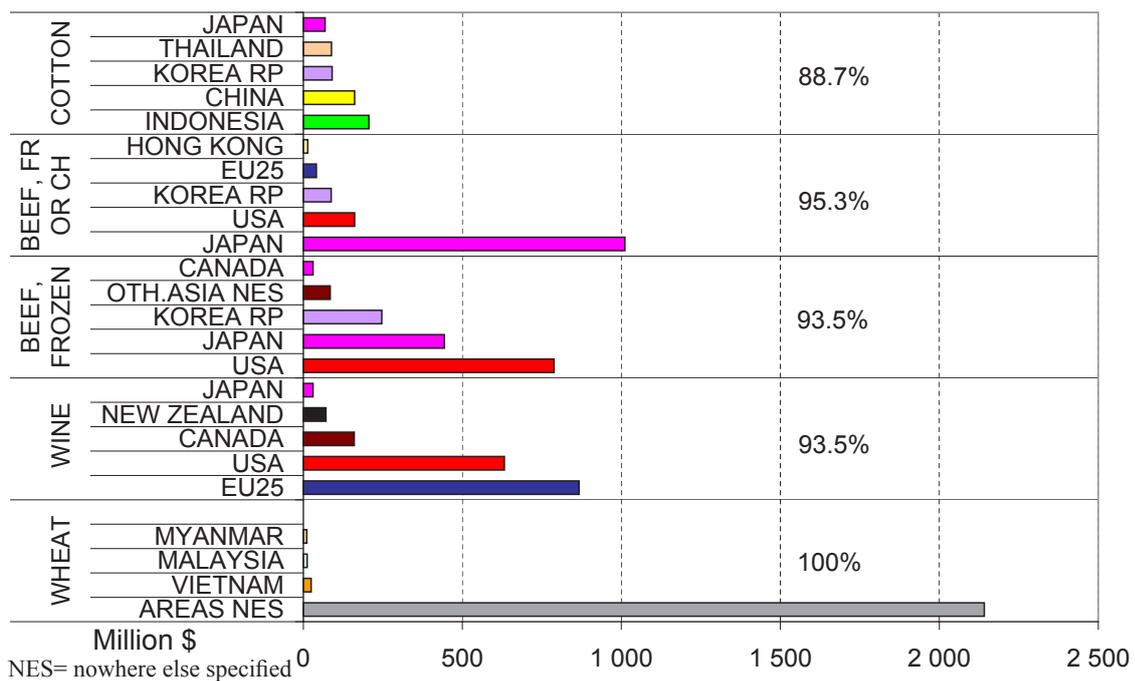
Trade background: Australia

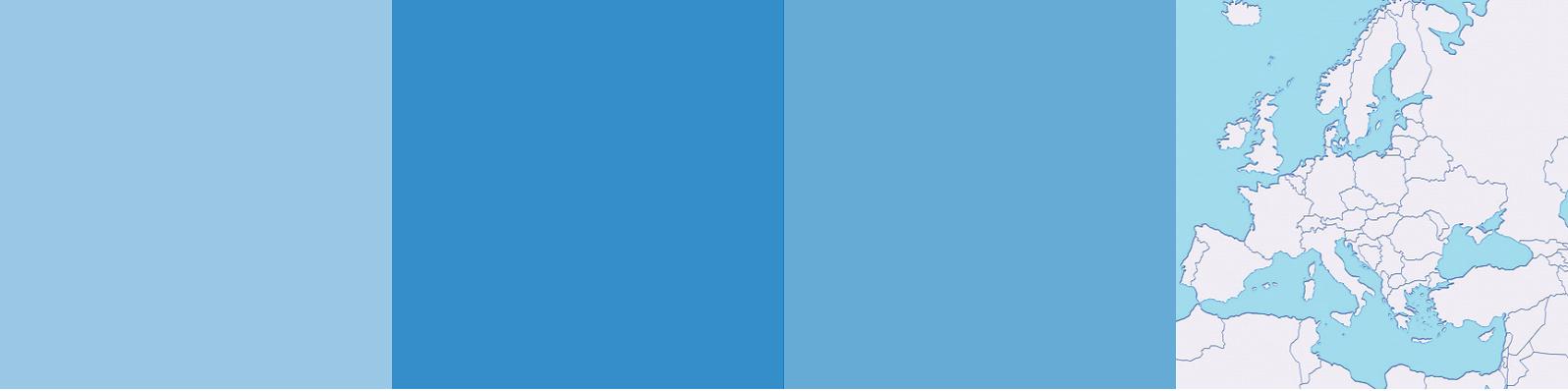
Graph 11: Agricultural exports by destination



Graph 12: Export value of main products by destination

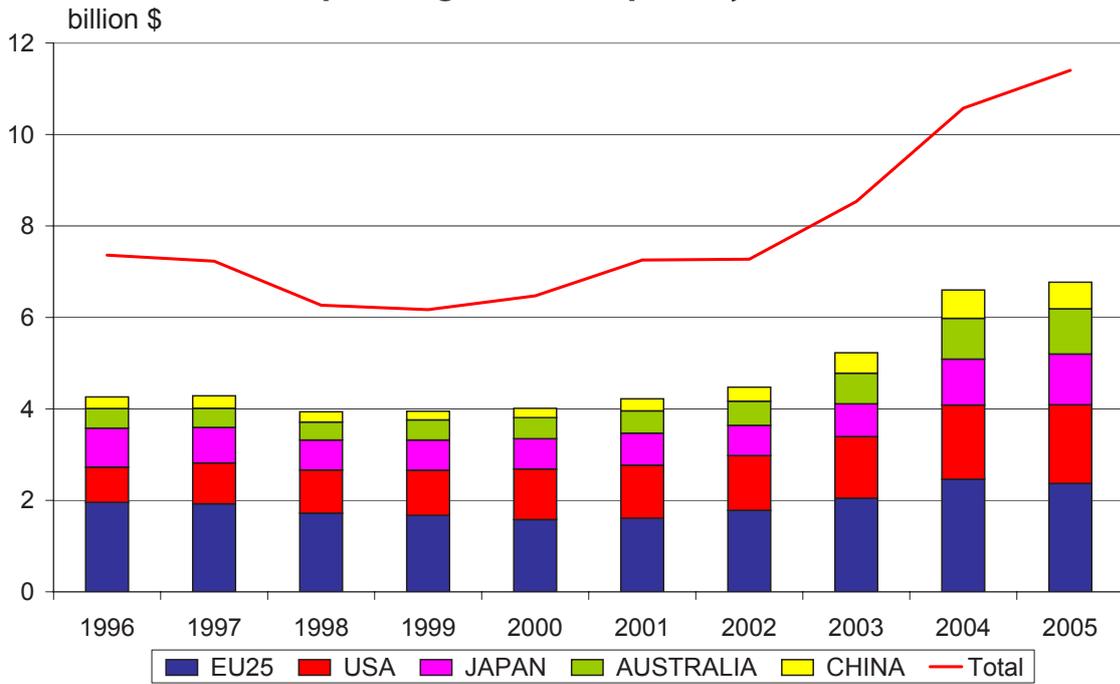
(and % total export)





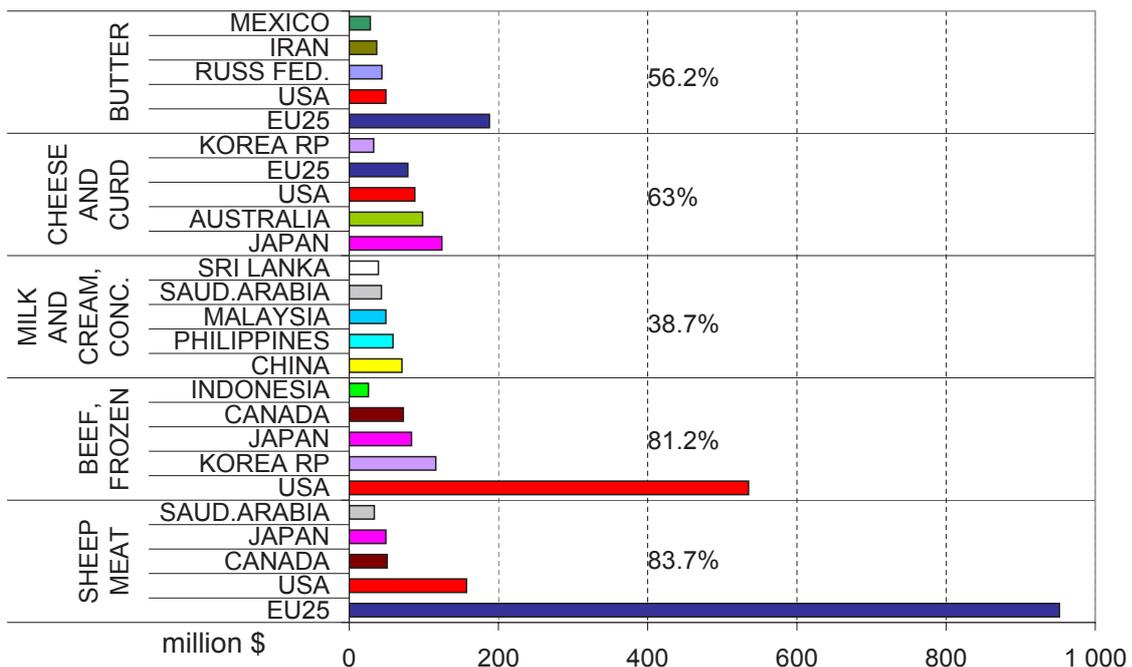
Trade background: New Zealand

Graph 13: Agricultural exports by destination



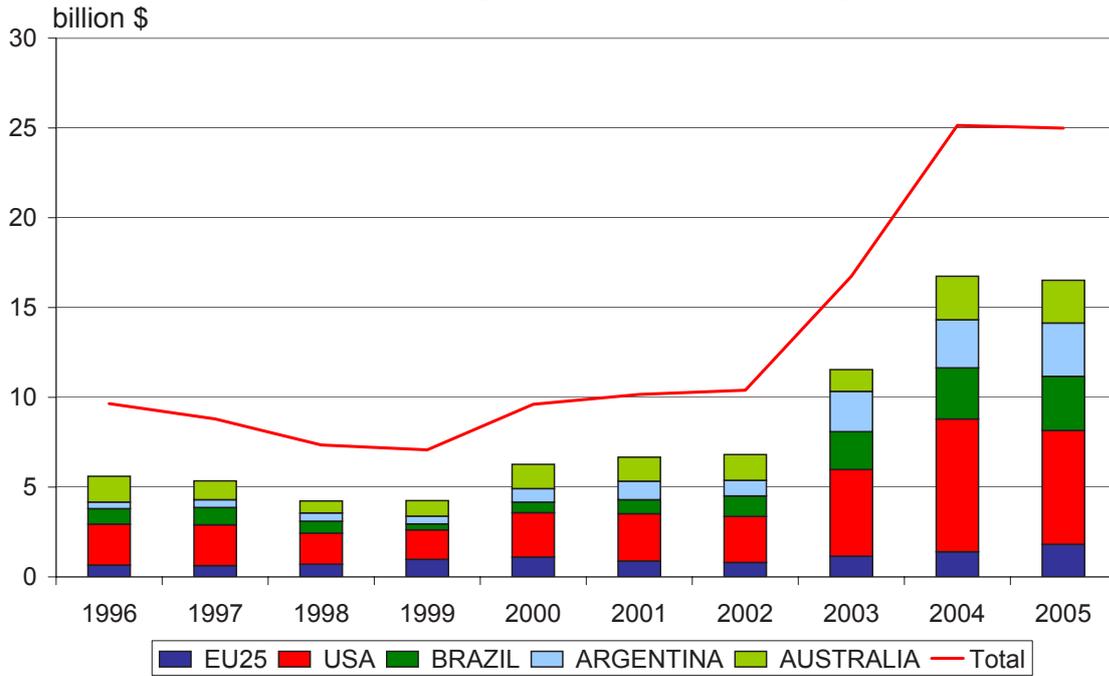
Graph 14: Export value of main products by destination

(and % total export)



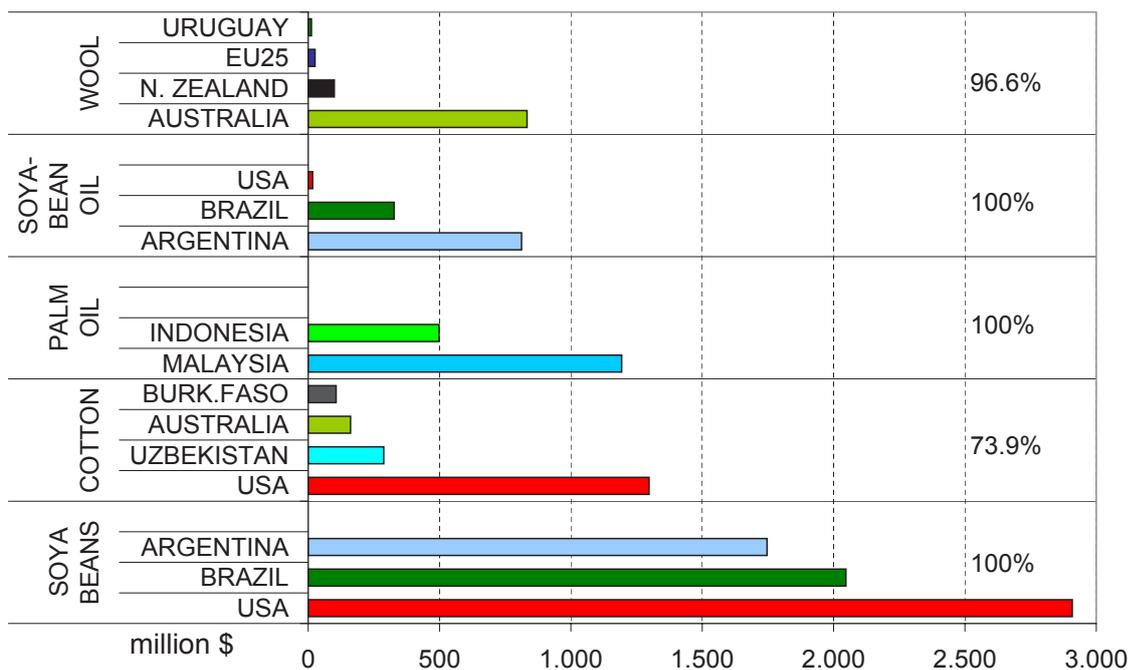
Trade background: China

Graph 15: Agricultural imports by origin



Graph 16: Import value of main products by origin

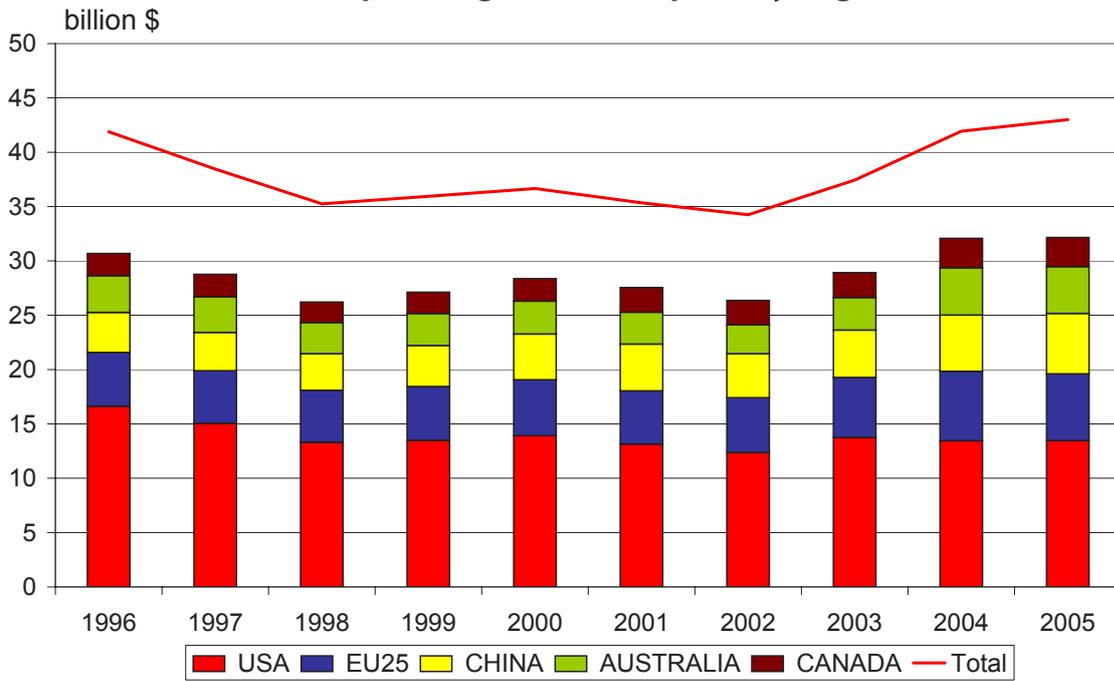
(and % total imports)





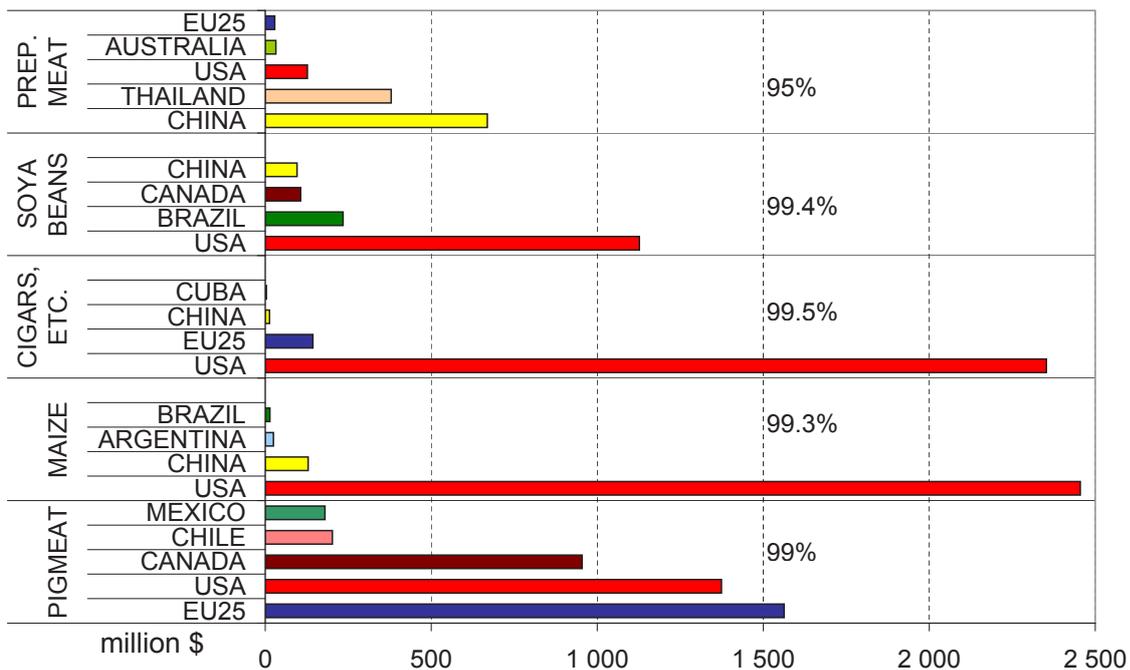
Trade background: Japan

Graph 17: Agricultural imports by origin



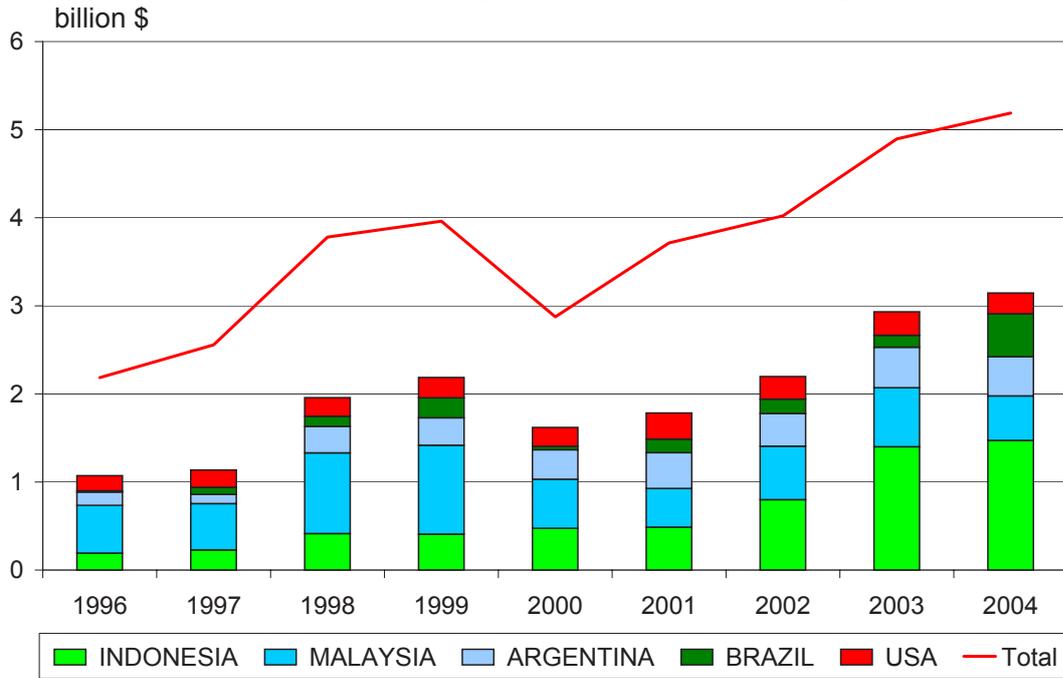
Graph 18: Import value of main products by origin

(and % total imports)



Trade background: India

Graph 19: Agricultural imports by origin



Graph 20: Import value of main products by origin

(and % total imports)

